April 6, 2022

SEC Proposes Changes to "Dealer" Definition

The Rules Would Require Certain Proprietary Trading Firms and Others to Register With the SEC as Dealers or Government Securities Dealers.

SUMMARY

On March 28, 2022, the Securities and Exchange Commission ("SEC" or "Commission") proposed new rules that would require certain market participants—including, in particular, proprietary trading firms, among other market participants—that satisfy certain qualitative standards or engage in specified levels of buying and selling government securities to register with the SEC, become a member of a self-regulatory organization and comply with federal securities laws and regulations, as well as Treasury regulations, as applicable. Certain market participants would be exempt from these rules, including any person that has or controls total assets of less than $50 million, is a registered investment company or complies with an existing exemption or exception to the dealer registration requirements. The Commission invites comment on all aspects of the proposal, which should be submitted by the later of 30 days following publication of the proposal in the Federal Register and May 27, 2022.

BACKGROUND

Federal securities laws have long required that market participants whose securities activities fall within the definition of "dealer" or "government securities dealer" under the Securities Exchange Act of 1934 (as amended, the "Exchange Act") register with the SEC.[1] Section 3(a)(5) of the Exchange Act defines "dealer" as "any person engaged in the business of buying and selling securities … for such person's own account through a broker or otherwise,"[2] but excludes, under the so-called "trader" exception, "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."[3] A parallel definition exists for the definition of "government securities dealer" under Section 3(a)(44) of the Exchange Act.[4]

Historically, whether a person is acting as a dealer or trader has been based on an analysis of all the relevant "facts and circumstances."[5] The SEC staff at one time employed a "10-factor" test for determining when registration as a government securities dealer was required.[6] All the facts and circumstances were considered, and, in general, no one factor would be determinative of the analysis.

Noting that advancements in electronic trading have led certain unregistered market participants—in particular, proprietary trading firms—to "play an increasingly significant liquidity providing role [in securities markets] . . . that has traditionally been performed by entities regulated as dealers," the Commission expresses concern that "investors and the markets lack the important protections that result from" registration and SEC regulation, and that "obligations and regulatory oversight that promote market stability and investor protection are not being consistently applied" to market participants engaged in similar activities.[7] In a marked break from the facts and circumstances history, the Commission proposes to remedy this perceived regulatory gap by, among other changes, further defining the phrase "as a part of a regular business" within the "dealer" and "government securities dealer" definitions under the Exchange Act to create three irrebuttable, single-factor qualitative tests for dealer registration and one irrebuttable quantitative test for government securities dealer registration.[8] As the SEC itself acknowledges in its cost-benefit analysis, the number of entities that might be covered by this new definition is unknown and the implications for trading in the equity and debt markets is unclear.[9]

THE PROPOSED RULES

The Commission has proposed two new rules—proposed rules 3a5-4 and 3a44-2 (the "Proposed Rules")—to further define "dealer" and "government securities dealer," respectively, and to require registration as a dealer or government securities dealer, unless an exception applies, if:

- in the case of a dealer or government securities dealer registration, one of the three qualitative standards are satisfied; or
- in the case of a government securities dealer registration, the quantitative test is satisfied.

The Commission makes clear, however, that a person that does not meet the qualitative or quantitative standards of the Proposed Rules, as discussed below, may nonetheless be a dealer or government securities dealer, and be required to register as such, "if it is otherwise engaged in a regular business of buying and selling securities for its own account by, for example, acting as an underwriter."[10] The Proposed Rules, therefore, state that there is no presumption that a person is not a dealer or government securities dealer because that person does not satisfy the quantitative or qualitative standards.

1. Qualitative Standards

Under the Proposed Rules, a person would be engaged in buying and selling securities for its own account "as part of a regular business," and thus be required to register, if that person "[e]ngages in a routine pattern of buying and selling securities [or government securities] that has the effect of providing liquidity to other market participants." The Commission notes that a person's intent is irrelevant and that the Proposed Rules "focus on the 'effect' of a person's activity . . . whether or not that effect is intended."[11] The Proposed Rules identify three types of activities that would be considered to have the effect of providing liquidity to other market participants, and would therefore require dealer registration.

a. Routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day

The Commission states that the term "routinely" "relates to the frequency with which a person engages in" such purchases and sales, and "means more frequent than occasional but not necessarily continuous."[12] The Commission's stated intent is to distinguish persons who engage in "isolated or sporadic" trading from those whose actions demonstrate that they are dealers.[13] Furthermore, the Commission states that "more frequent buying and selling is indicative of dealer activity."[14]

