SULLIVAN & CROMWELL LLP

s&c memo

March 1, 2024

SEC Redefines “Dealer” to Expand Registration Requirements

Though Narrower than Proposed, the Rules Remain Broad and Raise Many Significant Questions and Issues for the Market

SUMMARY

On February 6, 2024, the Securities and Exchange Commission (the “SEC” or “Commission”) voted 3-2 (with Commissioners Peirce and Uyeda dissenting) to adopt Rules 3a5-4 and 3a44-2 (together, the “Final Rules”) requiring certain liquidity providers to register as dealers or government securities dealers under the Securities Exchange Act of 1934 (the “Exchange Act”).[1] Although narrower than initially proposed, the Final Rules remain broad, and outstanding questions remain regarding their scope and potentially adverse effect on market liquidity.

The Final Rules include two new qualitative standards for determining whether an entity must register as a dealer or government securities dealer. 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 through either of two activities. The Final Rules specify that a person’s pattern of providing liquidity will be covered if the person either:

(1) regularly expresses trading interest that is (a) at or near the best available prices on both sides of the market for the same security and (b) communicated and represented in a way that makes it accessible to other market participants (the “Expressing Trading Interest Factor”); or

(2) earns 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 “Primary Revenue Factor”).

The registration requirement under the Final Rules is triggered by a single activity—providing liquidity—in a marked change from Commission staff's historic approach based on traditional dealer activities (*e.g.*, 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).[2]

The Commission articulates its approach as rooted in a single type of dealer activity—*de facto* market making—that it previously identified in a 2002 release.[3] But in so doing, the Commission does not address how the Final Rules are consistent with prior articulations of market making, except in one instance to reject commenters' requests to modify the rules to be consistent with one of those prior articulations (the *bona fide* market making concept in Regulation SHO). The Commission also focuses solely on the *effect* of a person's trading, regardless of intent.

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. However, the Final Rules make clear that the elimination of these standards does not mean that the conduct that would have been captured by them is not dealing activity in the Commission's view.

The Final Rules also narrow the proposed definition of "own account," such that, subject to a new anti-evasion provision, the Final Rules apply on an entity-by-entity basis rather than aggregating accounts across entities that are controlled by or are under common control with an entity. However, the scope and effect of the anti-evasion provision remains unclear.

The Final Rules will be effective April 29, 2024. The compliance date is April 29, 2025 for all persons who engage in activities that will require registration under the Final Rules.

KEY TAKEAWAYS

- ***Final Rules Shift Analysis to Focus Solely on Providing Liquidity to the Market*:** Although the Final Rules are narrower than the Proposed Rules in certain significant respects, we expect that the Final Rules will continue to cause concern for market participants. The Final Rules mark a shift in the SEC's focus to providing liquidity to the market, rather than on the historical multi-factor facts-and-circumstances test and regardless of a trader's intent. In this regard, the Final Rules will capture liquidity-providing firms that have not previously been considered or viewed by market participants to be dealers. This is particularly concerning since the Commission reiterated that "otherwise applicable court precedent and Commission interpretations will continue to apply," without specifying which precedents or interpretations; the Commission also indicates that it intends to withdraw various staff letters, but it does not state which ones. As Commissioner Uyeda noted

in dissent, the ultimate effect of the Final Rules and associated guidance could be to make the dealer category "practically limitless."

