SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-74581; File No. S7-05-15

RIN 3235-AL65

Exemption for Certain Exchange Members

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is proposing to amend Rule 15b9-1 ("Rule") under the Securities Exchange Act of 1934 ("Act" or "Exchange Act"), which exempts certain brokers or dealers from membership in a registered national securities association ("Association"). The proposed amendments would replace the current gross income allowance in the Rule with a narrower exemption from Association membership for a broker or dealer that carries no customer accounts and effects transactions on a national securities exchange. The proposed amendments would create an exemption for a dealer that effects transactions off the exchange of which it is a member solely for the purpose of hedging the risks of its floor-based activity, or a broker or dealer that effects transactions off the exchange resulting from orders that are routed by a national securities exchange of which it is a member, to prevent trade-throughs consistent with the provisions of Rule 611 of Regulation NMS.

DATES: Comments should be received on or before June 1, 2015.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-05-15 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-05-15. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

FOR FURTHER INFORMATION CONTACT: David Michehl, Special Counsel, at (202) 551-5627; Nicholas Shwayri, Special Counsel, at (202) 551-5667; or Charles Sommers, Attorney-Adviser, at (202) 551-5787, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION:

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I. Background

Rule 15b9-1generally provides an exemption for certain broker-dealers from the Exchange Act requirement to become a member of an Association. However, the equities markets have undergone a substantial transformation since the Commission previously considered the Rule. Over time, active, cross-market proprietary trading firms began relying on the Rule 15b9-1 exemption in ways that were not envisioned when the Rule was adopted or amended. The Commission is proposing to amend Rule 15b9-1 to better align the scope of its exemption, in light of today's market activity, with Section 15(b)(8) of the Exchange Act and the Commission's purposes underlying the adoption of Rule 15b9-1.

When the Exchange Act was adopted in 1934, the exchanges were the only self-regulatory organizations ("SROs")[1] and were charged with regulating the activities of their broker-dealer members.[2] Congress soon recognized, however, that the benefit of exchange regulation could be undermined by the absence of a complementary regulatory framework for the off-exchange market[3] and, in 1938, Congress provided for the creation of national securities

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1 An SRO is defined, in relevant part, as "any national securities exchange, registered securities association, or registered clearing agency. . . ." 15 U.S.C. 78c(a)(26). See also infra notes 26-28 and accompanying text.

2 See, e.g., 15 U.S.C. 78f(b) (requiring exchanges to be so organized as to enforce compliance by their members and persons associated with their members with the provisions of the Exchange Act).

3 "Off-exchange" trading as used herein means any securities transaction in an exchange-listed security that is not effected, directly or indirectly, on a national securities exchange.

associations.[4] Congress later mandated Association membership for all off-exchange market participants through Section 15(b)(8) of the Exchange Act,[5] which requires a broker-dealer to become a member of an Association unless it effects transactions solely on an exchange of which it is a member. This provision, among others, reflects an overarching principle in the Exchange Act that the SRO best positioned to conduct regulatory oversight should assume those responsibilities[6] and, correspondingly, that off-exchange trading is primarily the responsibility of an Association or Associations.

See 17 CFR 240.600(b)(45) (defining "national securities exchange"). Off-exchange trading includes securities transactions that occur on alternative trading systems and directly with a broker-dealer, acting either as agent or principal, and is also referred to as over-the-counter ("OTC") trading. The term "off-exchange" as used herein does not refer, as it does in some contexts, to transactions in securities, either in equities or other instruments, that are not listed on a national securities exchange.

4 See infra notes 31-33 and accompanying text (describing the early history and background behind the creation of national securities associations).

5 15 U.S.C. 78o(b)(8). Section 15(b)(8) of the Exchange Act was adopted in 1964. See infra notes 36-37 and accompanying text. Notably, however, from 1976-1983, broker-dealers engaged in off-exchange trading could either join an Association or be subject to direct regulation by the Commission under the SEC Only ("SECO") Program. See infra notes 38-48 and accompanying text.

6 As originally adopted in 1934, the regulation of broker-dealer activities on national securities exchanges was excluded from the Commission's authority. See Section 15 as adopted in 1934, Pub. L. No. 73-291, 48 Stat. 881, 895-96 (1934), infra note 27. Rather, regulation of broker-dealer activities on exchanges continued to be conducted by the exchanges themselves, many of which existed prior to the enactment of the Exchange Act. Consequently, this left regulation of the off-exchange market with the Commission, until passage of the Maloney Act in 1938, providing for the creation of voluntary, self-regulating Associations with powers to adopt and enforce rules to regulate the off-exchange market. Pub. L. No. 75-719, 52 Stat. 1070 (1938) (the "Maloney Act"); see also infra note 23 and accompanying text.

In the Exchange Act Amendments of 1975 (Pub. L. No. 94-29, 89 Stat. 97 (1975), the "1975 Amendments"), Congress recognized that, at the time, the allocation of self-regulatory responsibilities among SROs resulted in some cases in duplicative regulation of firms that were members of multiple SROs and varying standards, both in substance and enforcement, among SROs. S. Doc. No. 93-13 at 164-165 (1973). As a result, Congress adopted Section 17(d) of the Act, which provides the Commission with the

Section 15(b)(9) of the Exchange Act,[7] provides the Commission with authority to exempt any broker-dealer from the requirements of Section 15(b)(8), if that exemption is consistent with the public interest and the protection of investors. Pursuant to that authority, the Commission adopted Rule 15b9-1,[8] which was last substantively updated in 1983.[9] That Rule

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authority to allocate regulatory responsibilities among SROs with respect to matters as to which, in the absence of such allocation, such SROs would share authority. 15 U.S.C. 78q(d). In adopting Section 17(d), a Senate Report accompanying the 1975 Amendments expressed the view that "the Commission should play an affirmative role in allocating inspection and enforcement responsibilities among the self-regulatory organizations" and that "for reporting purposes each broker-dealer [should] be assigned to a designated principal self-regulator or government regulator who will be responsible for determining the broker-dealer's operating and financial status." See 1975 Amendments, Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Session 33 (1975).

As a general matter, SROs and the Commission have used the flexibility provided by Section 17(d) of the Act to allocate regulatory responsibilities in such a manner. 15 U.S.C. 78q(d). See, e.g., Exchange Act Release No. 63750 (January 21, 2011), 76 FR 4948 (January 27, 2011) (order approving 17d-2 plan to allocate regulatory responsibility to FINRA relating to surveillance, investigation, and enforcement of insider trading rules); Exchange Act Release No. 70052 (July 26, 2013), 78 FR 46665 (August 1, 2013) (order approving 17d-2 plan to add Topaz Exchange, LLC to existing plan with all other options exchanges to allocate regulatory responsibility to FINRA relating to, among other things, opening of accounts, supervision, suitability, discretionary accounts, advertising, customer complaints, customer statements, disclosure documents, and certification of personnel); Exchange Act Release No. 73641 (November 19, 2014), 79 FR 70230 (November 25, 2014) (order approving 17d-2 plan to allocate regulatory responsibility to FINRA for the Miami International Securities Exchange, LLC ("MIAX"), with respect to examination and enforcement responsibility relating to compliance by common members with the substantially similar rules of the two SROs and applicable provisions of the federal securities laws). See also infra notes 62-63 and accompanying text (discussing the allocation of regulatory responsibilities among SROs).

7 "The Commission by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (8) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order." 15 U.S.C. 78o(b)(9); Pub. L. No. 98-38, 97 Stat. 205 (1983).

8 17 CFR 240.15b9-1. See also infra notes 38-48 and accompanying text for a discussion on Rule 15b8-1, the predecessor to Rule 15b9-1.

was intended to address the limited activities of exchange-based specialists and floor brokers that were conducted off the exchange of which they were a member and that were ancillary to their floor-based business.[10] Specifically, the Rule exempts a broker-dealer from the requirement to become a member of an Association if it is a member of a national securities exchange, carries no customer accounts, and has annual gross income of no more than $1,000 that is derived from securities transactions effected otherwise than on a national securities exchange of which it is a member (the "de minimis allowance"). Importantly, the Rule permits income derived from transactions for the dealer's own account with or through another registered broker-dealer, to not count toward the $1,000 de minimis allowance (hereinafter, the "exclusion for proprietary trading").[11] As discussed more fully below, the de minimis allowance originally was designed to permit broker-dealers doing business on exchange floors to share in the commissions paid on occasional off-exchange transactions in customer accounts they introduced to other broker-dealers, up to a nominal amount.[12] In addition, when the exclusion for proprietary trading was

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9 See SECO Programs; Direct Regulation of Certain Broker-Dealers; Elimination, Exchange Act Release No. 20409 (November 22, 1983), 48 FR 53688 (November 29, 1983) ("SECO Programs Release").

10 See infra note 22 and accompanying text (explaining that the Rule is limited to receipt of a portion of the commissions paid on occasional over-the-counter transactions and certain other activities incidental to their activities as specialists).

11 The exclusion for proprietary trading (conducted with or through another registered broker-dealer) was not part of the original exemption, but was added in 1976. See infra notes 43-44 and accompanying text.

