



Morgan Lewis

**ADVANCED TOPICS IN  
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# Broker-Dealer Issues

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# SEC's New "Dealer" Rules

- In February 2024 the SEC adopted new rules that supplement the definitions of "dealer" and "government securities dealer" by further defining what it means to be "engaged in the business" of dealing in securities and government securities.
- The compliance date for the new rules is **April 29, 2025**.
- The new rules significantly broaden the scope of the dealer definition and upend the longstanding "dealer-trader" distinction that many firms have relied on to trade without triggering dealer status.
- Funds should evaluate whether they fall within the new rules and need to register with the SEC and FINRA.

# Broader Context: Dealer Definition

- Exchange Act § 3(a)(5) defines “dealer” to mean:



“any person ***engaged in the business*** of buying ***and*** selling securities ... for such person’s own account through a broker or otherwise” but excludes “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.***”

- Primary factor: engaged in trading as a business
  - So-called “dealer-trader distinction” as the historic analytical framework

# Dealer-Trader Distinction

## Dealer “engaged in the business”

- Regular clientele
- Hold themselves out as willing to buy and sell securities at a regular place of business
- Have a regular turnover of inventory (or participate in the distribution of new issues)
- Transact a substantial portion of their business with investors (or, in the case of dealers who are market makers, principally trade with other professionals)
- Acting as an underwriter in the distribution of new issues
- Acting as a market maker or specialist on an organized exchange or trading system
- Acting as a de facto or OTC market maker whereby market professionals or the public look to the person for liquidity
- Buying and selling securities directly to customers with an assortment of professional market activities, such as providing investment advice, extending credit, lending securities in connection with transactions, and carrying a customer’s securities account

## Trader

- Less regular volume
- Not handling other people’s money or securities
- Not making a market in securities
- Not furnishing dealer-type services (investment advice, credit extension, securities lending)

# The New Rules – Two Tests

- The new rules establish “trading interest” and “primary revenue” tests:

“Engages in a **regular pattern of buying and selling** securities that **has the effect of providing liquidity** to other market participants by:

- (1) **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
- (2) **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.”

- An entity that meets either test is deemed a dealer regardless of whether any other traditional indicators of dealer status are present.
- Narrow exclusions **from the rules** for registered investment companies, small firms (<\$50 million), sovereigns, central banks, and international financial institutions.

# Key Implications for Hedge Funds

**Dealers must register with the SEC and, generally, FINRA.**

The entity trading (i.e., the fund) is the entity required to register.

**FINRA membership application process is lengthy (can be six-plus months from filing).**

**SEC and FINRA rules applicable to dealers are extensive (and in many respects more burdensome than investment adviser requirements) and entail significant compliance costs.**

Significant requirements include net capital, licensing (e.g., Series 7, 57, etc.), recordkeeping, trade reporting, written supervisory procedures, and more frequent examinations.

**Net capital requirements may be incompatible with many funds' liquidity terms.**

**An unregistered dealer could be liable for rescission of transactions under Section 29(b) of the Exchange Act.**

# Game Plan for Fund Managers

1

**Fund managers must act now to evaluate dealer status.**

- Managers should evaluate both the new rules *and* existing requirements.

2

**Funds that need to register must begin the registration process immediately to register by April 29, 2025.**

3

**Managers with funds that are in the realm of dealer status should consider developing a testing methodology and documenting the results so that they can be shared with examiners.**