Statement

Dealer, No Dealer?[1] : Statement on 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



Commissioner Hester M. Peirce

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Thank you, Mr. Chair. I cannot support the final rule. Even though streamlined substantially,[2] it perpetuates the proposal’s fundamental flaw. The rule defines dealer in a way that is inconsistent with the statutory framework within which it sits and will distort market behavior and degrade market quality.

This rule turns traders, many of whom are customers, into dealers. Doing so runs counter to the statute, as the Commission and market participants have read it for decades. The Exchange Act defines a dealer as a person that is “engaged in the business of buying and selling securities” for its “own account through a broker or otherwise,” but—importantly—excludes “a person that buys or sells securities . . . for [its] own account, either individually or in a fiduciary capacity, but not as a part of a regular business.”[3] Nearly any firm in the financial markets that trades securities as a principal does so “as part of a regular business.” Recognizing the breadth of this language read out of context, the Commission has long appropriately interpreted this provision in a way that distinguishes between market participants that operate a dealing business and those that operate an investing and trading business.[4] To this end, the Commission and Commission staff repeatedly have issued guidance on what we have called the dealer-trader distinction.[5]

The rule the Commission is considering today obliterates this distinction by extending the definition of “dealer” to market participants that run investing and trading businesses, not dealing businesses. Rather than looking to whether the “regular business” of the firm bears the hallmarks of dealing activity,[6] today’s rule would capture any person whose “regular business” involves trading activity for its own account that provides liquidity on a more than “incidental” basis.[7] Although the Commission and its staff have previously stated that liquidity provision may be indicative of dealing activity, it has not to my knowledge ever before stated categorically that liquidity provision alone by a person trading for its own account constitutes dealing activity or that trading activity becomes dealing activity merely because it has the effect of providing liquidity.[8]

And for good reason: Once liquidity provision—not in the form of a service provided to market participants but as an effect of one's trading activity—turns a person into a dealer, the dealer-trader distinction becomes unintelligible. The rule itself demonstrates this: The statutory trader exception is no longer sufficient to exclude registered investment companies from the dealer definition; the final rule is so broad that the Commission has determined that it needed to expressly exclude these investment funds. The express regulatory exclusion for investment companies suggests that the Commission believes that the statutory exception for traders is insufficient to exclude entities that almost no one has conceived could be dealers, that likely could not operate under broker-dealer regulations, and for which Congress has established an entirely different statutory framework. Such a narrow reading of the statutory exception is clearly a misreading of the statute. The upheaval wrought by the rule's singular focus on liquidity provision creates uncertainty about dealer status for many market participants who rely on the trader exception.[9] Perhaps recognizing this, the Commission only briefly touches on the dealer-trader distinction in the release, conveniently avoids proffering any explanation for departing from the prior understanding of that exception, and instead asserts that the rule is "intended to reflect the longstanding [dealer-trader] distinction."[10]

The express regulatory exclusion avoids creating absurd results for registered investment companies, but the rule still produces absurdities. The adopting release acknowledges that the market participants that will be forced to register under the final rule may not have any characteristics of dealers under the current rule.[11] Instead, simply executing any of a number of common trading, investing, and risk management strategies could turn a market participant into a dealer if doing so happens to provide significant liquidity to the market. Not only will these entities be subject to a dealer regulatory regime that does not make sense for them,[12] but they will lose the protections now afforded to them as customers.[13]

In addition to harming the market participants who find themselves transformed into dealers, this rule harms the broader market. It penalizes liquidity provision, which means there will be less of it. The penalty comes in the form of a costly and ill-fitting regulatory regime for liquidity-providing market participants. For playing this important role, principal trading firms, private funds, and other market participants swept up by the rule will now have to "register with the Commission and become members of an SRO; [and] comply with Commission and SRO rules, including certain financial responsibility and risk management rules, transaction and other reporting requirements, operational integrity rules, and books and records requirements."[14] They also have to become members of the Securities Investor Protection Corporation ("SIPC"). When serving the markets comes with such onerous and unsuitable regulatory requirements, some market participants will decide to stop the activities that give rise to the positive liquidity provision externality. The Commission is attempting to solve the problem of inadequate liquidity provision in times of crisis by reducing liquidity provision ex ante. How this advances the Commission's objective of shoring up liquidity provision is beyond me.[15]