12 See Qualifications and Fees Relating to Brokers or Dealers Who Are Not Members of National Security [sic] Association, Exchange Act Release No. 7697 (September 7, 1965), 30 FR 11673, 11675 (September 11, 1965) ("Qualifications and Fees Release") (describing specialist or floor broker's proprietary off-exchange activity as generally limited to occasional commissions on introduced accounts and other transactions incidental to their activity as specialists or floor brokers). See also infra note 22.

adopted in 1976,[13] the circumstances under which an exchange specialist or floor broker would trade proprietarily off-exchange remained quite limited, such as when a regional exchange specialist would hedge risk on the primary listing market.[14]

Accordingly, those broker-dealers exempt from Association membership pursuant to Rule 15b9-1 when it was first adopted were broker-dealers with a business focused on the floor of an exchange of which they were a member.[15] The Commission crafted Rule 15b9-1 to accommodate limited activities ancillary to that floor-based business, and thereby left it to the exchange of which the specialist or floor broker was a member to continue to regulate the entirety of that broker-dealer's activities. Therefore, the scope of Rule 15b9-1 originally was consistent with the principle underlying Section 15(b)(8) of the Exchange Act, noted above, that the SRO best positioned to conduct regulatory oversight should assume those responsibilities.

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13 In adopting the exclusion for proprietary trading, the Commission indicated that an exchange floor broker, through another broker-dealer, could effect transactions for its own account on an exchange of which it was not a member. The Commission noted that such transactions ultimately would be effected by a member of that exchange. See Extension of Temporary Rules 23a-1(T) and 23a-2(T); Adoption of Amendments to SECO Rules, Securities Exchange Act Release No. 12160 (March 3, 1976), 41 FR 10599, 10600 (March 12, 1976) ("Adoption of Amendments to SECO Rules"). See also infra note 44.

14 In the Special Study of the Securities Markets in 1963, the Commission described how regional exchange specialists reduced their exposure, including by offsetting those positions on other exchanges. The Commission noted that "[s]pecialists on the Boston, Philadelphia-Baltimore-Washington, Pittsburgh, and Montreal stock exchange are in communication with each other by direct wires linking their floors and each may trade on the other exchanges at member rates" and "[s]pecialists who are sole members [of an exchange] also offset [their positions] with over-the-counter houses dealing in listed securities. Many of the offsetting transactions are done on the primary market, the NYSE, with the [specialist] buying or selling on that exchange as his needs dictate." Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, at 935 (1963) ("Special Study"). The Commission believes that the business of regional exchange specialists was substantially the same when the exclusion for proprietary trading in Rule 15b9-1 was adopted in 1976.

15 See infra note 22.

However, the equities markets have undergone a substantial transformation since the Commission previously considered Rule 15b9-1, evolving from markets with both manual and automated features and trading volumes concentrated on the primary listing exchanges, to a highly electronic, decentralized market with substantial competition among a large number and great variety of trading venues.[16] New types of proprietary trading firms have emerged, including those that engage in so-called high-frequency trading strategies. These firms tend to effect transactions across the full range of exchange and off-exchange markets, including alternative trading systems ("ATSs").[17] They also tend to use complex electronic trading strategies and sophisticated technology to generate a large volume of orders and transactions throughout the national market system.[18]

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16 See Concept Release Concerning Equity Market Structure, Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594, 3594-3596 (January 21, 2010) ("Concept Release") (discussing the evolution from "a market structure with primarily manual trading to a market structure with primarily automated trading").

17 ATSs fall within the statutory definition of national securities exchange, but are exempt from having to register as an exchange if they comply with Regulation ATS. See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844, 70856 (December 22, 1998). Regulation ATS requires ATSs to be registered as broker-dealers with the Commission, which entails becoming a member of an Association and complying with the broker-dealer regulatory regime. 17 CFR 242.301(b)(1). Unlike a registered national securities exchange, an ATS is not required to file proposed rule changes with the Commission. ATSs include both dark pools and electronic communications networks ("ECNs"). ECNs provide their best-priced orders for inclusion in the consolidated quotation data, while dark pools do not. See Concept Release, supra note 16 at 3599. See also infra notes 158 - 161 and accompanying text (describing some of these firms' activity on exchanges). ATSs did not exist when Rule 15b9-1 was last amended in 1983.

18 Many, but not all, such proprietary trading firms are often characterized by: (1) the use of extraordinarily high-speed and sophisticated computer programs for generating, routing and executing orders; (2) the use of co-location services and individual data feeds offered by exchanges and others to minimize network and other types of latencies; (3) the use of very short time-frames for establishing and liquidating positions; (4) the submission of numerous orders that are cancelled shortly after submission; and (5) ending the trading day in as close to a flat position as possible (that is, not carrying significant, unhedged

Over time, active, cross-market proprietary trading firms began relying on the Rule 15b9-1 exemption in ways that were not envisioned when the Rule was adopted or amended.[19] As noted above, the de minimis allowance of Rule 15b9-1, and the subsequent exclusion of income derived from proprietary transactions conducted with or through another registered broker-dealer from such allowance, were designed to permit exchange-based specialists or floor brokers to conduct limited activities off-exchange. However, because the Rule does not explicitly limit this exclusion from the de minimis allowance to dealer activities ancillary to a floor-based business, a broker-dealer, with or without a floor presence, may engage in unlimited proprietary trading in the off-exchange market without becoming a member of an Association. Consequently, many of the most active, cross-market proprietary trading firms have been able to rely on the exemption from Association membership, despite effecting a significant volume of transactions off-exchange.

As a result, an exemption that was developed to address limited off-exchange activity by exchange-based specialists or floor brokers is today being used by many broker-dealers without a floor-based business, and that conduct a substantial percentage of the volume of off-exchange trading in the U.S. securities markets. Specifically, during the fourth quarter of 2014, broker-dealers that are not Association[20] members ("Non-Member Firms") accounted for 45% of orders

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positions over night). See Concept Release, supra note 16, at 3606. See also Staff of the Division of Trading and Markets, Commission, "Equity Market Structure Literature Review, Part II: High Frequency Trading," at 4-5 (March 18, 2014) (available at http://www.sec.gov/marketstructure/research/hft_lit_review_march_2014.pdf).

19 These firms are registered with the Commission as broker-dealers but have elected to avail themselves of the Rule 15b9-1 exemption from membership in an Association.

20 Financial Industry Regulatory Authority, Inc. ("FINRA") is currently the sole Association. See infra note 34. In 1939, the Commission approved the National Association of Securities Dealers, Inc. ("NASD") as the first national securities association. See 4 FR 3564 (August 9, 1939). In 2007, the Commission approved

sent directly to ATSs, a significant category of off-exchange trading venue.[21] Preliminarily, the Commission does not believe the public interest finding that originally supported the adoption and amendments of Rule 15b9-1continues to apply today in this context.

Accordingly, the Commission is proposing to amend Rule 15b9-1 to better align the scope of its exemption, in light of today's market activity, with Section 15(b)(8) of the Exchange Act and the Commission's original purpose in adopting Rule 15b9-1, which was to accommodate broker-dealer activities ancillary to a floor-based business while preserving the traditional role of the exchange as the entity best suited to regulate member conduct on the exchange.[22] A broker-

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changes that consolidated the member firm regulatory functions of the NASD, an Association, and NYSE Regulation, Inc., and changed the name of the combined entity to FINRA. See Exchange Act Release No. 56145 (July 26, 2007), 72 FR 42169 (August 1, 2007).

21 ATSs received approximately 230 billion orders during 2014 that were sent directly to an ATS (i.e., orders received by a broker-dealer that are then sent to another trading desk of that broker-dealer (so called "desk-reports") are generally excluded from these order totals). Orders from Non-Member Firms accounted for 49% of orders sent directly to ATSs during the first quarter of 2014, 49% of orders sent directly to ATSs during the second quarter of 2014, 48% of orders sent directly to ATSs during the third quarter of 2014, and 45% of orders sent directly to ATSs during the fourth quarter of 2014. In 2013, ATSs received approximately 163 billion orders that were sent directly to an ATS. Orders from Non-Member Firms accounted for 34% of orders sent directly to ATSs during the first quarter of 2013, 38% of orders sent directly to ATSs during the second quarter of 2013, 42% of orders sent directly to ATSs during the third quarter of 2013, and 45% of orders sent directly to ATSs during the fourth quarter of 2013. On a volume-weighted basis (i.e., accounting for variations in total order volume sent to ATSs), Non-Member Firms accounted for 48% of orders sent directly to ATSs in 2014, 40% in 2013, and 32% in 2012. This information is from data obtained from FINRA's Order Audit Trail System ("OATS").

22 In adopting Rule 15b8-1, the Commission stated: "Among the broker-dealers that are not members of a registered national securities association are several specialists and other floor members of national securities exchanges, some of whom introduce accounts to other members. The over-the-counter business of these broker-dealers may be limited to receipt of a portion of the commissions paid on occasional over-the-counter transactions in these introduced accounts, and to certain other transactions incidental to their activities as specialists. In most cases, the income derived from these activities is nominal." See Qualifications and Fees Release, supra note 12, at 11675.

dealer that conducts off-exchange transactions outside the limited scope of Rule 15b9-1, as proposed to be amended, would be required to become a member of an Association. Consequently, such a broker-dealer would be subject, with respect to its off-exchange transactions, to the oversight and rules of an Association, the category of SRO primarily responsible for regulating trading in the off-exchange market in accordance with Section 15(b)(8).[23] Further, as a result of the proposal, a broker-dealer that does not trade off-exchange but that trades indirectly on multiple exchanges would be required in accordance with Section 15(b)(8), to become a member of an Association, or alternatively, a member of each exchange where it effects transactions other than transactions to hedge the risks of its floor-based activities.

