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WILL HEDGE FUNDS NOW BE SUBJECT TO SEC AND FINRA DEALER REGULATION?

A recent US Securities and Exchange Commission (SEC) settled enforcement action that found that a hedge fund acted as an unregistered "dealer" has blurred the traditional line between dealers and traders. On August 17, 2021, the SEC announced the settled enforcement action against an investment adviser and associated individuals (the Respondents) alleging that these persons caused executing brokers of a hedge fund to violate the order-marking and locate requirements of Regulation SHO.[1] Notably, the SEC also found that the Respondents caused the hedge fund to act as an unregistered "dealer" in violation of Section 15(a)(1) of the Securities Exchange Act of 1934 (Exchange Act) in connection with transactions related to certain securities purchase agreements and equity line agreements. This latter finding seems like a significant departure from statements of SEC officials and the existing SEC staff guidance that, since at least 1994, has consistently distinguished between dealer and trader activities when expressing the view that hedge funds do not act as dealers.[2] In this White Paper, we examine the SEC's historical positions regarding what constitutes a "dealer," SEC staff guidance that would appear specifically applicable to the alleged "dealer" conduct, and questions that hedge funds and other market participants should consider in evaluating the scope of the SEC's action to their operations.

MURCHINSON

In *Murchinson*, the SEC alleged that the hedge fund sub-advised by the Respondents entered into securities purchase agreements with multiple issuers whose stock traded on the Nasdaq Stock Market. Pursuant to those agreements, the hedge fund purchased hundreds of millions of dollars of the issuers' securities that were convertible or exchangeable into common stock. In addition, the SEC further alleged that the Respondents also caused the hedge fund to enter into equity line agreements with an issuer, pursuant to which the issuer could sell a specified dollar amount of stock (or "draw-down" amount) to be purchased by the hedge fund in a specified period.

The SEC alleged that the Respondents caused the hedge fund to engage in dealer activity when the investment adviser and some issuers agreed that, after the hedge fund sold the issuer's stock into US markets during a specified period, the hedge fund could purchase an equivalent amount of stock from the respective issuers, rather than the initial draw-down amount, at a specified percentage of the hedge fund's sales proceeds. The SEC alleged that by engaging in these activities, the Respondents caused the

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[1] *In the Matter of Murchinson Ltd., Marc Bistricer & Paul Zogala*, Exch. Act Rel. No. 92684 (Aug. 17, 2021) (*Murchinson*). With respect to the Regulation SHO violations, the SEC alleged that the Respondents caused the hedge fund to place "long" sale orders with the hedge fund's executing brokers for securities that the hedge fund was not "deemed to own." According to *Murchinson*, the Respondents should have identified these orders as "short" sales, and, because this order-marking information was erroneous, the Respondents caused the hedge fund's executing brokers to mismark such sale orders as "long" in violation of Rule 200(g) of Regulation SHO. In addition, the SEC alleged that in providing erroneous order-marking information, the Respondents also caused the hedge fund's executing brokers to violate Rule 203(b)(1) of Regulation SHO because the executing brokers neither borrowed nor located shares available for borrowing prior to effecting those sales.

[2] While the SEC's public position regarding hedge funds and the dealer-trader distinction has been public since at least 1994, the SEC's internal positions on this matter may indeed go farther back than that.

hedge fund to sell the issuers' common stock before purchasing, or entering into unconditional contracts to purchase, the stock being sold.

In connection with the equity line agreements, the SEC alleged that the Respondents caused the hedge fund to engage in dealer activity, without registering as a dealer with the SEC or being exempt from registration, by agreeing in certain instances to purchase from the issuer the number of shares the hedge fund had sold into US markets during specified periods, and to calculate the hedge fund's purchase price as a fixed percentage of the hedge fund's sales proceeds during each specified period. In addition, the SEC noted that the issuers filed prospectus supplements with the SEC in connection with the equity line agreements that identified the hedge fund as a statutory underwriter within the meaning of Section 2(a)(11) of the Securities Act of 1933 (Securities Act).[3]

In *Murchinson*, the SEC was scant on details bearing on a factual or legal analysis of dealer status generally, and, importantly, silent on the distinction between dealers and traders. That said, the SEC did highlight that the hedge fund profited by keeping a percentage of its sales proceeds and remitting the remainder of the proceeds to the issuers. As a result, the SEC's dealer conclusions would appear to hinge on the hedge fund primarily profiting from the spread it received in the transactions rather than from the appreciation in the value of the securities. In addition, the SEC's dealer conclusion also seemed to focus on the volume of activity, noting that the Respondents caused the hedge fund to sell hundreds of millions of dollars of common stock into US markets pursuant to the equity line agreements. These activities, according to the SEC, caused the hedge fund to be engaged in the regular business of buying and selling securities for its own account—without registering with the SEC as a dealer or being exempt from registration.

