

SEC's Cases Against Dealers Could Lead to the Supreme Court, Securities Lawyers Say

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The U.S. Securities and Exchange Commission is testing in multiple court cases the breadth of who qualifies as a securities “dealer” under federal law, even as the agency has proposed expanding its own definition of dealers.

Securities attorney said these cases addressing the scope of the 1934 Securities Exchange Act could reach the U.S. Supreme Court.

“Does the term dealer today mean what Congress intended it to mean in 1934, which is how the Supreme Court says we’re supposed to read the statute ... or does the term dealer mean something quite different, which is what the SEC is telling courts now,” said Gabriel Gillett, a partner at Jenner & Block.

In April 2022, the SEC proposed a rule to expand the definition of a securities dealer to include any entity that buys and sells securities but has yet to be adopted. In the meantime, the agency has brought multiple enforcement actions against penny stock traders advocating a new interpretation of securities dealer.

The proposed definition of dealer could affect financial market participants such as mutual, private and pension funds, but also individual investors, Gillett said.

“This has an impact on regular people,” he said. “This is a real red flag. It’s potentially a big problem. Investors, individuals, and other market participants need to understand what the SEC is trying to do here; they could really be at risk if the SEC’s view prevails.”



U.S. Securities and Exchange Commission building in Washington.

One of the cases is SEC v. Keener before the U.S. Court of Appeals for the Eleventh Circuit. Justin Keener is challenging a district court ruling that he was required but failed to register as a securities dealer with the agency when he bought and sold billions of newly issued penny stock shares from 2015 to 2018. Keener obtained the shares directly from issuers after converting debt securities, also known as convertible notes, according to the SEC.

In June, Gibson, Dunn & Crutcher sued the SEC in the U.S. District Court for the District of Columbia, alleging the agency failed to respond to a Freedom of Information Act request relating to its broker-dealer enforcement actions over the last five years. The case is pending.

The cases the SEC has brought involve defendants who are smaller players focusing on convertible lending.

Gillett said the cases focus on convertible securities, which start as debt but can be converted into equity. The SEC has argued that anyone who buys and sells securities as a business can be deemed a dealer even if they don't have customers, transaction-based compensation or meet the factors the SEC has traditionally relied upon, Gillett added.

The SEC has sought penalties and disgorgement from those it alleges have acted as a dealer without registering as a dealer.

Gillett said these cases might eventually get to and spark interest from the Supreme Court because they involve interpreting federal securities statutes, limit agency power to devise new interpretations of old statutes and potentially affect many people.

The Supreme Court recently ruled against broad interpretations of federal agency authority in striking down the Environmental Protection Agency's definition of "waters of the United States" under the Clean Water Act in *Sackett v. EPA*.

The Securities Exchange Act defines a dealer as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." A dealer must register with the SEC and the Financial Industry Regulatory Authority, subject to a slew of regulations and other requirements.

Mark Perlow, a partner at Dechert, said the SEC's reasoning for proposing a rule to expand the dealer definition is "very straightforward."

The dealer market for government securities has increasingly moved toward proprietary trading firms and electronic forms of creating automated trading portals, Perlow said.

"The SEC believes that they've lost the ability to regulate and to monitor a larger portion of this market than they have in the past," Perlow added.

Of the proposed rule, SEC Chair Gary Gensler said he believes "it reflects Congress's statutory intent that firms engaging in important liquidity-providing

roles in the securities markets, including in the U.S. Treasury market, be registered with the commission."

He added that "requiring all firms that regularly make markets, or otherwise perform important liquidity-providing roles, to register as dealers or government securities dealers also could help level the playing field among firms and enhance the resiliency of our markets."

Perlow said the Supreme Court has been reining in regulatory agencies' powers and the SEC might attract the justices' notice.

"I wouldn't be surprised if there were some challenges that argued that the SEC had stretched the meaning of the term dealer too far in this particular case," Perlow said.

He added when industry challenges the SEC, the challenge is typically based on three grounds: the agency lacks the authority, its cost-benefit analysis is inadequate and its rulemaking was arbitrary and capricious.

The likely challenge to the SEC will involve hedge funds, Perlow said.

"The SEC is worried that the proprietary trading firms it's trying to regulate here might just convert into hedge funds in order to avoid the scope of the rule," Perlow said.

In the past, the SEC has lost cases when it has attempted to change the definitions that have been in place for an extended time, Perlow added.

The judicial reasoning for the losses was if "Congress meant that this entire piece of the industry was intended to be regulated, it should have been clear to you 20, 30, 40 years ago," Perlow said.

The most notable case occurred 20 years ago when the SEC first attempted to regulate hedge fund managers before the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act allowed the agency to do so.

"The SEC lost a challenge that was brought by hedge fund managers and lost the ability to regulate hedge fund managers, and you could see a case playing out the same way here that somebody sues the SEC and they lose it on that ground," Perlow said.