A. Regulatory History

The primary purpose of an SRO is to regulate its members.[24] Although the Act provides a limited and targeted exception to Association membership requirements for broker-dealers, its approach to effecting supervision is relatively uniform: broker-dealers must be members of the SROs that regulate the venues upon which they transact. Section 19(g)(1) of the Act, among other things, requires every SRO to examine for and enforce compliance by its members and associated persons with the Act, the rules and regulations thereunder, and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) or Section 19(g)(2) of

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23 See Pub. L. No. 75-719, 52 Stat. 1070 (1938) (The Maloney Act, which established the concept of and framework for Associations, states in its preamble that its purpose was "[t]o provide for the establishment of a mechanism of regulation [Associations] among over-the-counter brokers and dealers operating in interstate and foreign commerce or through the mails, to prevent acts and practices inconsistent with just and equitable principles of trade, and for other purposes"). See also infra notes 26, 28-33 and accompanying text (describing the early history of the Maloney Act).

24 See, e.g., S. Doc. No. 93-13 at 147 (1973) (describing the structure of the self-regulatory system in which SROs "are delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with legal and ethical standards going beyond the basic requirements laid down in the Act.").

the Act.[25] A primary purpose of an Association as an SRO, among other things, is to regulate the off-exchange market.[26] Under the Exchange Act, as adopted in 1934, the direct regulation of broker-dealer activities on national securities exchanges was to be conducted by the exchanges themselves. As there was no SRO for the off-exchange market, regulation of the off-exchange market was to be the Commission's responsibility.[27] Congress recognized that the benefits of exchange regulation could be undermined in the absence of a complementary regulatory framework for the off-exchange market[28] and provided the Commission the authority to adopt

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25 15 U.S.C. 78q(d); 15 U.S.C. 78s(g).

26 The Maloney Act authorizes an Association to, among other things, establish rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest." 15 U.S.C 78o(b)(6). See also First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 692 (3d Cir. 1979) ("The purpose of [NASD] is to provide self-regulation of the over-the-counter securities market."); Special Study, supra note 14, at 65 (describing the NASD as "the agency with primary self-regulatory responsibility for over-the-counter markets.").

27 As adopted in 1934, Section 15 of the Exchange Act read, in relevant part: "It shall be unlawful, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges, (1) for any broker or dealer . . . to make or create, a market, otherwise than on a national securities exchange, for both the purchase and sale of any security . . . or (2) for any broker or dealer to use any facility of any such market. Such rules and regulations may provide for the regulation of all transactions by brokers and dealers on any such market, for the registration with the Commission of dealers and/or brokers making or creating such a market, and for the registration of the securities for which they make or create a market and may make special provision with respect to securities or specified classes thereof listed, or entitled to unlisted trading privileges, upon any exchange on the date of the enactment of this title, which securities are not registered under the provisions of section 12 of this title." Pub. L. No. 73-291, 48 Stat. 881, 895-96 (1934).

28 In considering adopting the Maloney Act, the House noted that: "The committee has been convinced that effective regulation of the exchanges requires as a corollary a measure of

rules and regulations concerning the off-exchange market to achieve investor protections comparable to those on exchanges.[29] After further study,[30] however, in 1938 Congress imposed a comprehensive regulatory framework for the off-exchange market through the Maloney Act.[31] The Maloney Act added Section 15A to the Act,[32] providing for the creation of national securities associations of broker-dealers, with powers to adopt and enforce rules to regulate the off-exchange market.[33] This led to the creation of NASD, the predecessor of FINRA, and the

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control over the over-the-counter markets. The problem is clearly put in the recent report of the Twentieth Century Fund on 'Stock Market Control': 'The benefits that would accrue as the result of raising the standards of security exchanges might be nullified if the over-the-counter markets were left unregulated and uncontrolled. . . . To leave the over-the-counter markets out of a regulatory system would be to destroy the effects of regulating the organized exchanges.'" H.R. Doc No. 1383, 73d Cong. 2d Sess. at 4 (1934) (quoting report on "Stock Market Control" by the Twentieth Century Fund).

29 Id.

30 See Statement of Senator Francis T. Maloney, Hearings before Committee on Banking and Currency on S. 3255, 75th Cong., 3d Sess. (1938) (noting that the Maloney Act came after "a long-time effort on the part of the Securities and Exchange Commission in rather close cooperation with members of the investment banking business and over-the-counter dealers and brokers.").

31 Pub. L. No. 75-719, 52 Stat. 1070 (1938).

32 15 U.S.C. 78o-3.

33 Id.; see also S. Rep. No. 75-1455, at 3-4 (1938) ("The committee believes that there are two alternative programs by which this problem [of regulation of the off-exchange market] could be met. The first would involve a pronounced expansion of the organization of the Securities and Exchange Commission; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law. . . . The second of these alternative programs, which the committee believes distinctly preferable to the first . . . is based upon cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation."). See also S. Rep. No. 74-1455, at 2-3 (1938) ("It has been deemed advisable to authorize the Commission to subject such activities [i.e., trading in the over-the-counter markets] to regulation similar to that prescribed for transactions on organized exchanges. This power is vitally necessary to forestall the widespread evasion of stock-exchange regulation by

only Association[34] registered to date.[35]

Section 15(b)(8) of the Act, enacted in 1964,[36] further strengthened regulatory oversight of the off-exchange market by prohibiting a broker-dealer from effecting any transaction "otherwise than on a national securities exchange" unless the broker-dealer was either a member of an Association, or met the Commission's standards with respect to training, experience, and other relevant qualifications.[37] In 1965, the Commission adopted Rule 15b8-1 to establish the

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the withdrawal of securities from listing on exchanges, and by transferring trading therein to 'over-the-counter' markets where manipulative evils could continue to flourish, unchecked by any regulatory authority") (quoting S. Rep. No. 73-792, at 6 (1934)). See also supra note 26.

34 See supra note 20. The National Futures Association ("NFA"), as specified in Section 15A(k) of the Act, also is registered as a national securities association, but only for the limited 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 Act.

35 The existing self-regulatory structure in which an Association serves as the regulator of the off-exchange market and exchanges focus their regulatory supervision on their respective markets has not been materially altered from a statutory perspective since its establishment. See Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256, 71258 (December 8, 2004).

36 Section 15(b)(8) as enacted provided: "No broker or dealer registered under section 15 of this title shall, during any period when it is not a member of a securities association registered with the Commission under section 15A of this title, effect any transaction in, or induce the purchase or sale of, any security (otherwise than on a national securities exchange) unless such broker or dealer and all natural persons associated with such broker or dealer meet such specified and appropriate standards with respect to training, experience, and such other qualifications as the Commission finds necessary or desirable . . . ." Pub. L. No. 88-467, 78 Stat. 565, 572-73 (1964).

37 In the Special Study, the Commission explained that the controls over entry into the securities business were inadequate, allowing entry by unqualified persons. Special Study, supra note 14, at 1, 23 (1963). Congress' amendments in 1964 responded to these findings.

SECO Program, which provided for the direct regulation by the Commission of broker-dealers that effected transactions off-exchange and that chose not to join an Association.[38]

Rule 15b8-1 provided for an exemption from the SECO Program, and by extension from Association membership, for those broker-dealers that: (1) were members of a national securities exchange; (2) did not carry customer accounts; and (3) had annual gross income derived from off-exchange activity that amounted to no greater than $1,000.[39] This set the basic framework for the Rule 15b9-1 exemption from Association membership that exists today. The Commission recognized that, at that time, exchange-based specialists and other floor brokers, which were comprehensively regulated by the exchange of which they were a member, occasionally introduced accounts to other members and shared in the commission revenues.[40] Rule 15b8-1 permitted these broker-dealers, who were not required to register with the

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38 Under the SECO Program, every associated person engaged directly or indirectly in securities activities for or on behalf of a non-member broker-dealer, and every associated person who supervised others engaged in any securities activities, was required to successfully complete either the general securities examination prescribed by the Commission or an alternative examination deemed satisfactory by the Commission. See Qualifications and Fees Release, supra note 12, at 11676 (defining the term "nonmember broker or dealer" as "any broker or dealer, including a sole proprietor, registered under section 15 of the Act, who is not a member of a national securities association registered with the Commission under section 15A of the Act."). Any broker-dealer could choose to join an Association or be regulated by the Commission directly under the SECO Program.

39 "Under Rule 15b8-1 (17 CFR § 240.15b8-1), any broker-dealer who is a member of a national securities exchange is exempt from the rule if he does not carry customers' accounts and if his annual gross income derived from his over-the-counter business is no more than $1,000. Should a broker-dealer's over-the-counter income exceed these limits for an accounting year, such broker-dealer and all persons associated with him become subject to the requirements of the rule." Id. at 11675.