SECTION 15(A)(1) OF THE EXCHANGE ACT

Section 15(a) of the Exchange Act generally makes it unlawful for any broker or dealer to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer (1) is registered with the SEC; (2) in the case of a natural person, is an associated person of a registered broker-dealer; or (3) satisfies the conditions of an exemption or safe harbor.

Registration as a broker-dealer carries significant obligations. Registered broker-dealers, for example, are required to become members of self-regulatory organizations and the Securities Investor Protection Corporation; must comply with extensive recordkeeping and reporting obligations, suitability requirements, and capital and margin requirements; and are subject to statutory disqualification

[3] That section broadly defines an "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission." As drafted, the Section 2(a)(11) definition of underwriter can encompass persons that may not be dealers as defined under Exchange Act Section 3(a)(5).

provisions that are intended to address the ability of bad actors to enter or remain in the securities industry.[4]

DEALER DEFINITION

Although there has been a significant amount of guidance produced (in the form of litigated cases, SEC enforcement actions, statements in SEC releases, and SEC staff interpretations) on what it means to be a "broker,"[5] the interpretive guidance regarding what it means to be a "dealer" has not been as extensive. Section 3(a)(5)(A) of the Exchange Act, as amended, defines a "dealer" as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise" (the Dealer Definition). Among other exemptions and exclusions,[6] Section 3(a)(5)(B) excludes from the Dealer Definition "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." When these two provisions are read in tandem, it appears that the primary factor for determining whether a person who buys and sells securities for their own account has to register under Section 15(a) of the Exchange Act is whether they are engaged in trading as a business. Accordingly, whether a person is "engaged in the business" of buying and selling securities is at the heart of the dealer-trader distinction.

DEALER-TRADER DISTINCTION

The dealer-trader distinction is an analytical framework that has been in place since at least 1951, when Louis Loss first published his seminal treatise on the securities laws.[7] Although the SEC and its staff articulated features of the dealer-trader distinction over the years,[8] the SEC provided a more

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[4] *See, e.g.*, Registration of Foreign Broker Broker-Dealers, Exch. Act Rel. No. 27017 (July 11, 1989), 54 Fed. Reg. 30013, 30015 (July 18, 1989) (Rule 15a-6 Adopting Release) (discussing obligations of registered broker-dealers).

[5] Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

[6] Under Section 3(a)(5)(C) of the Exchange Act, additional exceptions from the Dealer Definition are available to banks (as that term is defined in Section 3(a)(6)) that engage in certain enumerated activities. These exceptions are further codified as Exchange Act Rules 3a5-1, 3a5-2, and 3a5-3. 17 C.F.R. § 240.3a5-1, 3a5-2, and 3a5-3.

[7] *See* Louis Loss, Securities Regulation 722 (1st ed. 1951) (discussing dealer-trader distinction). In this connection, we note that the dealer-trader distinction may have been used or developed as an analytical concept within the SEC before the publication of Loss's treatise, given that Loss held various positions at the SEC during its formative years.

[8] *See, e.g.*, OTC Derivatives Dealers, Exch. Act Rel. No. 40594 (Oct. 23, 1998), 63 Fed. Reg. 59,362, 59,370 n.61 (Nov. 3, 1998) (listing dealer indicia in context of over-the-counter (OTC) derivatives dealers); Further Definitions of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," Exch. Act Rel. No. 66868 (Apr. 27, 2012), 77 Fed. Reg. 30,596, 30,607 (May 23, 2012) (discussing dealer-trader distinction in context of security-based swaps); Stephen V. Hart, SEC Staff No-Action Letter (Mar. 6, 1980); Public Securities Locating Services, SEC Staff No-Action Letter (Sept. 8, 1973); United Trust Co., SEC Staff No-Action Letter (Sept. 6, 1978); Continental Grain Co., SEC Staff No-Action Letter (Nov. 6, 1987); Burton Securities, SEC Staff No-Action Letter (Dec. 5, 1977); United Savings Association of Texas, SEC Staff No-

comprehensive discussion of the distinction and what it means to be "engaged in the business" of buying and selling securities in 2002. That year, the SEC proposed rules to grant banks exceptions and exemptions from the definitions of "broker" and "dealer" as part of the SEC's implementation of the Gramm-Leach-Bliley Act of 1999.[9] In that proposal, the SEC identified activities that historically have been associated with dealers and that would bring someone within the meaning of the phrase "engaged in the business."[10] The activities identified by the SEC in the 2002 Proposal include

