Morgan Lewis | Report

SEC ADOPTS NEW DEALER RULES TO CAPTURE LIQUIDITY PROVIDERS

February 2024

www.morganlewis.com

This report is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising. Links provided from outside sources are subject to expiration or change.

© 2024 Morgan Lewis

SEC ADOPTS NEW DEALER RULES TO CAPTURE LIQUIDITY PROVIDERS

On February 6, 2024, the US Securities and Exchange Commission (SEC) adopted new Rules 3a5-4 and 3a44-2 (the Final Rules) under the Securities Exchange Act of 1934 (the Exchange Act) to further define what it means to be engaged in the business of dealing in securities and government securities. The Final Rules principally could capture certain proprietary trading firms, some private funds, and other market participants whose trading activities the SEC views as de facto market making but who have historically viewed themselves as traders within the so-called dealer-trader distinction.[1]

The Final Rules will present an array of challenges for market participants that may be captured by the new definitional framework. This is especially the case for market participants that have had no direct exposure to the prescriptive requirements applicable to broker-dealers. These challenges, discussed in more detail below, are exacerbated by the relatively short window of time until the Final Rules' anticipated compliance date of around May 2025.

While the Final Rules will apply to market participants who act as dealers with respect to any type of security (e.g., equities, fixed income, digital assets), the most significant impact may be on participants in the government securities markets, which may be the SEC's primary goal. Indeed, the Final Rules are the second of three rules that will fundamentally restructure the US Treasury securities (Treasury) markets.[2]

BACKGROUND

Section 3(a)(5) of the Exchange Act defines the term "dealer" to mean "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise," excluding any person that buys or sells securities, "but not as a part of a regular business." Section 3(a)(44) contains a parallel definition of a "government securities dealer" but, for simplicity, in this report we use the term "dealer" to describe both dealers and government securities dealers.

The consequences of being a dealer are significant. Dealers generally must register with the SEC, become members of a self-regulatory organization (SRO) such as the Financial Industry Regulatory Authority, Inc. (FINRA), and comply with a litany of SEC and SRO rules and requirements, including certain financial responsibility and risk management rules, transaction and other reporting requirements, operational integrity rules, and books and records requirements.

The SEC has long interpreted the dealer definition to apply to market participants who act as de facto market makers, i.e., market participants who professionals or the public look to for liquidity. Yet the SEC

---

[1] For a detailed explanation of the dealer-trader distinction, please see the discussion in our report on the SEC's original proposal regarding the dealer rules, SEC Seeks to Make Certain Hedge Funds, Digital Asset Traders, and Other Proprietary Traders Register as Broker-Dealers.

[2] The first rule is with respect to mandated clearing of certain Treasury transactions. *See* Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities, Release No. 34–99149 (Dec. 13, 2023), 89 Fed. Reg. 2,714 (Jan. 16, 2024). The third rule, which has yet to be adopted, would place certain Treasury markets platforms within Regulation ATS. *See* Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities (Proposal), Release No. 94062 (Jan. 26, 2022), 87 Fed. Reg. 15,496 (Mar. 18, 2022).

and its staff have also for decades recognized the so-called "dealer-trader distinction," an analytical framework for assessing when a person's securities transactions do not rise to the level of being engaged in the business of dealing in securities as part of a regular business.[3]

Under the Final Rules, a person would be deemed to be engaged in buying and selling securities for their own account as a part of a regular business—and therefore within the definition of "dealer"—if such person is engaged in a "regular pattern of buying and selling [government] securities that has the effect of providing liquidity to other market participants" under either of two qualitative standards, subject to certain exclusions.

According to the SEC, the Final Rules are intended to retain the dealer-trader distinction for those market participants that only provide liquidity on an incidental basis while bringing within the dealer definition those that provide liquidity as part of a regular business.

QUALITATIVE METHODOLOGY UNDER THE FINAL RULES

Under the Final Rules, a person is engaged in buying and selling securities for their own account "as a part of a regular business" when the person meets at least one of two factors that the SEC has determined indicate that the person is engaged "in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants":

1. **Trading Interest Factor**: 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

2. **Primary Revenue Factor**: 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

Trading Interest Factor

The SEC describes the Trading Interest Factor as expanding the longstanding understanding that regular or continuous *quotation* is "a hallmark of market making or *de facto* market making (and, hence, dealer) activity" to reflect technological changes and the additional and evolving ways in which buyers and sellers of securities are brought together, including through nonfirm indications of interest.[4]

This factor captures market participants that are established sources of liquidity, including participants that employ automated, algorithmic trading strategies to generate a large volume of orders and transactions and participants that use passive market making strategies.

However, as discussed below, continuous two-sided expressions of trading interest is not a necessary condition for satisfying this factor. The SEC elaborated on how it interprets the concepts embedded in this factor, including (1) what is meant by "regularly," (2) the breadth of the meaning of "trading interest," and (3) the significance of timing with respect to transactions.

---

[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 (Oct. 30, 2002), 67 Fed. Reg. 67,496, 67,498-500 (Nov. 5, 2002) (the 2002 Proposal).

[4] Adopting Release at 31.