40 See supra note 22.

Commission as broker-dealers at the time,[41] to receive a portion of the commissions paid on occasional off-exchange transactions on these introduced accounts without becoming subject to the SECO rules and broker-dealer registration, so long as the income derived from those activities was nominal.[42]

In 1976, the Commission amended Rule 15b8-1 to provide that income derived from transactions for the dealer's own account effected with or through another registered broker-dealer would not count towards the $1,000 de minimis allowance.[43] In adopting this amendment to Rule 15b8-1, the Commission noted that an exchange-based floor broker could effect

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41 Until 1975, broker-dealers who traded exclusively on the floor of a national securities exchange were exempt from registration with the Commission. The 1975 Amendments required all broker-dealers, including exchange specialists and floor brokers, to register with the Commission, and extended the Commission's SECO rulemaking authority to any exchange member trading on an exchange other than an exchange of which it was a member. 1975 Amendments, supra note 6, at 121. The 1975 Amendments revised Section 15(b) such that the substance of then existing Section 15(b)(8) was captured in Sections 15(b)(7) - (9). See id. at 131. One purpose of the 1975 Amendments was to assure that the Commission could regulate and recoup the costs of regulating transactions of exchange members conducted on exchanges of which they were not a member. See 1975 Amendments, supra note 6, at 125 (amending Section 15 of the Exchange Act to provide the Commission with authority to "prescribe reasonable fees and charges to defray its costs" of regulation).

42 See Adoption of Amendments to SECO Rules, supra note 13. See also supra note 22 (noting that the over-the-counter business of these broker-dealers may be limited and the income derived from these activities is nominal).

43 "Any nonmember broker or dealer who is a member of a national securities exchange shall be exempt from this rule if (1) he carries no accounts of customers, and (2) his annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which he is a member is an amount no greater than $1,000. Provided however, [t]hat gross income derived from transactions otherwise than on such national securities exchange which are effected for his own account with or through another registered broker or dealer shall not be subject to such limitation." See Adoption of Amendments to SECO Rules, supra note 13, at 10601. Thus, broker-dealers registering with the Commission as a result of the 1975 Amendments became subject to the SECO rules in 1976, but could remain exempt from such rules pursuant to Rule 15b8-1 and its exclusion for proprietary trading.

transactions through another broker-dealer for its own account on an exchange of which it was not a member, and indicated that such transactions ultimately would be effected by a member of that exchange.[44] At the time this provision was adopted, the circumstances under which an exchange specialist or floor broker would trade proprietarily off the exchange were quite limited, such as when a regional exchange specialist would hedge risk on the primary listing market.[45]

In 1983, Congress amended the Act to eliminate the direct oversight of broker-dealers by the Commission.[46] Congress maintained the exception from membership in an Association in Section 15(b)(8) of the Act for those broker-dealers that effected transactions in securities only on an exchange of which they were a member. Congress also left unchanged the ability of the Commission to expand upon the statutory exception in Section 15(b)(8) through exemptive

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44 The Commission provided the following example to describe the application of the exclusion for proprietary trading: "a broker who is acting as a floor broker on a particular exchange, and who effects transactions for his own account otherwise than on that exchange through another broker-dealer who acts as a clearing member for the floor broker, would be permitted to effect transactions on exchanges of which neither he nor his clearing broker are members without becoming subject to the SECO rules." Id. In this example, "[t]he clearing broker would, of course, effect transactions on an exchange of which he was not a member through a member of that exchange." Id. at 10602, n. 8.

45 See supra note 14.

46 At that time, direct oversight of broker-dealers by the Commission was conducted through the SECO Program. 15 U.S.C. 78o(b)(8), as amended by Pub. L. No. 98-38, 97 Stat. 205, 206 (1983). See also H.R. Rep. No. 98-106, at 597 (1983) (citing a preference for self-regulation over direct regulation by the Commission. Among other benefits of self-regulation, the report noted that NASD had available a broader and more effective range of disciplinary sanctions to employ against broker-dealers than had the Commission).

Section 15(b)(8) is virtually the same as it was in 1983: "It shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than or commercial paper, bankers' acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to section 15A of this title or effects transactions in securities solely on a national securities exchange of which it is a member." 15 U.S.C. 78o(b)(8). In 1986, Congress enacted non-substantive amendments modifying a few terms in the statute. Pub. L. No. 99-571, 100 Stat. 3208, 3218 (1986). 15 U.S.C. 78o(b)(8).

authority in Section 15(b)(9) of the Act.[47] When the SECO rules were abolished in 1983, the Commission amended and renumbered Rule 15b8-1.[48] The substance of newly renumbered Rule 15b9-1 remained largely the same as Rule 15b8-1, with modifications that primarily accommodated transactions effected through the new Intermarket Trading System ("ITS") linkage,[49] and eliminated references to, and requirements under, the SECO Program.

Under the Rule as amended in 1983, a broker-dealer was not required to become a member of an Association if: (1) it was a member of a national securities exchange, (2) carried no customer accounts, and (3) had annual gross income no greater than $1,000 that was derived from securities transactions effected otherwise than on a national securities exchange of which the broker-dealer was a member.[50] As under the SECO rules, income derived from transactions effected for a broker-dealer's own account with or through another broker or dealer was not included in the $1,000 de minimis allowance.[51]

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47 See supra note 7.

48 See supra note 9.

49 See infra notes 126-130 and accompanying text.

50 "Any broker or dealer required by Section 15(b)(8) of the Act to become a member of a registered national securities association shall be exempt from such requirement if it: (1) Is a member of a national securities exchange, (2) carries no customer accounts, and (3) has annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than $1,000." 17 CFR 240.15b9-1(a); see also SECO Programs Release, supra note 9, at 53690.

51 "The gross income limitation contained in paragraph (a) of this section, shall not apply to income derived from transactions (1) for the dealer's own account with or through another registered broker or dealer or (2) through the Intermarket Trading System." 17 CFR 240.15b9-1(b); SECO Programs Release, supra note 9, at 53690.

Since 1983, Rule 15b9-1 has remained unchanged, except for a technical amendment in 2005 to update cross-references when the Commission adopted Regulation NMS.[52]

B. Regulatory Oversight of Off-Exchange Trading Activity

Section 19(g)(1) of the Act requires every SRO to examine for and enforce compliance by its members and associated persons with the Act, the rules and regulations thereunder, and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) or Section 19(g)(2) of the Act.[53] Without this relief, the statutory obligation of each individual SRO would result in duplicative examinations and oversight of broker-dealers that are members of more than one SRO ("common members"). Section 17(d)(1) of the Act is intended, in part, to eliminate overlapping examinations and regulatory functions.[54] With respect to a common member, Section 17(d)(1) authorizes the Commission, by rule or order, to relieve an SRO of the responsibility to receive regulatory reports, to examine for and enforce compliance with the applicable statutes, rules, and regulations, or to perform other specified regulatory functions.[55]

To implement Section 17(d)(1), the Commission adopted two rules: Rule 17d-1 and Rule 17d-2 under the Act.[56] Rule 17d-1 authorizes the Commission to name a single SRO as the designated examining authority ("DEA") to examine common members for compliance with the

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[52] Regulation NMS, Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37618 (June 29, 2005).

[53] 15 U.S.C. 78s(g).

[54] See 1975 Amendments, Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Session 32 (1975).

[55] 15 U.S.C. 78q(d)(1).

[56] 17 CFR 240.17d-1; 17 CFR 240.17d-2.

financial responsibility requirements imposed by the Act, or by the Commission or SRO rules.[57] To address regulatory duplication in areas other than financial responsibility, including sales practices and trading practices, the Commission adopted Rule 17d-2 under the Act.[58] Rule 17d-2 permits SROs to propose joint plans among two or more SROs for the allocation of regulatory responsibility with respect to their common members.[59] The regulatory responsibility allocated among SROs only extends to matters for which the SROs would share authority, which means that only common rules among SROs can be allocated under Rule 17d-2. Under paragraph (c) of Rule 17d-2, the Commission may declare such a plan effective if, after appropriate notice and opportunity for comment, it finds that the plan is necessary or appropriate in the public interest and for the protection of investors, to foster cooperation and coordination among SROs, or to remove impediments to and foster the development of a national market system and a national clearance and settlement system and in conformity with the factors set forth in Section 17(d) of the Act.[60] Commission approval of a plan filed pursuant to Rule 17d-2 relieves an SRO of those regulatory responsibilities allocated by the plan to another SRO.[61]

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57 See Exchange Act Release No. 12352 (April 20, 1976), 41 FR 18808 (May 7, 1976).

58 See Exchange Act Release No. 12935 (October 28, 1976), 41 FR 49091 (November 8, 1976).

59 "Any two or more self-regulatory organizations may file with the Commission a plan. . . for allocating among the self-regulatory organizations the responsibility to receive regulatory reports from persons who are members or participants of more than one of such self-regulatory organizations to examine such persons for compliance, or to enforce compliance by such persons, with specified provisions of the Securities Exchange Act of 1934, the rules and regulations thereunder, and the rules of such self-regulatory organizations, or to carry out other specified regulatory functions with respect to such persons." 17 CFR 240.17d-2.

