Expansion of Dealer Definition

Rule Change Adopted by the SEC on February 6, 2024

Last updated: 2/26/2024

Background

Chronology

- On March 28, 2022, the SEC published a rule proposal to expand the definition of “dealer” and “government securities dealer”
- The SEC adopted this rule change on February 6, 2024 (34-99477)
- As of February 26, 2024, the rule change had not been published in the Federal Register
- The effective date of the rule change is 60 days after publication in the Federal Register
- The compliance date is one-year from the effective date (approximately April/May 2025)

Requirement for dealers to be registered with the SEC

Dealer registration

- Section 15(a)(1) of the Securities Exchange Act of 1934 (the "Exchange Act") makes it unlawful for a broker or dealer to effect any transactions in any security unless the broker or dealer is registered with the SEC
- Subject to certain exceptions, including for banks and savings associations under certain conditions

Government Securities Dealer registration

- Section 15C(a)(1) of the Exchange Act makes it unlawful for a government securities broker ("GSB") or government securities dealer ("GSD") to effect any transactions in any government security unless the GSB or GSD is registered with the SEC
- Subject to certain exceptions, including for banks and savings associations under certain conditions

Exchange Act definitions of dealer and government securities dealer

Dealer

- "… any person engaged in the business of buying and selling securities … for such person's own account through a broker or otherwise."
- ***Excludes*** a person that that buys or sells securities "… ***for such person's own account***, either individually or in a fiduciary capacity, ***but not as part of a regular business***." (Section 3(a)(5) of the Exchange Act)

Government Securities Dealer

- "… any person engaged in the business of buying and selling government securities … for his own account through a broker or otherwise."
- ***Excludes*** a person that that buys or sells such securities "… ***for his own account***, either individually or in some fiduciary capacity, ***but not as part of a regular business***." (Section 3(a)(44) of the Exchange Act)

New Rules 3a5-4 and 3a44-2

New Rule 3a5-4

- Further defines what it means to be engaged in the business of buying and selling securities "***as a part of a regular business***" within the definition of "dealer"

New Rule 3a44-2

- Further defines what it means to be engaged in the business of buying and selling securities "***as a part of a regular business***" within the definition of "government securities dealer"

New Rules 3a5-4 and 3a44-2

- For ease of reference, this presentation below generally refers only to new Rule 3a5-4 (relating to the definition of a dealer), but the SEC has adopted parallel changes in new Rule 3a44-2 (relating to the definition of a government securities dealer)

FINANCIAL INFORMATION FORUM

Description of Rule Change

New Rule 3a5-4

- New Rule 3a5-4 is titled: Further definition of “as a part of a regular business” in connection with certain liquidity providers
- Historically, the SEC has distinguished between “dealers” (subject to SEC to registration as dealers) and “traders” (not subject to SEC registration as dealers)
- The new SEC rules redefine the historic “dealer-trader distinction”

Dealer-trader distinction

“The final rules are thus 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.”

New Rule 3a5-4: Trading Interest and Primary Revenue standards

(a) A person that is engaged in buying and selling securities for its own account is engaged in such activity "as a part of a regular business" … if that person:

(1) Engages in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants by:

(i) 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; or

(ii) 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 Standard

Trading Interest standard

- Elements
  - Regularly expressing trading interest
  - At or near the best available prices
  - On both sides of the market
  - For the same security
  - Communicated and represented in a way that makes it accessible to other market participants

Regular vs. continuous activity

"A market participant does not need to be continuously expressing trading interest to be engaging in a 'regular' business. The Exchange Act's definitions of 'dealer' and 'government securities dealer' do not include a requirement of continuous participation. The ordinary meaning of 'continuous' is 'characterized by continuity; extending in space without interruption of substance; having not interstices or breaks; having its parts in immediate connection; connected, unbroken' and 'marked by uninterrupted extension in space, time, or sequence,' as defined by the Oxford English and the Merriam-Webster dictionaries, respectively. While such 'continuous' expression of trading interest would be indicative of dealer activity, a continuous standard would not be appropriate because it would be too limited in markets for securities that exhibit varying degrees of depth and liquidity.

