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SEC SEEKS TO MAKE CERTAIN HEDGE FUNDS, DIGITAL ASSET TRADERS, AND OTHER PROPRIETARY TRADERS REGISTER AS BROKER-DEALERS

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SEC SEEKS TO MAKE CERTAIN HEDGE FUNDS, DIGITAL ASSET TRADERS, AND OTHER PROPRIETARY TRADERS REGISTER AS BROKER-DEALERS

On March 28, the US Securities and Exchange Commission (SEC) proposed rules (Proposal) that would require certain market participants to register as broker-dealers or government securities dealers, and potentially be subject to oversight by self-regulatory organizations (SROs) such as the Financial Industry Regulatory Authority (FINRA). More specifically, the SEC is proposing two new rules that would further define what it means for a person that buys securities or government securities to do so "as part of a regular business" and thus come within the meaning of a dealer. These proposed rules have the potential to bring a wide array of private funds, digital asset traders, certain exchange traded products, high frequency traders, and other proprietary traders within the definition of the term dealer (or government securities dealer), bringing an additional level of unnecessary costs and regulatory requirements to firms that generally do not have customers.

While the Proposal is arguably almost a decade in the making,[1] it will not be without its controversies, especially given the relatively weak investor protection and public interest rationales for requiring these firms to register as dealers or government securities dealers. **Comments on the Proposal are due 30 days after publication in the *Federal Register*, or May 27, 2022, whichever is later.** Firms that could be impacted should, at a minimum, submit an immediate comment requesting that the SEC extend the comment period given that (1) the Proposal marks a fundamental change in how market participants will be regulated; and (2) the SEC has numerous other concurrent rulemakings in motion that will also impact those market participants that will be impacted by this proposal.[2]

KEY TAKEAWAYS

- **Qualitative Standards**: Subject to certain exclusions, persons who routinely buy and sell securities and/or government securities, including digital asset securities, will have to register as dealers if they meet one of the following three qualitative standards:
  - Routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day;
  - 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

[1] *See, e.g.*, Mary Jo White, Chair, SEC, Enhancing Our Equity Market Structure, Address Before Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference (June 5, 2014); Mark Fitterman and Ignacio Sandoval, *High-Frequency Traders: A Review of the Challenges in Registering Them as Dealers*, J. Inv. Compliance (Aug. 14, 2014); Ignacio A. Sandoval, Steven W. Stone et al., *Challenges in Requiring High-Frequency Traders to Register as Dealers,* Nat'l L.J. (June 10, 2014).

[2] *See, e.g.*, Commissioner Hester M. Peirce Public Statement: Rat Farms and Rule Comments – Statement on Comment Period Lengths (Dec. 10, 2021); see also Administrative Procedure Act: Legislative History, S. Doc. No. 248, at 259 (1946) (stating that rulemakings "of great importance, or those where the public submission of facts will be either useful to the agency or a protection to the public, should naturally be accorded more elaborate public procedures.").

    - 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 interests.
- **Quantitative Standards**: Persons engaged in buying and selling more than $25 billion of trading volume in government securities for four out of the last six calendar months will have to register as a government securities dealer irrespective of whether the person meets any of the three qualitative standards above.
- **Exclusions**: Persons who have or control total assets of less than $50 million, and investment companies registered under the Investment Company Act of 1940 (1940 Act) would be excluded. However, some accounts under common control may have to be aggregated for purposes of the $50 million threshold.

BACKGROUND

Section 15(a) of the Securities Exchange Act of 1934

Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act) generally makes it unlawful for any broker or dealer to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer (1) is registered with the SEC; (2) in the case of a natural person, is an associated person of a registered broker-dealer; or (3) satisfies the conditions of an exemption or safe harbor.