60 Id.

61 Id. Exchanges also enter into Regulatory Services Agreements ("RSAs") whereby one SRO contractually agrees to perform regulatory services for another. See, e.g., FINRA News Release, FINRA Signs Regulatory Services Agreement with the Chicago Board

The principle underlying the self-regulatory structure in the Exchange Act is the concept that the SRO best positioned to conduct regulatory oversight should assume responsibility for that oversight.[62] As a general matter, the SROs and the Commission have used the flexibility provided by Section 17 to allocate responsibilities in such a manner.[63] Section 15(b)(8) of the Exchange Act further implements this construct of effective regulatory oversight by requiring Association membership of a broker-dealer unless it effects transactions solely on an exchange of which it is a member. Those exempt from Association membership pursuant to Rule 15b9-1 originally were exchange specialists and other floor members, and the off-exchange activity permitted under Rule 15b9-1 (including its predecessor rule) was intended only to accommodate limited activities ancillary to that floor-based business.

As the sole currently registered Association, FINRA is the SRO primarily responsible for regulating trading in the off-exchange market.[64] FINRA also conducts the vast majority of

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Options Exchange, Incorporated ("CBOE") and C2 Options Exchange, Incorporated ("C2") (December 22, 2014), available at http://www.finra.org/newsroom/newsreleases/2014/p602174. However, RSAs do not relieve the contracting SRO from regulatory responsibility for the performance of any regulatory services allocated pursuant to the RSA and are not filed with the Commission for approval.

62 Section 17(d)(1) of the Act provides that the Commission, in allocating authority among SROs pursuant to Section 17(d)(1), shall "take into consideration the regulatory capabilities and procedures of the self-regulatory organizations, availability of staff, convenience of location, unnecessary regulatory duplication, and such other factors as the Commission may consider germane to the protection of investors, cooperation and coordination among self-regulatory organizations, and the development of a national market system . . ." 15 U.S.C. 78q(d)(1).

63 See supra note 6; infra note 69.

64 See supra note 31.

broker-dealer examinations,[65] mandates broker-dealer disclosures, and writes and enforces rules governing broker-dealer conduct.[66] FINRA regulates trading in non-listed equities, fixed income, and other traded products, and investigates and brings enforcement actions against members for violations of its rules, the rules of the Municipal Securities Rulemaking Board, and the Exchange Act and the rules thereunder.[67] As noted above, the regulatory focus of national securities exchanges, which are also SROs, has been more narrow, with primary responsibility to regulate trading by their members on their respective exchanges,[68] enforce conduct rules (if they have not been relieved of that responsibility by 17d-2 Agreements), and otherwise perform member regulation for their members that are not also members of FINRA. Most exchanges have entered into 17d-2 Agreements with FINRA that allocate regulatory responsibility over common members to FINRA for compliance with common conduct rules.[69]

FINRA has developed a transparency and regulatory regime for the off-exchange market. All off-exchange trades are reported to FINRA,[70] and as a result FINRA has developed a set of

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65 The Commission staff also conducts risk-based examinations of broker-dealers. However, routine broker-dealer examinations are conducted by the SROs, and the Commission staff oversees the examination efforts of the SROs.

66 15 U.S.C. 78o-3.

67 Id.

68 Congress saw the codification of the regulations requiring the registration of off-exchange broker-dealers as "an essential supplement to regulation of the exchanges." H.R. Rep. No. 74-2601, at 4 (1936). See also supra note 28 and accompanying text.

69 See, e.g., Exchange Act Release No. 63430 (December 3, 2010), 75 FR 76758 (December 9, 2010) (order approving Rule 17d-2 plan to allocate regulatory responsibility to FINRA for certain Regulation NMS rules by 13 exchanges). Generally, FINRA is also the DEA for financial responsibility rules for exchange members that also are members of FINRA. See infra note 164 (discussing DEAs).

70 FINRA operates two Trade Reporting Facilities ("TRFs"), one jointly with NASDAQ and another with the NYSE. The TRFs are FINRA facilities for FINRA members to report transactions effected otherwise than on an exchange. See Exchange Act Release

trade reporting rules to support that transparency regime.[71] FINRA also has developed a regulatory audit trail, which provides regulatory data on orders, quotes, routes, cancellations, and executions.[72] FINRA has developed rules and guidance tailored to trading activity[73] and has developed surveillance technology and specialized regulatory personnel to provide surveillance, supervision, and enforcement of activity occurring off-exchange.[74] Furthermore, FINRA has a detailed set of member conduct rules that apply to all activities of a firm, whether on- or off-exchange.[75]

No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006) (order approving the NASDAQ TRF); Exchange Act Release No. 55325 (February 21, 2007), 72 FR 8820 (February 27, 2007) (notice of filing and immediate effectiveness of a proposed rule change to establish the NYSE TRF). In addition, FINRA operates the Alternative Display Facility ("ADF"), which is a FINRA facility for posting quotes and reporting trades governed by FINRA's trade reporting rules. See Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) (order approving the ADF); see also Exchange Act Release No. 71467 (February 3, 2014), 79 FR 7485 (February 7, 2014) (order approving a proposed rule change to update the rules governing the ADF).

71 See FINRA Rule 7000 Series – Clearing, Transactions and Order Data Requirements, and Facility Charges.

72 FINRA operates the OATS system, which is an integrated audit trail of order, quote, and trade information for all NMS stocks and OTC equity securities required to be submitted by FINRA members. See e.g., Exchange Act Release No. 54585 (October 10, 2006), 71 FR 61112 (October 17, 2006) (order approving a proposed rule change relating to the expansion of OATS reporting requirements to OTC equity securities). FINRA uses the OATS audit trail system to recreate events in the life cycle of orders and more completely monitor the trading practices of FINRA member firms. See FINRA.org, Order Audit Trail System (OATS), available at http://www.finra.org/industry/oats (last visited March 19, 2015).

73 See e.g., FINRA Rules 5240 (Anti-Intimidation/Coordination), 5250 (Payments for Market-Making), 5210.02 (Publication of Transactions and Quotations – Self-Trades), and 6140 (Other Trading Practices).

74 See FINRA.org, FINRA 2013 Year in Review and Annual Financial Report, available at http://www.finra.org/sites/default/files/Corporate/p534386.pdf (last visited March 19, 2015).

75 See Part V.B.4 discussing the competitive effects of off-exchange market regulation.

As noted, Rule 15b9-1 in its current form allows a broker-dealer to engage in unlimited proprietary trading in the off-exchange market without becoming a member of an Association, so long as its proprietary trading activity is conducted with or through another registered broker-dealer (i.e., not with a customer). In practice, this allows many cross-market proprietary trading firms to avoid Association membership, despite their effecting a significant volume of transactions in the off-exchange market. Non-Member Firms are not subject to oversight by an Association and their off-exchange transactions typically are not overseen by the exchanges of which they may be members. Exchanges traditionally have not assumed the role of regulating the totality of the trading of their member-broker-dealers, and exchanges are currently not well-positioned to assume that role, in light of the statutory scheme and, among other things, their limited access to data[76] and the proper rule set to regulate off-exchange trading. Exchanges generally do not have a detailed set of member conduct rules and non-exchange-specific trading rules, thus allowing such broker-dealers and their personnel to conduct business under a less specific regulatory regime than FINRA members. In this context and consistent with the statutory framework that places responsibility for off-exchange trading with an Association, therefore, the Commission preliminarily believes that an Association is better suited to regulate off-exchange trading.

The Commission estimates that, today, there are approximately 125 broker-dealers exempt from Association membership.[77] This group includes some of the most active cross-

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76 See Exchange Act Release No. 67457 (July 18, 2012), 77 FR 45722, 45728-30 (August 1, 2012) (discussing the use and limitations of current SRO audit trails and noting that "[m]ost SROs maintain their own specific audit trails applicable to their members" and "each SRO only has direct access to its own audit trails . . .").

77 The Commission believes that the majority of these firms rely on the Rule 15b9-1 exemption rather than the statutory exception from Association membership under

market proprietary trading firms, which generate a substantial volume of orders and transactions in the off-exchange market. For example, the Commission estimates that orders from Non-Member Firms represented a volume-weighted average of approximately 32% of all orders sent directly to ATSs during 2012.[78] By 2014, these Non-Member Firms represented a volume-weighted average of approximately 48% of orders sent directly to ATSs.[79]

Accordingly, the Commission believes that many of the broker-dealers today that rely on the Rule 15b9-1 exemption are very different from those for which the Rule originally was intended—exchange-based specialists and other floor members that focused their business on a single exchange of which they were a member. The presumption built into Section 15(b)(8) and further extended by Rule 15b9-1, namely that the exchange of which the firm is a member is in the optimal position to provide self-regulatory oversight, does not appear to hold for those firms that avail themselves of the exemption but are engaged in a significant amount of off-exchange trading.[80] For broker-dealers that conduct business only on one exchange, the exchange SRO is well-positioned to oversee the activities of those broker-dealers and write and enforce rules

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Section 15(b)(8) of the Act, 15 U.S.C. 78o(b)(8), because the Rule-based exemption is more permissive than the statute, allowing, for example, unlimited proprietary trading on an exchange of which a broker-dealer is not a member. The estimate of 125 firms is based on publicly available data reviewed by staff during March of 2015. See infra note 148.