- 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 market maker whereby market professionals or the public look to the person for liquidity; and
- 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.[11]

The SEC further elaborated that dealers generally are persons who normally have 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), and generally transact a substantial portion of their business with investors (or, in the case of dealers who are market makers, principally trade with other professionals). The SEC contrasted dealer activities with those of traders, who the SEC stated are viewed as

- having less regular volume;
- not handling other people's money or securities;
- not making a market in securities; and

Action Letter (Apr. 2, 1987); Fairfield Trading Corp., SEC Staff No-Action Letter (Jan. 10, 1988); Louis Dreyfus Corp., SEC Staff No-Action Letter (July 23, 1987).

[9] *See* 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, Exch. Act Rel. No. 46745 (Oct. 30, 2002), 67 Fed. Reg. 67,496, 67,498–500 (Nov. 5, 2002) (2002 Proposal).

[10] *See id.*

[11] *See id.* In addition to the factors listed in the 2002 Proposal, with respect to dealer status in the context of the Government Securities Act of 1986 (GSA), the SEC staff also identified the following factors: issuing or originating securities that would qualify as securities under the GSA; participating in a selling group or underwriting government securities; purchasing or selling government securities as principal from or to customers; carrying a dealer inventory; quoting a market in government securities or publishing quotes; advertising or otherwise holding oneself out as a government securities dealer, such as holding oneself out as being willing to buy and sell particular government securities on a continuous basis; rendering any incidental investment advice; extending or arranging for the extension of credit to others in connection with government securities; running a book or repurchase and reverse repurchase agreements on government securities; and using an interdealer broker, other than a retail screen broker, to effect any government securities transactions. *See, e.g.*, United Savings Association of Texas, SEC Staff No-Action Letter, *supra* note 6.

- not furnishing dealer-type services, such as providing investment advice, extending credit, or lending securities.[12]

Although the 2002 Proposal is almost two decades old, the SEC affirmed the use of the dealer-trader distinction as an analytical framework when it reiterated the underlying principles of the distinction in connection with the definition of "security-based swap dealer" for purposes of implementing the provisions of the Dodd-Frank Act under the SEC's purview.[13]

In addition to the statements above, senior SEC officials over the years had publicly acknowledged that hedge funds generally come within the meaning of a trader rather than a dealer. In 1994, Arthur Levitt, then chair of the SEC, provided this testimony before Congress:

> Hedge funds typically claim an exclusion from registration as securities dealers under Section 15(a) of the [Exchange Act] (15 U.S.C. § 78o(a)) based on the "trader" exception to the definition of "dealer." In general, a trader is an entity that trades securities solely for its own investment account and does not carry on a public securities business. On the other hand, a dealer buys and sells securities as part of a regular business, deals directly with public investors, engages in market intermediary activities, and may provide other services to investors.[14]

In 1998, Richard Lindsay, then director of what is now known as the Division of Trading and Markets, echoed Chairman Levitt's testimony, noting in written testimony that "hedge funds also rely on the trader exception from broker-dealer registration." [15]

ACQUA WELLINGTON

In 2001, the SEC staff issued a no-action letter (the Acqua Wellington Letter) to Acqua Wellington North American Equities Fund, Ltd. in which the SEC staff stated that it would not recommend enforcement action to the SEC if Acqua Wellington invested in equity lines of credit without registering with the SEC as a broker-dealer under Section 15 of the Exchange Act.[16] As explained in the Acqua Wellington Letter, an equity line of credit is an agreement with a public company under which an investor makes a commitment at signing to purchase a specified dollar amount of common stock on terms that enable the

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[12] 2002 Proposal, *supra* note 9, at 67498–500.

[13] *See* Further Definition of "Swap Dealer," *supra* note 8.

[14] *See, e.g.*, Testimony of Arthur Levitt, Chairman, SEC, Concerning Hedge Fund Activities in the US Financial Markets, Before the House Committee on Banking, Finance and Urban Affairs (Apr. 13, 1994).

[15] *See, e.g.*, Testimony of Richard R. Lindsey, Dir., Div. of Mkt. Regulation, SEC, Concerning Hedge Fund Activities in the US Financial Markets, Before the House Committee on Banking and Financial Services (Oct. 1, 1998). In a footnote, Director Lindsey further stated: "Hedge funds also claim an exclusion from registration as securities dealers under Section 15(a) of the Exchange Act (15 U.S.C. 78o(a)), based on the 'trader' exception to the definition of 'dealer.' In general, a trader is an entity that trades securities solely for its own investment account and does not carry on a public securities business, while a dealer buys and sells securities as part of a regular business, deals directly with public investors, engages in market intermediary activities, and also may provide other services to investors."