- ***Final Rules Do Not Resolve Conflicts Between Regulatory Requirements Applicable to Broker-Dealers and Investment Advisers and Private Funds:*** The Final Rules impose certain broker-dealer regulatory requirements, such as net capital requirements and customer protection regulations, that commenters expressed were "inappropriate and untenable" for entities such as private funds that do not have the types of customers intended to be protected by the broker-dealer regulatory regime. The Commission also rejected commenters' view that the Exchange Act dealer and government securities dealer definitions implicitly require that a dealer have customers, citing to certain Exchange Act rules (such as provisions of the broker-dealer net capital rule) that presuppose there are dealers without customers, as well as citing to the Commission's rulemaking further defining the term "security-based swap dealer." The Commission did not, however, address the inconsistencies between the Final Rules' new tests and the precedents it cited, which still presuppose publication of quotations or other indicia of a person holding itself out as a market maker or dealer that the Final Rules do not require.
- ***The Scope of Final Rules Is Unclear:*** There are also significant open questions regarding the scope of the Final Rules, which could ultimately reduce market liquidity and increase costs for firms and investors. For example, the qualitative standards adopted by the Commission turn on ambiguous terms such as "regularly" and "primarily," which the Commission declined to clarify with the level of precision requested by commenters. Also, the anti-evasion provision and the Commission's corresponding guidance could cause significant confusion regarding whether trading by affiliates needs to be aggregated.
- ***The Number of Affected Entities Required to Register Is Unclear:*** The Commission estimates that 31 non-broker-dealer firms would be required to register by the Final Rules (including 13 to 22 proprietary trading firms and four to 12 hedge funds). But this estimate covered only the Primary Revenue Factor—not the Expressing Trading Interest Factor—and was generally limited to the Treasury securities market (*i.e.*, it did not meaningfully address the equities options, or other fixed-income markets). Also, the Commission did not estimate the number of firms that will need to expend significant resources to monitor for compliance with the Final Rules. Nor did the Commission's economic analysis adequately consider the potential adverse effects to market liquidity and costs if certain firms pull back from certain securities markets to avoid the significant burdens of dealer registration.

BACKGROUND

Market participants whose securities activities fall within the definition of "dealer" or "government securities dealer" under the Exchange Act must register with the SEC and comply with the SEC's extensive dealer regulations. 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," but excludes—pursuant to 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*." A parallel definition exists for the definition of "government securities dealer" under Section 3(a)(44) of the Exchange Act.

On March 28, 2022, the Commission proposed Rules 3a5-4 and 3a44-2 (together, the "Proposed Rules"), which outlined three qualitative tests for registration as a dealer or government securities dealer, one

quantitative test for registration as a government securities dealer, and an expansive definition of "own account" that would have aggregated activities across entities.[4] As discussed in our previous memorandum on this topic, the Proposed Rules marked a notable change from the Commission's historical facts-and-circumstances approach to determining whether the totality of the circumstances of a person's activities required registration as a dealer.[5] By contrast, the Proposed Rules would have captured activities that "ha[ve] the effect of providing liquidity to other market participants."

In response to comments, and as noted above, the Commission narrowed the scope of the Final Rules. Specifically, the SEC (1) did not adopt one of the three proposed qualitative tests for dealer and government securities dealer registration or the quantitative test for government securities dealer registration and (2) included a narrower definition of "own account," coupled with an anti-evasion provision. However, the Commission rejected calls to narrow the Final Rules further by, among other things, excluding private funds, investment advisers and crypto asset security trading.

FINAL RULE

Qualitative Standards

The Final Rules include two qualitative standards for determining whether a person must register as a dealer or government securities dealer: the Expressing Trading Interest Factor and the Primary Revenue Factor. In the release accompanying the Proposed Rules, the Commission included a somewhat circular passage attempting to make a distinction between providing liquidity versus taking it as justification for the proposed qualitative standards:

> While all market participants who buy or sell securities in the marketplace arguably contribute to a market's liquidity, the Proposed Rules focus on market participants who engage in a routine pattern of buying and selling securities for their own account that has the effect of providing liquidity. Said differently, for market participants engaging in any of the activities identified by the qualitative standards of the Proposed Rules, liquidity provision is not incidental to their trading activities. Rather, these persons are 'in the business' of buying and selling securities for their own account and providing liquidity as part of a regular business. The Proposed Rules would set forth three standards that the Commission believes would appropriately distinguish and identify such liquidity provision as a "regular business."[6]

Expressing Trading Interest Factor

The Commission provided gloss on key terms used within the Expressing Trading Interest Factor:

Regularly

In response to commenter concerns, the Final Rules use "regularly" rather than "routinely" in the Expressing Trading Interest Factor. "Regularly" applies to a person's expression of trading interest both within a trading

day and over time, but is intended to distinguish between persons engaging in "isolated or sporadic expressions of trading interest" from those whose trading activity demonstrates that they are dealers. However, the Commission noted that a person does not need to be "continuously expressing" trading interest to be a dealer.

