WILMERHALE

US District Court Vacates Controversial Dealer Rules

DECEMBER 13, 2024

On November 21, 2024, the US District Court for the Northern District of Texas vacated rules adopted by the Securities and Exchange Commission (SEC) in February 2024. Those rules had defined language in the definitions of "dealer" and "government securities dealer" (collectively, dealers) under the Securities Exchange Act of 1934 (Exchange Act) in a way that could be read to capture many market participants—including proprietary trading firms, private funds and crypto trading firms—not currently registered as broker-dealers.[1]

If implemented, the Dealer Rules were expected to have far-reaching consequences across asset classes, causing market participants engaged in liquidity-providing activities to be required to register with the SEC as broker-dealers or government securities broker-dealers pursuant to Section 15(a) or Section 15C of the Exchange Act, become self-regulatory organization (SRO) members and comply with other rules applicable to registered broker-dealers. Under the theory adopted by certain SEC officials that most crypto assets are offered and sold as securities, the Dealer Rules could have included within the definition of "dealer" participants in decentralized finance (DeFi) markets, which also have been scrutinized under other SEC rulemaking, including the proposal to further define language in the definition of "exchange."[2]

While the District Court has made its rulings, the SEC could appeal the decisions to the US Court of Appeals for the Fifth Circuit. However, given new SEC leadership in the incoming Trump Administration, there could be less appetite for such an appeal.

---

[1] *Nat'l Ass'n of Private Fund Managers et al. v. Securities & Exchange Comm'n*, No. 4:24-cv-00250 (N.D. Tex. Nov. 21, 2024); *Crypto Freedom All. of Texas et al. v. Securities & Exchange Comm'n*, No. 4:24-cv-00361 (N.D. Tex. Nov. 21, 2024); *see also* 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, 89 Fed. Reg. 14938 (Feb. 29, 2024) (Adopting Release).

[2] Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," 88 Fed. Reg. 29448 (May 5, 2023).

This client alert describes the Dealer Rules, the District Court's decisions and some of their key consequences.

Background on the Dealer Rules

In February, the SEC adopted Rule 3a5-4 and Rule 3a44-2 under the Exchange Act (the Dealer Rules), which significantly narrowed the so-called trader exception to the definitions of "dealer"[3] and "government securities dealer"[4] available to persons who buy and sell securities for their own account but not "as a part of a regular business."[5] These new rules were designed to address a growing number of market participants not registered as dealers that the SEC viewed as "de facto market makers" in the securities and government securities markets like traditional dealers but without the additional regulations that apply to registered firms.[6]

Specifically, the Dealer Rules broadly defined what it meant to buy and sell securities "as a part of a regular business" to capture securities and government securities market participants that:

- regularly express 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
- earn 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.

As a result, absent an exemption or exclusion, the Dealer Rules required larger market participants engaged in trading that has the effect of providing liquidity to register as broker-dealers or government securities broker-dealers under the Exchange Act and to comply with numerous regulatory requirements associated with registration. The Dealer Rules established several exclusions from the definition of "dealer" for persons having or controlling less than $50 million in assets, as well as registered investment companies, central banks, sovereign entities and international financial institutions. However, many market participants that are regulated under different securities law frameworks, like private funds, were not excluded. Moreover, the Dealer Rules did not form an exclusive basis for establishing dealer status, so a person could have met the definition of "dealer" even if it did not engage in the liquidity-providing activities covered by the new Dealer Rules.

---

[3] 15 U.S.C. § 78c(a)(5).

[4] 15 U.S.C. § 78c(a)(44).

[5] For more information on the SEC's Dealer Rules, please see the WilmerHale Client Alert available here.

[6] *See* Chair Gary Gensler, *Statement on Final Rules Regarding the Further Definition of a Dealer-Trader* (Feb. 6, 2024), https://www.sec.gov/newsroom/speeches-statements/gensler-statement-dealer-trader-020624.

