Navigating Dealer Status After SEC Settlement With Adviser

By **Ignacio Sandoval and Steven Stone** (September 16, 2021)

Ignacio Sandoval

Steven Stone

On Aug. 17, the U.S. Securities and Exchange Commission announced a settled enforcement action against Murchinson Ltd., a Canadian investment adviser to a hedge fund; Marc J. Bistricer, the person controlling Murchinson; and Paul E. Zogala, a trader at Murchinson responsible for trading securities for the hedge fund.

The SEC alleged that they caused executing brokers of a hedge fund to violate the order-marking and locate requirements of Regulation SHO, and caused the hedge fund to act as an unregistered dealer in violation of Section 15(a)(1) of the Securities Exchange Act.[1]

This latter finding seems like a significant departure from statements of SEC officials and existing SEC staff guidance that has consistently distinguished between dealer and trader activities when expressing the view that hedge funds do not act as dealers.

As a result, hedge funds and other market participants should reevaluate their trading practices and assess whether changes need to be made in order to avoid being deemed dealers and thus subject to SEC and Financial Industry Regulatory Authority registration requirements.

Engagement of Dealer Activity

In Murchinson, the SEC alleged that the hedge fund subadvised by the respondents acted as an unregistered dealer in connection with securities purchase agreements and equity line agreements it entered into with several issuers.

The SEC alleged that the respondents caused the hedge fund to engage in dealer activity when the respondents and some issuers agreed that after the hedge fund sold the issuer's stock during a specified period, the hedge fund could purchase an equivalent amount of stock from the respective issuers — rather than the initial drawdown amount — at a specified percentage of the hedge fund's sales proceeds.

By engaging in these activities, the SEC alleged that the respondents caused the hedge fund to sell the issuers' common stock before purchasing, or entering into unconditional contracts to purchase, the stock being sold.

In connection with the equity line agreements, the SEC alleged that the respondents caused the hedge fund to engage in dealer activity by agreeing to purchase from the issuer the number of shares the hedge fund had sold into U.S. markets during specified periods and to calculate the hedge fund's purchase price as a fixed percentage of its sales proceeds during each specified period.

The SEC's order was scant on details bearing on a factual or legal analysis of dealer status generally — and importantly — silent on the distinction between dealers and traders. The SEC did, however, highlight that the hedge fund profited by keeping a percentage of its sales proceeds and remitting the remainder of the proceeds to the issuers.

The SEC's dealer conclusions appear to hinge on the profits obtained from the spread as well as on the volume of activity, noting that the respondents caused the hedge fund to sell hundreds of millions of dollars of common stock into U.S. markets pursuant to the equity line agreements, causing the hedge fund to be engaged in the regular business of buying and selling securities for its own account.

This approach by the SEC raises questions regarding the ability of hedge funds to enter into these types of agreements in the future, but also calls into question whether hedge funds will be subject to further scrutiny as potential dealers for their historical trading activities.

Why Dealer Status Matters

Section 15(a) of the 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.

Although there has been a significant amount of guidance produced on what it means to be a broker,[2] 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."

Section 3(a)(5)(B) excludes from the dealer definition "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."

When these two provisions are read in tandem, it appears that the primary factor for determining a person's dealer status is whether that person is engaged in the business of buying and selling securities, which is at the heart of the so-called dealer-trader distinction. In short, a person is engaged in the business of dealing if they act as an underwriter, act as an actual or de facto market marker, and buy and sell securities directly to and from customers.[3]

A trader, in contrast, is viewed as having less volume, not handling other people's money, not making markets and not furnishing traditional dealer types services like advice, credit or securities lending facilities.[4]

As it relates to Murchinson, in 2001 the SEC staff issued a no-action letter to Acqua Wellington North American Equities Fund Ltd. in which the SEC staff stated that it would not recommend enforcement action to the SEC if Acqua Wellington invested in equity lines of credit without registering with the SEC as a dealer under Section 15 of the Exchange Act.[5]

Acqua Wellington was to engage in activities that were substantially similar to those in Murchinson and notably would have deemed it an underwriter.

Tidal Shift in Dealer-Trader Distinction

In light of the guidance above, the SEC's finding that a hedge fund acted as an unregistered dealer could signal a tidal shift in the SEC's views regarding the dealer-trader distinction, especially given that senior SEC officials over the years had publicly acknowledged that hedge funds generally come within the meaning of a trader rather than a dealer.[6]

In this respect, the SEC's allegations and dealer analysis, while not explicit, seem to rest on

two premises.