In contrast, to be a market maker for purposes of Rule 144, the dealer must have submitted bona fide quotations for at least 12 trading days in the last 30 days (for an inter-dealer quotation system) or 12 continuous trading days (for an alternative trading system). The Commission did not adopt this kind of formula. Similarly, the Final Rules did not discuss or include reference to the definition of "market maker" from Rule 15c3-1(c)(8), which means "a dealer who, with respect to a particular security, (i) regularly publishes bona fide, competitive bid and offer quotations in a recognized interdealer quotation system or (ii) furnishes bona fide competitive bid and offer quotations on request; and (iii) is ready, willing and able to effect transactions in reasonable quantities at his quoted prices with other brokers or dealers."[7] The Commission also expressly declined to adopt the test for bona fide market making as defined in Regulation SHO, despite commenters' observations that they found it clearer than the standards in the Proposed Rules.[8]

Instead, the Commission explained that whether trading activity was "regular" will depend on the liquidity and depth of the relevant market for a security. In more liquid markets, expressing trading interest on both sides of the market for a security on a one-off basis would not be sufficient; instead more frequent periods of expressing trading interest on both sides of the market both intraday and across days would be required "given the efficiency in which securities can be bought and sold and the market's ability to absorb orders without significantly impacting the price of the security." In less liquid markets, the term "regular" would "account for the possibility of more interruptions or wider spreads for the best available prices."

According to the Commission, "market participants that have established themselves as significant market intermediaries—and critical sources of liquidity—in a market by employing automated, algorithmic trading strategies that rely on high frequency trading strategies to generate a large volume of orders and transactions would be captured by the expressing trading interest factor." According to the Commission, this group of market participants include those that employ passive market-making strategies involving the submission of non-marketable resting orders (bids and offers) that provide liquidity to the marketplace at specified prices.

Trading Interest

The Final Rules define "trading interest" broadly to mean: (i) an "order" as the term is defined under SEC Rule 3b-16 (that is, "any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order"); or (ii) any non-firm

indication of a willingness to buy or sell a security that identifies the security and at least one of the following: quantity, direction (buy or sell), or price.[9]

The Commission emphasized that the Expressing Trading Interest Factor is meant to "update the Commission's longstanding understanding that regular or continuous 'quotation' is a hallmark of market making or *de facto* market making (and, hence, dealer) activity" to reflect new technological developments in the ways that firms communicate interest. Thus, the definition is intended to capture the traditional quoting engaged in by dealer liquidity providers, new and developing quoting equivalents, and the orders that actually result in the provision of liquidity. In other words, "[t]o be captured by the expressing trading interest factor depends less on the method used to communicate trading interest, and more on whether the person is expressing trading interest on both sides of the market for the same security that has the effect of providing liquidity in the same security to other market participants." Trading interest includes, but is not limited to, firm two-sided quotations, streaming quotes, request for quotes ("RFQs") and order books. With respect to RFQs, however, the Commission stated that a market participant seeking price information by requesting quotes on a security, without including prices, on both sides of the market would generally not satisfy the Expressing Trading Interest Factor because that trading interest, absent more, would not be "at or near the best available price."[10]

In response to commenters' concerns that this factor could capture investment advisers whose fiduciary duties may require them to submit trading interests throughout a trading day, the Commission stated that the revisions to the "own account" definition (discussed below) should alleviate such concerns. In this regard, the Commission noted that the trading interest expressed by investment advisers for purposes of their fiduciary duty to their clients and their clients' accounts, such as when investment advisers place orders or request quotations on behalf of their clients, would not be activity captured by the Expressing Trading Interest Factor, unless the investment adviser itself is the account holder or the account is held for the benefit of the investment adviser. The Commission's statements seem focused on potential registration consequences for the adviser itself but do not grapple with the consequences for the adviser's clients, such as private funds, which the Commission later confirms could be captured by the Final Rule.