Regularly

The SEC explains that the term "regularly" is meant to distinguish persons with isolated or sporadic expressions of trading interest from those whose regularity of expression of trading interest demonstrates that they are dealers. The term does not, however, require continuous expressions of trading interest or trading interest that extends without interruption.

While the SEC explains that whether a person is engaged in regular expressions of trading interest depends on the depth and liquidity of the relevant market, it goes on to state that "regular" means "more frequent periods of expressing trading interest on both sides of the market both intraday and across days" in most liquid markets, given the market's ability to absorb orders without significantly impacting the price of the security.

In contrast, if the market for a security is less liquid, and it is difficult to execute orders in a security or large orders can dramatically affect the price of the security, the term "regular" would account for the possibility of more interruptions or wider spreads for the best available prices.

Trading Interest

The use of the term "trading interest" is intended to account for the different ways that the SEC asserts market participants can make markets, such as through the use of streaming quotes, request for quotes (RFQs), or order books. The SEC explains that trading interest means an order or any nonfirm indication of a willingness to buy or sell a security that identifies the security and one or more of the following: quantity, direction (buy or sell), or price.

However, a person that seeks price information by requesting quotes on a security on both sides of the market, without including prices, does not satisfy the "trading interest" element of the factor because the person is not providing information that is at or near the best available price. Moreover, the SEC expressed its belief that when investment advisers express a trading interest for purposes of carrying out their fiduciary duties to their clients (including when investment advisers request quotes or place orders for clients), they are not captured by the Trading Interest Factor unless an investment adviser itself is the account holder or the account is held for the benefit of such investment adviser.

The SEC's reference to nonfirm indications of interest when discussing "trading interest" in the adopting release directly correlates to its proposed amendments to Exchange Act Rule 3b-16 where it would similarly define trading interest to capture RFQs, indications of interest, and similar types of order-related messaging to bring additional platforms within the meaning of an "exchange."[5]

Absence of a Time Limitation

The Final Rules do not impose a requirement that the trading interest be expressed simultaneously on both sides of the market, which would have limited the persons who fall within the scope of the new dealer definition. Rather, persons will need to determine whether they express trading interests on both

---

[5] See Amendments regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) that Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, Exchange Act Release No. 94062 (Jan. 26, 2022), 87 Fed. Reg. 15,496 (Mar. 18, 2022). For a comprehensive discussion of that proposal, read our report SEC Proposes Changes to Regulation ATS for Communication Protocol Systems.

sides of the market sufficiently close in time such that they are providing liquidity in the security to other market participants.

Primary Revenue Factor

Under this factor, a market participant's primary source of revenue must be earned through bid-ask spreads (i.e., spread-capture strategies) or liquidity incentives offered by trading venues, rather than through capital appreciation. The SEC specifically used the term "revenue" instead of "profit" to make clear that a market participant's trading strategy would not need to be profitable to cause them to be considered a dealer. The term "trading venues" is intended to accommodate the different kinds of venues where market participants engage in liquidity-providing dealer activity today and in the future as venues evolve.

To this end, we note that the SEC's proposed market structure changes may impact how market participants earn liquidity incentives offered by trading venues since those proposals would amend Regulation NMS to (1) change the tick sizes under Rule 612 to establish a variable minimum pricing increment model that would apply to both the quoting and trading of NMS stocks and (2) reduce the access fee caps under Rule 610 of Regulation NMS in conjunction with the reduction of the minimum pricing increments, and require national securities exchanges to make the amounts of all fees and rebates determinable at the time of execution.

No Presumption

The Final Rules make clear that no presumption will arise that a person is not a dealer solely because that person does not satisfy either the Trading Interest Factor or the Primary Revenue Factor. Put differently, not fitting within the new definitions is not a safe harbor from dealer status, and market participants should consider whether their activities, based on other facts and circumstances and existing SEC interpretations and case law, still might qualify them as dealers.

Crypto

The SEC declined to exclude crypto securities from the Final Rules. In response to a commenter who asked how to apply "trading interest" to decentralized finance (DeFi), the SEC provided that persons would need to analyze the totality of the circumstances against all elements of the Trading Interest Factor. This result is not surprising given that the SEC's approach to crypto assets has generally been to treat them as securities. To this end, the SEC stated that persons engaged in "automated market-maker" activities should consider whether they are dealers under the Final Rules.

EXCLUSIONS

As adopted, the Final Rules provide limited exclusions from the definition of "as a part of a regular business" for (1) a person that has or control total assets of less than $50 million (De Minimis Exclusion), (2) registered investment companies, (3) central banks,[6] (4) sovereign entities, and (5) international financial institutions.[7]

---

[6] The term "central bank" means a reserve bank or monetary authority of a central government (including the Board of Governors of the Federal Reserve System or any of the Federal Reserve Banks) and the Bank for International Settlements.

[7] The term "international financial institution" means the African Development Bank; African Development Fund; Asian Development Bank; Banco Centroamericano de Integración Económica; Bank for Economic

© 2024 Morgan Lewis

Despite several commenters asking for registered investment advisers, private funds, and certain types of securities (e.g., crypto) to be excluded from the Final Rules, the SEC declined to do so.