78 This estimate is based on data from OATS. See supra note 21.

79 This information is based on data from OATS. In 2013, these Non-Member Firms represented a volume-weighted average of approximately 40% of orders sent directly to ATSs. Id.

80 For example, based on disclosures on Form BD as of March 2015, there were 13 Non-Member Firms that are members of only CBOE, an options exchange, that do not disclose as part of their business activities on Form BD being a “put and call broker or dealer or option writer.” Similarly, five Non-Member Firms disclose on Form BD that they are a “broker or dealer making inter-dealer markets in corporate securities over-the-counter” and are not members of FINRA.

tailored to their business model and conduct. For a broker-dealer that trades electronically across a range of exchange and off-exchange venues, however, the individual exchange or exchanges of which the broker-dealer may be a member are not able to as effectively regulate the off-exchange activity of the broker-dealer because such exchange(s) today has neither the resources nor the necessary expertise to oversee such off-exchange activity.[81] The Commission is concerned that the reliance on the Rule 15b9-1 exemption by cross-market proprietary trading firms, given that exchanges focus their regulatory oversight on their respective exchanges, undermines the effectiveness of the regulatory structure of the off-exchange market and the equities markets more broadly.

As noted, FINRA currently is the SRO to which off-exchange trades are reported.[82] However, because it does not have jurisdiction over Non-Member Firms, it is unable to enforce compliance with the federal securities laws and rules, or apply its own rules, to broker-dealers that conduct a significant amount of off-exchange trading activity, including those that engage in so-called high-frequency trading strategies. As a result, FINRA's ability to perform comprehensive market surveillance, especially for violations of Commission rules, as well as its ability to understand and reconstruct activity in the off-exchange market generally, is limited because Non-Member Firms are not consistently identified in trade reports to the TRFs[83] or the

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[81] The Commission notes that, while today an exchange may not be able to effectively regulate off-exchange activity, it may be able to acquire the resources and expertise to do so.

[82] See supra note 70.

[83] Reports to the TRFs can only be made by FINRA members. See FINRA Rules 7210A(k) and 7210B(i) (defining the term "Trade Reporting Participant" or "Participant" as "any member of FINRA in good standing that uses the System").

ADF, and their order activity is not captured by OATS.[84] Accordingly, FINRA is unable to monitor the off-exchange market activity of Non-Member Firms, and detect potentially manipulative or other illegal behavior, as efficiently or effectively as it can with FINRA members.[85] Obtaining additional data, such as through the Consolidated Audit Trail ("CAT"),[86] or the assumption of post-trade surveillance and investigation by the Non-Member Firm's

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84 When a Non-Member Firm routes an order to a FINRA member which then routes the order to an exchange or off-exchange for execution, OATS data would indicate only that the FINRA member received an order from a Non-Member Firm. The identity of the Non-Member Firm is often not captured because such Non-Member Firms are not required to use a unique Market Participant Identifier ("MPID") or other identifier when routing orders to a FINRA member. In some cases, FINRA is able to identify the Non-Member Firm that participated in a transaction if, for example, it has an MPID and provides it to the firm to which it routed an order and that firm reports it to FINRA. FINRA has solicited comment from its members on a proposed FINRA rule change that would require FINRA members to identify Non-Member Firms in off-exchange transactions reported to OATS. See FINRA Regulatory Notice 14-51, Equity Trading Initiatives: OATS and ATS Reporting Requirements (November 2014), available at https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p601681.pdf. This proposal has not yet been filed with the Commission pursuant to Section 19(b)(1) of the Act. 15 U.S.C. 78s(b)(1).

85 Non-Member Firms that engage in off-exchange transactions are not required to submit audit trail data to FINRA. See FINRA Rules 6610 and 6622(a)(i). The Commission believes that this lack of audit trail reporting is problematic because an Association has statutory responsibility for regulatory oversight of the off-exchange market. Although the Commission understands some off-exchange trades between Non-Member Firms are voluntarily reported by clearing firms, clearing firms are not obligated to report such transactions. Lack of comprehensive reporting of off-exchange transactions to FINRA, among other things, undermines FINRA's ability to effectively surveil the off-exchange market. By extension, this also undermines the ability of the Commission and investors to fully benefit from the self-regulatory model envisioned by Congress in the Exchange Act.

86 Rule 613 under the Act requires SROs to jointly submit to the Commission a national market system plan ("NMS Plan") to create, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to NMS securities, that would capture customer and order event information for NMS securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution. See Exchange Act Release No. 67457 (July 19, 2012), 77 FR 45721 (August 1, 2012) ("CAT Release"); 17 CFR 242.613.

member exchange, would neither confer jurisdiction nor provide needed oversight tools to FINRA over Non-Member Firms that participate in the off-exchange market. No exchange currently is positioned to regulate its members' conduct in the off-exchange market, as the exchanges generally have access only to order and trade data for transactions effected on their markets.[87] Moreover, even if exchanges were able to access the necessary trading data (a possibility that would increase with the deployment of CAT),[88] the Commission believes that piecemeal regulation of the off-exchange market by multiple SROs based on the membership status of the participants and a web of regulatory allocations among SROs, through the use of multiple 17d-2 agreements, is significantly less efficient and frustrates the structure established by Congress that an Association regulate the off-exchange market.[89] In addition, an Association's regulatory responsibility for the off-exchange market includes an obligation to monitor those markets for operational and regulatory issues, as well as issues relating to market

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87 While some exchanges have rules requiring the reporting of certain off-exchange transactions by their members, these rules, as they currently exist, would not provide the exchanges with the complete view of the market that the Commission believes is necessary to effectively regulate the off-exchange market. For example, NYSE MKT LLC ("NYSE MKT") Rule 410B - Equities (Reports of Listed Securities Transactions Effected Off the Exchange) only requires reporting of off-exchange transactions in securities listed on NYSE MKT that are not reported to the Consolidated Tape. See Exchange Act Release No. 58705 (October 1, 2008), 73 FR 58995 (October 8, 2008) (order approving, among other things, NYSE MKT Rule 410B); see also, e.g., CBOE Rule 6.49 (Transactions Off the Exchange) (requiring that CBOE members executing transactions in options listed on the exchange other than on CBOE merely keep a record of such transaction for a period of one year).

88 The Commission notes that the CAT NMS plan would not be implemented for several years. In accordance with Rule 613, the SROs would be required to report the required data to the central repository within one year after effectiveness of the NMS plan; broker-dealers, other than small broker-dealers, would be required to report the required data to the central repository within two years after effectiveness of the NMS plan; and small broker-dealers would be required to report the required data within three years after effectiveness of the NMS plan. 17 CFR 242.613.

89 See supra notes 28-33 and accompanying text.

disruptions.[90] The Commission is concerned that the inability of an Association to reliably identify and enforce regulatory compliance by cross-market proprietary trading firms that are Non-Member Firms in the off-exchange market, creates a risk to the fair and orderly operations of the market.

Further, because FINRA is unable to apply the rules it has developed for the off-exchange market to Non-Member Firms, its ability to create a consistent regulatory framework for the off-exchange market is undermined. FINRA has sought to establish a robust regulatory regime for broker-dealers, including broker-dealers conducting business in the off-exchange market, and has developed a detailed set of rules in core areas such as trading practices,[91] business conduct,[92] financial condition and operations,[93] and supervision.[94] Because Non-

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[90] 15 U.S.C. 78o-3.

[91] See FINRA Rule 5000 Series – Securities Offerings and Trading Standards and Practices. For instance, FINRA has rules prohibiting members from coordinating prices and intimidating other members. See FINRA Rule 5240(a), providing, among other things, that "[n]o member or person associated with a member shall: (1) coordinate the prices (including quotations), trades or trade reports of such member with any other member or person associated with a member, or any other person; (2) direct or request another member to alter a price (including a quotation); or (3) engage, directly or indirectly, in any conduct that threatens, harasses, coerces, intimidates or otherwise attempts improperly to influence another member, a person associated with a member, or any other person." The Commission notes that CBOE has stated that it views any collusion, intimidation and harassment by a CBOE member as "inconsistent with the just and equitable principles of trade." See CBOE Regulatory Circular RG97-167 (February 7, 2000) and CBOE Rule 4.1. See also supra note 73 and accompanying text.

[92] See FINRA Rule 2000 Series – Duties and Conflicts.

[93] See FINRA Rule 4000 Series – Financial and Operational Rules. See e.g., FINRA Rule 4370(a) providing, among other things, that "[e]ach member must create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption. Such procedures must be reasonably designed to enable the member to meet its existing obligations to customers. In addition, such procedures must address the member's existing relationships with other broker-dealers and counter-parties." Although NYSE MKT LLC Equities Rule 4370 is similar to FINRA Rule 4370(a), for example, a number of other exchanges do not have such a rule.

