SULLIVAN & CROMWELL LLP

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November 22, 2024

District Court Strikes Down SEC's Dealer Rule

Court Holds that the SEC's Effort to Significantly Broaden the "Dealer" Definition Exceeded Its Statutory Authority

SUMMARY

On November 21, 2024, the U.S. District Court for the Northern District of Texas granted motions for summary judgment in two related cases[1] and vacated Exchange Act Rules 3a5-4 and 3a44-2, which took effect earlier this year. The rules would have required certain liquidity providers to register with the SEC as dealers or government securities dealers. The court agreed with both sets of plaintiffs that the rules exceeded the SEC's statutory authority and ordered that they be vacated in their entirety. Market participants should consider their obligations to register as dealers under prior SEC interpretations and guidance, as well as in light of the court's determination that "dealers have customers" and provide "services" to investors.

BACKGROUND

The SEC adopted Rules 3a5-4 and 3a44-2 (the "Dealer Rules") under the Exchange Act on February 6, 2024. The Dealer Rules introduced two new qualitative standards for determining whether an entity must register as a dealer or government securities dealer. In a marked change from SEC staff's historical approach, the registration requirement under the Dealer Rules would have been triggered by a single activity—providing liquidity. The Dealer Rules became effective on April 29, 2024, with a compliance date of April 29, 2025. For additional information, please see our memorandum on the Dealer Rules.

Many market participants reacted with concern to the promulgation of the Dealer Rules due to their broad nature, significant questions regarding their ultimate scope and their potentially adverse effect on market liquidity. In particular, the Dealer Rules could have scoped in certain proprietary trading firms and private

funds—some of which have traded in securities markets for decades without registering as dealers—based solely on their provision of liquidity to the market, replacing the SEC's historical multi-factor facts-and-circumstances test. As a result, the Dealer Rules would have imposed certain broker-dealer regulatory requirements, such as net capital requirements and customer protection regulations, that commenters characterized as "inappropriate and untenable" for trading firms and funds that do not have the types of customers intended to be protected by the broker-dealer regulatory regime. The SEC also stated that participants in the digital asset markets, such as those using liquidity pools and automated market maker software, could be considered dealers under the Dealer Rules if their activities had the effect of providing liquidity in the digital asset markets (to the extent transactions in digital assets constitute securities transactions).

In response to these concerns, two sets of plaintiffs—associations representing private fund managers and the digital asset industry—sued the SEC, alleging that, among other things, the Dealer Rules exceeded the SEC's statutory authority under the Exchange Act and were arbitrary and capricious under the Administrative Procedure Act (the "APA").

Court Opinions

The court concluded that the SEC had exceeded its statutory authority in promulgating the Dealer Rules "by expanding [the] definition of dealer, untethered from the text, history, and structure of the [Exchange] Act." Having resolved the cases on that basis, the court did not address the plaintiffs' APA claims.

In its opinion in the private fund managers' case, the court first concluded that "[t]he Exchange Act's text does not regulate trading entities without customers as dealers." In this regard, the court determined that the Dealer Rules' focus on liquidity provision to the market alone was inconsistent with the statutory phrase "the business of buying and selling securities," which "reinforces the customer-order-facilitation context of the [Exchange] Act." The court then turned to the history of the term "dealer" and found that, when Congress enacted the Exchange Act, that term "had accumulated a settled meaning . . . 'limited to one who . . . buys and sells securities to customers.'"[2] The court also noted that the SEC had, until recently, taken the position that what distinguished a trader from a dealer was not volume or frequency of trading, but rather client-facing activities such as attempts to attract a clientele, soliciting investors, handling client money and securities and assisting clients in buying and selling.

The court also found it significant that the SEC deemed it necessary to provide an exception to the Federal Reserve because of the expansiveness of the dealer definition. According to the court, the SEC's "late recognition of a latent authority is good evidence to question the [SEC]'s statutory interpretation"—the court was skeptical that almost 90 years could have passed without the SEC realizing that the Federal Reserve was purportedly operating as an unregistered dealer, which constitutes a felony.

The court then considered the structure of the Exchange Act and determined that, since "dealer" and "broker" are sister-terms that must be read consistently, and there was no dispute that the broker definition—effecting trades for the account of others—refers only to trading on behalf of customers, reading the customer nexus out of the dealer definition would improperly create inconsistencies between the two terms.

