ALERTS

SEC's Dealer Rule Vacated

November 26, 2024

Executive Summary

On Nov. 21, 2024, Judge Reed O'Connor of the US District Court for the Northern District of Texas ("District Court") vacated recently adopted rules 3a5-4 and 3a44-2 (together, the "Dealer Rule") of the Securities Exchange Act of 1934, as amended ("Exchange Act").[1] In concluding that the Securities and Exchange Commission (the "SEC" or "Commission") exceeded its statutory authority in adopting the Dealer Rule, the District Court determined that the Dealer Rule was "untethered from the text, history, and structure of the [Exchange] Act."[2]

Notably, in determining to vacate the Dealer Rule, the District Court placed significant weight on the fact that "Congress defined the term 'dealer' against a pre-existing historical backdrop … indicative of an understanding that dealers have customers."[3] While it is encouraging that the District Court adopted a view that entities without customers, like private funds, cannot generally be considered "dealers," it remains to be seen what effect this will have on the SEC's enforcement efforts, which pre-date the Dealer Rule. Whether the SEC pursues an appeal of the decision vacating the Dealer Rule will be a decision for the new administration.

Background

Exchange Act section 3(a)(5)(A) defines "dealer" as "any person engaged in the business of buying and selling securities … for such person's own account through a broker or otherwise." Relatedly, Exchange Act section 3(a)(5)(B) notes that "[t]he term 'dealer' *does not include* 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*." (Emphasis added). The exception provided by Exchange Act section 3(a)(5)(B) is intended to carve-out from the definition of dealer people who trade for their own accounts, but not as part of a regular business (e.g., "traders").

On Feb. 6, 2024, the Commission adopted the Dealer Rule[4] to "further define" what it means to be "engaged in the business" of buying and selling securities for one's own account. The Dealer Rule established two *non-rebuttable* qualitative standards (collectively, the "Qualitative Tests") [5] that, if met, would require registration with the SEC as a "dealer" or "government securities dealer" (collectively, a "Dealer").

On March 18, 2024, various associations of private fund managers[6] brought an action challenging the Dealer Rule, alleging, among other things, that the rule violated the Administrative Procedure Act ("APA") because it exceeded the SEC's authority under Exchange Act and, separately, was arbitrary and capricious.

District Court Decision

On Nov. 21, 2024, the District Court granted Plaintiffs' motion for summary judgement, holding that the Commission had exceeded its statutory authority under the Exchange Act in adopting the Dealer Rule, and vacated the Dealer Rule in full. As the District Court found that the Commission had exceeded its statutory authority, the District Court did not address Plaintiffs' claim that the SEC's rulemaking was arbitrary and capricious, nor did it rule on the Dealer Rule as applied to private funds in particular.

In granting the Plaintiffs' motion for summary judgement, the District Court focused heavily on whether being "engaged in the business" of buying and selling securities for one's own account covers people who do not provide liquidity as a service to *customers*. The District Court agreed with Plaintiffs' argument that the "history of the Exchange Act make[s] unmistakably clear that a 'dealer' (like a 'broker') is in the business of 'effect[ing] securities transactions *for customers*.'"[7] Further, the District Court found the Commission's argument – that the dealer definition covers, and has always been understood to cover, people without customers – would make the dealer-trader distinction "unintelligible."[8]

While the Commission pointed to two cases from the Eleventh Circuit in support of its position that Dealers do not need customers,[9] the District Court distinguished these cases as being limited to the specific conduct at issue and concluded that neither case supported the proposition that "merely regularly buying and selling securities renders someone [without customers] a dealer."[10]

Conclusion

While the District Court's rulings vacated the Dealer Rule in its entirety, market participants should continue to assess whether they might be deemed Dealers under existing SEC guidance. For instance, SEC guidance notes that quoting a market – that is, a simultaneous bid and ask – for a security (for instance, on a disclosed basis in an "over-the-counter" market), holding oneself out as willing to buy and sell a security on a regular basis and engaging in trading in securities for the benefit of others are all indicative of "dealer" status.[11] Firms engaging in such activities should be cognizant of whether their trading counterparties could be viewed as "customers" and whether such arrangements might otherwise be viewed as offering "dealer" services.

Further, the SEC has successfully brought cases in recent years finding certain participants in the convertible debt market[12] to be unregistered dealers. Such cases and related enforcement actions have been based on the statutory definition of "dealer" under the Exchange Act rather than the Dealer Rule. Notwithstanding the absence of clear customer relationships, the District Court discussed two of these cases and indicated that the holdings in those two cases are compatible with the District Court's holdings in the Dealer Litigations.[13] While SEC staff may, under the incoming administration, continue to bring enforcement actions for this type of convertible debt financing activity, we would not expect the SEC to materially expand the type of activity targeted in such actions.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *Nat'l Ass'n of Priv. Fund Managers v. SEC*, No. 4:24-cv-00250 (N.D. Tex. Nov. 21, 2024) ("Private Fund Litigation"); *Crypto Freedom All. of Tex. v.*

SEC, No. 4:24-cv-00361 (N.D. Tex. Nov. 21, 2024) (the "Crypto Security Litigation," together with Private Fund Litigation the "Dealer Litigations").

[2] *Nat'l Ass'n of Priv. Fund Managers*, No. 4:24-cv-00250, at 7.

[3] *Id.* at 9.

[4] "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer," Exchange Act Release No. 34-99477 (February 6, 2024) 89 Fed. Reg. 14938 (Feb. 29, 2024). *See also* SRZ's previous Alert regarding the substance of the Dealer Rules, available here.

[5] One test that targeted the regularity of a market participant's expressions of trading interest and another that targets a market participant's primary source of revenue.

[6] The National Association of Private Fund Managers; Alternative Investment Management Association, Limited; and Managed Funds Association were plaintiffs in the Private Fund Litigation. The parallel Crypto Security Litigation was brought by the Crypto Freedom Alliance of Texas, et al. The Private Fund Litigation and Crypto Security Litigation plaintiffs are collectively referred to herein as the "Plaintiffs."

[7] *Nat'l Ass'n of Priv. Fund Managers*, No. 4:24-cv-00250, at 10 (quoting Pls.' Br. in Supp. Mot. Summ. J. 10, ECF No.). (Emphasis added).

[8] *Id.* at 9.

[9] *See SEC v. Almagarby*, 92 F.4th 1306 (11th Cir. 2024); *SEC v. Keener*, 102 F.4th 1328 (11th Cir. 2024).

[10] *Nat'l Ass'n of Priv. Fund Managers*, No. 4:24-cv-00250, at 15.

[11] *See* Exchange Act Release No. 34-40594, 63 Fed. Reg. 59362 (Nov. 3, 1998).

[12] Generally, purchasers of convertible debt notes from microcap issuers who subsequently convert such notes into common stock at a steep discount to the stock's then-current market price and quickly liquidate the stock following receipt.

[13] *See* FN 9, supra.

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