

SEC's New Dealer Definition – Who's Now in Scope?

On February 6, 2024, the SEC approved—in a 3-to-2 vote along party lines—[updates](#) to the dealer definition that will expand the scope of market participants required to register with the SEC as dealers. The changes clarify “in the regular course of business” and will capture roughly 40 principal trading firms (PTFs), as well as private funds and even some crypto asset trading. Absent an exception or exemption, in-scope entities must register with the SEC as a dealer, become a member of a self-regulatory organization (SRO), and comply with federal securities laws and regulatory obligations. The rule exempts SEC-registered investment companies.

Effective Date
60 days after Federal Register publication

Compliance Date
1 year after effective date

Background

Section 3(a)(5) of the *Securities Exchange Act of 1934* (Exchange Act) 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,” but excludes “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**.” Section 3(a)(44) of the Exchange Act defines a government securities dealer as “any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise,” but “does not include any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as **part of a regular business**.” Market participants that meet these statutory definitions are required to register with the SEC as a dealer and then subject to regulatory obligations (compliance with the Net Capital Rule and audited financial statements) unless an exemption or exception applies. Dealers that also are government securities dealers are further subject to rules issued by the Treasury (financial responsibility, capital requirements, record-keeping, and reports and audits).

The SEC previously issued guidance on the application of trader exclusion to dealer registration, most notably an SEC 2002 Release. The following activities are indicators that a market participant may be acting as a dealer:

- Underwriting
- 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 firm for liquidity
- Buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment advice, extending credit and lending securities in connection with transactions in securities, and carrying a securities account

In recent years, market participants that regularly provide market liquidity have not registered, either as dealers or government securities dealers. In the U.S. Treasury market, PTFs now account for about half of the daily volume in the

interdealer market. While many PTFs may not engage in underwriting or providing investment advice, the SEC is concerned that many PTFs are acting as de facto market makers without registration.

Qualitative Factors

New Rules 3a5-4 and 3a44-2 further define what it means to be engaged in the business of buying and selling securities “as a part of a regular business” under the “dealer” and “government securities dealer” definitions.

A firm would be deemed to be engaged in buying and selling securities for its own account as a part of a regular business, and therefore acting as a dealer or government securities dealer, if it engages in a routine pattern of buying and selling securities that has the effect of providing liquidity to other market participants. The final rule adds two qualitative factors that would be considered to have the effect of providing liquidity to other market participants:

- **Trading Interests. Regularly** expressing trading interests that are at or near the best available prices on both sides of the market for the same security and that are communicated and represented in a way that makes them accessible to other market participants.
- **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.

Trading Interest

A market participant does not need to be continuously expressing trading interest to be engaging in regular business. Whether activity is regular will depend on the liquidity and depth of a security’s relevant market. 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 covered by the trading interest factor. Regular in a liquid market would mean more frequent periods of expressing trading interest on both sides of the market both intraday and across days. For a less liquid security where it may be difficult to execute orders or where a large order can dramatically affect price, the term “regular” would account for the possibility of more interruptions or wider spreads for the best available prices.

Who Could Be Included in Scope?

The trading interest criteria could scope in common activities that have not historically been considered dealer activity.

- **High Frequency Traders.** Market participants that have established themselves as significant market intermediaries—and critical sources of liquidity—in a market by employing automated, algorithmic trading strategies that rely on high-frequency trading strategies to generate a large volume of orders and transactions could be in scope.
- **Portfolio Managers.** A portfolio manager that takes long/short positions or seeks arbitrage opportunities or an asset manager with a fund that has an active fixed-income trading strategy involving indications of interest to trade bonds, as well as swaps, on similar or even identical underlying issuers to take advantage of mispricing or create a unique nondirectional risk profile in a trade.
- **Digital Assets.** The final rule is technology agnostic. An automated market maker (AMM) allows digital assets to be traded without permission and automatically by using liquidity pools instead of a traditional market of buyers and sellers. AMMs that buy and sell securities for their own account must consider whether they are dealers and subject to registration requirements.