CHANGES FROM THE PROPOSAL

No 'Roughly Comparable' Purchases and Sales Qualitative Factor

The SEC did not adopt one of the qualitative factors that was proposed: routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day. This proposed factor was intended to prevent those who engaged in isolated or sporadic securities transactions from being considered dealers, but commenters' concerns about its compliance challenges and potential for capturing ordinary-course investing were enough to sway the SEC to remove this part of the proposal.

No Quantitative Standard

The SEC also did not include the proposed quantitative standard, which would have required dealer registration for persons who engaged in buying and selling more than $25 billion of government securities in each of four of the last six calendar months irrespective of whether the person would have satisfied a qualitative standard.

Removal of this factor is a significant victory for market participants in the government securities markets as it would have captured Treasury basis trading without regard to any of the qualitative factors. While the quantitative factor is not part of the Final Rules, we would not be surprised if the SEC were to use the proposed standard to at least filter some market participants to assess whether they come within any of the qualitative factors.

Aggregation Provision Replaced with Anti-Evasion Provision

The SEC had proposed to define "own account" to include accounts "held in the name of a person over whom that person exercises control or with whom that person is under common control." However, the SEC revised the Final Rules to define "own account" to mean an account (1) held in the name of that person or (2) held for the benefit of that person.

The SEC describes this as being consistent with its historical "entity" approach to broker-dealer regulation. To prevent market participants from taking advantage of this change, the SEC adopted an anti-evasion provision prohibiting persons from evading dealer registration by indirectly engaging in activities that would otherwise satisfy the qualitative factors (described above) or disaggregating accounts.

Cooperation and Development in the Middle East and North Africa; Caribbean Development Bank; Corporación Andina de Fomento; Council of Europe Development Bank; European Bank for Reconstruction and Development; European Investment Bank; European Investment Fund; European Stability Mechanism; Inter-American Development Bank; Inter-American Investment Corporation; International Bank for Reconstruction and Development; International Development Association; International Finance Corporation; International Monetary Fund; Islamic Development Bank; Multilateral Investment Guarantee Agency; Nordic Investment Bank; North American Development Bank; and any other entity that provides financing for national or regional development in which the US government is a shareholder or contributing member.

COMPLIANCE DATE

The Final Rules will become effective 60 days after they are published in the *Federal Register*, and the compliance date will be one year after the effective date. Thus, compliance with the Final Rules will be required around May 2025. As discussed further below, this provides a short time frame for firms to evaluate the rules and register as a dealer if required.

Notwithstanding the SEC's intended compliance date, it remains to be seen whether any potential litigation could derail that timeline. The SEC's rulemaking under Chair Gary Gensler has been the subject of various lawsuits, some successful, on the basis of the authority of the SEC and deficiencies in the SEC's approach to rulemaking under the Administrative Procedures Act. Given the continued ambiguities in the Final Rules (which could allow the SEC and its enforcement staff to enforce the Final Rules in an arbitrary and capricious manner) and potential deficiencies in the economic analysis, the Final Rules may be ripe for challenge.

WHAT'S LEFT OF THE DEALER-TRADER DISTINCTION?

The dealer-trader distinction has been articulated since at least 1951, when Louis Loss first published his seminal treatise on the securities laws,[8] and the SEC and its staff have articulated features of the dealer-trader distinction over the years,[9] including 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.[10] 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."

The activities identified by the SEC in this proposal included the following:

- Acting as an underwriter in the distribution of new issues;

---

[8] *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.

[9] *See, e.g.*, OTC Derivatives Dealers, Exchange Act Release 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," Exchange Act Release 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).

[10] *See supra* n.3.

- 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
- 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.[11]

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.[12]

While the SEC described the Final Rules as "intended to reflect the longstanding distinction between so-called 'traders'—whose liquidity provision is only incidental to their trading activities—and persons who are 'in the business' of providing liquidity as part of a 'regular business,' and so are 'dealers' and 'government securities dealers' under the Exchange Act," it is not clear exactly who the SEC would view as a mere trader.

Notably, the SEC also provides no additional guidance about what "liquidity provision" might be "only incidental" to a trader's trading activities. Indeed, "incidental" is used only once in the adopting release.

Interpreting the SEC's view of the dealer-trader distinction is further muddied by the SEC's statement that staff in the SEC's Division of Trading and Markets will be reviewing no-action letters and staff statements

---

[11] *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* n.5.

[12] *See* 2002 Proposal, 67 Fed. Reg. at 67,498-500.

to determine which interpretations around "dealer" status may need to be withdrawn in connection with the Final Rules.

LOOKING AHEAD: DEALER REGISTRATION AND REGULATION

Market participants that are potentially impacted by the Final Rules should evaluate whether their current activities could cause them to be a dealer under the Final Rules. Further, because the Final Rules are not the exclusive means for determining dealer status, and in light of the SEC's apparently evolving and more expansive view of the dealer definition, market participants should consider evaluating their dealer status on a holistic basis and looking at all of the historic indicia of dealer status that are discussed above.

Market participants should also evaluate how dealer requirements (such as capital, trade reporting, and recordkeeping requirements) would impact their business model, whether their business model can be changed to avoid dealer status (yet not also trip the anti-evasion provision of the new rules), the time and expense involved in registering as a dealer and applying to become a FINRA member, and whether, when taking into account all of these factors and their own tolerances for regulatory risk, they want to register as a dealer.

