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SEC proposes changes to definition  
of dealer and government  
securities dealer

## Overview

On March 28, 2022, the Securities and Exchange Commission (SEC) issued a proposal to change two rules—Rules 3a5-4 and 3a44-2—to identify certain activities “as part of a regular business,” in the definition of a “dealer” or “government securities dealer,” based on certain qualitative and quantitative standards.<sup>1</sup> Any person whose activities meet the standards is defined as a dealer,<sup>2</sup> barring any exception or exemption, and is required to:

- Register with the SEC;
- Become a member of a self-regulatory organization (SRO); and
- Comply with federal securities laws and regulatory obligations, including as applicable, SEC, SRO, and Treasury rules and requirements.

Several unregistered entities—including principal trading firms (PTFs), private funds, and other market participants—are providing liquidity in the Treasury markets. The SEC aims to require most of these entities to register as dealers. **If finalized, this rule would have significant consequences for these entities—including registration, reporting, and capital requirements.**

## Scope of the proposal

Per the proposal, all “persons” as defined in Section 3(a)(9) of the Exchange Act (unless such person was otherwise exempted or excepted) that provide liquidity “as part of a regular business” would be required to register as dealers with the SEC. The proposal clarifies that “as part of a regular business” in the Exchange Act includes a person or entity that is engaged in a routine pattern of buying and selling securities for their own account, that has the effect of providing liquidity or acting as market maker.

Importantly, it is not a requirement that the person or entity intends to provide liquidity, as long the effect of their activities is liquidity provision. Moreover, the SEC has made it clear that the proposal does not constitute the exclusive means defining a person as a dealer. The proposal does not extend to the following:

- Any person that has or controls total assets of less than \$50 million

- An investment company registered under the Investment Company Act

## Compliance date

The proposal includes a compliance period of one year from the effective date of any final rules. However, the proposed compliance period does not cover market participants whose activities require dealer registration after the effective date of any final rules.

## Qualitative standards

The qualitative standards in the proposal apply to both securities and government securities and include the following activities:

- Routinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day;
- Routinely involved in trading interests that are at or near bid and ask prices that are accessible to other market participants; or
- Earning revenue primarily from capturing bid-ask spreads or from capturing any incentives offered by trading venues to liquidity-supplying trading interests.

## Quantitative standard

A quantitative standard also applies but only to government securities. Under this standard, any person or entity would be required to register as a government securities dealer if they engaged in buying and selling more than \$25 billion of trading volume in government securities in four out of the last six calendar months.

The quantitative standard also has an aggregation requirement. For accounts under \$50 million, persons must be considered for aggregation with any accounts (including those under \$50 million) that are controlled by or under common control with that person. The SEC’s goal with this provision is to avoid rule evasion by entities setting up legal entities whose trades or capital may not reach the proposal’s purview.

# Effect of the proposal on currently unregistered liquidity providers

For entities that would require dealer registration under the proposal, significant changes would be required, including:

- **Regulatory capital requirements:** Entities would be subject to net capital requirements after registration as a dealer. SEC's net capital rule requires dealers to maintain sufficient permanent capital to meet liabilities leading to capital restructuring.<sup>3</sup> Compliance with the capital rule may affect the amount and form of capital required. These entities would also be required to comply with generally accepted accounting principles (GAAP), which require that equity capital be permanent in nature. Investors in the dealers would not be able to have the right to withdraw capital as they may currently have.
- **New reporting requirements:** Registered dealers would also be subject to new financial and non-financial regulatory reporting requirements. They would have to file a monthly Financial and Operational Combined Uniform Single (FOCUS) report, which must be audited by an external audit firm under Public Company Accounting Oversight Board (PCAOB) standards every year. They would also have to file trade and transaction reports such as Consolidated Audit Trail (CAT) and Trade Reporting and Compliance Engine (TRACE), among others. Currently, unregistered PTFs do not report any of this information to regulators. Private fund advisers report certain information on the private funds they manage to the SEC annually (and, for certain large advisers of certain large hedge funds, each quarter), but they do not report transactions.
- **Regulatory examinations:** Registered dealers are subject to examinations by the SEC and the Financial Industry Regulatory Authority (FINRA).
- **Other compliance costs:** Registered dealers would incur significant cost and require operational changes in technology and infrastructure capabilities for regulatory compliance with dealer rules. In addition to the operational and technology costs associated with capital and reporting rules, firms will have to build the infrastructure necessary to comply with FINRA's supervision and personnel registration rules. This would include, among other things, training and development of firm personnel on new regulatory requirements and

perhaps hiring of resources where potential gaps in roles and responsibilities are determined.

- **Ambiguity of asset classes under scope:** Although the proposal focuses primarily on trading in treasury securities, equities, and listed options, the proposal does not explicitly state the asset classes under scope. As such, digital assets may also fall, given that the regulatory definition of digital assets under federal securities law is still unsettled.
- **Reduction in liquidity activities:** Pension plans, foundations, arbitrage traders, and other organizations involved in similar liquidity-providing activities may cease or reduce these activities as they are simply not able to comply with dealer compliance requirements (capital restructuring and cost of raising permanent capital) or find that it is not economically feasible for them to continue these activities.