The Commission casts this rule as part of an effort to protect competition,[16] but the rule will drive competitors out of the markets. By penalizing trading and investing strategies that have the effect of providing liquidity to the markets, the rule will dampen liquidity provision. The extra costs will cause firms to consolidate so that they can spread the fixed costs of the dealer regulatory regime over more activity. Small and mid-size participants that enhance the diversity and robustness of the ranks of liquidity providers will disappear, and liquidity providers will become more concentrated and more homogenous, which will make both these firms and the market more fragile.

The Commission contends that this rule is necessary to give us "more comprehensive regulatory oversight of securities markets."[17] The SEC commonly falls back on this justification for rulemaking, but being an effective regulator does not require comprehensive surveillance and a prescriptive regulatory regime governing the activities of every market participant. In any case, we already have lots of data to conduct regulatory oversight: the Consolidated Audit Trail's comprehensive monitoring of the equity and options markets, the ever-expanding Form PF to collect granular private fund data, the Trade Reporting and Compliance Engine ("TRACE"), large trader reporting, data arising from mandatory proprietary trader registration with FINRA, and the list goes on.

[18] A regulator's temptation may be to put every corner of the market under a regulatory spotlight and into a regulatory straitjacket, but a clear-eyed view takes into account the costs of such "comprehensive oversight" to the healthy, dynamic functioning of the market and the investors and issuers that participate in it.

In addition to these fundamental flaws, the new rule comes with other problems, including serious implementation challenges. The rule is ambiguous in scope, which almost certainly will bring in firms the Commission has given no thought to including.[19] These firms will incur significant costs in registering as dealers or changing their businesses so they do not have to register. The implementation period is too short, particularly given the involvement of both FINRA and SIPC.[20] The likely interactions with other rules are unpredictable. And, not surprisingly, the rule reflects little thought regarding its practical application in the crypto markets.[21]

Thank you to the staff in the Division of Trading and Markets, the Division of Economic and Risk Analysis, and the Office of General Counsel for your work on this release. You continue to impress me with your diligence and concern for the well-being of our markets. I know that the work will not stop with today's adoption, but will continue through implementation, so thank you in advance for that.

I have a number of questions:

1. For DERA, the economic analysis acknowledges that the rule's consequences are difficult to predict.[22]
    1. What metrics do we plan to use to measure the positive and negative consequences of this rule in a retrospective review several years from now?
    2. What could we see that would suggest the rule was a success?
    3. Will we be able to measure whether the rule has harmed liquidity provision?
2. The decision not to scope out private funds and pension funds is puzzling given the ill-fitting nature of dealer rules on funds.
    1. What is the logic for excluding registered investment companies, but not private funds and pension funds, which are also pooled investment vehicles?
    2. How many private funds and pension funds do you anticipate will be pulled into dealer registration by these new amendments?
    3. Will a private fund or pension fund that has to register as a dealer under the rule face any unique challenges? For example, a private fund's liquidity rights for investors could conflict with the net capital rule, or assessing applicability of the rule that pursues multiple independent trading strategies might have to coordinate trading in violation of the fund's policies and procedures.
    4. How will the relationship of a private fund or a pension fund with its broker-dealers change so as to diminish customer protections if the fund has to register as a dealer?
3. The Release explains that a crypto automated market maker might have to register as a dealer under the final rules. How can a software protocol register as a dealer?
4. What will the Commission do to work with FINRA and SIPC to ensure that all new dealers swept up by the rule will be able to be onboarded within the one-year compliance period?
5. The final rule does not exclude investment advisers, as some commenters had hoped.
    1. Why would it make sense for an investment adviser, which is already subject to a regulatory framework, to register as a dealer, and would doing so present any challenges to carrying out the adviser's fiduciary duties?
    2. If an adviser provides seed capital for a strategy that triggers the new dealer definition,

would the adviser have to register? If so, why does that make sense?

