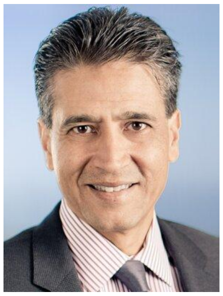
Why SEC Abandoned Microcap Convertible Debt Crackdown

By **Jorge deNeve, Michele Layne and Bill Martin** (July 21, 2025)



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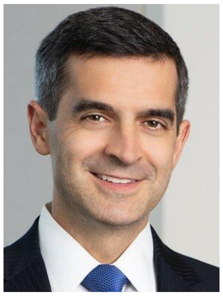

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On June 18, the U.S. Securities and Exchange Commission filed joint stipulations to dismiss three cases targeting microcap convertible debt lenders, marking a significant disavowal of a controversial enforcement initiative. This follows the SEC's dismissal of three similar cases — and claims in a fourth — on May 22.

The cases centered on alleged violations of dealer registration requirements under the Securities Exchange Act. The SEC argued that the defendants, which financed struggling microcap companies in exchange for deeply discounted convertible equity, were operating as unregistered securities dealers because they were engaged in the regular buying and selling of securities "as part of a regular business."

The actions alarmed investment firms that viewed the SEC's theory of who qualifies as a securities dealer as novel and unrestrained. None of these cases involved allegations of fraud or false statements — a likely critical factor in the new SEC leadership's decision to abandon these cases.

The SEC's Crackdown on Lenders Targeting Microcap Companies

The SEC's campaign against microcap convertible debt lenders, often derided as "toxic lending," targeted lenders that structured financing deals with penny stock companies in ways that led to significant equity dilution.

One prominent example was the SEC's case against Auctus Fund Management and its principals, Louis Posner and Alfred Sollami.

In June 2023, the SEC alleged that Auctus generated over $100 million in profits through 100 convertible debt transactions with microcap companies between 2012 and 2021. According to the SEC, Auctus provided financing to microcap companies in exchange for promissory notes that could be converted into equity shares of those companies at a substantial discount from the market price of the shares.

Auctus also allegedly made cash repayment so onerous that almost all loans resulted in Auctus obtaining large amounts of equity shares. Auctus then allegedly sold the newly issued shares shortly after acquiring them.

The SEC claimed that Auctus' conduct required that it register as a securities dealer pursuant to Section 15(a)(1) of the Exchange Act. The SEC focused solely on registration violations and did not allege any fraud or deceit. The SEC sought injunctive relief, a civil penalty, disgorgement of Auctus' profits, and cancellation of any securities Auctus still held pursuant to its actions.

Courts Backed the SEC's Lawsuits While the SEC's Republican Commissioners Expressed Dismay

The defendants in these cases argued that the Exchange Act's definition of a "dealer" — someone "engaged in the business of buying and selling securities … for such person's own account" — did not apply to them. They claimed their activities did not involve customer transactions and therefore should not trigger dealer registration requirements. Otherwise, many of the defendants argued, every hedge fund, family office and day trader would be required to register as a securities dealer.

Courts uniformly disagreed, with rulings from both district courts and the U.S. Court of Appeals for the Eleventh Circuit affirming the SEC's position.

In SEC v. Almagarby, the Eleventh Circuit affirmed a judgment against an individual who purchased debt instruments for microcap companies from third parties; negotiated — with those microcap companies — terms for exchanging those instruments for convertible debt; and then converted the debt into stock.[1]

In its February 2024 opinion, the court highlighted the "volume and regularity of Almagarby's transactions" and that he "brought new shares to the market."[2] It concluded that Almagarby was a "dealer" as opposed to a "trader" under the Exchange Act, rejecting any requirement that a dealer have customers.

The court underscored that the "'centerpiece' of the Exchange Act's dealer definition is the word 'business,' which is 'a particular occupation or employment habitually engaged in for livelihood or gain.'"

Despite these courtroom victories, the SEC commissioners did not uniformly believe in the wisdom of these cases. The SEC Republican commissioners expressed discomfort with the enforcement initiative, even though some of the cases were authorized during the first Trump administration.