Industry Challenges to the Dealer Rules and the Court's Decisions

a. Private Fund Managers Case

In March, three industry trade associations representing private fund managers sued the SEC in the US District Court for Northern District of Texas seeking an order vacating and setting aside the Dealer Rules (the Private Fund Managers case), arguing that the Dealer Rules exceeded the SEC's statutory authority and were arbitrary, capricious and contrary to law under the Administrative Procedure Act (APA). On November 21, 2024, the District Court granted a motion for summary judgment in favor of the plaintiffs, ruling that the SEC had exceeded its statutory authority in adopting the Dealer Rules and vacating the Dealer Rules in their entirety.[7]

The District Court expressed concern that the Dealer Rules would have turned ordinary trading activity that regularly has the effect of providing liquidity to the marketplace—without more—into dealer activity. In the District Court's view, this interpretation was an expansion of the definition of "dealer" that was inconsistent with the historical understanding of what makes someone a dealer and would have made "unintelligible" the distinction between "dealers," who are required to register with the SEC, and "traders," who are not.[8]

In reaching its decision, the District Court considered the text and structure of the Exchange Act and the history of the definition of "dealer." The District Court viewed "dealer" as a sister term to "broker," which specifically requires a person to effect securities transactions "for the account of *others*," that is, for customers. The District Court explained that at the time Congress enacted the Exchange Act, the "business" of buying and selling securities was understood to involve effecting an order for a customer and that the definitions of "broker" and "dealer" were merely designed to capture two different models for performing that service. The District Court further reasoned that the existence of a shared regulatory framework for brokers and dealers premised on the protection of customers reinforced that the terms "broker" and "dealer" should be read consistently in this manner. As a result, the District Court concluded that being engaged in the business of buying and selling securities as a "dealer"—like acting as a "broker"—needed to be tied to a customer business to distinguish that activity from ordinary trading.

The District Court also highlighted consequences of the Dealer Rules that it believed demonstrated the implausibility of the SEC's broad interpretation of what makes someone a dealer. For example, the Dealer Rules included an exception for central banks that are part of the Federal Reserve System, an indication that the SEC recognized the broad nature of the Dealer Rules—i.e., that

---

[7] *Nat'l Ass'n of Private Fund Managers et al. v. Securities & Exchange Comm'n*, No. 4:24-cv-00250 (N.D. Tex. Nov. 21, 2024).

[8] *Id*. at 9.

under the new rules, central banks' trading in government securities in a manner that provides market liquidity amounts to acting as a dealer.

Given its decision that the SEC exceeded its statutory authority, the District Court in the Private Fund Managers case declined to opine on the plaintiffs' arguments that the Dealer Rules violated the APA or were inconsistent with the Exchange Act with respect to private funds.

b. Crypto Industry Groups Case

In April, shortly after the plaintiffs in the Private Fund Managers case filed their complaint, two crypto industry groups filed a similar challenge in the same District Court, focused on the Dealer Rules' application to crypto market participants (the Crypto Industry Groups case).[9] On November 21, 2024, the same day that the District Court granted a motion for summary judgment in the Private Fund Managers case, the District Court also granted a motion for summary judgment to the plaintiffs. In the Crypto Industry Groups case, the District Court incorporated its analysis from the Private Fund Managers case, noting the significant overlap in arguments, and included an additional reason for its ruling, agreeing with the plaintiffs that the Dealer Rules departed from the long-held understanding that the "business" of dealing has always included "services offered" to investors and "merely engaging in trading activities for a person's own investing or trading objectives" is not a "service" that triggers dealer registration.[10] In other words, for buying and selling to trigger dealer status, it would need to be part of a service provided to customers or counterparties and not merely have the effect of providing liquidity to the market more broadly.

Key Implications of Vacating the Dealer Rules

We expect that the District Court's decisions will have several consequences.

a. General Consideration

First, the Dealer Rules could have required proprietary trading firms, private funds and other firms that provide liquidity in securities (including crypto assets offered and sold as investment contracts) to register as broker-dealers. The Dealer Rules had a one-year compliance period that began on April 29, 2024. Because the broker-dealer registration process typically takes at least six months, firms that believed they were covered by the Dealer Rules may have exited the market, modified their activities or begun the broker-dealer registration process. Now that the Dealer Rules have been vacated, these firms may reenter the market, revisit their earlier activities and/or withdraw their registration or SRO membership applications, unless the SEC obtains a stay of the District Court's orders pending the resolution of any appeal.

