

Aggressive SEC Enforcement Actions Could Limit Small Business Recovery Resources

The commission's Enforcement Division has waged an overly aggressive and entirely unnecessary campaign against the very firms that provide capital and liquidity to the small businesses the SEC says it wants to help.

BY HELGI WALKER, BARRY GOLDSMITH, JONATHAN SEIBALD AND BRIAN RICHMAN

In recent public statements, the chair and other commissioners of the Securities and Exchange Commission have struck the right chord: they have vowed to leverage every tool in their regulatory tool kit to facilitate the flow of capital to the thousands of small businesses that are struggling to stay afloat in the wake of the COVID-19 pandemic. However, contrary to the SEC's stated priorities, the commission's enforcement division has waged an overly aggressive and entirely unnecessary campaign against participants in the market for convertible debt—the very firms that provide capital and liquidity to the small businesses the SEC says it wants to help. Witness *SEC v. Fierro* in the U.S. District Court for the District of New Jersey, or *SEC v. Keener* and *SEC v. Almagarby* in the U.S. District Court for the Southern District of Florida.

In these litigated enforcement actions, the enforcement division has taken the novel position that various lenders in the shares of convertible debt—firms that do not directly interact with the investing public—are actually “dealers” subject to the full range of registration and other regulatory requirements applicable to public securities businesses. Why? Because some borrowers opt to satisfy their outstanding debt by allowing the lender to convert that debt into discounted shares of stock in the borrower, which the lender under SEC regulations can sell after waiting six months. The enforcement division



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insists that this well-established activity satisfies the definition of a dealer because the lender is “buying and selling securities” for its “own account.”

That is just wrong. The division's theory would not only sweep in thousands of unsuspecting businesses that buy and sell securities; it breaks with the plain terms of the Securities Exchange Act, over a century of precedent and decades of the commission's own guidance. A dealer is a known quantity under our nation's securities laws, and no one—including the SEC—has ever thought that the term referred to any business that just so happened to buy and sell securities, even a lot of securities. Quite the contrary. The term distinguishes a particular, preexisting type of public securities business—a dealer—from another type of preexisting public securities

business—a “broker.” Such businesses occupy two sides of the same coin. Under the Exchange Act, while a broker effectuates a client’s trades as an agent—buying and selling securities for the client—a dealer effectuates a client’s trades as a principal—buying and selling securities from or to the client.

Either way, the key is public customers. Many individuals and businesses trade securities—but only a broker or a dealer holds itself out to the investing public as a public securities business. The commission has long recognized as much. In 1992, for instance, in *In re Gordon Wesley Sodorff Jr.*, the commission acknowledged that certain “factors”—such as handling investors’ money and securities, rendering investment advice and sending “subscription agreements to investors for their review and signature”—are what “distinguish[ed] the activities of a dealer from those of a private investor or trader.” SEC guidance has made the same point for decades—listing similar customer-facing factors in, for example, 1977, 1987, 1993, 1998, 2002, 2003, 2007 and 2008. And the courts have long agreed, as the U.S. District Court for the Northern District of Texas explained in 2016, in *Chapel Investments v. Cherubim Interests*: “To be considered a dealer, a person must be engaged in the securities business, such as soliciting investor clients, handling investor clients’ money and securities, rendering investment

advice to investors, and sending investors subscription agreements for their review and execution.”

This customer focus is not just compelled by the law, but by sound public policy. Dealers, after all, are subject to an expensive, complex regulatory regime designed to protect investors, including standards of professional conduct, financial responsibility requirements, record-keeping requirements and employee-supervisory obligations. Which is all well and good for entities with customers, but entirely nonsensical for businesses without that just happen to buy and sell securities for their own account.

For these reasons, convertible debt lenders are not—and, before the Enforcement Division’s misguided enforcement endeavor, have never been—considered dealers. A convertible debt lender, as the name implies, loans money to a small business in exchange for a convertible note. It is not, to quote the Exchange Act, in the “regular business” of “dealing.” It does not “buy[] and sell[]” the same security in the same condition. It does not interact with the investing public. It does not hold investor’s securities. It does not quote a two-way market. And it does not offer investment advice—to anyone, ever. In no world, then, is it engaged in the public-facing business of offering dealer services to others.

That should end the matter. The Enforcement Division should never try to change the law (not

to mention the commission’s long-standing guidance) through regulation by enforcement, outside the proper legislative or rulemaking processes. That is especially true here, where the Enforcement Division’s targeting of vital financing providers threatens to take much-needed capital out of the convertible debt markets, squeezing small businesses and introducing a level of regulatory uncertainty that would be inappropriate in the best of times—and we are far from that. If the Enforcement Division really believes that convertible debt lenders are dealers just because their business involves buying and selling securities, who is next? Hedge funds? Investment companies? Day traders?

Consistent with its stated goal of supporting small businesses during the pandemic, and in order to adhere to the long-established meaning of “dealer” under the federal securities laws, the commission should rein in the Enforcement Division’s misguided campaign against those who provide much-needed capital to small businesses through the convertible debt market.

Helgi Walker is a partner at Gibson, Dunn & Crutcher and chair of the firm’s administrative law and regulatory practice group. Barry Goldsmith is a partner at the firm and co-chair of the firm’s securities enforcement practice group. Jonathan Seibald and Brian Richman are associates at the firm.