

Broker-Dealer

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Federal District Court Vacates the Security and Exchange Commission's Expanded Dealer Rule

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What You Need To Know:

- A federal district court vacated the SEC's recently implemented Dealer Rule.
- The Dealer Rule imposed registration requirements on many previously exempt hedge funds, private funds, and traders.
- Because it is unlikely that the ruling will be appealed, the pre-Dealer Rule status quo is most likely here to stay.

On Nov. 21, Judge Reed O'Connor of the Northern District of Texas vacated the Security and Exchange Commission's (SEC) newly enacted Rules 3a5-4 and 3a44-2 (collectively, the Dealer Rule), which expanded the scope of who qualified as a broker-dealer under the Securities Exchange Act of 1934 (Exchange Act). The Dealer Rule would have required hundreds of previously exempt individuals and entities to register with the SEC and was widely opposed by individuals and entities connected to the crypto and finance industries. In his opinion, Judge O'Connor held that the SEC violated the Administrative Procedure Act (APA) by acting arbitrarily and capriciously in promulgating the rule. An SEC spokesperson stated that the agency was reviewing Judge O'Connor's decision before deciding whether to appeal the ruling to the Fifth Circuit Court of Appeals.¹

Background of the Dealer Rule

On March 29, 2022, the SEC proposed the Dealer Rule to revise the definitions of "dealer" and "government securities dealer" under Sections 3(a)(5) and 3(a)(44), respectively, of the Exchange Act.²

At the time, the SEC wanted to identify certain activities that would constitute a "regular business" requiring a person engaged in certain liquidity-providing activities to register as a "dealer" or a "government securities dealer." The Dealer Rule created a three-part qualitative test to determine whether a person or entity was required to register as a dealer. This test, along with the rest of the Dealer Rule, represented a significant expansion of the definition of a dealer and thus imposed a significant regulatory burden on many previously exempt individuals and entities, including dozens of previously exempt private funds and crypto businesses.

The Dealer Rule was met with mixed reactions, with many individuals and entities submitting comments in favor of or against the Dealer Rule. Commentators were concerned about the new definition being overly broad and about compliance challenges associated with the Dealer Rule. However, the SEC eventually passed the rule in a three-to-two vote and promulgated the Dealer Rule on Feb. 29, 2024.³ The Dealer Rule was set to go into effect on April 29, 2024, with required registrants having a one-year period to comply with the new registration and reporting requirements. At the time, many observers noted that the new definition was so broad that had the SEC not included an exception in the Dealer Rule, the Federal Reserve would have had to register under the new rule.

Legal Challenges

Almost immediately, the Dealer Rule was challenged in court. Two lawsuits were brought in the Northern District of Texas. The first was brought by the National Association of Private Fund Managers and other investment industry groups, while the second was brought by the Blockchain Association and the Crypto Freedom Alliance of Texas, two cryptocurrency organizations. The plaintiffs alleged that the Dealer Rule placed high regulatory burdens on private funds and would decrease liquidity in the long term.

At the time, Bryan Corbett, the CEO of the Managed Funds Association, one of the plaintiffs in the first case, stated that “[t]he Dealer Rule is indeterminate and leaves certain market participants uncertain of their need to comply with the dealer regulatory framework. Alternative asset managers are not dealers. They are customers of dealers. If the rule is permitted to stand, it could mean that managers in scope and the funds they manage would lose their customer protections with their dealer counterparties and could not participate in IPOs. This would harm funds, their investors, and issuers looking to raise capital.” In their filings, the plaintiffs alleged that the Dealer Rule was arbitrary and capricious under the APA and that, in enacting the Dealer Rule, the SEC exceeded the scope of its authority. The SEC argued that the new definition was authorized under the Exchange Act because the previously exempt entities were actually dealers, since they provided liquidity. The SEC further argued that this provision of liquidity was sufficient to impose a registration requirement on the previously exempt funds.

Vacatur of the Dealer Rule and Judge O’Connor’s Reasoning

At the time the Exchange Act was enacted, there was a common law understanding that both brokers and dealers traditionally interacted with customers. In vacating the Dealer Rule, Judge O’Connor stated that under the statutory scheme enacted under the Exchange Act, Congress incorporated the common law understanding and differentiated brokers and dealers “based on how one engaged in the transactions of securities, be that for the account of others—a broker—or for one’s own account—a dealer.”⁴ According to Judge O’Connor, the issue with the revised rules was that the SEC effectively ignored that distinction, a distinction that had stood undisturbed for 90 years.⁵ Judge O’Connor noted that suddenly, in 2022, the SEC discovered it had authority it had not claimed for the entirety of its existence.⁶

Applying the Dealer Rule to private funds, Judge O’Connor held that these funds trade for their “own best interests, and not to provide advice or services to other investors.”⁷ The protections of the Exchange Act are designed to protect customers, and without customers, the notice and registration requirements of the Exchange Act do not make sense.⁸ Dealers have to be “in the business of customer-order facilitation.”⁹ Private funds are not such entities, yet under the Dealer Rule, they would have been required to register as if they were.

Judge O’Connor ultimately vacated the Dealer Rule, as opposed to remanding it to the SEC for revision. The decision to vacate first turned on the determination that the SEC acted in excess of its authority rather than on a determination that the SEC failed to justify its decision for an otherwise permissible rule.¹⁰ Second, because vacatur merely reestablished the status quo of the past 88 years, there was no concern that vacatur would be disruptive to the industry. Thus, given these factors, Judge O’Connor felt justified in vacating the Dealer Rule in its entirety.

The Future of the Dealer Rule and a Possible Appeal

Whether the SEC appeals Judge O’Connor’s ruling remains to be seen. Because the Northern District of Texas is under the jurisdiction of the Fifth Circuit, it is highly unlikely that the agency would have the ruling reversed on appeal. This ruling is just one of several unfavorable rulings handed down by courts to the SEC in the past few years. With several other legal challenges still pending, and with the incoming administration in January 2025, the fate of the Dealer Rule and of other rules enacted during Gary Gensler’s tenure as chair of the SEC remains unclear. The SEC may consider revisiting many of the rules and rulemaking processes implicated by these cases, whether through reopened comment periods, new rule proposals or revised re-proposals, or other further engagement with market participants.

After the ruling was released, Corbett stated, “MFA looks forward to working with the next SEC Chair to pursue policies that support robust capital markets, change the adversarial relationship between policymakers and market participants, and embrace alternative asset managers as drivers of economic growth.” Although Gensler stated that he will step down in January 2025, the incoming administration has yet to indicate who will replace him. Regardless of who is chosen, it is likely that his successor will not attempt to revive the Dealer Rule. The status quo on dealer registration and exemption is here to stay, at least for the time being.

Next Steps

For any questions or to further discuss any regulations, please reach out to the authors of this article or directly to your regular Lowenstein Sandler investment management contact.

¹ Douglas Gillison, *US Court Vacates SEC ‘Dealer Rule’ on Treasury Markets*, REUTERS, Nov. 21, 2024, <https://www.reuters.com/markets/us/us-court-vacates-sec-dealer-rule-treasury-markets-2024-11-21/#:~:text=Adopted%20in%20February%20over%20Republican,to%20register%20as%20broker%20dealers>.

² 87 C.F.R. § 23054 (2022).

³ 89 C.F.R. § 14938 (2024).

⁴ *National Association of Private Fund Managers v. Securities and Exchange Commission*, No. 4:24-cv-00250-O at 8 (N.D. Tex. Nov. 21, 2024).

⁵ *Id.* at 9.

⁶ *Id.* at 12.

⁷ *Id.* at 13.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at 18.

Contacts

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