The phrase "roughly comparable" is intended to capture "purchases and sales similar enough, in terms of dollar volume, number of shares, or risk profile, to permit liquidity providers to maintain near market-neutral positions by netting one transaction against another transaction."[15] Purchases and sales need not be exactly the same, and a market participant need not fully net its positions to be considered a dealer under the Proposed Rules—instead, "roughly comparable" purchases and sales "would fall within a reasonable range that generally would have the effect of offsetting one transaction against the other."[16] The Commission further states its belief that "a person that closes or offsets, in the same day, the overwhelming majority of the positions it has opened" will likely fall within the scope of the Proposed Rules.[17] Although the Proposed Rules intentionally do not provide a bright-line test to determine "roughly comparable" purchases and sales, the SEC's economic analysis "assumes a daily buy-sell imbalance between two identical or substantially similar securities, in terms of dollar volume, below 10% or, alternatively, 20%, may be indicative of purchases and sales that are 'roughly comparable.'"[18] The SEC requests comment on "whether this approach is appropriate and whether this standard should include a trading threshold."[19]

Securities that are considered "the same" for this purpose are those that are "of the same class and hav[e] the same terms, conditions, and rights."[20] The Commission notes that determining whether securities are "substantially similar" is a facts and circumstances determination that would take into account factors including whether:

- "the fair market value of each security primarily reflects the performance of a single firm or enterprise or the same economic factor or factors, such as interest rates; and"

- "changes in the fair market value of one security are reasonably expected to approximate, directly or inversely, changes in, or a fraction or a multiple of, the fair market value of the second security."[21]

The Commission further notes that "[a] person routinely making roughly comparable purchases and sales of the same or substantially similar securities, such that the sale or purchase of one security offsets the risk associated with the sale or purchase of the other, permitting that person to maintain a near market-neutral position, would meet this aspect of this standard." [22]

The SEC has also provided certain "nonexclusive examples of purchases and sales of 'substantially similar' securities":

- Selling a Treasury security and buying another Treasury security in the same maturity range, as used by the Federal Reserve Bank of New York's Open Market Operations. For example, selling a 4.5-year Treasury security and buying a 5-year Treasury security, or a 9.5 year Treasury security versus a 10-year Treasury security;
- Buying an exchange traded fund and selling the underlying securities that make up the basket of securities held by the exchange traded fund that was purchased; and
- Buying a European call option on a stock and selling a European put option on the same stock with the same strike and maturity.

The Commission has also provided examples of purchases and sales of securities that are not "substantially similar":

- Buying stock in one company (*e.g.*, Ford) and selling stock in another company in the same industry (*e.g.*, Chrysler);
- Buying stock and selling bonds issued by the same company; and
- Buying cash Treasury securities and selling Treasury futures.[23]

The Commission also states that this provision would apply with respect to such purchases and sales made "in a day" in order to capture trading activity that is typical of dealers, while excluding "non-dealers pursuing longer-term investment strategies."[24] The Proposal is silent on whether the "substantially similar" standard would encompass the arbitrage of convertible derivatives against the underlying securities, arbitrage between the securities of two companies subject to a business combination, and arbitrage between different classes of common stock—high vote and low vote. But the Proposal does indicate that the standard would not be satisfied by trading securities and related futures contracts where the latter is not a security.[25]

b. 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

The term "routinely" has the same meaning as discussed above. The Commission states that this provision refers to "trading interests,"[26] which includes orders and certain non-firm indications of a willingness to buy or sell, rather than "quotations" in order to account for the varied ways in which market participants make markets.[27]

The SEC provides that the phrase "best available prices on both sides of the market" is intended to describe the activity of liquidity-providing dealers, which helps to determine the spread between the best bid and offer for a given security and narrow bid-ask spreads.[28] Although this concept may be clear in the listed equities markets, the SEC does not address how it should be applied to fixed income or equity securities that trade primarily over-the-counter. The Commission further clarifies that a liquidity provider "must both buy and sell securities" in order to be subject to the Proposed Rules.[29] The SEC does not provide clear guidance on what it means for trading interests to be "communicated and represented in a way that makes them accessible to other market participants."[30]

c. 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

The Commission explains that this provision focuses on revenue, rather than profit, because a market participant can provide liquidity and be a dealer without being profitable.[31] According to the SEC, this standard is meant to encompass "trading in a manner designed to profit from spreads in liquidity incentives, rather than with a view toward appreciation in value."[32] While the Commission also declines to propose a bright-line test with respect to this prong of the quantitative analysis, it makes clear that a person that derives the majority of its revenue from capturing bid-ask spreads, buying at the bid and selling at the offer, or capturing incentives offered by trading venues would "likely" be within the scope of the Proposed Rules.[33] The Commission notes that this provision applies to activity on "trading venues"[34] rather than just, for example, national securities exchanges, in order to capture dealer activity wherever it occurs.[35]