[16] *See* Acqua Wellington North American Equities Fund, Ltd., SEC Staff No-Action Letter (July 11, 2001, pub. avail. Oct. 11, 2001).

company to determine the timing and dollar amount of securities the investor will receive. Because the investor has committed to purchase stock upon signing, an equity line, as described in the letter, is designed to provide a company with more flexibility to sell stock when market conditions are most favorable than conducting a series of private placements. As the investor under an equity line, Acqua Wellington agreed to purchase a maximum dollar amount of the company's registered common stock over a specified period of time (in general, 12 to 24 months). Under the terms of that arrangement, the issuer had the right, but not the obligation, to sell common stock to Acqua Wellington, up to a specified maximum dollar amount, in a series of draw-downs. As described in the letter, when a company gave Acqua Wellington notice that the company intended to make a draw-down under the equity line, Acqua Wellington was obligated to purchase the dollar amount of common stock from the company at a predetermined percentage discount from a price determined by a mathematical formula during the draw-down period that is designed to approximate the current market price.

As described in the letter, the company had the sole ability to determine how much common stock to sell within specific minimum and maximum dollar amounts for each draw-down, subject to the aggregate maximum dollar amount for the entire equity line. The number of shares Acqua Wellington would be required to purchase would be determined by the dollar amount specified by the company in its draw-down notice. Once a draw-down occurred in accordance with the terms of the equity line agreement, Acqua Wellington would have been required to purchase the stock. The letter states that Acqua Wellington would not know if or when the company would choose to sell its stock to Acqua Wellington. While the equity line agreement required the company's stock to be publicly traded, the letter states that the agreement did not link the company's draw-down rights to a specified trading volume in the stock during the draw-down period or otherwise link the draw-down amount to Acqua Wellington's ability to sell the shares, and would not require Acqua Wellington to sell at a set price per share. The argument advanced by Acqua Wellington was that, as a result, it would take the risk of ownership from the time of signing the equity line agreement that there could be no ready market for the sale of the securities it purchases pursuant to the equity line of credit.

In making its argument to the staff that it should not be deemed a dealer, Acqua Wellington listed the following as factors that the SEC staff generally considered when evaluating whether someone is a dealer:

- Advertises or otherwise holds itself out as willing to buy or sell securities from its own account on a continuous basis
- Purchases or sells securities as principal from or to customers
- Carries a dealer inventory in securities
- Quotes a market in securities
- Provides investment advice
- Extends or arranges for the extension of credit in connection with securities transactions
- Runs a book of repurchase and reverse repurchase agreements
- Uses an interdealer broker for securities transactions
- Lends securities to customers
- Issues or originates securities
- Guarantees contract performance or indemnifies the parties for any loss or liability from the failure of the transaction to be successfully consummated
- Participates in a selling group or acts as an underwriter

In its letter, Acqua Wellington stated that other than being named an underwriter pursuant to Rule 415(a)(4) under the Securities Act or as an underwriter or a selling securityholder in a resale shelf offering, it did not and would not engage in any of the factors listed in its letter. In discussing why underwriter status should not be dispositive of dealer states, Acqua Wellington noted that

- the term underwriter is not defined by the particular person's general business, but by the person's participation in a particular offering, i.e., a public offering;
- the term underwriter may include both non-broker-dealers, such as individual investors and employees of issuers, as well as broker-dealers;
- in defining the term underwriter, the Securities Act makes no distinction between professional investment bankers and non-broker-dealer investors;
- Acqua Wellington's status as underwriter in an equity line investment has more in common with an institutional or private investor purchasing stock in a private placement than with the types of underwriters that commonly are viewed as dealers; and
- Acqua Wellington faces risk more akin to an investor than an underwriter that is also a dealer because Acqua Wellington does not control how much stock it will have to buy, does not control when it will have to buy the stock, and receives no assurance that there will be an active trading market in the stock at the time it purchases or determines to sell the stock.

OBSERVATIONS

The SEC's finding that a hedge fund acted as an unregistered "dealer" could signal a tidal shift in the SEC's views regarding the dealer-trader distinction, as well as the continued viability of the Acqua Wellington Letter. With respect to the former, the SEC's allegations and dealer analysis, while not explicit, seem to rest on two premises.