Further, in response to comments regarding how "trading interests" applies to decentralized finance ("DeFi") markets, the SEC stated that it is not excluding any particular type of securities from the Final Rules and that whether a particular activity in the crypto asset securities market, including in the DeFi market, gives rise to dealer activity requires an analysis of the totality of the particular circumstances against all elements of the Expressing Trading Interest Factor. Thus, according to the Commission, persons using automated market makers in crypto asset markets could be dealers under the Final Rules.

Both Sides of the Market

The Final Rules specify that, in order to come within the Expressing Trading Interest Factor, trading interests must be expressed on both sides of the market for the same security. The Commission declined to adopt a requirement, consistent with many market participants' understanding, that such trading interest be expressed simultaneously on both sides of the market in order to count as dealer activity. While simultaneously expressing trading interest on both sides of the market in the same security "is indicative of dealer activity," according to the Commission market participants also can be acting as dealers by regularly providing liquidity even where the expressions of trading interest on both sides of the market for the same security are not simultaneous, because the markets for different securities have varying structures, trading volume and liquidity. The Commission also expressed concern that "adding a simultaneity condition could lead to behavior where a dealer might, for example, express trading interest to buy and sell in alternate moments in time to evade the requirement to register;" but the Commission did not explain why its anti-evasion prohibition (discussed below) would not adequately address that concern.

Thus, according to the Commission, market participants will need to analyze whether their trading activity on both sides of the market is "sufficiently close in time to have the effect of providing liquidity in the same security." In this regard, the Commission indicates that private equity funds and liquidity funds are "unlikely" to be captured by the Final Rules because "they are generally long-only investors that are not likely to regularly communicate trading interests on both sides of the market or earn revenue primarily from capturing bid-ask spreads."

Accessible to Other Market Participants

According to the Commission, the phrase "accessible to other market participants" reflects the plain meaning that a person expresses trading interests to more than one market participant. For example, where a person makes a trading interest available (such as streaming two-way indicative quotes) to more than one market participant, even if the person made that trading interest available through individual communications, that person would be expressing trading interest accessible to other market participants. By contrast, when an investor seeking liquidity sends a single, one-sided RFQ to a number of potential liquidity providers, the Commission stated that this action by itself does not generally trigger the Expressing Trading Interest Factor because it is on one side of the market in an isolated instance.

Primary Revenue Factor

The Final Rules adopt the Primary Revenue Factor as proposed. The Commission declined commenters' suggestions to base this factor on profit rather than revenue on the basis that dealer status requires only that a person be "in the business," not that that business be profitable. The Commission also declined to limit "trading venues" to national securities exchanges and alternative trading systems ("ATSs"), stating that

the term is designed to capture current trading venues that use a variety of technologies, as well as trading venues that use technologies and venues that may develop over time.

While the Commission refused to adopt a bright-line rule on what percentage of revenue would be "primary," it expressed the view that a person who derived a majority of its revenue from capturing bid-ask spreads or trading incentives would "likely" be in the regular business of buying and selling securities or government securities for its own account. By contrast, the Commission stated that "it is unlikely that a person who regularly earns more revenue from an appreciation in the value of its inventory of securities than from capturing bid-ask spreads or incentive payment for liquidity provision, would be considered to earn revenue 'primarily' from capturing bid-ask spreads or trading incentives."

However, the Commission did not address the period of time over which a person should assess whether it triggers this factor (*e.g.*, annual revenue? quarterly? monthly?). Nor did the Commission clearly explain what it means by "bid-ask spread," given that all trading in some sense involves buying at someone's bid and selling at someone's offer. The release accompanying the Proposed Rules had suggested that this concept included "buying at a lower price than, and selling at a higher price than, the midpoint of the bid-ask spread," but this language does not appear in the Final Rules.

