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Alert | Financial Regulatory & Compliance

February 2024

SEC Expands Dealer Registration Requirements

On Feb. 6, 2024, the U.S. Securities and Exchange Commission (SEC) adopted new Rules 3a5-44 and 3a44-2 (the final rules) under the Securities Exchange Act of 1934 (the Exchange Act), which require market participants engaging in certain dealer roles to register with the SEC, become members of a self-regulatory organization (SRO), and comply with federal securities laws and regulatory obligations. By broadening the definition of what the SEC considers a securities dealer, the final rules capture market participants with active large-scale trading operations, including hedge funds and principal trading firms.

Section 3(a)(5) of the Exchange Act defines the term "dealer" as "any person engaged in the business of buying and selling securities…for such person's own account." Excluded from this definition is any 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"—a statutory exclusion often referred to as the "trader" exception.

Absent an exception or exemption, "dealers" must register with the SEC, become members of a self-regulatory organization such as FINRA, and comply with federal securities laws, regulatory obligations, and applicable SRO and Treasury rules and requirements, such as rules regarding financial responsibility, risk management, transaction reporting, and operational integrity.

The final rules narrow the "trader" exception by expanding upon the phrase "as part of a regular business" via the establishment of qualitative standards that identify activities in connection with significant liquidity-providing roles that would cause persons engaging in such activities to be "dealers" or

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"government securities dealers," and therefore subject to the registration requirements of Sections 15 and 15C of the Exchange Act.

The final rules state that a person buying and selling securities for their own account is engaged in such activity "as part of a regular business" if that person engages in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants by:

- 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
- 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.

Excluded from the final rules are (i) any persons who have or control assets under $50 million, (ii) registered investment companies (e.g., mutual funds and exchange-traded funds), and (iii) central banks, sovereign entities, or international financial institutions. The final rules make it clear there will be no presumption that a person is not a dealer or government securities dealer solely because that person does not engage in the activities identified as being "part of a regular business" in the final rules. There are also no specific exclusions in the final rules for registered investment advisers or private funds, and the SEC's adopting release notes that certain hedge fund strategies, such as those involving high-frequency trading, could meet the final rules' definition of dealing.

An earlier version of the rules as set forth under a March 2022 SEC proposal would have automatically classified firms that bought or sold over $25 billion in government bonds in four of the preceding six months as securities dealers. This caused considerable consternation among the hedge fund industry, and the SEC ultimately abandoned the $25 billion threshold along with some other contentious parts of the initial proposal, a move that captures significantly fewer firms than it would have otherwise. Even so, an SEC analysis accompanying the final rules found that the new rules could apply to up to 43 firms, including up to 16 private funds, which include hedge funds.[1]

By contrast, private equity funds may not fall within the new definition given they are generally long-only investors that are unlikely to regularly express trading interest on both sides of the market or earn revenue primarily from capturing bid-ask spreads.

The final rules will take effect 60 days after the adopting release is published in the *Federal Register*, with a compliance date one year after the effective date. Given the time required to register as a dealer, market participants should determine whether their activities require them to register as dealers, and, if so, begin the registration process as soon as practicable.

[1] Adopting Release Section III.B.2.c

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