Commissioner Mark Uyeda has questioned whether microcap lenders had received adequate guidance and "fair notice" that their activities required dealer registration. In a speech in November 2023, Uyeda stated that after reading the SEC's Guide to Broker-Dealer Registration, it would have been "understandable" for a microcap convertible debt lender "to conclude that their conduct did not require them to register with the Commission as a dealer since they were using their own money and did not provide services to clients or do business with the public."[3]

In his view, according to an August 2024 statement, these convertible debt cases "introduced a novel interpretation that such activities meant that investors were 'dealers.'"[4] He also stated that prior to 2017 — the date that the first microcap convertible debt case was filed — investors in convertible debt "had no reason to believe that their activity could trigger dealer registration obligations."[5]

In February 2024, both Commissioners Uyeda and Hester Peirce dissented from the adoption of the controversial dealer rule, which expanded the scope of what entities qualify as a dealer under the Exchange Act.

A provision of the rule expressly defined a "dealer" as someone earning "revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interest."[6] In announcing the adoption of the rule, the SEC stated that it would cover "those who take on significant liquidity-providing roles in the markets."[7]

In his statement explaining his dissent from adopting the dealer rule, Uyeda stated, "Until recently, the Commission has enforced dealer registration in a manner consistent with the idea that 'broker' and 'dealer' relate to customer orders."[8] In her dissent, Peirce lamented that the dealer rule "turns traders, many of whom are customers, into dealers," and that doing so "runs counter to the statute, as the Commission and market participants have read it for decades."[9]

In November 2024, the U.S. District Court for the Northern District of Texas vacated the dealer rule on the ground that the SEC had exceeded its statutory authority in adopting the rule.[10] After filing an initial notice of appeal under the prior administration, the new Republican-led SEC decided to dismiss the appeal in February.

Why the SEC Pulled Back

The SEC's sudden reversal appears to reflect a shift in priorities under its Republican-led leadership. The current SEC has signaled a back-to-basics approach, focusing on traditional enforcement areas and fraudulent conduct.

While the dismissed cases highlighted the risks to the borrower's investors of convertible microcap lending — such as stock dilution and falling share prices — the absence of fraud allegations and prior similar cases likely doomed these cases.

The sole current Democratic commissioner, Caroline Crenshaw, issued a strong dissent from the decisions to drop these cases, stating on May 22, "It is astonishing that an agency tasked with enforcing the law has decided the law does not matter."[11] Crenshaw added that a "customer requirement is simply not part of the [Exchange Act's] definition" of "dealer."

Addressing concerns that a broad dealer definition would sweep in investment advisers and hedge funds, she pointed to the Eleventh Circuit's Almagarby opinion, which distinguished institutional asset managers by pointing out that such managers do not rely on "dilution financing or the rapid resale of microcap share issues as their sole source of income."[12]

Key Takeaways

The SEC's reversal highlights the sweeping shift in priorities under the new administration, offering some relief for microcap convertible debt lenders — and potentially the broader investment community. These dismissals send a message that the new SEC administration will focus on clear fraud and will not pursue cases where the SEC's application of regulatory requirements to certain conduct may be novel.

However, the lack of regulatory rulemaking will create uncertainty for these lenders, as courts have consistently ruled that those that routinely provide convertible debt financing qualify as securities dealers. Some microcap companies have sued the microcap lenders under state usury laws and may, in the future, try to leverage court rulings that lenders violated the Exchange Act to further attack the underlying transactions.

Lastly, the priority changes introduced by this new SEC also should serve as a stark warning that the SEC's enforcement activity can pivot sharply with the next change in leadership.

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[1] SEC v. Almagarby, 92 F.4th 1306, 1312-13 (11th Cir. 2024).

[2] Id. at 1316-17.

[3] https://www.sec.gov/newsroom/speeches-statements/uyeda-remarks-sec-reg-outside-us-5th-annual-scott-friestad-memorial-lecture.

[4] https://www.sec.gov/newsroom/speeches-statements/uyeda-statement-ghs-investments.

[5] Id.

[6] Id.

[7] https://www.sec.gov/newsroom/press-releases/2024-14.

[8] https://www.sec.gov/newsroom/speeches-statements/uyeda-statement-dealer-trader-020624.

[9] https://www.sec.gov/newsroom/speeches-statements/peirce-statement-dealer-trader-020624.

[10] Nat'l Ass'n of Priv. Fund Managers v. Sec. & Exch. Comm'n, 2024 WL 4858589, at *3-8 (N.D. Tex. Nov. 21, 2024).

[11] https://www.sec.gov/newsroom/speeches-statements/crenshaw-statement-dealer-lawsuits-052225.

[12] Id.