In its opinion in the case brought by the digital asset industry, the court also agreed with the additional argument that the "'business' of dealing has always included 'services offered' to investors, 'not merely engaging in trading activities for a person's own investing or trading objectives.'" By "defin[ing] anyone engaging in trading activities that affect market liquidity as a 'dealer,'" the court reasoned, the Dealer Rules impermissibly "remove[d] the distinction between 'trader' and 'dealer' as they have commonly been defined for nearly 100 years" in the Exchange Act.

In both opinions, the court distinguished two cases from the Eleventh Circuit, *SEC* v. *Almagarby*[3] and *SEC* v. *Keener*.[4] The SEC had cited those cases to support the proposition that the Dealer Rules' definition of "regular business" was consistent with the Exchange Act because those cases focused on factors such as the volume, regularity and frequency of a firm's securities transactions in determining whether the firm is a dealer. However, the district court here observed that those other cases specifically limited their holdings to the particular conduct at issue, which was underwriting, and that one of those cases (*Almagarby*) expressly acknowledged that private funds are not traditionally understood as dealers. Harmonizing these cases with its rulings here, the district court explained that courts must "consider a wide variety of indicia of dealer activity . . ., many of which sound in [customer] service-related activities[,]"—such as soliciting investor clients, handling investor clients' money and securities and rendering investment advice to investors—to determine whether someone is a dealer, and not focus solely on whether a firm merely trades with customers in a way that incidentally provides market liquidity.

Analysis

In vacating the Dealer Rules, the court noted that it "'re-establish[ed] the status quo' that existed prior to the [SEC's] action." Accordingly, in analyzing whether a particular entity is a dealer, market participants should consider SEC's historical approach (prior to the Dealer Rules) to determining the types of activity that constitutes dealer activity.[5] At least for firms based in the Northern District of Texas, that analysis may also take into account the court's view that, when a firm is not providing services to a customer, it is not a dealer.

The court's vacatur of the Dealer Rules is effective as of November 21, 2024. The federal rules provide the SEC 60 days from that date—until January 20, 2025—to file a notice of appeal from the district court's

decisions. Even if the SEC files a notice of appeal during that period, it will be up to the incoming administration to decide whether to pursue the appeal.

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ENDNOTES

1 The two related cases were brought by the National Association of Private Fund Managers, Alternative Investment Management Association and Managed Funds Association, and by the Crypto Freedom Alliance of Texas and the Blockchain Association. Sullivan & Cromwell represented the Crypto Freedom Alliance of Texas and the Blockchain Association in the litigation.

2 Citing *Schafer* v. *Helvering*, 299 U.S. 171, 174 (1936).

3 92 F.4th 1306 (11th Cir. 2024).

4 102 F.4th 1328 (11th Cir. 2024).

5 For example, the SEC historically has considered the following activities to be indicia of dealer status: acting as an underwriter, purchasing or selling securities from or to customers, carrying a dealer's inventory, quoting a market in securities, advertising or holding itself out as a dealer, extending credit, running a matched book of repurchase and reverse repurchase transactions and rendering advice on securities transactions. *See United States Savings Ass'n of Texas*, SEC No-Action Letter, 1987 SEC No Act. LEXIS 2021, at *2-3 (Apr. 12, 1987) (articulating a ten-factor test). *See also* OTC Derivatives Dealers, SEC Release No. 34-40594 (Oct. 23, 1998), 63 Fed. Reg. 59,362, 59,370 n.61 (Nov. 3, 1998) ("[A]n OTC derivatives dealer may not engage directly or indirectly in any activity that may otherwise cause it to be a 'dealer' as defined in Section 3(a)(5) of the Exchange Act (15 U.S.C. § 78c(a)(5)). This includes, but is not limited to, without regard to the security, (1) purchasing or selling securities as principal from or to customers; (2) carrying a dealer inventory in securities (or any portion of an affiliated broker-dealer's inventory); (3) quoting a market in or publishing quotes for securities (other than quotes on one side of the market on a quotations system generally available to non-broker-dealers, such as a retail screen broker for government securities) in connection with the purchase or sale of securities permitted under Rule 15a-1; (4) holding itself out as a dealer or market maker or as being otherwise willing to buy or sell one or more securities on a continuous basis; (5) engaging in trading in securities for the benefit of others (including any affiliate), rather than solely for the purpose of the OTC derivatives dealer's investment, liquidity, or other permissible trading objective; (6) providing incidental investment advice with respect to securities; (7) participating in a selling group or underwriting with respect to securities; or (8) engaging in purchases or sales of securities from or to an affiliated broker-dealer except at prevailing market prices.").

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