Member Firms are not subject to these or other FINRA rules, they may be subject to a less robust regulatory framework than FINRA members that themselves trade off-exchange. Non-Member Firms also are not subject to the costs associated with FINRA membership.[95]

As is discussed in more detail in the Economic Analysis, firms that become FINRA members would become subject to the fees charged by FINRA to all of its member firms. FINRA charges each member firm certain regulatory fees designed to recover the costs to FINRA of the supervision and regulation of members, including performing examinations,

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94 See FINRA Rule 3000 Series – Supervision and Responsibilities Relating to Associated Persons. This rule series generally requires FINRA member firms to, among other things, establish, maintain, and enforce written procedures to supervise the types of business in which the firm engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. See e.g., FINRA Rules 3110 (Supervision), 3120 (Supervisory Control System), and 3170 (Tape Recording of Registered Persons by Certain Firms). See also FINRA By-Laws Article III – Qualifications of Members and Associated Persons. Any person associated with a member firm who is engaged in the securities business of the firm—including partners, officers, directors, branch managers, department supervisors, and salespersons—must register with FINRA. Other SROs do not have similar standards for associated persons of member broker-dealers.

95 The Commission notes that FINRA may need to consider reassessing the structure of its fees, including its Trading Activity Fee, in order to assure that it is fairly and equitably applied to many of the Non-Member Firms that, as a result of the amendments to Rule 15b9-1, may join FINRA. FINRA uses the TAF to recover the costs to FINRA of the supervision and regulation of members, including performing examinations, financial monitoring, and policy, rulemaking, interpretive, and enforcement activities. See FINRA Schedule A to the By-Laws of the Corporation, Section 1(a), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4694 ("FINRA Schedule A"). The TAF is generally assessed on FINRA member firms for all equity sales transactions that are not performed in a broker-dealer's capacity as a registered exchange specialist or market maker. See id. at Section 1(b). As discussed above, many of the broker-dealers that may be required to join FINRA if the proposed amendments are adopted effect transactions in large volumes throughout the national market system, and often in a capacity other than as a registered market-maker. Accordingly, the Commission notes that FINRA may need to consider reevaluating the structure of the TAF to assure that it appropriately takes into account this business model. See also infra notes 174-175 and accompanying text for further discussion of the TAF.

financial monitoring, and policy, rulemaking, interpretive, and enforcement activities.[96] FINRA's regulatory fees include a Trading Activity Fee ("TAF").[97]

The number of trades subject to the TAF in the off-exchange market—and thus the aggregate fees collected by FINRA for that market segment—would not be expected to materially change if the proposed amendments are adopted because, in general, the TAF currently is assessed on the ATSs where Non-Member Firms effect off-exchange transactions, rather than on the Non-Member Firms. However, it is likely that certain on-exchange trades by Non-Member Firms that currently are not covered by the TAF would be captured.[98] As such, the Commission preliminarily believes that FINRA may need to consider reevaluating its fee

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96 FINRA Schedule A, supra note 95, at Section 1.

97 FINRA assesses each member a TAF on the sale of all covered securities. For the purposes of determining the TAF, covered securities include, among other things, all exchange-registered securities wherever executed and all other equity securities traded otherwise than on an exchange. FINRA last adjusted the TAF rate for sales of covered equity securities effective July 2012. FINRA's regulatory fees also include a Gross Income Assessment ("GIA") and a Personnel Assessment.

In addition, Section 3 of Schedule A to the FINRA By-Laws states that each member will be assessed a regulatory transaction fee that is determined periodically in accordance with Section 31 of the Exchange Act. Section 31(c) generally requires each national securities association to pay the Commission a fee based on the aggregate dollar amount of sales of certain securities transacted by or through any member of such association otherwise than on a national securities exchange. 15 U.S.C. 78ee(c). The Commission preliminarily believes that FINRA's Section 3 fees will not change as a result of the proposed amendments to Rule 15b9-1. The fees collected by FINRA under Section 3 are intended to correspond to its obligations to the SEC under Section 31(c) of the Act. However, if the proposal is adopted, as Non-Member Firms become FINRA members, FINRA could seek to reallocate Section 3 fees among FINRA members. Nonetheless, because the Commission generally believes that Section 3 fees are passed through by FINRA members to the parties to covered transactions, we do not expect the burden of Section 3 fees to materially change.

98 As is discussed in more detail in the Economic Analysis, the Commission preliminarily estimates that some firms could be subject to a TAF of up to $3.2 million based on their current sales of covered securities. See Section V.C.2.

structure to ensure that it appropriately reflects the activities of, and regulatory responsibilities towards, these FINRA members, if the proposal is adopted.

In addition, under the proposal a broker-dealer that effects transactions on multiple exchanges, and not on ATSs or elsewhere in the off-exchange market, would need to become a member of an Association if it effects transactions indirectly on exchanges of which it is not a member (i.e., through another broker-dealer that is a member of that exchange) in accordance with Section 15(b)(8), unless one of the specified exceptions in the proposed amendment is available.[99] The Commission believes that this is consistent with the statutory framework and would address an activity potentially not subject to effective regulatory oversight in today's market. Specifically, if such a broker-dealer were a member of one exchange but conducted a significant amount of activity indirectly on other exchanges of which it was not a member, the exchange of which it was a member would not be well-positioned to regulate the member's activity on those other exchanges. As with the off-exchange market, individual exchanges today lack access to data,[100] the proper rule set and the necessary expertise to regulate trading on other exchanges. Under these circumstances—where the broker-dealer would not be conducting "off-exchange" activity but would be effecting transactions on an exchange of which it is not a member, the Commission believes that an Association is best-positioned to oversee this activity.[101] As discussed elsewhere in this release, FINRA currently conducts cross-market

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99 The Commission is not currently aware of any broker-dealer with such a business model.

100 See supra note 76.

101 The Commission also believes that this would be consistent with the statutory framework, which subjected broker-dealers that effect transactions on an exchange of which they are not a member first to Commission, and then to Association, oversight. In amending Rule 15b8-1 in 1976 to add the exclusion for proprietary trading, the Commission also revised the text of Rule 15b8-1 by substituting the phrase "otherwise than on a national securities exchange of which he is a member" to replace the phrase

surveillance and is provided exchange audit trail data pursuant to existing RSAs and 17d-2 agreements.[102] In contrast, exchanges generally do not conduct cross-market surveillance and most have allocated this responsibility to FINRA. Accordingly, the Commission believes that, as a practical matter and consistent with Section 15(b)(8), FINRA is currently in the best position to regulate cross-market activity[103] by broker-dealers that effect transactions on exchanges other

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"otherwise than on a national securities exchange." See Adoption of Amendments to SECO Rules, supra note 13, at 10600. The Commission made this revision "to conform the scope of the SECO rules to the Commission's authority" under Section 15(b)(8) and 15(b)(9) (as revised in 1975) to subject "broker-dealers who effect transactions on exchanges other than those of which they are members to the SECO rules." Id. This change reflected the Commission's understanding that broker-dealers effecting transactions on exchanges of which they were not a member should be subject to the then-existing regulatory framework (i.e., either Association membership or direct Commission regulation under the SECO program) governing off-exchange trading. As noted above, Congress amended the Act in 1983 "to eliminate direct regulation of broker-dealers by the Commission through the SECO Program and to require any broker-dealer engaged in an over-the-counter ('OTC') securities business to join a registered securities association." See SECO Programs Release, supra note 9, at 53688. Consistent with the Commission's rationale in 1976, the Commission believes that broker-dealers that effect transactions on exchanges of which they are not a member should be subject to the current regulatory framework governing off-exchange trading, namely, membership in an Association.

102 See, e.g., News Release, FINRA, BATS Global Markets, FINRA Enter Regulatory Service Agreement (February, 6, 2014), available at https://www.finra.org/Newsroom/NewsReleases/2014/P443474. Such agreements provide detailed data that allow FINRA to comprehensively identify the market-wide activity of broker-dealers, and to surveil behavior for violative activity that might otherwise go undetected if surveillance were only being conducted on an exchange-specific basis.

103 In advance of the 1975 Amendments, Congress contemplated reforms to the regulatory structure of the securities markets in which an Association's role would be expanded, while exchanges would focus their regulatory activities on their respective markets: ". . . the time has come to begin planning a framework which will guide the development of the self-regulatory system in the future. In the revised system, a single nationwide entity [an Association] would be responsible for regulation of the retail end of the securities business, including such matters as financial responsibility and selling practices, while each exchange would concentrate on regulating the use of its own trading facilities . . . the regulatory activities of the NASD (the only organization presently registered as a national securities association) would encompass many of the present regulatory

than those of which the broker-dealer is a member, even if they do not effect transactions in the off-exchange market.[104]

In sum, the Commission is concerned that some of the most active cross-market proprietary trading firms may not be subject to effective regulatory oversight by an exchange or Association with respect to the full range of their market activity. Accordingly, the Commission is proposing to amend Rule 15b9-1, as described below, to appropriately tailor the exemption from Association membership for today's markets.

II. Discussion of Amendments to Rule 15b9-1

A. Prior Comments on Association Membership

In 2010, the Commission issued a Concept Release that, among other things, solicited comment on whether all proprietary trading firms should be required to register as broker-dealers and become members of FINRA to help assure that their operations were subject to full regulatory oversight.[105] The Commission received six comment letters that directly addressed the question as it relates to FINRA membership, including one comment letter from FINRA.[106]

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activities of the NYSE and other exchanges over retail activities of their members. This 'expanded' NASD would have direct responsibility, subject to SEC oversight, for enforcing SEC rules and its own rules . . ." S. Doc. No. 93-13 at 16, 169 (1973).