No Presumption against Dealer Status

The Final Rules include a provision providing that no presumption will arise that a person is not a dealer or government securities dealer solely because that person does not satisfy the qualitative tests set forth above. Instead, the tests are non-exclusive ways in which a person could be determined to be engaged in dealer activity—existing court precedent and Commission interpretations also will continue to apply.

Exclusions

The Commission adopted as proposed exclusions for:

(1) a person that has or controls assets of less than $50 million and
(2) an investment company registered under the Investment Company Act of 1940.

The Final Rules also incorporated an "official sector exclusion," which excludes from the Final Rules central banks, sovereign entities and international financial institutions.[11]

The Commission declined to add an express exclusion for private funds or registered investment advisers. "Depending on the totality of the facts," the Commission responded, "a private fund may be engaged in the business of buying and selling securities for its own account." Similarly, according to the Commission, "a registered investment adviser that is trading for its 'own account' could nevertheless meet the definition of a 'dealer' and therefore should be required to register." The Commission was not convinced by commenters who stated that registered investment advisers and private funds are subject to appropriate regulatory and

disclosure frameworks, such that dealer registration and regulation is unnecessary. In particular, the Commission expressed the view that persons who engage in a pattern of trading for their own account having the effect of providing liquidity to other market participants, including through portfolio management and trading strategies that may seek to take advantage of pricing differentials in bid-ask spreads, could be engaged in dealer activity. However, the Commission asserted that the changes to the "own account" definition (discussed below) are responsive to concerns related to separately managed accounts and investment advisers trading on behalf of their clients, including those exercising discretion—"these investment advisers generally will not be captured by the [F]inal [R]ules because they would not be buying and selling for their 'own account.'" Taking the Commission's statements together, it seems that an adviser itself may not trigger registration under the Final Rule, but the funds and other clients on whose behalf it trades could trigger registration.

Aggregation and Anti-Evasion

One of the most contentious elements of the Proposed Rules was its broad definition of a person's "own account," which would have meant any account that is "held in the name of that person," or "held in the name of a person over whom that person exercises control or with whom that person is under common control," or "held for the benefit of those persons," subject to certain exclusions. In response to comments,[12] the Commission abandoned the proposed aggregation approach by narrowing the "own account" definition (and removing the proposed definitions of "control" and "parallel account structure") and, instead, incorporated an anti-evasion provision.

The Final Rules define "own account" to mean: any account: (i) held in the name of that person; or (ii) held for the benefit of that person. In this regard, the Commission states that it has determined to focus in the first instance on an analysis of activity on an entity-by-entity basis, rather than aggregating accounts across entities that are controlled by or are under common control with an entity.

To address concerns that persons may seek to structure their business for the purpose of evading dealer registration, the Commission included an anti-evasion provision in the Final Rules. The anti-evasion provision specifically provides that no person shall evade the registration requirements of this section of the Final Rules by either:

- engaging in activities indirectly that would satisfy the qualitative tests ("First Anti-Evasion Prong"); or
- "disaggregating accounts" ("Second Anti-Evasion Prong").

According to the Adopting Release, the First Anti-Evasion Prong makes clear that persons are prohibited from evading the dealer registration requirements under the Final Rules by, among other things, using another person or entity to indirectly engage in activity that would meet the qualitative standard.

For purposes of this Second Anti-Evasion Prong, "disaggregate" means separating or breaking up accounts for the purpose of evading the dealer registration requirements. According to the Adopting Release, this prong is intended to address persons who seek to evade the requirements of the Final Rules—not by reducing or changing their activity to avoid triggering the Final Rules—but by spreading the activity across entities or accounts such that the level of activity is the same, with no real change with respect to liquidity provision. The Second Anti-Evasion Prong thus is intended to address market participants who disaggregate their existing business for the purpose of evading the Final Rules, but not to encompass the ordinary course business activities of persons who have no such intent or purpose. For instance, the Commission states that it would generally consider management by a registered investment adviser of separately owned client accounts that follow substantially the same investment objectives and strategies to be ordinary course business activities, and so would not impute the trading in the clients' accounts to the adviser's "own account," absent intent to evade the dealer registration requirements.

