SULLIVAN & CROMWELL LLP

S&C memo

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SEC Adopts Changes to "Dealer" Definition with Modifications from the Proposal

The Rules Are Intended to Require Additional Market Participants, Including Certain Proprietary Trading Firms, Private Funds and Investment Advisers, to Register with the SEC as Dealers or Government Securities Dealers

On February 6, 2024, the Securities and Exchange Commission voted 3 to 2 (Commissioners Peirce and Uyeda dissenting) to adopt Rules 3a5-4 and 3a44-2 under the Exchange Act to require certain market participants to register as dealers or government securities dealers under the Exchange Act (the "Final Rules").[1] The Final Rules impose these requirements by further defining "as part of a regular business" in Sections 3(a)(5) and 3(a)(44) of the Exchange Act.

In response to comments, and in a significant departure from the proposed rules, which we discussed in detail in our memorandum of April 6, 2022, the Final Rules omit (1) a proposed quantitative standard, which would have defined a person as a "government securities dealer" if it exceeded a stated dollar threshold of trading volume in government securities and (2) a proposed qualitative standard, which would have defined a person as a "dealer" or "government securities dealer" if it routinely made roughly comparable purchases and sales of the same or substantially similar securities in a day.

The Commission did, however, adopt two qualitative standards based on the proposed rules. Specifically, under the Final Rules, a person that is engaged in buying and selling securities or government securities for its own account is engaged in such activity "as a part of a regular business" and thus is required to register as a dealer or government securities dealer if that person engages in a regular pattern of buying and selling securities or government securities that has the effect of providing liquidity to other market participants by:

- Regularly (rather than "routinely," as proposed) 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
- 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.

The Final Rules and related adopting release provided additional guidance regarding some of the key terms and concepts within these standards (including that "primarily" is unlikely to include a person that regularly earns more revenue from inventory appreciation than from bid-ask spreads or incentive payments), but the Commission declined to adopt several suggestions that would have better aligned these standards with existing precedent or otherwise limited the scope of the standards. The Commission also emphasized that these standards are non-exclusive ways in which a firm could be determined to be engaged in dealer activity, and that existing court precedent and Commission interpretations will also continue to apply.

In another significant departure from the proposed rules—which would have defined "own account" broadly 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"—the Final Rules define the term to mean an account: (i) held in the name of that person; or (ii) held for the benefit of that person. Instead of that broader definition, the Final Rules include an anti-evasion provision that prohibits a person from evading registration by: (1) engaging in activities indirectly that would satisfy a qualitative standard; or (2) disaggregating accounts.

The Final Rules provide exclusions for a person that:

- has or controls total assets of less than $50 million;
- is registered as an investment company under the Investment Company Act of 1940; and
- in an addition to the proposed rules, is a central bank, sovereign entity, or international financial institution.

The Commission declined to adopt other exclusions proposed by commenters, including for private funds and investment advisers, noting that such a person "could be acting as a dealer depending upon the particular activities in which it is engaged." The Commission also declined certain commenters' requests to exclude crypto asset securities from the Final Rules, noting that the dealer framework is a functional analysis based on the securities trading activities undertaken by a firm, not the type of securities being traded.

The Final Rules will become effective 60 days following the date of publication of the adopting release in the Federal Register. The compliance date for the Final Rules is one year after the effective date, though the Commission emphasized that this one-year compliance period is available only for "market participants who are engaging in activities covered by the [F]inal [R]ules prior to the compliance date" and is not a more general exemption from dealer registration for persons whose activities otherwise satisfy the definition of dealer "under applicable Commission interpretations and court precedent."

In the coming days, Sullivan & Cromwell LLP expects to publish a more detailed memorandum summarizing and analyzing the Final Rules and the guidance provided by the Commission in the adopting release.

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ENDNOTES

[1] *See* Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers, SEC Release No. 34-99477 (Feb. 6, 2024), *available at* https://www.sec.gov/files/rules/final/2024/34-99477.pdf. *See also* SEC Fact Sheet: Final Rules: Changes to Definition of Dealer and Government Securities Dealer (Feb. 6, 2024), *available at* https://www.sec.gov/files/34-99477-fact-sheet.pdf.

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