Primary Revenue

“Primary” will require an analysis of all facts and circumstances. This analysis is a little more straightforward for traditional securities in looking at price appreciation versus capturing bid/ask spreads. An assessment will be more complicated for the market structures and activity for crypto assets.

*“Whether a particular activity in the **crypto asset** securities market, including in the so-called DeFi market, gives rise to dealer activity will require an analysis of the totality of the particular facts and circumstances. Market participants will need to determine, based on their trading activities, whether their **portfolio management** and trading strategies meet this standard.”*

“The dealer framework is a functional analysis based on the securities trading activities undertaken by a person, not the type of security being traded. The final rules apply to the buying and selling of all securities, including crypto assets that are securities or government securities within the meaning of the Exchange Act”

Dealer status requires only that a person be in business, not that the endeavor is profitable. The SEC deliberated and elected to use “revenue” and not “profit” to capture a situation where a liquidity provider’s activity fails to be profitable.

Trading Venue

Under the second criteria, a trading venue can be “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 interest internally by trading as principal or crossing orders as agent.” The rule applies to the liquidity provided and is agnostic as to what platform that happens on. This scope is intended to capture both current and future venue platforms.

Own Account/Anti-Abuse Provision

In response to comment letter feedback, the SEC backed away from an aggregation provision and a bright-line quantitative test of \$25 billion trading volume in government securities that would require dealer registration even if the above qualitative factors were not met.

In the absence of these provisions and to address potential structuring to avoid registration, the final rule includes an anti-abuse provision and a definition of “own account.” To exclude separately managed accounts and investment adviser trading on behalf of their clients from the assessment of dealer status, “own account” is defined to mean an account:

- Held in the name of that person, or
- Held for the benefit of that person

The anti-abuse provision prohibits structuring activities indirectly that would satisfy the qualitative factors or disaggregating accounts for the purpose of evading the dealer registration requirements. For example, the SEC would generally consider management by a registered investment adviser of separately owned client accounts that follow substantially the same investment objectives and strategies to be ordinary course business activities, and so would not impute the trading in the clients’ accounts to the adviser’s “own account,” absent intent to evade the dealer registration requirements. Potentially evasive activity includes, but is not limited to:

- Coordinating and integrating trading across commonly controlled groups of legal entities such that it would not meet the qualitative standard, including by switching which legal entity is engaged in trading to evade the “regular” requirement of the qualitative standard
- A person who uses two legal entities to separately purchase and sell securities
- A person who uses several legal entities to purchase and sell securities, but rotates the activity across or among entities in a way that none of the legal entities trades frequently enough to satisfy the “regular” test

Exclusions

As proposed, the final rule has an exclusion from de facto market making classification if an entity controls less than \$50 million in total assets.

The final rule has an exemption for registered investment companies registered under the *Investment Company Act of 1940* based on that group’s existing comprehensive regulatory framework and oversight.

The SEC firmly rejected comment letter feedback for an exclusion for private funds and 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.”

If a private fund were required to register as a dealer, its leverage would be limited by net capital requirement.

The SEC also declined to provide an exemption for public pension funds.

Other exclusions include central banks, sovereign entities, and international financial institutions.

Conclusion

The asset management team at **FORVIS** has more than 50 years of experience providing accounting, tax, and consulting services to various types of investment holdings, including conventional debt and equity investments, loans, businesses, alternative investments, and other unique assets. As of June 2023, Convergence Optimal Performance ranked FORVIS as a top 20 accounting and audit firm to registered investment advisors. FORVIS also was ranked in the top 20 by assets under management. We have experience providing services to funds ranging from emerging managers to \$100-plus billion in assets under management. Our knowledge allows us to provide tailored services to help meet your unique needs. We provide services to private, public, and Cayman funds. For more information, visit forvis.com.

Contributors

Brian Matlock

Partner/Financial Services

National Asset Management Leader

brian.matlock@forvis.com

Anne Coughlan

Director

anne.coughlan@forvis.com