Regular trading activity

"Whether a person's activity is 'regular' will depend on the liquidity and depth of the relevant market for the security. For example, in markets that have significant liquidity and market depth, and have experienced advancements in technology and electronic trading, like the U.S. Treasury market, expressing trading interest on both sides of the market for the same security as part of an investment strategy on a one-off basis would not be sufficiently regular to be caught by the expressing trading interest factor. Rather, 'regular' in the most liquid markets would mean more frequent periods of expressing trading interest on both sides of the market both intraday and across days given the efficiency in which securities can be bought and sold and 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 that 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 interests

"The term 'trading interest' accounts for the varied mechanisms that permit market participants to effectively make markets. These include, but are not limited to, the use of streaming quotes, request for quotes ('RFQs'), or order books. To be captured by the expressing trading interest factor depends less on the method used to communicate trading interest, and more on whether the person is expressing trading interest on both sides of the market for the same security that has the effect of providing liquidity in the same security to other market participants."

Simultaneous expression of trading interests

"While simultaneously expressing trading interest on both sides of the market in the same security is indicative of dealer activity, market participants also can be acting as dealers by regularly providing liquidity even where the expressions of trading interest on both sides of the market for the same security are not simultaneous, particularly because the markets for different securities have varying structures, trading volume, and liquidity."

Primary Revenue Standard

Primary Revenue standard

- Elements
  - 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

Primary revenue standard

"Further, in response to one commenter's example, while the analysis of this specific scenario would depend on the totality of circumstances, as a general matter, it is unlikely that a person who regularly earns more revenue from an appreciation in the value of its inventory of securities than from capturing bid-ask spreads or incentive payment for liquidity provision, would be considered to earn revenue 'primarily' from capturing bid-ask spreads or trading incentives."

Trading venues

"The term 'trading venues' is intended to accommodate the variety of venues in which market participants today engage in liquidity-providing dealer activity. In addition, the use of this term is intended to capture venues as they evolve, wherever that activity occurs, whether on a national securities exchange, an ATS, any other broker- or dealer-operated platform for executing trading interest internally by trading as principal or crossing orders as agent, or any other platform performing a similar function. The particular venue matters less than the fact that a market participant provides liquidity on it."

Exclusions; Aggregation; Non-evasion; No Presumption

Exclusions

- Person that has or controls total assets of less than $50 million
- Investment company registered under the Investment Company Act of 1940
- Central bank, sovereign entity or international financial institution

International financial institutions

- African Development Bank
- African Development Fund
- Asian Development Bank
- Banco Centroamericano de Integración Económica
- Bank for Economic 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
- Any other entity that provides financing for national or regional development in which the U.S. Government is a shareholder or contributing member

Own account

- “Own account” means any account
  - Held in the name of that person, or
  - Held for the benefit of that person

Private funds and registered investment advisers

"The Commission, however, is not including an express exclusion for private funds or registered investment advisers. Depending on the totality of the facts, a private fund may be engaged in the business of buying and selling securities for its own account. Similarly, a registered investment adviser that is trading for its 'own account' could implicate dealer registration requirements…. However, the Commission is mindful of concerns raised by commenters regarding the application of the dealer regime to registered investment advisers and private funds and as such has made significant changes to the definition of 'own account' to remove the aggregation standard in order to appropriately tailor the scope of persons captured by the final rules."

Aggregation

"In response to concerns raised by commenters related to, among other things, the breadth of the proposed rule's aggregation approach, the Commission has determined to focus in the first instance on an analysis of activity on an entity-by-entity basis, rather than aggregating accounts across entities that are controlled by or are under common control with an entity."