Registration as a broker-dealer carries significant obligations. Registered broker-dealers, for example, are required to become members of SROs and the Securities Investor Protection Corporation; must comply with extensive recordkeeping and reporting obligations, suitability requirements, and capital and margin requirements; and are subject to statutory disqualification provisions that are intended to address the ability of bad actors to enter or remain in the securities industry.[3]

Dealer Definition

Although there has been a significant amount of guidance produced (in the form of litigated cases, SEC enforcement actions, statements in SEC releases, and SEC staff interpretations) on what it means to be a "broker,"[4] the interpretive guidance regarding what it means to be a "dealer" has not been as extensive.

Section 3(a)(5)(A) of the Exchange Act, as amended, 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" (the Dealer Definition). Among other exemptions and exclusions,[5] Section 3(a)(5)(B) excludes from the Dealer Definition "a person that buys or sells securities . . . for such person's own account,

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[3] *See, e.g.*, Registration of Foreign Broker Broker-Dealers, Exch. Act Rel. No. 27017 (July 11, 1989), 54 Fed. Reg. 30013, 30015 (July 18, 1989) (Rule 15a-6 Adopting Release) (discussing obligations of registered broker-dealers).

[4] Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

[5] Under Section 3(a)(5)(C) of the Exchange Act, additional exceptions from the Dealer Definition are available to banks (as that term is defined in Section 3(a)(6)) that engage in certain enumerated activities. These exceptions are further codified as Exchange Act Rules 3a5-1, 3a5-2, and 3a5-3. 17 C.F.R. § 240.3a5-1, 3a5-2, and 3a5-3.

either individually or in a fiduciary capacity, but not as a part of a regular business." When these two provisions are read in tandem, it appears that the primary factor for determining whether a person who buys and sells securities for their own account has to register under Section 15(a) of the Exchange Act is whether they are engaged in trading as a business. Accordingly, whether a person is "engaged in the business" of buying and selling securities is at the heart of the dealer-trader distinction.

Dealer-Trader Distinction

The dealer-trader distinction is an analytical framework that has been in place since at least 1951, when Louis Loss first published his seminal treatise on the securities laws.[6] Although the SEC and its staff articulated features of the dealer-trader distinction over the years,[7] the SEC provided a more comprehensive discussion of the distinction and what it means to be "engaged in the business" of buying and selling securities in 2002. That year, the SEC proposed rules to grant banks exceptions and exemptions from the definitions of "broker" and "dealer" as part of the SEC's implementation of the Gramm-Leach-Bliley Act of 1999.[8] In that proposal, the SEC identified activities that historically have been associated with dealers and that would bring someone within the meaning of the phrase "engaged in the business."[9]

The activities identified by the SEC in the 2002 Proposal include:

- acting as an underwriter in the distribution of new issues;
- acting as a market maker or specialist on an organized exchange or trading system;
- acting as a de facto market maker whereby market professionals or the public look to the person for liquidity; and

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[6] *See* Louis Loss, Securities Regulation 722 (1st ed. 1951) (discussing dealer-trader distinction). In this connection, the dealer-trader distinction may have been used or developed as an analytical concept within the SEC before the publication of Loss's treatise, given that Loss held various positions at the SEC during its formative years.

[7] *See, e.g.*, OTC Derivatives Dealers, Exch. Act Rel. No. 40594 (Oct. 23, 1998), 63 Fed. Reg. 59,362, 59,370 n.61 (Nov. 3, 1998) (listing dealer indicia in context of over-the-counter (OTC) derivatives dealers); Further Definitions of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," Exch. Act Rel. No. 66868 (Apr. 27, 2012), 77 Fed. Reg. 30,596, 30,607 (May 23, 2012) (discussing dealer-trader distinction in context of security-based swaps); Stephen V. Hart, SEC Staff No-Action Letter (Mar. 6, 1980); Public Securities Locating Services, SEC Staff No-Action Letter (Sept. 8, 1973); United Trust Co., SEC Staff No-Action Letter (Sept. 6, 1978); Continental Grain Co., SEC Staff No-Action Letter (Nov. 6, 1987); Burton Securities, SEC Staff No-Action Letter (Dec. 5, 1977); United Savings Association of Texas, SEC Staff No-Action Letter (Apr. 2, 1987); Fairfield Trading Corp., SEC Staff No-Action Letter (Jan. 10, 1988); Louis Dreyfus Corp., SEC Staff No-Action Letter (July 23, 1987).