As noted above, the compliance date for the Final Rules is a little over a year away, and the process for registering as a dealer can be lengthy. To assist market participants in their decision-making and planning, below is a brief overview of the dealer registration process and a discussion of some of the key regulatory implications of dealer status.

Registration Process

If a market participant meets the new dealer definition, it will need to register with the SEC by filing Form BD. Perhaps more significantly, firms that register as dealers will also need to become members of an SRO, which will, in most cases, be FINRA.[13] The process for applying for membership with FINRA is rigorous and time-consuming, and it is not currently expected that FINRA would offer a short-form

[13] Section 15(b)(8) of the Exchange Act requires a dealer to become a member of a national securities association unless the dealer effects transactions solely on a national securities exchange of which it is a member. Currently, FINRA is the only securities association registered with the SEC. While it is possible for a dealer to register with one or more securities exchanges without being a member of FINRA, Section 15(b)(8) and Rule 15b9-1 under the Exchange Act would limit such a dealer to transacting on securities exchanges of which it is a member, with limited exceptions. *See* Exchange Act Rule 15b9-1 (as amended Nov. 6, 2023, with a compliance date of Sept. 6, 2024); Exemption for Certain Exchange Members, Exchange Act Release No. 98202 (Aug. 23, 2023), 88 Fed. Reg. 61,850 (Sept. 7, 2023) (substantially narrowing an exemption from the FINRA membership requirement in Rule 15b9-1 for certain proprietary trading dealers that effect securities transactions other than on an exchange where they are members). In other words, any dealer that wishes to transact off-exchange, such as through ATSs or with other broker-dealers (i.e., OTC), is required to be a member of FINRA. As such, in this report we focus on the process for applying for membership with FINRA and the FINRA rules. While the membership process and rules for FINRA are generally more burdensome than the exchange membership process and exchange rules, many of the exchanges have outsourced certain regulatory functions to FINRA and have similar rules to FINRA so that exchange membership can entail similar regulatory burdens.

membership application process for new dealers like it has adopted for certain proprietary trading firms that must become FINRA members due to the recent amendments to Rule 15b9-1 of the Exchange Act.[14]

The membership process requires the submission of a New Membership Application (NMA), which is a detailed application that involves the applicant providing information with respect to each of the 14 membership standards set forth in FINRA Rule 1014. In reviewing these membership standards, FINRA will require detailed information and documentation of all aspects of the applicant's business and compliance program, including the applicant's business plan, management team (including their experience and securities licensing status), regulatory and disciplinary history, policies and procedures, supervisory structure, capitalization, key vendors and service providers, and operational capabilities.

Importantly, FINRA expects applicants that intend to use electronic platforms or systems (including order management and trading systems) to be "operationally ready" at the time of filing the NMA, meaning that any firm intending to file an NMA as a result of the new rules should be ready for a live walk-through demonstration of its systems, all activities to be conducted on the systems should be fully functional, and the street-facing and internal views of the systems should be able to be demonstrated via videoconference. Being operationally ready also means that a firm will need to have vendors that will support compliance with new regulatory obligations engaged and ready to be connected.

The application process is typically iterative, with several rounds of written questions from FINRA culminating in a membership interview, and can take six months or longer from the time of submitting a "substantially complete" application. FINRA filed a comment letter with the SEC indicating that it would seek to expedite the membership process for firms that are captured by the new rules to the extent possible, but firms that intend to register as dealers and become FINRA members should nevertheless act quickly. Notwithstanding FINRA's assurances, the NMA process could involve unexpected speedbumps to the extent that new dealers' businesses present novel issues requiring FINRA staff to consult with the SEC's Division of Trading and Markets.

Other considerations that firms should take into account when planning for dealer registration include:

- A firm should expect to spend several months preparing its FINRA NMA and supporting materials.
- Many new dealers will have personnel, including management, who will need to pass licensing exams (e.g., Series 7, Series 57, and Series 24 exams depending on role and security types), and FINRA will not approve an NMA until the firm satisfies minimum licensing requirements. Preparing for these exams can take several months of studying.
- Some firms may need to hire new personnel or engage outsourced resources. For example, FINRA members are required to have a licensed Financial and Operations Principal (FinOp) who is responsible for the firm's compliance with regulatory net capital requirements and filing periodic financial reports with the SEC and FINRA. Firms without an affiliated broker-dealer are unlikely to have a person with the requisite license or expertise to serve as a FinOp. Further, a firm must have an appropriately qualified chief compliance officer and designate an anti-money laundering compliance person. It may be advisable to hire such individuals with previous broker-dealer experience.
- Many firms will need to engage vendors and service providers to facilitate their compliance with various aspects of their broker-dealer obligations such as trade reporting

[14] *See* FINRA Regulatory Notice 23-19.

and recordkeeping requirements. Firms will need to allow for sufficient lead time to research, diligence, and onboard these vendors and service providers.

- To the extent that a firm’s current business model conflicts with or would be significantly constrained by the dealer regulatory requirements, the firm may need to implement structural changes that will require significant time to plan and execute.