The Adopting Release also provides examples of potentially evasive activity:

- coordinating and integrating trading across commonly controlled groups of legal entities such that it would not meet the qualitative tests, including by switching which legal entity is engaged in trading to evade the "regular" requirement of the qualitative standard;
- using two legal entities to separately purchase and sell securities; or
- using several legal entities to purchase and sell securities, but rotating the activity across or among entities in a way that none of the legal entities trades frequently enough to satisfy the "regular" test under either qualitative factor.

In determining whether a person is evading the dealer registration requirements in violation of the anti-evasion provision, the Commission may consider, for example:

- whether there are: (i) information barriers to prevent sharing of information or sufficiently segregate trading, (ii) overlapping personnel across accounts or entities, or (iii) separate account statements for each account;
- the identification of personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, that do not have authority to execute trades or pre-approve trading decisions for accounts or entities;
- a business purpose that demonstrates that there is no coordinated buying and selling between accounts or entities.

With respect to trading conducted through separate legal entities, there appear to be some broad principles that can be derived from this discussion by the Commission:

- separate accounts that comply with the separate account requirement of Rule 105 of Regulation M should not be subject to aggregation;
- aggregation units used for purposes of Regulation SHO should not be subject to aggregation; and

- business units separated by information barriers designed to accomplish disaggregation of positions for purposes of Section 13(d) and Section 16 of the Exchange Act should not be subject to aggregation.

Outside of these general principles, aggregation will require a facts-and-circumstances analysis.

Compliance Date

The Final Rules include a one-year compliance period from April 29, 2024 for all persons who engage in activities that meet the dealer registration requirements under the Final Rules. The Commission emphasized, however, that the one-year compliance period only applies to market participants who are engaging in activities covered by the Final Rules prior to the compliance date, and does not apply to persons whose activities otherwise satisfy the definition of dealer under applicable Commission interpretations and court precedent.

Next Steps

Firms engaged in frequent trading activities on both sides of the market should promptly assess their trading under the Final Rules. This assessment could include analyses of:

- the source of revenues and the percentage of revenue derived from each source;
- how, and how often, trading intent is communicated to market participants;
- whether trading interest is expressed on both sides of the market (*i.e.*, both buys and sells);
- how often trades are executed on both sides of the market;
- whether the trading interest expressed can be viewed as providing liquidity, rather than taking liquidity;
- whether trading authority is coordinated across business units, desks or affiliates; and
- whether the types of markets where trading interest is expressed on both sides are liquid markets or illiquid markets.

The Commission did not include a time period within the Final Rules that market participants should use to analyze their trading activity. Thus, it would appear to be prudent to analyze trading activity over both short—*i.e.*, one-month—and long—three- to six-month—periods.

If an entity concludes that it must register as a dealer with the Commission as a result of the Final Rules, the entity should keep in mind that FINRA rules provide for a 180-day review period for dealer registration applications. While FINRA has indicated that it will take steps to expedite the processing of applications, new registrants will have an array of policies, procedures and systems that need to be implemented before FINRA will approve an application. Thus, waiting until the end of 2024 to make a determination on the need to register with the Commission may not leave enough time to adopt and implement the new policies, procedures and systems that will be needed before the application is approved. We would also expect that

an entity registering with the Commission will need to hire new regulatory compliance and regulatory reporting personnel in order to meet the obligations under the Commission's rules and regulations.

*   *   *

Copyright © Sullivan & Cromwell LLP 2024

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), 89 Fed. Reg. 14,938 (Feb. 29, 2024), *available at* https://www.sec.gov/files/rules/final/2024/34-99477.pdf ("Adopting Release"); *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.

2 *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.").