[8] *See* Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exch. Act Rel. No. 46745 (Oct. 30, 2002), 67 Fed. Reg. 67,496, 67,498–500 (Nov. 5, 2002) (2002 Proposal).

[9] *See id.*

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- buying and selling securities directly to customers with an assortment of professional market activities, such as providing investment advice, extending credit, lending securities in connection with transactions, and carrying a customer's securities account.[10]

The SEC further elaborated that dealers generally are persons who normally have regular clientele, hold themselves out as willing to buy and sell securities at a regular place of business, have a regular turnover of inventory (or participate in the distribution of new issues), and generally transact a substantial portion of their business with investors (or, in the case of dealers who are market makers, principally trade with other professionals). The SEC contrasted dealer activities with those of traders, who the SEC stated are viewed as:

- having less regular volume;
- not handling other people's money or securities;
- not making a market in securities; and
- not furnishing dealer-type services, such as providing investment advice, extending credit, or lending securities.[11]

Although the 2002 Proposal is almost two decades old, the SEC affirmed the use of the dealer-trader distinction as an analytical framework when it reiterated the underlying principles of the distinction in connection with the definition of "security-based swap dealer" for purposes of implementing the provisions of the Dodd-Frank Act under the SEC's purview.[12]

In addition to the statements above, senior SEC officials over the years publicly acknowledged that hedge funds generally have come within the meaning of a trader rather than a dealer. In 1994, Arthur Levitt, then chair of the SEC, provided this testimony before Congress:

> Hedge funds typically claim an exclusion from registration as securities dealers under Section 15(a) of the [Exchange Act] (15 U.S.C. § 78o(a)) based on the "trader" exception to the definition of "dealer." In general, a trader is an entity that trades securities solely for its own investment account and does not carry on a public securities business. On the other hand, a dealer buys and sells securities as part of a regular business, deals directly

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[10] *See id.* In addition to the factors listed in the 2002 Proposal, with respect to dealer status in the context of the Government Securities Act of 1986 (GSA), the SEC staff also identified the following factors: issuing or originating securities that would qualify as securities under the GSA; participating in a selling group or underwriting government securities; purchasing or selling government securities as principal from or to customers; carrying a dealer inventory; quoting a market in government securities or publishing quotes; advertising or otherwise holding oneself out as a government securities dealer, such as holding oneself out as being willing to buy and sell particular government securities on a continuous basis; rendering any incidental investment advice; extending or arranging for the extension of credit to others in connection with government securities; running a book or repurchase and reverse repurchase agreements on government securities; and using an interdealer broker, other than a retail screen broker, to effect any government securities transactions. *See, e.g.*, United Savings Association of Texas, SEC Staff No-Action Letter, *supra* note 5.

[11] 2002 Proposal, *supra* note 8, at 67498–500

[12] *See* Further Definition of "Swap Dealer," *supra* note 7.

> with public investors, engages in market intermediary activities, and may provide other services to investors.[13]

In 1998, Richard Lindsay, then director of what is now known as the Division of Trading and Markets, echoed Chairman Levitt's testimony, noting in written testimony that "hedge funds also rely on the trader exception from broker-dealer registration."[14]

PROPOSED RULES

As explained by the SEC, and discussed above, the operative concept in the definitions of "dealer" and "government securities dealer"—that distinguishes the regulated entity from the unregulated trader—is that the dealer is engaged in buying and selling securities for its own account "as part of a regular business." The SEC is proposing two rules—Rules 3a5-4 and 3a44-2—to further define these terms to identify certain activities that would constitute a "regular business" requiring a person engaged in those activities to register as a "dealer" or a "government securities dealer." According to the SEC, proposed Rules 3a5-4 and 3a44-2 would expand upon existing SEC and staff statements regarding dealers and traders to further define three qualitative standards designed to more specifically identify activities of certain market participants who assume dealer-like roles, and in particular, those persons whose trading activity in the market "has the effect of providing liquidity" to other market participants. Proposed Rule 3a44-2, which would apply only to government securities dealers, would include a quantitative standard that would establish a bright-line test, under which a person engaging in certain specified levels of activity would be deemed to be buying and selling government securities "as a part of a regular business," regardless of whether it meets any of the qualitative standards.