2. Quantitative Standard

In addition to the qualitative standards described above, Proposed Rule 3a44-2, which applies only to government securities dealers, would also include a quantitative standard that would establish an irrebuttable bright-line test pursuant to which a person engaging in certain specified levels of activity in the U.S. Treasury market would be considered a government securities dealer, regardless of whether that person meets any of the qualitative standards described above. Specifically, a person would be considered to be engaged in buying and selling government securities for its own account "as a part of a regular business" if that person, "[i]n each of 4 out of the last 6 calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities."[36] The Proposal indicates that transactions associated with repurchase agreements would not count towards this threshold.[37]

The Commission set this threshold based on its analysis of historical U.S. Treasury securities transactions reported to TRACE and expects 46 non-FINRA member firms to be above the $25 billion threshold. Of those, 22 are classified as proprietary trading firms and 20 are classified as dealers.[38]

3. Persons Excluded from the Proposed Rules

The Proposed Rules would apply to all "persons" as such term is defined in Section 3(a)(9) of the Exchange Act, unless such person was otherwise exempted or excepted.[39] The Proposed Rules would not apply to:

- a person that has or controls total assets of less than $50 million; or
- an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act").

The Commission believes that persons that have or control less than $50 million in assets are less likely to pose the types of financial and operational risks that the Proposed Rules are intended to address.[40] Registered investment companies are proposed to be excluded because they are already subject to substantial Commission regulatory requirements.[41]

Other existing statutory or regulatory exceptions or exemptions (such as the foreign broker-dealer exemption pursuant to Exchange Act Rule 15a-6) would continue to apply.[42]

Notably, private funds are not categorically excluded from the scope of the Proposed Rules since, according to the Commission, its intent is to "tak[e] a similar approach to regulating dealer activity across market participants" and private funds are not otherwise subject to the Investment Company Act's regulatory framework.[43] Investment advisers registered under the Investment Advisers Act of 1940 (the "Investment Advisers Act") are also not categorically excluded from the Proposed Rules, though, as described below, the Commission has proposed guidance with respect to when client accounts of an investment adviser need to be considered.[44]

4. Definitions of "Own Account" and "Control"

a. "Own Account"

The Proposed Rules would define a person's "own account" to mean any account that is:

- held in the name of that person;
- held in the name of a person over whom that person exercises control or with whom that person is under common control, subject to certain exclusions (described below); or
- held for the benefit of those persons identified in the two preceding bullet points.

The following accounts would be excluded from a person's "own account":

- "an account in the name of a registered broker, dealer or government securities dealer, or an investment company registered under the Investment Company Act";
- "with respect to an investment adviser registered under the [Investment Advisers Act], an account held in the name of a client of the adviser unless the adviser controls the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client"; and

- "with respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser registered under the [Investment Advisers Act], unless those accounts constitute a parallel account structure."[45]

b. "Control"

The Proposed Rules incorporate the definition of "control" under Exchange Act Rule 13h-1 with respect to determining which accounts should be aggregated for purposes of the "control" prong in the "own account" definition noted above.[46]

The Commission notes that these definitions are "designed to focus on the trading activity occurring at the firm or legal-entity level or the trading activity that is being employed on behalf of, or for the benefit, of the entity, and limit the registration burden to those entities engaged in dealer activity," and "intended to avoid incentivizing market participants to change their corporate structures for the purpose of avoiding registration."[47]

In this regard, the Commission clarifies that, while a person that meets the qualitative or quantitative standards is not subject to the Proposed Rules if that person has or controls total assets of less than $50 million, the accounts of such an under-$50-million person must be considered for purposes of determining whether another person's trading activities or volume falls within the qualitative or quantitative standards.[48]

With respect to registered investment advisers, aggregation of client accounts would not be required in the case of traditional investment management agreements. However, where the adviser is the general partner of one or more partnerships or the managing member of one or more limited liability companies—as is often the case for private funds—aggregation of client accounts would be required. Moreover, to prevent an "investment adviser from dividing trading activities among multiple clients to avoid the application of the Proposed Rules," aggregation is required when there is a parallel account structure.[49]

The SEC provides two examples of the operation of the definition of "own account" and "control" in the Proposal. We attach these examples as Appendix A to this memorandum.