3 Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, SEC Release No. 34-46745 (Oct. 30, 2002), 67 Fed. Reg. 67,496, 67,498–500 (Nov. 5, 2002) ("A person generally may satisfy the definition, and therefore, be acting as a dealer in the securities markets by conducting various activities: (1) underwriting; (2) acting as a market maker or specialist on an organized exchange or trading system; (3) acting as a de facto market maker whereby market professionals or the public look to the firm for liquidity; or (4) buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment advice, extending credit and lending securities in connection with transactions in securities, and carrying a securities account. These principles demonstrate that the analysis of whether a person meets the definition of a dealer depends upon all of the relevant facts and circumstances.").

4 *See* 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.

5 Adopting Release, at 9. The SEC had previously favorably referenced a "10-factor" test for determining when registration as a government securities dealer was required. *See* 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 (citing approvingly the ten-factor test as articulated in *United States Savings Ass'n of Texas*, SEC No-Action Letter, 1987 SEC No Act. LEXIS 2021, at *2-3 (Apr. 12, 1987)).

6 The Commission made similar assertions in the Adopting Release. *See, e.g.*, Adopting Release at 25 ("The [F]inal [R]ules are thus intended to reflect the longstanding distinction between so-called 'traders'—whose liquidity provision is only incidental to their trading activities—and persons who

are 'in the business' of providing liquidity as part of a 'regular business,' and so are 'dealers' and 'government securities dealers' under the Exchange Act.").

[7] *See* 17 C.F.R. § 240.15c3-1(c)(8).

[8] *See* 17 C.F.R. § 242.203(c)(1) (defining "market making" by reference to the definition in Section 3(a)(38) of the Exchange Act, which includes "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioners, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis"). In the administrative materials for Regulation SHO, the Commission has further provided examples of activities that do or do not constitute "bona-fide market making activities." *See, e.g.*, Exchange Act Release No. 34-50103, 69 Fed. Reg. 48,008, 48015 (Aug. 6, 2004); Exchange Act Release No. 58775, 73 Fed. Reg. 61,690, 61,698-99 (Oct. 17, 2008). However, the Commission declined to refer to these standards as part of the Final Rules. Adopting Release at 30 n.76.

[9] The Commission has separately proposed to amend Rule 3b-16 and to redefine "trading interest" to mean "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." *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/files/rules/proposed/2022/34-94062.pdf. The Final Rules do not discuss the potential interplay with this proposed rule, or the fact that this language is almost identical to the second prong of "trading interest" under the Final Rules.

[10] However, later in the Adopting Release the Commission suggested that non-firm trading interest could be captured by this test, stating, "it will be possible to assess whether a non-firm trading interest is actually 'at or near the best available price,' using the similar information that market participants use to make bids and offers, including recently completed purchases and sales and the totality of indications of willingness to buy or sell at specified prices. For example, market participants can use similar information to that used by registered broker-dealers to assess whether a customer order was executed at the best available price." Adopting Release at 47-48.

[11] The following entities are specifically identified as an "international financial institution" under the Final Rules: (1) African Development Bank; (2) African Development Fund; (3) Asian Development Bank; (4) Banco Centroamericano de Integración Económica; (5) Bank for Economic Cooperation and Development in the Middle East and North Africa; (6) Caribbean Development Bank; (7) Corporación Andina de Fomento; (8) Council of Europe Development Bank; (9) European Bank for Reconstruction and Development; (10) European Investment Bank; (11) European Investment Fund; (12) European Stability Mechanism; (13) Inter-American Development Bank; (14) Inter-American Investment Corporation; (15) International Bank for Reconstruction and Development; (16) International Development Association; (17) International Finance Corporation; (18) International Monetary Fund; (19) Islamic Development Bank; (20) Multilateral Investment Guarantee Agency; (21) Nordic Investment Bank; (22) North American Development Bank. The term also includes any other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member.

[12] It is not clear why the Commission believes its decision not to adopt its proposed aggregation requirement actually addresses the full range of comments it cites. For example, commenters also raised concerns about aggregation of trading by independent portfolio managers within a single fund, as well as concerns about the treatment of inter-affiliate transactions.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.