As a Part of a Regular Business

Under proposed Rules 3a5-4 and 3a44-2, a person[15] that buys and sells securities (or government securities) for its own account would engage in such activity "as a part of a regular business" if the person engages in a routine pattern of buying and selling securities that has the effect of providing liquidity to other market participants.

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[13] *See, e.g.*, Testimony of Arthur Levitt, Chairman, SEC, Concerning Hedge Fund Activities in the US Financial Markets, Before the House Committee on Banking, Finance and Urban Affairs (Apr. 13, 1994).

[14] *See, e.g.*, Testimony of Richard R. Lindsey, Dir., Div. of Mkt. Regulation, SEC, Concerning Hedge Fund Activities in the US Financial Markets, Before the House Committee on Banking and Financial Services (Oct. 1, 1998). In a footnote, Director Lindsey further stated, "Hedge funds also claim an exclusion from registration as securities dealers under Section 15(a) of the Exchange Act (15 U.S.C. § 78o(a)), based on the 'trader' exception to the definition of 'dealer.' In general, a trader is an entity that trades securities solely for its own investment account and does not carry on a public securities business, while a dealer buys and sells securities as part of a regular business, deals directly with public investors, engages in market intermediary activities, and also may provide other services to investors."

[15] A person under the proposed rules would be defined by cross referencing to the definition of a person in Exchange Act Section 3(a)(9). That section defines a person as a natural person, company, government, or political subdivision, agency, or instrumentality of a government.

Qualitative Standards Applicable to Securities and Government Securities

Under the proposed rules, a person would provide liquidity to other market participants where a person engages in one or more of the following qualitative standards:

- Routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day (Intra-Day Purchase Standard);
- 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 (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 interests (Revenue Standard).

Intra-Day Purchase Standard: In discussing the Intra-Day Purchase Standard, the SEC states that:

- "*Routinely*" means more frequent than occasional but not necessarily continuous, such that a person's transactions in roughly comparable positions, throughout the day and routinely over time, constitute "[engaging] in a routine pattern of buying and selling securities that has the effect of providing liquidity for market participants."
- "*Roughly comparable*" would generally capture purchases and sales similar enough, in terms of dollar volume, number of shares, or risk profile, to permit liquidity providers to maintain near market-neutral positions by netting one transaction against another transaction. To be "roughly comparable," the dollar volume or number of shares of, or risk of offset by, the purchases and sales need not be exactly the same. The SEC explains that a full netting of positions may fail to capture a number of significant firms, due to the unique characteristics of certain liquidity providers in today's markets. Instead, "roughly comparable" purchases and sales would fall within a reasonable range that generally would have the effect of offsetting one transaction against the other. According to the SEC, a person that closes or offsets, in the same day, the overwhelming majority of the positions it has opened, has likely made "roughly comparable purchases and sales.
- "*The same*" securities means that the securities bought and sold are securities of the same class and having the same terms, conditions, and rights.
- "*Substantially similar*" securities for purposes of the rule would be based on the facts and circumstances analysis that would take into account factors such as, for example, whether (1) the fair market value of each security primarily reflects the performance of a single firm or enterprise or the same economic factor or factors, such as interest rates; and (2) changes in the fair market value of one security are reasonably expected to approximate, directly or inversely, changes in, or a fraction or a multiple of, the fair market value of the second security.

Trading Interest Standard: In discussing this standard, the SEC states that:

- "*Routinely*" means that the person must express trading interests more frequently than occasionally, but not necessarily continuously. This standard relates to the frequency of the activity both intraday and across time, and means both repeatedly within a day and on a regular basis over time.
- By using "*routinely*," the SEC states that the proposed rules are intended to reflect market evolution to capture significant liquidity providers who express trading interests at a high enough frequency to play a significant role in price discovery and the provision of market liquidity, even if their liquidity provision may not be continuous like that of some traditional dealers.

