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Expanding Oversight of Active, Proprietary Trading Firms: SEC Proposes Amendments to Rule 15b9-1

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Overview

On March 25, 2015, the Securities and Exchange Commission ("SEC" or "Commission") proposed an amendment to Rule 15b9-1 (the "Proposal") under the Securities Exchange Act of 1934 ("Exchange Act") that, if adopted, would close an historical exception to the general requirement that registered broker-dealers must become members of a registered national securities association ("Association"), effectively, the Financial Industry Regulatory Authority ("FINRA").[1] In doing so, the SEC intends to require SEC-registered broker-dealers that are members of one or more securities exchanges to also become members of FINRA, subject to FINRA rules and oversight. According to the SEC, FINRA membership would help accomplish a key regulatory goal: enhancing the oversight of off-exchange and cross-market trading activity.[2]

Current Rule 15b9-1 Framework

Currently, Section 15(b)(8) of the Exchange Act requires a broker dealer to register with an Association unless it effects transactions solely on a national securities exchange ("exchange") of which it is a member.[3] Rule 15b9-1 further exempts from Association membership a broker-dealer that: (1) is a member of a national securities exchange, (2) does not carry customer accounts, and (3) derives an annual gross income of $1,000 or less from securities transactions that are not effected on the national securities exchange of which it is a member (the "*de minimis* allowance").[4] The de minimis allowance excludes income derived from a broker-dealer's proprietary trading transactions with or through another broker-dealer.[5] Rule 15b9-1 was initially adopted to address the supplementary activities of exchange specialists and other floor members engaged in limited off-exchange trading.[6]

Proposed Changes

The rapidly evolving nature of the equities markets has led to the creation of active cross-market proprietary trading firms that trade electronically across exchange and off-exchange platforms.

According to the SEC, because Rule 15b9-1 does not explicitly limit the exclusion from the de minimis allowance to dealer activities ancillary to a floor-based business, many of these proprietary trading firms have been able to engage in unlimited proprietary trading in the off-exchange market without becoming members of FINRA. In the Proposal, the SEC states that it seeks to realign Rule 15b9-1's original limited purposes with the state of current market activity and Section 15(b)(8).[7] The Proposal would amend current Rule 15b9-1 in three significant ways:

1. **Elimination of the *De Minimis* Allowance**: The Proposal would eliminate the *de minimis* allowance (including the exclusion for proprietary trading).[8] As a result, and subject to the exceptions below for certain hedging and exchange order routing activity, a proprietary trading broker-dealer would have to register with an Association if it engaged in any trading activity off exchanges of which it is a member.[9]
2. **Floor Member Hedging Exemption**: The Proposal would also create a more targeted exemption from FINRA membership for exchange members that trade on the exchange floor (i.e., specialists or floor brokers) and limit their off-exchange transactions solely to transactions for the purpose of hedging the risks of their floor-based activities.[10] Dealers relying on this exemption would be required to adopt written policies and procedures to ensure that their off-exchange transactions are legitimate hedges to mitigate the risk associated with floor activities.[11] Various factors, including a broker-dealer's business model and financial position, will determine whether a transaction appropriately mitigates risk under this hedging exemption.[12]
3. **Regulation NMS Routing Exemption**: Finally, the Proposal would create an exemption from Association
   membership for proprietary trading exchange members whose sole off-exchange transactions result from orders routed by an exchange of which it is a member to prevent trade-throughs on that exchange.[13] The orders must be routed from an exchange of which the broker-dealer is a member to another trading center.[14] The Commission believes that such activity by an exchange routing broker-dealer would allow the exchange to maintain oversight of the broker-dealer's market activity.[15]

As described, broker-dealers who no longer qualify for the Rule 15b9-1 exemption would have to comply with Section 15(b)(8) by limiting their trading to exchanges of which they are members or registering with FINRA.

Potential Implications

If adopted, the Proposal would require proprietary trading firms that are not currently members of FINRA to: (1) limit their trading to exchanges of which they are members, (2) join FINRA, (3) join together with other proprietary trading firms to form an Association (an interesting but likely not practical alternative), or (4) cease conducting business as a broker-dealer.

To the extent proprietary trading firms choose to join FINRA, they will be subject to FINRA rules. Obtaining FINRA membership requires an extensive application and takes about six months; we

would hope that the SEC and FINRA would consider a streamlined application process for proprietary trading firms that seek to become members, given that such firms are already SEC registered, are already subject to the SEC net capital rule and do not have customers. Proprietary trading firms that become FINRA members will also be subject to FINRA fees and incur various implementation costs. According to the Proposal, for instance, firms would spend approximately $3.3 million in implementation costs, which include FINRA application costs and costs to implement OATS reporting.

Although the SEC expects that the benefits of the proposed rule will outweigh its costs, it is a little unclear how the proposal ultimately will impact the OTC market. In 2014, non-FINRA member broker-dealers accounted for 35.31% of the 104.5 billion orders reported in the OTC markets. On a volume-weighted basis, such firms accounted for 48% of the 230 billion orders sent directly to an ATS. Depending on how proprietary trading firms react to the rule if it is adopted, liquidity may be affected. Some firms may decide to stop their off-exchange trading in lieu of joining FINRA. Other firms that join FINRA may opt to reduce their off-exchange activity to curb the increased costs of trading associated with FINRA membership. The Commission is soliciting comments on various aspects of the changes described above. Comments are due on June 1, 2015.

Conclusion

The Proposal reflects the Commission's latest effort to address the evolving structure of the equities markets and the increased volume of proprietary trading, including through the use of high-frequency trading strategies. If adopted, the Proposal would likely result in an expansion of FINRA's jurisdiction. To the extent that a broker-dealer may be required to become a FINRA member, it should be prepared for the costs associated with FINRA membership and compliance with FINRA rules. Thus, broker-dealers currently engaged in off-exchange activity should consider the impact of the Proposal on their activities and whether they could rely on any of the proposed exemptions.

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[1] Exemption for Certain Exchange Members, Exchange Act Release No. 74581 (Mar. 25, 2015), 80 Fed. Reg. 18035 (Apr. 2, 2015) (to be codified at 17 C.F.R. § 240.15b9-1) ("Proposal"). 15 U.S.C. § 78o(3). FINRA is registered as a national securities association under Section 15A(a) of the Exchange Act. The National Futures Association ("NFA") is registered as a limited purpose national securities association under Section 15A(k) of the Exchange Act, only for the purpose of regulating the activities of NFA members that are registered as brokers or dealers in security futures products under Section 15(b)(11) of the Exchange Act. See Proposal at 18039 n.34.

[2] Off-exchange trading means off-exchange trading of exchange-listed securities, and would include trading on an ATS or directly with a broker-dealer acting as agent or principal, and is also referred to as over-the-counter ("OTC") trading. See Proposal at 18037 n.3.

[3] 15 U.S.C. § 78o(b)(8).

[4] 17 C.F.R. § 240.15b9-1.

[5] *Id.*

[6] Proposal at 18038.

[7] Proposal at 18036-18041.

[8] The Proposal also would eliminate an exception from the *de minimis* requirement for transactions through the former Intermarket Trading System, which no longer exists.

[9] Proposal at 18046.

[10] *Id.* at 18046-18047.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 18049.

[14] *Id.*

[15] *Id.*

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