The first premise appears to be that a hedge fund profiting from a spread rather than a stock's appreciation in value is determinative of dealer status. While the SEC has often treated the form of compensation, i.e., transaction-based, as being a dispositive fact in alleging that a person is acting as an unregistered broker, the same cannot be said of dealer status.

None of the factors identified by the SEC in its various releases, or by the staff as articulated in the Acqua Wellington letter, speak to the form of compensation as a factor — let alone a dispositive one — in determining whether a person comes within the meaning of the term dealer. Many types of market participants trade toward a view to earning a spread.

A question that market participants may have to grapple with now is whether their profit models will be subject to attack in the same way as payment for order flow has been the subject of increasing regulatory and policy scrutiny.

The second premise appears to be that trading volume can be determinative of whether a person is engaged in the business of being a dealer. As with spread, this factor is new and not included in previous guidance regarding dealer status — and in some respects, is contradictory to existing guidance.

For example, in a release adopting rules regarding the registration of municipal securities dealers, the SEC stated that it "would appear that the nature of a bank's activities, rather than the volume of transactions or similar criteria, are of greater relevance in determining when a bank is a municipal securities dealer."[7]

The SEC's use of an enforcement action — rather than formal SEC or staff guidance — to announce spread and volume as new factors for evaluating a person's dealer status exposes the agency to criticism that it is using settlements with vulnerable market participants to impose significant changes in policy.

While this criticism is not new, the legitimacy of this concern has only increased as the SEC seemingly embarks on a more aggressive enforcement agenda, especially one that might not be indulged by the courts if respondents chose to litigate.

Implications for Hedge Funds and Other Traders

Although settled enforcement proceedings may not carry the same precedential status as formal SEC opinions or other determinations — let alone an opinion of a court — given the SEC's stance in Murchinson, it may be prudent for market participants to reevaluate their trading practices and consider such practices as susceptible to recharacterization as dealer activities by the SEC.

Indeed, Murchinson seems to call into question the long-standing dealer-trader distinction and creates further regulatory uncertainty for market participants.

To this end, and as an initial matter, market participants might wish to consider whether they have stock purchase agreements and equity line agreements like those described in Murchinson and in the Acqua Wellington letter. If they do, they might wish to revisit any policies, procedures, guidelines and practices designed to keep them on the trader side of the line between trader and dealer.

More generally, market participants might wish to consider the source of their profits and the extent to which those profits rely on spreads versus appreciation. If the former, it may be advisable for market participants to assess their volume, both in general and with respect to specific securities.

Helpful metrics for assessing volume can include whether a market participant must register as a large trader under Exchange Act Rule 13h-1, or whether they have triggered the position limit rules of the various exchanges and self-regulatory organizations.

While it is too soon to predict the SEC's next moves when it comes to the dealer-trader distinction, it is never a bad idea for market participants to take defensive measures.

Ignacio Sandoval and Steven Stone are partners at Morgan Lewis & Bockius LLP.

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[1] In the Matter of Murchinson Ltd., Marc Bistricer, and Paul Zogala, Exchange Act Release No. 92684 (Aug. 17, 2021), https://www.sec.gov/litigation/admin/2021/34-92684.pdf.

[2] 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."

[3] 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, Exchange Act Release No. 46745 (October 30, 2002), 67 Fed. Reg. 67,496, 67,498 –500 (November 5, 2002).

[4] Id.

[5] See Acqua Wellington North American Equities Fund, Ltd., SEC Staff No-Action Letter (July 11, 2001, pub. avail. Oct. 11, 2001).

[6] See Testimony of Arthur Levitt, Chairman, SEC, Concerning Hedge Fund Activities in the U.S. Financial Markets, Before the House Committee on Banking, Finance and Urban Affairs (Apr. 13, 1994). See, also, Testimony of Richard R. Lindsey, Dir., Div. of Mkt. Regulation, SEC, Concerning Hedge Fund Activities in the U.S. Financial Markets, Before the House Committee on Banking and Financial Services (Oct. 1, 1998).

[7] Securities Exchange Act Release No. 11742 (Oct. 15, 1975). We note that definition of a municipal securities dealer and that of a dealer as substantially the same.