- The proposed rules would use the term "*trading interest*" rather than "*quotations*," with trading interest being defined in the same way as in the proposed changes to Rule 3b-16 of the Exchange Act[16]—any non-firm indication of a willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price.
- In the SEC's view, the phrase "*best available prices on both sides of the market*" more specifically and clearly describes the activity of liquidity-providing dealers, which help determine the spread between the best available bid price and the best available ask price for a given security.
- The proposed rules would apply only when those trading interests that are at or near the best available prices on both sides of the market are "communicated and represented in a way that makes them accessible to other market participants."

Revenue Standard: In discussing this standard, the SEC states that:

- Capturing bid-ask spreads is done by buying at the bid and selling at the offer, which would include buying at a lower price than, and selling at a higher price than, the midpoint of the bid-ask spread. The spread between these prices provides compensation for providing liquidity, which the SEC views as standing ready to buy or sell and enabling other market participants to reliably make purchases and sales.
- The SEC further states that, when a liquidity provider, as a result of its routine purchases and sales of securities, captures "incentives offered by trading venues to liquidity-supplying trading interests" with such frequency and consistency that its revenue is made up primarily of this form of compensation, it will be considered to be engaged in a routine pattern of providing liquidity as a service and generally standing ready to buy or sell securities, and so would fall within the scope of the Proposal.
- This standard would apply with respect to activity on "trading venues," which the SEC has recently proposed to define to mean "a national securities exchange or national securities association that operates an SRO trading facility, an ATS, an exchange market maker, an OTC market maker, a futures or options market, or any other broker or dealer operated platform for executing trading interests internally by trading as principal or crossing orders as agent."

Quantitative Standard Applicable Only to Government Securities

Under Proposed Rule 3a44-2, a person would be deemed a government securities dealer if in each of four out of the last six calendar months, that person engaged in buying and selling more than $25 billion of trading volume in government securities. A person would be a dealer under this standard irrespective of whether the person meets any of the qualitative standards discussed above.

Excluded Persons

The proposed rules provide two exclusions from the definition of a dealer irrespective of whether such persons meet the qualitative or quantitative standards. The first exclusion is for an investment company registered under the 1940 Act. The second is for a person that has or controls total assets of less than $50 million. This latter definition corresponds to the definition of an institutional account under FINRA Rule 4512(c).

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[16] Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities, Exchange Act Release No. 94062 (Jan. 26, 2022), 87 Fed. Reg. 15496 (Mar. 18, 2022). Morgan Lewis published a LawFlash on this proposal in February 2022.

Own Account, Control, and Aggregation

As explained by the SEC, the Proposal would define a person's "own account" in a way that recognizes that corporate families and entities may be organized in various structures, focusing on the trading activity occurring at the firm or legal-entity level or the trading activity that is being employed on behalf of, or for the benefit, of the entity, and limit the registration burden to those entities engaged in dealer activity. To achieve this result, the proposed rules would define a person's "own account" as any account:

1. held in the name of that person;
2. held in the name of a person over whom that person exercises control or with whom that person is under common control subject to the following exclusions:
    a. An account in the name of a registered broker, dealer, or government securities dealer, or an investment company registered under the 1940 Act;
    b. An account held in the name of a client of an investment adviser registered under the Investment Advisers Act of 1940 (Advisers Act) unless the adviser controls the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client; or
    c. With respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser registered under the Advisers Act unless those accounts constitute a parallel account structure.
3. Held for the benefit of those persons identified above.

The concept of control would cross reference the meaning of control in Exchange Act Rule 13h-1. Under Rule 13h-1(a)(3):

> The term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise. For purposes of this section only, any person that directly or indirectly has the right to vote or direct the vote of 25% or more of a class of voting securities of an entity or has the power to sell or direct the sale of 25% or more of a class of voting securities of such entity, or in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that entity.