## Action plan going forward

The proposal raises a host of considerations for market participants regarding their compliance program. Actions for firms to consider when a rule is in its proposal stage are as follows:

- **Interpret and understand the proposal:** Potentially affected firms should work with counsel on the interpretation and understanding of the proposed definitions and determine if they would be required to register as a dealer. It is also possible that a firm would satisfy the quantitative or the qualitative standards of the rule changes by transacting in assets other than those that are reported to CAT. Such a firm would still be required to register as a dealer and report any transactions it may have in National Market System (NMS) stocks, over-the-counter (OTC) equities, and listed options. However, such a firm could have a relatively low number of CAT-reportable order events and hence relatively low costs of CAT reporting.
- **Identify the current or future entity that would register and perform a pro forma capital computation:** The net capital rule will require significant permanent funding to support the positions that are deemed to be market-making. Some non-market-making positions that act as hedges may reduce capital charges, while others may increase them dramatically. Firms should perform pro forma capital calculations to determine how to structure and capitalize the entity they choose to register and what positions should be put into that entity.

## SEC proposes changes to definition of dealer and government securities dealer

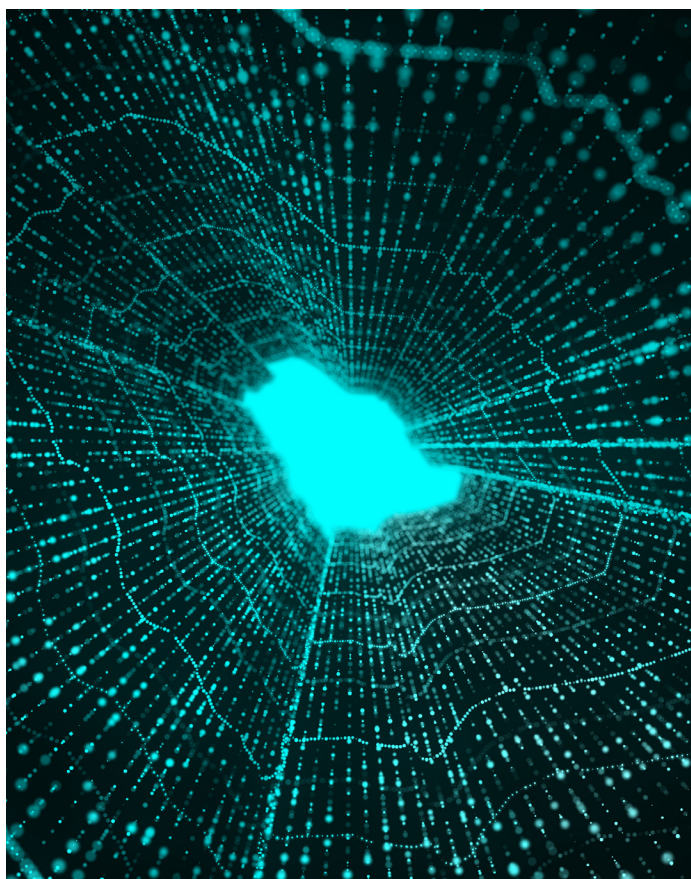
- **Conduct a gap assessment of the technology and systems design and implementation capabilities required:** Firms should conduct a gap assessment of their technology capabilities. Building the systems that will be needed may require a substantial investment. Systems will be needed to support, among other things:
  - Monthly FOCUS and financial reporting
  - Monitoring of daily capital compliance
  - Trade execution (assuming the firm will desire to execute directly with exchanges)
  - Trade reporting
  - Compliance supervision and registration of personnel
- **Conduct a gap assessment of the compliance program against leading practices and regulatory expectations:** Firms should conduct a gap assessment to baseline the maturity of their compliance program and identify improvement areas. Firms that do not have compliance programs in place should identify areas of focus as per the proposed rule. The gap assessment should focus on the practices and requirements such as capital maintenance, compliance program, etc.

Actions for firms to consider if firms fall under the rule compliance and the proposed rule finalizes:

- **Identify a project manager and team:** The many work streams necessary to establish a dealer will require a coordinated effort.
- **Refresh the gap analyses referred to above:** Assuming the initial gap analyses was conducted to get a general understanding of the impact, they should now be revised to include the specific tasks needed to be done along with persons responsible and timelines for each of those tasks. The output of the gap analyses should be a work plan the project management team can utilize.
- **Take steps to line up additional funding:** As mentioned above the dealer would require permanent capital necessary to comply with the net capital rule. As investor's right to redeem their investment is generally not permanent under GAAP funding, so their agreements may need to be reworked. The dealer would also need to line up funding for systems and other infrastructure design and build.

- **Hire and train people:** A newly established dealer would need people who have experience in dealer compliance, systems, and operations.
- **Register the new dealer and its principals with the SEC and FINRA:** In addition to filing relevant forms, the new dealer would have to obtain a new member agreement with FINRA and register certain employees with it. Those persons may be required to take examinations as a prerequisite to being registered.
- **Engage with an external auditor:** Dealers are required to file annual financial statements that are audited under PCAOB audit standards.

The SEC is currently reviewing comments received during the comment period. If this rule is finalized, then PTFs, private funds, and few other market participants that provide liquidity may have to register as dealers. If a currently unregistered firm must register, it would require considerable compliance and operational changes. At this time, firms that believe they may be implicated should engage in appropriate assessment; and if the rule is finalized in its current form, firms would need to make a wide array of changes.



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## Endnotes

1. US Securities and Exchange Commission (SEC), [“SEC proposes rules to include certain significant market participants as ‘dealers’ or ‘government securities dealers,’”](#) press release, March 28, 2022.
2. Section 3(a)(5) of the Exchange Act (the Act) defines the term “dealer” as any person who engages in the business of buying and selling securities in their own account through a broker or otherwise. The Act excludes a person who buys or sells securities in their own account, either individually or in a fiduciary capacity, but not as a part of a regular business. The proposed rules (under the Exchange Act) define a “dealer” as any person who engages in buying and selling securities for their own account as part of a regular business, which has an effect of providing liquidity or acting as market maker.
3. SEC, [“Key. SEC Financial Responsibility Rules,”](#) accessed October 13, 2022.





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