---

[9] *Crypto Freedom All. of Texas et al. v. Securities & Exchange Comm'n*, No. 4:24-cv-00361 (N.D. Tex. Nov. 21, 2024).

[10] *Id*. at 5-6.

Second, assuming the District Court's reasoning withstands a potential appeal, the orders define "dealer" to require some nexus to customer- or counterparty-facing activity to distinguish dealers from "traders." The District Court's reasoning would make it difficult to find that proprietary traders that do not provide services to customers and only incidentally provide liquidity to the market acted as dealers.

Third, the Dealer Rules presented special challenges for private funds. Broker-dealer registration would have restricted permissible investment strategies for private funds because, as a registered broker-dealer, a fund would need to comply with broker-dealer regulatory requirements, such as the Net Capital Rule.[11] Accordingly, funds also may have pursued different investment strategies or changed their trading programs.

Fourth, because the Dealer Rules were vacated, if the SEC would like to promulgate a new rule, it will need to follow the full notice-and-comment rulemaking process. For such a complicated rulemaking, that is unlikely to happen by the time Chair Gensler resigns in January 2025. The new chair of the SEC will have authority over the rulemaking agenda and rulemaking staff and may determine not to pursue further rulemaking in this area.

b. Considerations for Crypto Market Participants

In addition to the implications of the decisions explained above, there are other considerations specifically for crypto market participants. The SEC intended for the Dealer Rules to apply to persons engaged in transactions where crypto assets are offered and sold as investment contracts. It was unclear which crypto asset intermediaries would be required to register. In particular, DeFi trading protocols raise difficult interpretive issues.[12] The SEC suggested that "automated market makers" in DeFi markets could be subject to broker-dealer registration, but as Commissioner Peirce explained when the Dealer Rules were finalized, an automated market maker is merely a software protocol.[13] This uncertainty and the lingering threat of an enforcement action could have caused certain firms to cease providing liquidity in crypto markets or through DeFi protocols. With the Dealer Rules vacated, concerns around dealer status under those rules should be mitigated. However, given other long-standing precedent for determining "dealer" status, DeFi market

---

[11] 17 C.F.R. § 240.15c3-1 (requiring broker-dealers to maintain a specific level of net capital at all times).

[12] *See, e.g.*, Adopting Release, 89 Fed. Reg. at 14960 ("[C]ommenters questioned whether the proposed rules would apply to participants in so-called DeFi products, structures and activities, including those involving the use of smart contracts, automated market makers, or other 'all-to-all' or peer-to-peer execution protocols. Commenters expressed concerns that the uncertainty of whether the proposed rules applied to such users or participants could lead to less liquidity in the crypto asset markets.").

[13] Comm'r Hester M. Peirce, *Dealer, No Dealer?: 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* (Feb. 6, 2024), https://www.sec.gov/newsroom/speeches-statements/peirce-statement-dealer-trader-020624.

participants involved with crypto assets should assess their regulatory status based on their specific facts and circumstances.

Contributors

Bruce H. Newman
PARTNER

bruce.newman@wilmerhale.com
+1 212 230 8835

Stephanie Nicolas
PARTNER

stephanie.nicolas@wilmerhale.com
+1 202 663 6825

Andre E. Owens
PARTNER

andre.owens@wilmerhale.com
+1 202 663 6350

Susan Schroeder
PARTNER

susan.schroeder@wilmerhale.com
+1 212 230 8865

Tiffany J. Smith
PARTNER

tiffany.smith@wilmerhale.com
+1 212 295 6360

Elizabeth L. Mitchell
PARTNER

elizabeth.mitchell@wilmerhale.com
+1 202 663 6426

Matthew Beville
SPECIAL COUNSEL

matthew.beville@wilmerhale.com
+1 202 663 6255

Kyle P. Swan
SENIOR ASSOCIATE

kyle.swan@wilmerhale.com
+1 202 663 6409

Joshua Nathanson
ASSOCIATE

joshua.nathanson@wilmerhale.com
+1 202 663 6193