This control concept effectively means that certain firms will have to aggregate trading activities and assets to determine whether collectively, and individually, a firm or the entities under a firm's control come within the meaning of a dealer or government securities dealers. In furtherance of this aggregation concept, the proposed rules would define a *parallel account structure* to mean a structure in which one or more private funds (each a "parallel fund"), accounts, or other pools of assets (each a "parallel managed account") managed by the same investment adviser pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account.

No Presumption

Notably, the proposed rules provide that a person should not presume that they are not a dealer or government securities dealer simply because they do not satisfy the Qualitative Standards mentioned above.

IMPLICATIONS

While there are some serious questions as to whether the Proposal would actually do much—if anything—to further investor protection or the public interest, additional questions arise regarding the broad scope of Proposal and possible confusion regarding how this would be applied in practice. Moreover, the use of qualitive standards rather than bright line tests will add further confusion in the industry and leave many at the whims SEC enforcement and examination staff who may end up applying these standards in an arbitrary and perhaps capricious manner.

Private Funds: Perhaps the most immediate impact of the Proposal if it is adopted as is will be on private funds and their advisers. Although the SEC suggests that the Proposal is largely meant to capture those proprietary traders that act as liquidity providers, the unclear standards are likely to capture a significant number of private funds, especially those funds that use arbitrage strategies or that seek to benefit from market inefficiencies. Moreover, the Proposal's "parallel account structure" could potentially capture a broader array of private funds and their advisers under the Intra-Day Purchase Standard where separate funds focused on similar or complimentary industries or sectors, for example, suddenly are captured under the vague standard that captures trading in "similar securities." Moreover, absent further guidance from the SEC, the definition of "own account" and the aggregation provisions as drafted make it difficult to determine where the dealer registration obligation falls—the adviser, the fund, or both.

Registered Investment Companies: While the exclusion for registered investment companies is a positive development, it does not make explicit that an investment company's registered investment adviser would be excluded under the "own account" standard above. At a minimum, the SEC should consider specifically excluding from the Proposal those advisers that solely manage investment companies that are registered under the 1940 Act, and making clear in no uncertain terms that the assets and trading activities of a registered investment company are explicitly excluded when assessing an registered investment advisers activities.

Digital Assets: The SEC makes one reference to digital assets in the Proposal, simply to state that persons that routinely buy and sell digital asset securities could come within the meaning of the term dealer. As with other proposals, the lack of discussion regarding digital asset securities calls into question whether the SEC has met its obligations under the Administrative Procedure Act since the Proposal's analysis corresponds to traditional equity and fixed income securities. Those markets are understood, while the digital asset markets are nascent and still developing. The SEC's disregard for pending executive branch and legislative branch action in digital assets, and for the activities of its sibling regulatory agencies, could result in a chilling effect that will hamper the United States' role as a leader in financial technology innovation. Finally, there are some investment vehicles holding digital assets (and futures on digital assets) that are registered under the Securities Act of 1933 but that may not be investment companies registered under the 1940 Act. While the SEC staff has previously taken the position that Bitcoin and Ethereum were not securities,[17] it is understood that, anecdotally, SEC enforcement staff may be taking the position in court that those views were personal and that the SEC

[17] William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018).

had not asserted that Bitcoin and Ethereum were not securities.[18] If the SEC were to eventually take the view that Bitcoin and Ethereum are securities, these types of investment vehicles could potentially be captured under the Proposal.

Security-Based-Swap Dealers: The dealer-trader distinction was the analytical framework used by the SEC when it adopted rules applicable to the status and registration of security-based swap dealers. Because the Proposal fundamentally changes the nature of the dealer-trader distinction, it is unclear whether security-based swap dealers and persons who engage in security-based swap transactions will still be able to rely on that framework that was endorsed by the SEC just 10 years earlier.