Dealer Regulatory Requirements

Registered dealers are subject to many regulatory requirements that could present significant challenges for firms that are currently not regulated as brokers or dealers. Below is an overview of some of the key regulations that may present challenges for new dealers. (This list is not intended to be an exhaustive list of all regulatory requirements.)

SEC Rules. All dealers are required to comply with the following requirements, among others, under the Exchange Act and rules thereunder:

- *Net Capital*. Dealers are required to comply with regulatory net capital and reporting requirements as set forth primarily in Rules 15c3-1 and 17a-11 under the Exchange Act. The net capital requirements apply on a “moment-to-moment” basis, meaning that dealers must comply with the requirements at all times. Even transitory violations that have no operational impact on the dealer still require self-reporting and can lead to significant regulatory consequences. The net capital rules include (1) complicated rules for what assets are allowable or count toward the dealer’s minimum net capital, (2) rules regarding haircuts (i.e., discounts to market value) on noncash assets, and (3) limitations on leverage and borrowing. The net capital rules also include restrictions on withdrawals of capital and requirements to notify regulators of significant declines in capital and low capital levels. Firms will want to obtain advice from their accountants and other advisors regarding the impact of the various capital requirements on their current and anticipated trading and related activities.
- *FOCUS Reports and Audited Financial Statements.* Dealers are required to prepare and file Financial and Operational Combined Uniform Single reports (FOCUS reports) and, subject to certain exceptions, annually file financial statements with the SEC and FINRA and engage an independent accounting firm to audit those financials.
- *Recordkeeping.* Dealers are subject to detailed recordkeeping requirements under the Exchange Act and FINRA rules, which in many ways are broader and more prescriptive than those requirements applicable to registered investment advisers. For example, dealers are required to maintain records of all communications relating to their “business as such” and are required to maintain electronic records in a specific format that can be operationally burdensome.
- *CAT Reporting.* Dealers are required to record and report detailed information on quotes, orders, routes, and trade execution for exchange-listed equities and options, including related events such as cancellations, modifications, and acceptances of an order or route, pursuant to the SEC’s Consolidated Audit Trail (CAT) rule (Rule 613 of Regulation NMS) and related plans.
- *Fingerprinting of Personnel.* Dealers are required to obtain the fingerprints of certain personnel and submit them for an FBI background check and are otherwise not permitted to employ (including as independent contractors) or have associated with them persons who are subject to statutory disqualification.

FINRA Rules. In addition to SEC requirements, dealers are subject to a number of burdensome requirements under the FINRA rules, including the following:

- *Form U4.* A FINRA member is require to complete and file a Form U4 for each individual who is applying for registration with the member and promptly update Form U4 after registration with any new or changed information. The form requires detailed information about the individual including their employment history, outside business activities, and information about certain regulatory, criminal, civil, and financial events. Members are required to verify the accuracy and completeness of the information on Form U4, meaning the member cannot just rely on information provided by the individual and must conduct a background check. FINRA can bring enforcement actions against individual representatives that provide inaccurate information on their Form U4.
- *Licensing.* A dealer's management and certain other personnel will need to comply with FINRA's licensing requirements. This could include passing a variety of different representative- and/or principal-level exam combinations, including the Securities Industry Essentials (SIE), Series 7 (General Securities Representative), Series 57 (Securities Trader), Series 14 (Compliance Officer), Series 24 (General Securities Principal), Series 27 (FinOp), Series 4 (Registered Options), and/or Series 99 (Operations Professional).
- *Outside Business Activities.* FINRA requires a member's registered representatives to report to the member certain "outside business activities," and representatives are also required to disclose certain "other business" activities on their Forms U4. The scope of what constitutes an outside business activity or other business is interpreted broadly by FINRA (e.g., it can include renting a second home), and FINRA can bring enforcement actions against firms and individuals in connection with deficient reporting/disclosure and handling of such matters.
- *Private Securities Transactions.* FINRA members are also required to supervise their associated persons' "private securities transactions," which are broadly defined as "any securities transaction outside the regular course or scope of an associated person's employment with a member." This FINRA rule can pick up private investment activity by associated persons (including buying and selling personal interests in private funds) as well as activity whereby an associated person participates in effecting transactions for an affiliate, and, as with the outside business activity rule, can serve as the basis for enforcement actions against firms and individual associated persons.
- *Restrictions on Equity IPO Participation.* FINRA Rule 5130 prohibits FINRA members from receiving allocations of "new issues" as that term is defined in the rule.[15]

[15] FINRA Rule 5130(i)(9) defines "new issue" to mean "any initial public offering of an equity security as defined in Section 3(a)(11) of the Exchange Act, made pursuant to a registration statement or offering circular. New issue shall not include: (A) offerings made pursuant to an exemption under Section 4(a)(1), 4(a)(2) or 4(a)(5) of the Securities Act, or Securities Act Rule 504 if the securities are 'restricted securities' under Securities Act Rule 144(a)(3), or Rule 144A or Rule 505 or Rule 506 adopted thereunder, or offerings made under Regulation S of the Securities Act or otherwise made outside of the United States or its territories unless the securities offered and sold in the Regulation S offering or other offering made outside of the United States are also registered for sale in the United States under the Securities Act in connection with a concurrent initial public offering of an equity security in the United States; (B) offerings of exempted securities as defined in Section 3(a)(12) of the Exchange Act, and rules promulgated thereunder; (C) offerings of securities of a commodity pool operated by a commodity pool