OBSERVATIONS AND IMPLICATIONS

The Proposed Rules, if adopted, would extend the Commission's dealer registration and other regulatory requirements to many market participants—particularly proprietary trading firms (since, by the Commission's own analysis, there are at least 22 such firms that would exceed the proposed government securities bright-line quantitative threshold), but potentially investment advisers and hedge funds—that do not consider themselves (and do not hold themselves out to be) dealers. In this regard, although the SEC's economic analysis suggests that relatively few private funds would be captured by the Proposed Rules, that analysis is based on incomplete data and uncertain assumptions.

Registering and complying with the Commission's extensive dealer regulations is likely to be onerous, particularly for firms that are not currently SEC-registered, not affiliated with any SEC-registered entities, and not otherwise subject to regulatory capital requirements, and the specter of registration could affect how such firms participate in the securities and government securities markets, with potential impacts to, among other things, liquidity, price discovery, and volatility. Despite the size and complexity of persons that the SEC believes will be covered by the Proposed Rules, it estimates a mere $600,000 of costs to initially register with the Commission and $265,000 of annual costs thereafter, which seems to assume very simple and small organizations seeking to register.[50]

Also, the incremental benefits of such regulations, especially for the firms already registered as investment advisers and transacting with or through registered broker-dealers, may well be minimal, as reflected in the SEC's own cost-benefit analysis. Instead, this analysis suggests the SEC's broader concern is with capturing wholly unregulated proprietary trading firms, and ensuring such firms cannot restructure their business to avoid registration. Even if not intended, however, the impact on investment management firms is likely to be significant, particularly because the Proposal leaves unanswered exactly how these firms could or should restructure to comply, or who could or should bear the costs of their compliance.

Furthermore, market participants are likely to have questions about the scope of the Proposed Rules. While, as noted above, the Proposal establishes irrebuttable qualitative and quantitative standards to identify when a person is acting as a dealer or government securities dealer, certain of those standards are subject to interpretation (*e.g.*, how many purchases and sales constitute trading that is "more frequent than occasional"?).[51] What is more, the Commission's focus on the "effect" of market activity, as opposed to a market participant's "intent" or strategy, is likely to lead to second-guessing and chill legitimate investment or trading strategies (such as arbitrage trading) that contribute to price discovery and liquidity. The SEC provides no quantification of these costs.

This Proposal also follows a number of other Commission proposals that could signal significant changes for securities markets and market participants, including, among others, with respect to the trading of government securities[52] and the regulation of private funds[53] that market participants will need to consider.

Finally, the potential impact of the Proposed Rules on digital asset and decentralized finance ("DeFi") firms and markets is uncertain. With respect to these issues, the Proposal notes only that Proposed Rule 3a5-4 would apply to "any digital asset that is a security or a government security within the meaning of the Exchange Act."[54] Furthermore, it is not clear that registration, to the extent a firm is deemed to be a dealer or government securities dealer pursuant to the Proposed Rules, is compatible with the business models followed by certain firms active in DeFi markets or even with the structure of registered investment advisers.

COMPLIANCE DATE

The Proposal includes a one-year compliance period from the effective date of any final rules with respect to a market participant that is not registered as a dealer or government securities dealer prior to such effective date, but whose activities fall within the scope of the final rules and would be required to register. However, the Proposal does not include a compliance period for market participants whose activities following the effective date of any final rules would require registration—such market participants would need to monitor for compliance with the qualitative and quantitative tests even when unregistered to avoid violations of the rules.[55]

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ENDNOTES

[1] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer (March 28, 2022) (the "Proposal"), *available at* https://www.sec.gov/rules/proposed/2022/34-94524.pdf, at 15.

[2] 15 U.S.C. § 78c(a)(5)(A).

[3] 15 U.S.C. § 78c(a)(5)(B) (emphasis added); *see also* Proposal at 21-22 (detailing the trader exception).

[4] 15 U.S.C. § 78c(a)(44) (general definition); 15 U.S.C. § 78c(a)(44)(a) (trader exception).

[5] Proposal at 20-21, fn. 51.