Investor Protection and Public Interest: While the Proposal broadly speaks to investor protection and public interest rationales in furtherance of the changes, the benefits seem shallow when compared to the costs. For example, if the SEC is seeking to increase market transparency, there is already a framework for reporting transactions. These include the consolidated audit trail (CAT), the Trade Reporting and Compliance Engine (TRACE) and the large trader reporting regime. Moreover, given that the vast majority of those persons that would have to register under the Proposal do not have customers, the SEC's investor protection rationale is especially suspect, particularly since FINRA rules are really customer protection focused.

Banks, Insurance Companies, and Credit Unions: The Proposal lacks exclusions for entities subject to another, and perhaps more comprehensive, regulatory framework. In this regard, banks, credit unions, insurance companies, and others could end being captured by the Proposal in a way that the regulators for these entities may not have intended. While there are statutory exemptions from the definition of dealer for banks engaged in certain activities,[19] those exemptions do not necessarily capture the activities outlined in the Proposal. In addition, credit unions, although performing bank-like functions in some instances, do not benefit from the types of exclusions available to banks. Similarly, insurance companies, which may engage in the routine buying and selling of securities for a host of legitimate reasons, also do not enjoy the benefit a statutory exclusion from the dealer definition like banks.

Statutory Authority: Finally, the SEC's statutory authority to re-define terms in the definition of dealer may be susceptible to challenge. To this end, Section 3(b) of the Exchange Act gives the SEC the authority to define terms used in the Act. That provision reads, in relevant part:

> The Commission and the Board of Governors of the Federal Reserve System, as to matters within their respective jurisdictions, shall have power by rules and regulations to define technical, trade, accounting, and other terms used in this chapter, consistently with the provisions and purposes of this chapter.

While this provision appears to provide the SEC with broad authority, the SEC's use of that provision has been subject to successful challenge.[20] Indeed, given the vast number of rulemakings that the SEC has undertaken, the following statement from the Rule 3b-9 Case may still echo today:

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[18] For context, the SEC is currently involved in litigation against LBRY, a blockchain-based file-sharing and payment network that powers decentralized platforms, primarily social networks and video platforms. On its twitter page, LBRY recounted certain verbal arguments made by the SEC. While these reports are anecdotal, at best, they do further muddy the waters regarding the SEC's views on digital assets.

[19] *See, e.g.*, Exchange Act Section 3(a)(5)(C).

[20] *See, e.g.*, American Bankers Association v. SEC, 804 F.2d 739 (D.C. Cir. 1986) (Rule 3b-9 Case).

> In the end, all of the SEC's efforts to avoid the "plain meaning" of the definitions of "broker," "dealer" and "bank" fail. We give effect to the statutory language not simply because its meaning is as "plain" as can be, but because it reflects a basic decision by Congress on how to allocate responsibility among different federal agencies for regulating financial institutions and markets. Rule 3b-9, whatever its beneficial purpose or the regulatory need for some such authority, still represents an attempt by one federal agency to reallocate, on its own initiative, the regulatory responsibilities Congress has purposefully divided among several different agencies. It is tantamount to one of the regulatory players unilaterally changing the rules of the game. The SEC by itself cannot extend its jurisdiction over institutions expressly entrusted to the oversight of the Comptroller, the Board of Governors, the FDIC, and others.[21]

Ruel 15a-6 and Cross-Border Activities: The Proposal indicates that Exchange Act Rule 15a-6, which provides an exemption from broker-dealer registration for foreign broker-dealers that engage in certain specified activities with US persons, would still be available for some entities that may end up coming within the new dealer framework. However, it is unclear whether the SEC's territorial and entity approach to questions of broker-dealer registration would be impacted. For instance, under the entity approach to registration, only an affiliate of a foreign broker-dealer operating in the United States would have to register in the United States if the foreign broker-dealer otherwise does not engage in US-facing activities. Under the aggregation provisions of the Proposal, it is unclear whether a US parent that controls a foreign entity that engages in dealer activities would be subject to the Proposal. While the Proposal seems to suggest that the foreign entity would benefit from Rule 15a-6, because that foreign entity would be an exempt broker-dealer, there would be appear to be no provision that would exclude the US parent from counting its foreign subsidiary's activities for purposes of the Proposal.

[21] *Id.*

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