- *Self-Reporting of Regulatory Violations.* FINRA Rule 4530 requires reporting to FINRA of civil, criminal, and regulatory matters relating to the member or associated persons as well as quarterly statistics and summary information regarding written customer complaints and copies of specified criminal and civil actions. Significantly, FINRA Rule 4530 also requires a member to self-report to FINRA any internal findings by a member of regulatory violations by the member or any associated person, subject to certain materiality thresholds.
- *TRACE Reporting.* FINRA members are required to report eligible fixed-income trades to FINRA's Trade Reporting and Compliance Engine (TRACE).
- *Gifts and Entertainment.* FINRA members and their associated persons are prohibited from giving anything of value (a gift) in excess of $100 per year to any person where the gift is in relation to the business of the employer of the recipient of the gift. However, this does not prohibit "ordinary and usual business entertainment" (such as an occasional meal, sporting event, theater production, or comparable entertainment event) provided that the entertainment is "neither so frequent nor so extensive as to raise any question of propriety."
- *Examination.* FINRA conducts periodic exam of its members. As compared to SEC exams of registered investment advisers, FINRA exams can be more frequent and rigorous. They can include routine ("cycle") exams, for-cause exams, sweeps, special exams, and joint exams with other regulators.
- *Continuing Membership Application.* FINRA members are required to file a Continuing Membership Application (CMA) with FINRA and obtain FINRA approval before undertaking certain changes to the firm or its business. Notably, FINRA requires a CMA for a change in the direct or indirect ownership of a member that results in one person or entity owning or controlling 25% or more of the member's equity or partnership capital. While the FINRA rules permit a member to complete a change of control prior to obtaining FINRA approval, there are limitations and potential risks to such an approach.
- *Mandatory Arbitration.* FINRA members are required to arbitrate any disputes with other FINRA members and with their associated persons through FINRA.

As noted, the above requirements are merely a summary of only select regulatory requirements that apply to dealers. Many of these requirements, while onerous when a business is built with them in mind, will prove to be exceptionally onerous for existing businesses that have not planned for such requirements. Moreover, for certain types of firms, such as private funds, the requirements clearly may result in a "square peg, round hole" result.

---

operator as defined under Section 1a(5) of the Commodity Exchange Act; (D) rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition; (E) offerings of investment grade asset-backed securities; (F) offerings of convertible securities; (G) offerings of preferred securities; (H) offerings of an investment company registered under the Investment Company Act; (I) offerings of securities (in ordinary share form or ADRs registered on Form F-6) that have a pre-existing market outside of the United States; and (J) offerings of a special purpose acquisition company subject to Securities and Exchange Commission rules and regulations, a business development company as defined in Section 2(a)(48) of the Investment Company Act, a direct participation program as defined in Rule 2310(a) or a real estate investment trust as defined in Section 856 of the Internal Revenue Code."

ADDITIONAL OBSERVATIONS

Authority to Adopt Rules

While we have seen some commentary suggesting that the SEC may not have had the authority to define terms used in the definition of dealer and government securities dealer in the way it has, we note that Section 3(b) of the Exchange Act provides the SEC with fairly broad authority to do just that. As noted in our report on the proposal, Section 3(b) of the Exchange Act specifically provides that

> 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.

Moreover, it is not novel for the SEC to use this authority to define statutory terms in the way it has with the Final Rules, having done so for equity securities (Rule 3a11-1), the definition of a common trust fund as used in Section 3(a)(12) of the Exchange Act (Rule 3a12-6), the definition of a penny stock (Rule 3a51-1), and for terms used in Section 3(a)(1) of the Exchange Act (Rule 3b-16).

That said, and as we previously noted in our report on the proposed rules, the SEC's use of its authority under Section 3(b) has been challenged where it goes beyond what Congress intended with the framework it designed under the federal securities laws.

Negative Implications Associated with the Exclusions and No Presumption Language

On the topic of congressionally developed frameworks, in excluding registered investment companies from the Final Rules the SEC highlighted that they are subject to a comprehensive regulatory framework. Yet, the SEC did not exclude registered investment advisers, pension funds, private funds, or a host of other regulated entities from the Final Rules, while also making clear that the Final Rules are not the exclusive means by which a person can come within the meaning of the term dealer.

An apparent concern of the SEC here is that its approach to exclusions in the Final Rules could be susceptible to allegations that it was arbitrary and capricious. While we will not discuss the constituent parts of the "arbitrary and capricious" standard here, the SEC's explanations for only excluding registered investment companies and not other registrants does raise the specter that the SEC will have to further explain itself to a court.

But perhaps more alarming is the negative implication that arises from excluding registered investment companies when considering the no presumption language. If registered investment companies are excluded from the Final Rules but can still be deemed dealers otherwise, what is the limiting principle?