[6] *See, e.g.*, *United States Savings Ass'n of Texas*, SEC No-Action Letter. 1987 SEC No Act. LEXIS 2021, at *2-*3 (Apr. 12, 1987). The Commission has cited this ten-factor test approvingly in Resale of Restricted Securities: Changes to Method of Determining Holding Period of Restricting Securities Under Rules 144 and 145 (Rule 144A Release), 55 Fed. Reg. 17,933, 17,937 (Apr. 30, 1990).

[7] *Id.* at 3-4 (footnote omitted).

[8] The SEC notes that "existing Commission interpretations and precedent will continue to apply" even if the Proposed Rules are adopted. *Id.* at 32, fn. 87.

[9] Proposal at 114.

[10] *Id.* at 94 (footnote omitted).

[11] *Id.* at 48, fn. 131.

[12] *Id.* at 48-49 (footnote omitted).

[13] *Id.* at 49.

[14] *Id.* (footnote omitted).

[15] *Id.* at 50 (footnote omitted).

[16] *Id.*

[17] *Id.*

[18] *Id.* at 50, fn. 136.

[19] *Id.*

[20] *Id.* at 52. The Proposal notes that securities bearing the same CUSIP would be considered "the same" for purposes of the Proposed Rules.

[21] *Id.* at 53.

[22] *Id.*

[23] *Id.* at 53-54.

[24] *Id.* at 54.

[25] *Id.* at 11.

[26] *Id.* at 56-57. "Trading interest" means "an order, as defined in paragraph (e) of [Rule 300 of Regulation ATS], or any non-firm indication of a willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price." *Id.*

[27] *Id.*

[28] *Id.* at 58.

ENDNOTES (CONTINUED)

[29] *Id.*

[30] The SEC instead cross-references guidance regarding the bona fide market-maker exception from Regulation SHO's locate and close-out requirements. It then goes on to explain that those exceptions "are only available to registered broker-dealers that publish continuous quotations for a specific security in a manner that puts the broker-dealer at economic risk. Broker-dealers that do not publish continuous quotations, or publish quotations that do not subject the broker-dealer to such risk (*e.g.*, quotations that are not publicly accessible, are not near or at the market, or are skewed directionally towards one side of the market), would not be eligible for the bona-fide market-maker exceptions under Regulation SHO. In addition, broker-dealers that publish quotations but fill orders at different prices than those quotes would not be engaged in bona-fide market making for purposes of Regulation SHO." *Id.* at 59, fn. 157. Since the Proposed Rules expressly do not require "quotations" or continuous quotations, it is unclear what guidance this discussion provides, other than to express the Commission's views on Regulation SHO.

[31] *Id.* at 62.

[32] *Id.* at 60.

[33] *Id.*

[34] A "trading venue" means "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." *Id.* at 62-63 (footnote omitted).

[35] *Id.* at 63.

[36] "Government securities" has the meaning provided in Section 3(a)(42)(A) of the Exchange Act. *Id.* at 71. This includes "[s]ecurities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States," including: Treasury bills, notes, floating rate notes, bonds, inflation-protected securities, and Separate Trading of Registered Interest and Principal Securities, but excluding auction awards and repurchase or reverse repurchase transactions in U.S. Treasury securities. *Id.* at 71, fn. 165.

[37] *Id.* at 112.

[38] *Id.* at 74, fn. 171.

[39] 15 U.S.C. § 78c(a)(9) ("The term 'person' means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.").

[40] *Id.* at 35-36. The Commission also notes that this standard "parallel[s] an established standard for distinguishing between 'retail' and 'institutional' investors in other contexts." *Id.* at 35 (footnote omitted).

[41] *Id.* at 37.

[42] *Id.* at 12.

[43] *Id.* at 39. For similar reasons, the Proposed Rules would apply to all "trading venues," including to ATSs and Communication Protocol Systems, since the Rules "are designed to capture dealer activity wherever that activity occurs." *Id.* at 63.

[44] *Id.* at 40.

ENDNOTES (CONTINUED)

[45] The Proposed Rules define "parallel account structure" as "a structure in which one or more private funds (each a 'parallel fund'), accounts, or other pools of assets (each a 'parallel managed account') managed by the same investment adviser pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account." The Proposed Rules assume that participants in parallel accounts will know the universe of parallel accounts and be able to perform, when required, aggregation of positions and trading activity. No authority or other learning is cited to support this assumption.