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[1] The rulemaking process is not a game but sometimes the Commission treats it as one. This rulemaking, for example, could be recast as "Dealer, No Dealer?" The long running, popular game show, "Deal or No Deal," presented contestants with 26 sealed briefcases, each of which represents an amount between one penny and $1 million. The contestant picks one, leaves it unopened, and then proceeds to pick other briefcases to be opened. As each briefcase's contents are revealed, the contestant's odds of winning the $1 million change. A shadowy "banker," watching the odds and the contestant's emotions change, presents the contestant with periodic sell-your-briefcase deals of less than $1 million. Thus, how much contestants take home varies greatly and arbitrarily without having much to do with their actions. This rulemaking process has the same feel: whether a particular market participant lands in the dealer or no-dealer bucket seems largely a function of chance and the mercurial Commission's whim. To add a bit more rigor and predictability to the process, at the very least, we ought to have reproposed the rule to allow commenters to weigh in on a rule that differs substantially from what was proposed. Even under the new rule, classification as a dealer under the Commission's new approach will be somewhat arbitrary.

[2] The Commission, in the final rule, makes substantial changes to the "own account" definition, eliminates the quantitative prong, and includes only the following two (rather than three, as proposed) qualitative prongs:

• 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.

Adopting Release at 20-21.

[3] Exchange Act § 3(a)(5)(A)-(B).

[4] See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exch. Act. Rel. No. 47364 (Feb. 14, 2003), 68 FR 8686, 8688 (Feb. 23, 2003) ("Definition of Terms Release") ("As developed over the years, the dealer definition has been interpreted to exclude 'traders.'").

[5] Id. See also Steven Lofchie, Guide to Broker-Dealer Regulation: Registration Requirement—Dealer Registration, https://www.findknowdo.com/us-federal/law-firm/law-firm-analysis/bd-guide-registration-requirement-dealer-registration (citing the following no-action letters providing such guidance: Fairfield Trading Corp. (SEC No-Act, Jan. 10, 1988); Continental Grain Company (SEC No-Act, Nov. 6, 1987); International Investment Group, Inc. (SEC No-Act, July 23, 1987)).

[6] According to a leading treatise on the regulation of broker-dealers, these "hallmarks," articulated through no-action letters and in Commission releases, include:

(a) issuing or originating securities; (b) participating in a selling group or underwriting securities . . . ; (c) purchasing or selling securities as principal from or to customers, rather than from or to only brokers or dealers; (d) carrying a dealer inventory; (e) quoting a two-way market in securities, or publishing any quotations on or through any quotation system used by dealers, brokers or institutional investors, or otherwise quoting prices other than on a limited basis through a 'retail screen broker;' (f) holding itself out as a dealer or market-maker, or as otherwise willing to buy or sell particular securities on a continuous basis; (g) rendering incidental investment advice; (h) handling another's money or securities, or executing securities transactions on another's behalf; (i) extending or arranging for the extension of credit to others in connection with securities; (j)

conducting processing or clearing activities; (k) obtaining a regular clientele; (l) trading to facilitate others', rather than consistently with one's own judgment, investment and liquidity objectives; (m) using an interdealer broker . . . ; and (n) running a matched book of repurchase and reverse-repurchase agreements."

Lofchie, supra note 5.

[7] See Adopting Release at 25.

[8] In the Definition of Terms Release, the Commission did note that dealers "generally provide liquidity services," but nothing in that release suggests that liquidity provision standing alone would make a firm a dealer. Indeed, the Commission explained that "dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory . . . , and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals)." Definition of Terms Release, 68 FR at 8688 (emphasis added). In other words, liquidity provision is relevant in the context of other indicia of dealing activity, as something that one presumably intentionally provides as a service to investors or other professionals. Nothing in this language warrants concluding that the Commission's position before this release lends any support to a rule that defines dealer to include a person solely because its trading activity "has the effect of providing liquidity to other market participants," much less that the final rule "reflect[s]" (rather than abolishes) "the longstanding distinction between" traders and dealers. Adopting Release at 25-26.