The first premise appears to be that a hedge fund profiting from a spread rather than a stock's appreciation in value is determinative of dealer status. While the SEC has often treated the form of compensation (i.e., transaction-based) as being a dispositive fact in alleging that a person is acting as an unregistered broker (a fact that many courts have viewed with increasing skepticism),[17] the same cannot be said of "dealer" status. None of the factors identified by the SEC in its various releases, or by the staff as articulated in the Acqua Wellington Letter, speak to the form of compensation as a factor—let alone a dispositive one—in determining whether a person comes within the meaning of the term dealer. Many types of market participants trade toward a view to earning a spread, including high-frequency traders and mutual funds that specifically use arbitrage strategies to profit from inefficient markets. A question that market participants may have to grapple with now is whether their profit models will be subject to attack in the same way that payment for order flow has been the subject of increasing regulatory and policy scrutiny.

The second premise appears to be that trading volume can be determinative of whether a person is engaged in the business of being a dealer. As with spread, this factor is new and not included in previous guidance regarding dealer status. And in some respects, it is contradictory to existing guidance.

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[17] *See, e.g.*, *SEC v. Kramer*, 778 F. Supp. 2d 1320, 1335 (M.D. Fla. 2011); *SEC v. M & A W, Inc.*, No. C-01-3376, 2005 WL 1514101 (N.D. Cal. June 20, 2005).

For example, in a release adopting rules regarding the registration of municipal securities dealers, the SEC stated:

> While the determination of when a bank is a municipal securities dealer might be premised on, among other matters, the number of transactions engaged in by the bank in a non-fiduciary capacity or the rate of turnover of the bank's inventory of municipal securities, the Commission does not now have sufficient data or experience with bank municipal securities dealers to ascertain whether such tests are appropriate. In any event, it would appear that the nature of a bank's activities*, rather than the volume of transactions or similar criteria*, are of greater relevance in determining when a bank is a municipal securities dealer.[18]

In short, the SEC's use of an enforcement action—rather than formal SEC or staff guidance—to announce spread and volume as new factors for evaluating a person's dealer status exposes the agency to criticism that it is using settlements with vulnerable market participants to impose significant changes in policy. While this criticism is not new, the legitimacy of this concern has only increased as the SEC seemingly embarks on a more aggressive enforcement agenda, especially one that might not be indulged by the courts if respondents choose to litigate.

Finally, the similarities between the activities in the Acqua Wellington Letter and those in *Murchinson* call into question the continued viability of that letter. While the SEC did not formally withdraw the letter, it did call into question the extent to which market participants can look to the activities in that letter to approximate whether their activities cross certain thresholds.

IMPLICATIONS FOR HEDGE FUNDS AND OTHER 'TRADERS'

Although settled enforcement proceedings may not carry the same precedential status as formal SEC opinions or other determinations—let alone an opinion of a court—given the SEC's stance in *Murchinson*, it may be prudent for market participants to reevaluate their trading practices and consider such practices as susceptible to recharacterization as dealer activities by the SEC.

Indeed, *Murchinson* seems to call into question the longstanding dealer-trader distinction and creates further regulatory uncertainty for market participants. To this end, and as an initial matter, market participants might wish to consider whether they have stock purchase agreements and equity line agreements like those described in *Murchinson* and in the Acqua Wellington Letter. If they do, they might wish to consult with counsel who can help them not only navigate the line between trader and dealer—indeed, attempt to find the line—but also revisit any policies, procedures, guidelines, and practices designed to keep them on the trader side of that line. More generally, market participants might wish to consider the source of their profits and the extent to which those profits rely on spreads versus appreciation. If the former, it may be advisable for market participants to assess their volume, both in general and with respect to specific securities. Helpful metrics for assessing volume can include whether

[18] Adoption of Rule 15ba2-1, Related Form Msd, Rule 15ba2-2 and Temporary Rule 15ba2-3(T) Relating to the Registration of Municipal Securities Dealers Under Section 15b(A) of the Securities Exchange Act of 1934; Adoption of Temporary Rule 15a-1(T) Relating to the Registration of Municipal Securities Brokers and Dealers Under Section 15 of the Act; and Delegation of Authority to the Staff of the Commission, Exch. Act Rel. No. 11742 (Oct. 15, 1975) (Emphasis added.). We note that the definition of a municipal securities dealer and that of a dealer as substantially the same.

a market participant must register as a large trader under Exchange Act Rule 13h-1, or whether they have triggered the position limit rules of the various exchanges and self-regulatory organizations.[19]

While it is too soon to predict the SEC's next moves when it comes to the dealer-trader distinction, it is never a bad idea for market participants to take defensive measures.

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[19] *See, e.g.*, FINRA, Index Options Position Limit Rules.