[46] Exchange Act Rule 13h-1(a)(3) states that "control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise. For purposes of this section only, any person that directly or indirectly has the right to vote or direct the vote of 25% or more of a class of voting securities of an entity or has the power to sell or direct the sale of 25% or more of a class of voting securities of such entity, or in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that entity."

[47] *Id.* at 80.

[48] *Id.* at 87. The Commission further notes that "[i]n particular, a person must consider for aggregation purposes any accounts (including those under $50 million) that are controlled by, or under common control with, that person. The Commission believes that requiring aggregation of accounts of those persons that have or control less than $50 million in total assets would prevent the organizing of corporate structures for the purpose of avoiding dealer registration." *Id.* The proposal also provides several examples to illustrate the application of the Proposed Rules' "own account" and "control" definitions. *Id.* at 87-90.

[49] *Id.* at 86.

[50] *Id.* at 135. The SEC also estimates OATS reporting costs of $849,000 to $7,231,000 and costs of CAT reporting at $443,000 to $4,756,000. *Id.* at 137.

[51] *Id.* at 48.

[52] *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 (Jan. 26, 2022), *available at* https://www.sec.gov/news/press-release/2022-10.

[53] *See* Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers (Jan. 26, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-5950.pdf; *see also* SEC Proposes Significant Amendments to Private Fund Reporting (Feb. 1, 2022), *available at* https://www.sullcrom.com/files/upload/sc-publication-SEC-proposes-amendments-private-fund-reporting.pdf.

[54] *Id.* at 15, fn. 36.

[55] *Id.* at 34-35.

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APPENDIX A

EXAMPLES OF "OWN ACCOUNT" AND "CONTROL"

The Commission provided the following examples to illustrate the application of the Proposed Rules' definitions of "own account and control"[1]:

Example 1

- A, B and C are under common control; all are controlled by D. A, B, C, and D are all limited liability companies. None of the firms are registered brokers, dealers, government securities dealers, or registered investment companies.
  - Aggregation by Parent D
    - D would aggregate the trading activities and volume of A, B, C and D to determine if D would be captured by paragraph (a) of the Proposed Rules. If as a result of this aggregation, D meets the quantitative or qualitative standards of (a), and it has or controls more than $50 million in total assets, it would be captured by the Proposed Rules.
  - Aggregation by D's Subsidiaries
    - A, B, and C would also need to aggregate each other's trading activities and volume to determine if they would individually be captured by the qualitative or quantitative standards of paragraph (a) of the Proposed Rules. If, as a result of aggregation A, B, and C each meet the qualitative or quantitative standards of (a), but A has or owns less than $50 million in total assets, A would be excluded from the Proposed Rules under paragraph (a). A's activities and volume, however, would still be considered for purposes of B, C, and D.
    - If B registers as a dealer, its trading activities and volume would no longer be considered by A, C, or D.

Example 2

- A is a registered investment adviser with clients B, C, D, E, F and G. A has an investment advisory contract with each of B and C under which A exercises investment discretion with respect to B's and C's assets each in an account separately managed by A. D and E are hedge funds. A is the general partner of both D and E, and controls D and E as a result of its capital contributions to and rights to amounts upon dissolution of each fund. F and G are also hedge funds. A has an investment advisory contract with each of F and G under which A exercises investment discretion with respect to F's and G's assets. F and G pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions. Neither A nor any of its clients is a registered broker, dealer, government securities dealer, or registered investment company.
  - Aggregation by A
    - A would not need to aggregate its trading activities with the trading activities of B, C, F or G unless A controls B, C, F or G as a result of the right to vote or direct the vote of the voting securities issued by these clients, the right to sell or direct the sale of the voting securities issued by these clients, or the amount of capital contributions to or rights to amounts upon these clients' dissolution.
    - A would need to aggregate its trading activities with the trading activities of both D and E because A has control over each fund as a result of its capital contributions to and rights to amounts upon dissolution of each fund.

- Aggregation by A's Clients
  - B and C would not need to aggregate their trading activities even if B and C were determined to be under common control (which would be a facts and circumstances determination), because common control would be solely because both are clients of A.
  - D and E would need to aggregate their trading activities because they are under common control of A, which has the right to direct the vote of the voting securities of each fund and the right to capital contributions upon dissolution of the fund and not solely because each fund is a client of A.
  - Each of F and G would need to aggregate the trading activities of the other fund. F and G's activities would constitute a parallel account structure (even if they are under common control solely because both F and G are clients of A) because F and G are managed by the same investment adviser, pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account.

ENDNOTES

[1] *Id.* at 87-90.