

The SEC's Dealer Rule Lingers On

Also, FSOC meets; confirmation hearing for Atkins and Gould set; senators back CDFI Fund

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The SEC’s dealer rule was overturned by a federal judge last November – coincidentally the same day that its main proponent, **Gary Gensler**, announced his resignation. But although the regulation’s chief backer is gone, aspects of his controversial policy are still kicking, at least in some courts. Getting rid of something, it turns out, can be harder than it seems.

The rub is that the theory behind Gensler’s effort – that firms trading large volumes of securities should be labeled “dealers” and subjected to much stricter oversight – has been pushed for years by the agency in enforcement actions. In fact, several federal judges have ruled in the SEC’s favor, potentially enshrining the notion in legal precedent. That includes two decisions that have been upheld on appeal in the 11th Circuit.

Overall there are about a half dozen similar cases the enforcement division has brought since 2017, accusing investment firms that trade penny stocks of operating as unregistered dealers. The litigation hasn’t drawn much attention, except from a small group of hedge fund lawyers who have been watching the developments closely. Lately, however, alarm has been growing and the industry has escalated its pushback.

Last month, the Managed Funds Association and other groups filed an amicus brief in the Eighth Circuit to highlight what they see as the “far-reaching and detrimental effects on the proper functioning of the nation’s financial markets.”



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In the case, a trial court agreed with the SEC’s contention that a firm called Carebourn Capital operated as a dealer when it flipped securities issued by microcap companies. While the brief didn’t weigh in on the underlying behavior, it stressed that the decision, if allowed to stand, “would make a felon of every institutional investor – every hedge fund, mutual fund, pension fund and private-investment office – in America.”

The filing also suggested that the SEC may be trying to do an end-run around the Texas federal judge who last year found the agency didn’t have the authority to adopt the dealer rule. “The commission is at it again – this time in litigation,” the brief pointed out. “Here, the commission sued a small defendant, without the means to defend itself, and pressed a theory that, if taken seriously, would – once again – seem

to subject many of the world's largest, most prominent market participants to a regulatory scheme Congress has not provided.”

(The brief was written by **Eugene Scalia**, the Gibson, Dunn & Crutcher partner and former Labor secretary who represented the trade associations in their successful challenge to the dealer rule.)

Outside of court, the industry has also been pressing the SEC to clarify its thinking on the issue. One step that it has requested is for the agency to issue some type of guidance memorializing a more limited definition of what constitutes a dealer.

That ask may well get a friendly reception. The two Republicans in the SEC's majority, Acting Chairman **Mark Uyeda** and Commissioner **Hester Peirce**, both voted against the dealer rule, partly because it was so expansive. They are also not likely to approve any more enforcement actions based on a similar theory.

The industry campaign, combined with the Republican takeover at the SEC, already appears to be having an effect – at least on some of the pending litigation. Earlier this month, agency lawyers asked federal judges in Illinois and New York to put cases on hold while settlements are negotiated.

The Eighth Circuit case, however, is a bit trickier because the SEC doesn't have the choice to drop it – the other side appealed. The agency recently asked for an extension on its response, which is now due in May. There is great anticipation in the hedge fund world about what it will say.

Stepping back: There's been so much talk about “regulation by enforcement” at the SEC (especially by crypto firms) that the term has almost lost its meaning. But some securities lawyers argue that the actions brought against the penny stock trading firms are a textbook example. “They are changing the definition of dealer on a case-by-case basis,” says **Nick Morgan**, a former trial attorney at the agency who now runs the Investor Choice Advocates Network.

As a result, the Gensler-era expansion of the dealer definition lives on like a zombie, despite the death of the rule that formalized it. The two 11th Circuit opinions backing that broad view are likely to remain as precedent, potentially allowing a later chairman to restart the effort. “Nothing prevents the SEC in five years time from picking up where Gensler left off,” Morgan notes.

That’s why the MFA filed its amicus brief in the Carebourn case, notes **Matt Daigler**, the association’s vice president of regulatory affairs. “The court should reject the SEC’s overly-expansive interpretation of the dealer definition and avoid setting a precedent that risks exposing many other market participants – including private funds, mutual funds and even the Federal Reserve – to future enforcement actions,” he says.

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New-Look FSOC: Donald Trump’s regulators convened for their first FSOC meeting today, with deregulation at the top of the agenda. In an unusually extensive readout from the closed meeting, the Treasury Department recounted that Secretary **Scott Bessent** emphasized his intention “to prioritize enhancements to the member agencies’ supervisory and regulatory frameworks, as well as other efforts to position banks and other regulated entities to foster innovation and otherwise support economic growth.”

Bessent encouraged council members “to re-focus their supervision on material financial risks.” He also “expressed support for ongoing banking agency work to remove reputational risk as a basis for supervisory criticism,” the readout said. The latter is consistent with the desires of Republicans on Capitol Hill, who see examiners’ focus on the nebulous concept as one reason for the alleged debanking of conservatives.

Acting Comptroller **Rodney Hood**, who attended the meeting, announced later in the afternoon that the OCC will cease exams related to reputational risk and remove references to it from supervisors’ handbooks. “The OCC’s examination process has always been rooted in ensuring appropriate risk management processes for bank activities,” said Hood in a statement. “Focusing future examination activities on more transparent risk areas improves public confidence in the OCC’s supervisory process and makes clear that the OCC has not and does not make business decisions for banks.”

Also on the FSOC agenda were an update on Treasury market resilience efforts, a Fed briefing on cyber threats and a discussion of “ongoing concerns regarding the availability and increased costs of property insurance for homeowners and the potential effects on the housing market and broader financial system.”

Confirmation Hearing: The Senate Banking Committee teed up three regulators for a nomination hearing next Thursday: SEC chairman pick **Paul Atkins**, comptroller choice **Jonathan Gould** and **Luke Pettit**, to be assistant Treasury secretary for financial institutions. It’s been an especially long wait for Atkins, who was announced all the way back in early December and is surely itching to get on the job.

Pushback: Treasury's Community Development Financial Institutions Fund got a vote of support from Capitol Hill today, as 23 senators signed a letter opposing cuts to its

operations. The program was targeted in a White House executive order last Friday.

The lawmakers addressed their letter to Bessent, who oversees the fund and has signaled he will defend it. Earlier this week, he issued a statement praising CDFIs and calling their mission consistent with the administration's priorities.

The group of senators (12 Democrats and 11 Republicans) now rallying behind Bessent includes **Mike Crapo**, chairman of the Senate Finance Committee, as well as Democrats **Mark Warner** and **Charles Schumer**, the minority leader. “The CDFI Fund's public-private partnership model aligns with this administration's emphasis on ensuring that taxpayer dollars are spent efficiently and with measurable impact,” the lawmakers stressed. “Every federal dollar injected into a CDFI generates at least eight more dollars from private-sector investment.”

They added that “a reduction in the functions and operations of the CDFI Fund will have a corresponding impact on CDFI-certified entities and local communities and we urge you to avoid this unfortunate outcome.”

The executive order directs the head of the CDFI fund to file a report to OMB Director **Russell Vought** by tomorrow justifying the legality of its various efforts and functions. Bessent has said the department will comply.