Inter-affiliate transactions

"The Commission is not adding an exclusion for inter-affiliate transactions because the Commission is removing the aggregation provision, and the final rules have been modified to focus on the trading activity of a person for an account in the name of, or for the benefit of, that person. In the context of whether a person is acting as a dealer, the Commission continues to believe each person must independently consider its own trading activities to determine whether its activities require dealer registration."

Non-evasion provision

- No person shall evade the registration requirements of this section by:
  - Engaging in activities indirectly that would satisfy paragraph (a) of this section i.e., the Expressing Trading Interest and Primary Revenue standards], or
  - Disaggregating accounts

No presumption

- “No presumption shall arise that a person is not a dealer within the meaning of section 3(a)(5) of the Act solely because that person does not satisfy paragraph (a) of this section [i.e., the Expressing Trading Interest and Primary Revenue standards]”

Non-exclusiveness

"The final rules are not the exclusive means of establishing that a person is a dealer or government securities dealer; otherwise applicable Commission interpretations and precedent will continue to apply.... A person engaging in other activities that satisfy the definition of dealer under otherwise applicable interpretations and precedent, such as underwriting, will still be a dealer even though those activities are not addressed by the two qualitative factors."

Changes from Proposed Rule

Changes to standards from proposed rule

Standard	Proposed Rule	Final Rule
Intro to Qualitative Standards	"Engages in a routine pattern of buying and selling government securities that has the effect of providing liquidity to other market participants by:"	Replaces "routine" with "regular"
1st Qualitative Standard	"Routinely making roughly comparable purchases and sales of the same or substantially similar government securities in a day"	Removed
2nd Qualitative Standard (Expressing Trading Interest)	"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"	• Replaces "routinely" with "regularly" • Adds the phrase "for the same security"

Changes to standards from proposed rule (continued)

Standard	Proposed Rule	Final Rule
3rd Qualitative Standard (Primary Revenue)	"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"	Adopted as proposed (but see change to intro above)
Quantitative Standard (for government securities only)	"In each of four out of the last six calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities "	Removed

Other changes from proposed rule

- Removes from the definition of “own account” an account “held in the name of a person over whom that person exercises control or with whom that person is under common control”
- Adds anti-evasion provision
- Adds exclusions for central banks, sovereign entities and international financial institutions

Other Statements in Adopting Release

Purpose for rule change: regulatory oversight

The identification, registration, and regulation of these market participants as dealers will provide regulators with a more comprehensive view of the markets through regulatory oversight and will support market stability and resiliency and protect investors by promoting the financial responsibility and operational integrity of market participants that are acting as dealers.

Purpose for rule change: leveling the playing field

Further, the final rules will promote competition among entities that regularly provide significant liquidity by applying consistent regulation to these entities, thus leveling the competitive playing field between liquidity provision conducted by entities that are currently registered as dealers and government securities dealers and by entities that are not.

Crypto

In addition, as discussed in more detail below, the Commission is not excluding certain types of securities, specifically crypto asset securities, from the application of the final rules. As stated in the Proposing Release, the proposed rules would apply to any “security” as defined in section 3(a)(10) or “government security” as defined in section 3(a)(44) of the Exchange Act. The dealer framework is a functional analysis based on the securities trading activities undertaken by a person, not the type of security being traded. Accordingly, the final rules will apply with respect to any crypto asset that is a “security” or “government security” within the meaning of the Exchange Act.

Customers

Further, the Commission disagrees with the argument that certain market participants, including PTFs, are not dealers because they do not have customers. There is no requirement in the statutory text of either section 3(a)(5) or section 3(a)(44) that dealers have customers.

Compliance period

Considering FINRA's expressed commitment to expedite the application process, a compliance date of one year from the effective date of the final rules will provide a sufficient period of time for affected market participants to comply with the final rules.

Compliance period (continued)

The Proposing Release explained that the proposed compliance period would not cover market participants whose activities following the effective date of the final rules would require registration under those rules…. However, the one-year compliance period will be applicable to all affected market participants, as we agree that a common transition period will be easier to administer and more equitable.

Contact fifinfo@fif.com with comments or questions