[9] The Commission offers little comfort when it warns: "[N]o presumption shall arise that a person is not a dealer or government securities dealer as defined by the Exchange Act solely because that person does not satisfy the standard set forth in the final rules." Adopting Release at 31.

[10] Adopting Release at 25.

[11] Adopting Release at 10.

[12] Some market participants may be precluded from registering as dealers. See, e.g., Adopting Release at 187 ("If any affected funds are prohibited from registering as dealers or have investors that are prohibited from investing in a dealer, then we agree that those affected funds may incur additional costs, including costs of revising organizational documents, splitting dealing and non-dealing activities into separate legal entities, or changing investment strategies and withdrawal of investors, whichever option is least costly.").

[13] See, e.g., Comment Letter of Committee on Capital Markets Regulation (Oct. 19, 2022) at 4, https://www.sec.gov/comments/s7-12-22/s71222-20146736-312040.pdf. They also may lose the ability to invest in initial public offerings. See id.

[14] Adopting Release at 11-12 (footnotes omitted).

[15] Many commenters noted that the Treasury markets, which are a main focus of the rulemaking, likely will suffer. See, e.g., Comment Letter of Committee on Capital Markets Regulation at 1 ("[T]he Proposal would reduce liquidity in the U.S. Treasury markets potentially increasing the severity and frequency of significant volatility in such markets with negative implications for financial stability."); Comment Letter of Managed Funds Association (Dec. 5, 2022) at 2, https://www.sec.gov/comments/s7-12-22/s71222-20152322-320250.pdf (stating that the rule "also could have significant negative unintended consequences for investors and markets, in particular the U.S. Treasury market").

[16] See, e.g., Adopting Release at 134-35 (arguing that it is "closing the regulatory gap that currently exists and ensuring consistent regulatory oversight of persons engaging in regular liquidity provision in securities markets").

[17] Adopting Release at 6.

[18] As I have explained elsewhere, some of these market surveillance tools also go too far. See, e.g., Hester Peirce, That Cat is a Dangerous Dog, RealClearPolicy, Oct. 9, 2019, https://www.realclearpolicy.com/articles/2019/10/09/this_cat_is_a_dangerous_dog_111285.html; Hester M. Peirce, The Changing Nature of Form PF, May 3, 2023, https://www.sec.gov/news/statement/peirce-statement-form-pf-050323.

[19] Although the Commission promises it is "requir[ing] only entities engaging in de facto market making activity to register as dealers," Adopting Release at 18, the qualitative criteria are imprecise. The adopting release explains, for example, that "[w]hether a person's activity is 'regular' will depend on the liquidity and depth of the relevant market for the security." Adopting Release at 36. It further explains that "the term 'regularly' will capture those market participants that engage in the activity described in the expressing trading interest factor on a frequent enough basis (both within a trading day and over time) that they do so as part of a regular business." Adopting Release at 38. That circular explanation does little to clarify the muddy regulatory language.

[20] The Commission justifies the short compliance period by asserting that the benefits are just too great to wait: "In light of the significant benefits afforded by dealer registration to investors and the markets, it is important for persons engaging in activities that meet the dealer registration requirements to register as soon as possible." Adopting Release at 96. The economic analysis does not support that assertion. See, e.g., Adopting Release at 98 ("Although the final rules may have small negative effects on market liquidity and efficiency, due to increases in costs for affected parties, the final rules may also promote liquidity and efficiency by limiting the probability that significant liquidity providers fail.").

[21] The rule covers providers of liquidity in crypto asset securities. Not only do the tired questions about when a crypto asset is a security remain, but the rule raises new questions about how the rule will apply in the context of automated market makers ("AMMs"). For example, given that an AMM is a software protocol, who will have to register? In light of the difficulties that other would-be crypto registrants have encountered with the SEC and FINRA, will those persons even be able to register? Rather than engage seriously with these questions, the Commission hints that "certain persons engaging in crypto asset securities transactions may be operating as dealers" already. Adopting Release at 81.

[22] See, e.g., Adopting Release at 98 ("Although the final rules may have small negative effects on market liquidity and efficiency, due to increases in costs for affected parties, the final rules may also promote liquidity and efficiency by limiting the probability that significant liquidity providers fail.").