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SEC Expands Dealer Rule To Proprietary Traders, Private Funds

By **Jessica Corso**

Law360 (February 6, 2024, 4:38 PM EST) -- A divided U.S. Securities and Exchange Commission passed a pair of rules Tuesday that now include proprietary trading firms and some hedge funds in its definition of securities dealers, expanding the agency's oversight authority that one dissenting commissioner called "another salvo in the commission's war on private funds."

SEC Chair Gary Gensler was joined by fellow Democratic Commissioners Caroline Crenshaw and Jaime Lizárraga in voting to finalize rules expanding the definition of "dealer" under the Securities Exchange Act of 1934 to include some market participants that operate as liquidity providers while trading in their own accounts.

The two rules primarily target proprietary trading firms but could also draw in some private funds, including hedge funds, requiring them to register as members of the Financial Industry Regulatory Authority and meet certain reporting, recordkeeping and minimum capital requirements.

"I am pleased to support this adoption because it requires that firms that act like dealers register with the commission as dealers, thereby protecting investors as well as promoting market integrity, resiliency, and transparency," Gensler said in a written statement.

Republican Commissioners Hester Peirce and Mark Uyeda, meanwhile, voted against the rules' adoption, with Uyeda calling the regulation "another salvo in the commission's war on private funds."

He pointed to a number of other recent rulemakings targeting the industry, including a regulation aimed at bolstering transparency around fund performance and fees and mitigating conflicts of interest that is currently the subject of a Fifth Circuit lawsuit.

"The commission has not considered the aggregate effects of the various rules proposed and/or adopted for private funds since the proposing release," Uyeda said in prepared remarks. "The lack of such analysis makes the final rules arbitrary and capricious."

Jessica Wachter, the director of the SEC's Division of Economic and Risk Analysis, told the commissioners Tuesday that the agency estimates fewer than 16 private funds will have to register as dealers under the new rules.

Peirce expressed concerns that some sovereign wealth funds and pension funds could be swept up into the rules as well.

The final rules grant an exemption for central banks, sovereign entities and international financial institutions. The SEC said in the text of the rules that pension funds should not be captured under the new "securities dealer" definition despite not being given an explicit exclusion.

Following Tuesday's meeting, Morrison Foerster LLP attorney Val Dahiya told Law360 some uncertainty remains as to just which entities will be required to register under the new rules. Whether a lawsuit follows from the vote held Monday could depend on how aggressively the SEC interprets the new definition, she said.

"That's a certain segment of market participants that the SEC wasn't necessarily intending to capture, but you could unintentionally capture those kinds of entities," Dahiya, a former SEC and FINRA employee, said.

There will probably be a number of discussions over the coming months between SEC staff and market participants about potential gray areas in the rules, she added.

Ignacio Sandoval of Morgan Lewis & Bockius LLP said the industry is still digesting the new rules, and it's difficult to tell at the moment whether litigation will follow. He told Law360 that there were some modifications to the final rules that could come as a relief to industry participants who pushed back on the initial proposal.

One major change is the SEC dropped a proposed requirement that said anyone trading in more than $25 billion in government securities in four out of the most recent six months would be required to register as a dealer.

Sandoval said the dollar figure was "just an arbitrary number" that threatened to sweep up market participants whose activity wouldn't otherwise constitute dealing.

In agreeing to drop the volume requirement, the SEC agreed that the proposed $25 billion threshold could sweep in nondealing investors like those who take large long positions in treasuries and hold them to maturity.

"I think there is a measure of relief" for industry participants, Sandoval said, particularly since the adopted rules appear to narrow their focus largely to proprietary trading firms.

But he said there was still concern about whether the rules erode the traditional distinction between dealers and traders, who traditionally do not have customers.

Supporters of the regulations, including the Wall Street reform advocacy organization Better Markets, said the SEC was reacting to the growth in the kind of high-frequency trading that can lead to large market price swings and even, potentially, crashes.

"High-frequency trading firms played a significant role in both the 2010 flash crash in the U.S. equities market and the 2014 flash crash in the U.S. Treasury market," Better Markets' Director of Securities Policy Benjamin Schiffrin said in a statement.

"Yet despite the volume of trading represented by high-frequency trading firms, many are not registered as a dealer or government securities dealer," Schiffrin said.

In a statement Tuesday, Gensler said he saw the impact of regulatory gaps in dealer registration firsthand at the beginning of his Wall Street career in the 1980s, when a number of firms in the treasury markets began collapsing.

That wave of firm failures led to the passage of a law that brought broker-dealers in the treasury securities market under the SEC's purview and, today, proprietary trading firms represent over half of the volume on interdealer broker treasury markets, Gensler said.

"In essence, these [proprietary trading firms] and other firms are acting in a manner consistent with dealers in the securities markets," he said, adding that not requiring them to register as dealers "deprives investors and the markets themselves of important protections — protections that benefit market integrity, resiliency, transparency, and more."

--Editing by Lakshna Mehta.

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