Prior to the Final Rules, it was unlikely that the industry would have seriously considered a registered investment company as coming within the meaning of the term dealer and having to register as such. However, the narrow exclusion and no presumption language certainly raises the concern. While the SEC may not bring an enforcement action against a registered investment company for being a dealer, there is certainly nothing to stop private litigants from making such a claim against a registered investment company or other registrants. Clearing agencies, for example, routinely novate transactions. Do they run the risk of being deemed dealers? What about securities exchanges that participate in matching trades? There is no exclusion for them being deemed brokers.

Loss of Customer Status

In her statement on the adoption of the new rules, Commissioner Hester M. Peirce emphasized a critical point: "This rule turns traders, many of whom are customers, into dealers. . . . Not only will these entities be subject to a dealer regulatory regime that does not make sense for them, but they will lose the protections now afforded to them as customers." Commissioner Peirce is referring to the notion that, under FINRA and SEC rules, the definition of a customer generally excludes other broker-dealers.[16]

The impact of this is potentially significant. While market participants that will be required to newly register as dealers likely are financially sophisticated, able to fend for themselves in the markets in which they provide liquidity, and not devoid of bargaining power, there are a host of potential protections provided under the Exchange Act and FINRA rules for "customers" that will no longer apply to their relationships with other broker-dealers.

Additionally, broker-dealers are required to provide disclosures to customers and obtain customer consent prior to trading with a customer on a "net" basis.[17] Further, broker-dealers are obligated to seek to provide best execution for orders of their customers and customers of other broker-dealers.[18] Broker-dealers also must deliver periodic account statements and confirmations to customers as prescribed in applicable rules. These obligations fall away when a broker-dealer is executing trades for another broker-dealer.[19]

While newly registered dealers may not need such protections, they (and the other broker-dealers that provide services to them) will still need to consider whether there are aspects of their existing relationships that will change in a way that should be accounted for through other means, such as through agreements and pricing.

---

[16] The term "customer" as applicable to a broker-dealer is defined differently under various SEC rules and FINRA regulations. *See, e.g.*, SEC Rule 15c1-1 (definition applicable to any rule adopted pursuant to Section 15(c)(1)); Rule 600(b)(23) of Regulation NMS ("Customer means any person that is not a broker or dealer."); FINRA Rule 0160(b)(4) (Definitions) ("The term 'customer' shall not include a broker or dealer."); FINRA Rule 12100(k) (Code of Arbitration Definitions) ("A customer shall not include a broker or dealer."). *See also Citigroup Glob. Mkts. Inc. v. Abbar*, 761 F.3d 268, 275 (2d Cir. 2014) ("We hold that a 'customer' under FINRA Rule 12200 is one who, while not a broker or dealer, either (1) purchases a good or service from a FINRA member, or (2) has an account with a FINRA member.").

[17] *See* FINRA Rule 2124 (Net Transactions with Customers).

[18] *See* FINRA Rule 5310 (Best Execution). *See also* Exchange Act Release No. 51808 (June 9, 2005), 70 Fed. Reg. 37,496, 37,538 (June 29, 2005) (stating that the duty of best execution requires a broker-dealer to execute customers' trades at the most favorable terms reasonably available under the circumstances, i.e., at the best reasonably available price); *Geman v. SEC*, 334 F.3d 1183, 1186 (10th Cir. 2003) ("[T]he duty of best execution requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances.") (quoting *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir.), *cert. denied*, 525 U.S. 811 (1998)); *Kurz v. Fidelity Mgmt. & Rsch. Co.*, 556 F.3d 639, 640 (7th Cir. 2009) (describing the "duty of best execution" as "getting the optimal combination of price, speed, and liquidity for a securities trade").

[19] Antifraud provisions of the Exchange Act still apply where one broker-dealer is executing trades for another broker-dealer.

Moreover, in an unexpected twist, newly registered dealers may not only lose customer status themselves, but there could also be facts and circumstances under which they are deemed to have customers to whom they owe new obligations, such as if they are trading with or for counterparties that are themselves not also dealers.

Implications for Private Funds

Some of the dealer regulatory requirements may pose particularly significant challenges in the context of private funds. As an initial matter, the dealer rules will require the registration of the legal entity that is engaging in the trading activity that is subject to the rule, which in the case of a private fund would be the fund itself rather than the fund's investment manager, even though the fund does not itself have personnel.

In addition, to the extent that a fund sponsor has multiple funds that engage in trading strategies that implicate dealer registration, this raises the prospect of having to separately register each fund as a dealer or to otherwise "push out" the dealer function to a separate entity, which may raise different challenges or, in many cases, not be possible.

Further, because the net capital rules generally serve to prohibit a dealer from withdrawing capital earlier than one year after the capital has been contributed, some funds' current liquidity terms and policies may conflict with the net capital requirements. The complex requirements in the net capital rules regarding allowable assets and haircuts may make it impossible to engage in certain trading strategies.

Additionally, to the extent that a fund currently engages in trading activity that would implicate dealer status under the Final Rules and receives allocations of new issues, the fund would need to decide between those two activities, as dealers are prohibited from receiving equity IPO allocations under the FINRA rules. Further, investors in the fund that own a large enough interest in the fund would be restricted from receiving equity IPO allocations under FINRA new issue rules.

Dealer registration could also raise confidentiality and privacy concerns for some fund investors. For example, if a fund is registered as a dealer, SEC Form BD would require disclosure of any limited partner of the fund who has the right to receive upon dissolution, or has contributed, 5% or more of the fund's capital, as well as certain owners of those limited partners and certain owners of those owners. Moreover, this ownership information would be publicly available on FINRA's BrokerCheck website.

Data, Data, Data

As reflected in the adopting release, in assessing the number of market participants that could be subject to the Final Rules, the SEC used various data sources including TRACE data and information from Form PF.

While the SEC estimated that a relatively low number of private funds would likely be subject to the Final Rules and required to register as dealers, we note that the SEC will have more information at its disposal in the future by which it may be able to assess whether market participants come within the qualitative standards discussed above.

For instance, under the CAT, certain RFQ responses will be reportable. In addition, we note that two days after the Final Rules were adopted, the SEC and the Commodity Futures Trading Commission adopted changes to Form PF to require enhanced reporting on, among other things, investment strategies and expanded reporting in turnover.

Morgan Lewis

MORGAN LEWIS HAS INTERDISCIPLINARY KNOW-HOW TO ASSIST

Morgan Lewis has a large, diverse, and sophisticated investment management practice, with experience spanning all of the critical regulatory touchpoints of the new dealer rules. Our lawyers advise broker-dealers of all sizes on the full range of issues involving broker-dealer regulation including registration, market structure, and trading, among other regulatory issues, and we also have a comprehensive private funds practice that can assist impacted private fund managers with navigating the new rules.

Ways in which we can help include:

- Helping compare a firm's current activities against the new factors that trigger dealer status
- Helping strategize how to potentially structure a business to avoid dealer status
- Developing policies, procedures, and controls to help mitigate the risk of dealer status
- If a firm likely will qualify as a dealer, helping plan for, prepare, and submit an application to register as a dealer with the SEC and become a FINRA member
- Developing policies, procedures, and controls to assist a firm in complying with its dealer obligations
- Advising newly registered dealers in the context of regulatory exams, enforcement inquiries, and other litigation

CONTACTS

If you have any questions or would like more information on the issues discussed in this report, please contact any of the following:

Boston

David C. Boch	+1.617.951.8485	david.boch@morganlewis.com
Richard A. Goldman	+1.617.951.8851	rich.goldman@morganlewis.com
Barry N. Hurwitz	+1.617.951.8267	barry.hurwitz@morganlewis.com
Daniel A. Nelson	+1.617.341.7830	daniel.nelson@morganlewis.com
Stephen C. Tirrell	+1.617.951.8833	stephen.tirrell@morganlewis.com

Chicago

Brian Jacobson	+1.312.324.1793	brian.jacobson@morganlewis.com
Zeke Johnson	+1.312.324.1783	zeke.johnson@morganlewis.com
Michael M. Philipp	+1.312.324.1905	michael.philipp@morganlewis.com
Sarah V. Riddell	+1.312.324.1154	sarah.riddell@morganlewis.com

Los Angeles

Ayman A. Khaleq	+1.212.612.7459	ayman.khaleq@morganlewis.com

Miami

Ethan W. Johnson	+1.305.415.3394	ethan.johnson@morganlewis.com

New York

Thomas V. D'Ambrosio	+1.212.309.6964	thomas.dambrosio@morganlewis.com
Kristin Lee	+1.212.309.6024	kristin.lee@morganlewis.com
Jedd H. Wider	+1.212.309.6605	jedd.wider@morganlewis.com
Joseph D. Zargari	+1.212.309.7020	joseph.zargari@morganlewis.com
James E. Doench	+1.212.309.6310	james.doench@morganlewis.com

Philadelphia

Timothy W. Levin	+1.215.963.5037	timothy.levin@morganlewis.com
Christine M. Lombardo	+1.215.963.5012	christine.lombardo@morganlewis.com
John J. O'Brien	+1.215.963.4969	john.obrien@morganlewis.com

Washington, DC

Nicole Alkire	+1.202.739.5765	nicole.alkire@morganlewis.com
Peggy Blake	+1.202.739.5769	peggy.blake@morganlewis.com
Gregg S. Buksbaum	+1.202.739.5080	gregg.buksbaum@morganlewis.com
Laura E. Flores	+1.202.373.6101	laura.flores@morganlewis.com
Amy Natterson Kroll	+1.202.739.5746	amy.kroll@morganlewis.com
W. John McGuire	+1.202.373.6799	john.mcguire@morganlewis.com
Christopher D. Menconi	+1.202.373.6173	christopher.menconi@morganlewis.com
Courtney C. Nowell	+1.202.739.5223	courtney.nowell@morganlewis.com
Christopher M. Paridon	+1.202.739.5138	christopher.paridon@morganlewis.com
Ignacio Sandoval	+1.202.739.5201	ignacio.sandoval@morganlewis.com
Steven W. Stone	+1.202.739.5453	steven.stone@morganlewis.com
Kyle Whitehead	+1.202.739.5717	kyle.whitehead@morganlewis.com
Christine Ayako Schleppegrell	+1.202.739.5259	christine.schleppegrell@morganlewis.com

ABOUT US

Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide elite legal services across industry sectors for multinational corporations to startups around the world. For more information about us, please visit www.morganlewis.com.