104 A broker-dealer would not need to become a member of an Association if it conducts no activity in the off-exchange market and it becomes a member of each exchange upon which it effects transactions. Although the Commission is not aware of such broker-dealer business model existing today, if one were to arise, the Commission notes that the exchanges upon which such broker-dealer directly effects transactions could enter into an RSA to ensure effective cross-market supervision of this activity. The Commission acknowledges that in the future another SRO could assume these responsibilities pursuant to 17d-2 Agreements, subject to Commission approval, and RSAs.

105 See Concept Release, supra note 16, at 3612.

106 See letters to Elizabeth M. Murphy, Secretary, Commission, from Kimberly Unger, Executive Director, Security Traders Association of New York, Inc., dated April 30, 2010 ("STANY Letter"); from Liam Connell, Chief Executive Officer, Allston Trading,

The six comment letters offered contrasting views. Three commenters expressed their support for enhanced oversight of proprietary trading firms, including a requirement to become members of FINRA, generally asserting that because proprietary trading firms are not all members of FINRA there is a lack of uniform regulation among registered broker-dealers.[107] Three commenters expressed opposition to the idea of requiring proprietary trading firms to become FINRA members, asserting their belief that such firms are already subject to full regulatory oversight,[108] requiring such firms to join FINRA would be costly and burdensome,[109] and that,

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LLC, and Richard B. Gorelick, Chief Executive Officer, RGM Advisors, LLC, and Adam Nunes, President, HRT Financial LLC, Hudson River Trading, LLC, and Cameron Smith, General Counsel, Quantlab Financial, LLC, dated April 23, 2010 ("Allston Letter"); from Donald R. Wilson, Jr., DRW Trading Group, dated April 21, 2010 ("DRW Letter"); from Marcia E. Asquith, Senior Vice President and Corporate Secretary, Financial Industry Regulatory Authority, dated April 23, 2010 ("FINRA Letter"); letter to the Commission from Berkowitz, Trager & Trager, LLC, dated April 21, 2010 ("Berkowitz Letter"); and from Stephen M. Barnes, J.D., Salt Lake City, Utah, received October 3, 2011 ("Barnes Letter").

107 See FINRA Letter, supra note 106, at 4-5; Barnes Letter, supra note 106, at 32-33 (suggesting that, to level the regulatory playing field, high-frequency trading firms should be required to register as broker-dealers with the Commission and become members of an SRO such as FINRA or an exchange); and STANY Letter, supra note 106, at 14 (suggesting that the Commission review and consider registration requirements of market participants that are not required to be registered with FINRA and noting that enhanced surveillance and enforcement should improve investor confidence in the markets). See also letter to the Honorable Mary Schapiro, Chairman, Commission, from Kimberly Unger, Executive Director, Security Traders Association of New York, Inc., dated May 10, 2010, at 14 (urging the Commission to work towards a more harmonized regulatory structure, which the commenter believes will put FINRA in a better position to address regulatory gaps through a holistic, cross-market approach to regulation that can detect problematic activity across multiple markets and products).

108 See Allston Letter, supra note 106, at 14-15 (stating that it is inaccurate to say that proprietary trading Non-Member Firms are not subject to full regulatory oversight and noting that such firms are generally members of several exchanges and are consequently subject to multiple regulators).

109 See Berkowitz Letter, supra note 106, at 1 (stating that requiring proprietary trading firms to register as broker-dealers and become members of FINRA would add significant costs and burdens to those firms).

because proprietary trading firms do not have customers, there would be no benefit to requiring such firms to become members of FINRA.[110] The Commission has considered these comments, and, for the reasons set forth throughout this release, is proposing to amend Rule 15b9-1 as described herein.

B. Overview of Amendments

As noted above, Section 15(b)(8)[111] of the Act[112] generally prohibits any registered broker or dealer from effecting transactions in securities unless it (1) is a member of an Association or (2) effects transactions in securities solely on an exchange of which it is a member. Section 15(b)(9)[113] of the Act provides the Commission authority to exempt any broker or dealer from the requirements of Section 15(b)(8). The Commission has, by rule, exercised its exemptive authority. Specifically, Rule 15b9-1[114] generally exempts any broker or dealer from membership in an Association if it: (1) is a member of a national securities exchange; (2) carries no customer accounts; and (3) has annual gross income of no more than $1,000 that is derived from purchases or sales of securities effected otherwise than on an exchange of which it is a member. However, income derived from transactions for the dealer's

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110 See DRW Letter, supra note 106, at 4 (stating that FINRA's focus is on investor protection and not proprietary trading, and, therefore, there would be no benefit to requiring proprietary trading firms that do not undertake a customer business to become members of FINRA).

111 See supra note 46.

112 15 U.S.C. 78a et seq.

113 See supra note 7.

114 See supra notes 50-51.

own account with or through another registered broker or dealer,[115] or through the ITS, is excluded from such de minimis allowance.

The Commission is proposing to eliminate the existing de minimis allowance (including the exclusion for proprietary trading) and replace it with a more targeted exemption from Association membership for a broker-dealer that conducts business on a national securities exchange, to the extent it effects transactions off-exchange for the dealer's own account with or through another registered broker-dealer, that are solely for the purpose of hedging the risks of its floor-based activities, by reducing or otherwise mitigating the risks thereof. The proposed amendments also include an exemption for a broker-dealer to the extent it executes orders that are routed by a national securities exchange of which it is a member, to prevent trade-throughs on such national securities exchange consistent with the provisions of Rule 611 of Regulation NMS.

C. Elimination of the De Minimis Allowance

The Commission proposes to eliminate the de minimis allowance in its entirety. Specifically, the Commission is proposing to delete the following language from Rule 15b9-1(a): "and (3) has annual gross income derived from purchases and sales of securities otherwise on a national securities exchange of which it is a member in an amount no greater than $1000." The Commission also is proposing to delete paragraphs (b) and (c) of the Rule, as they set forth two exceptions to the de minimis allowance.[116] Paragraph (b) provides that income derived from (1) transactions for the dealer's own account with or through another registered broker-dealer, and

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115 See supra note 51.

116 See supra notes 50-51.

(2) transactions through the ITS, do not count toward the $1,000 de minimis allowance, and paragraph (c) defines the ITS.

As discussed above, the $1,000 de minimis allowance originally was intended to permit exchange specialists and other floor members to receive a nominal amount of commissions on occasional off-exchange transactions for accounts referred to other members, without subjecting them to SECO rules and broker-dealer registration and, later, Association membership.[117] Since the de minimis allowance was first adopted in 1965, the securities markets have undergone a significant transformation. At that time, virtually all trading activity was conducted manually on the floors of national securities exchanges.[118] Today, however, electronic cross-market order routing and trading strategies are a significant component of the markets, and exchange floor-based businesses represent only a small fraction of market activity. The $1,000 de minimis allowance has never been adjusted, and the Commission is unaware of any floor members today that refer accounts to other broker-dealers in exchange for a share of the broker's commission revenues. Although the Commission is proposing to eliminate the de minimis allowance, it is soliciting comment on whether the de minimis allowance might continue to be appropriate in today's markets. In particular, the Commission seeks responses to the following questions:

1. Do exchange floor members currently rely on the $1,000 de minimis allowance? If so, how? Please describe the number and types of floor members that rely on the allowance. Please provide the nature and extent of reliance on the allowance. Also, please provide any available data on the amount and frequency of

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117 See supra note 39 and accompanying text.

118 See, e.g., Special Study, supra note 14, at 98 ("Trading by NYSE members on the Exchange but from off the floor accounts for approximately 5 percent of total Exchange purchases and sales . . .").

commissions or referral fees that floor members may continue to receive with respect to off-exchange transactions.

2. If the de minimis allowance is being used by exchange floor members, is it being relied upon for its original purposes (i.e., accommodating occasional commission splitting or referrals by such members)? If not, for what purposes are floor members today relying on the de minimis allowance?

3. If exchange floor members currently rely on the de minimis allowance and the Commission retains that allowance, should the $1,000 limit be changed? Why or why not? What should the limit be?

4. If the de minimis allowance were eliminated, as proposed, would some exchange floor members be required to become members of an Association? If so, how many? Please provide the basis of any estimate. What would be the effect on those firms?

5. Do other broker-dealers that are not floor members rely on the de minimis allowance? If so, for what activities? Specifically, do cross-market proprietary trading firms, as discussed above, rely on the allowance? If so, why? Are there other types of businesses that use the allowance? If so, please describe them. How and why do they rely on the allowance?

6. If the de minimis allowance were eliminated, what would be the effect on these non-floor-based broker-dealer firms? For example, if the allowance were eliminated, would there be effects on the business of firms that would be required to register with an Association, and if so what would they be? Would business incentives change such that firms might adjust their business model or their

trading volume by leaving the off-exchange market, moving transactions on-exchange, or leaving the markets altogether? Would the effects be different on broker-dealers trading equities from those trading options?

D. Floor Member Hedging Exemption

Although the Commission proposes to eliminate the de minimis allowance in its entirety, it also proposes to replace the allowance with an exemption from Association membership for exchange member broker-dealers that operate on the floor of the exchange, to the extent they effect transactions off-exchange solely for the purpose of hedging the risks of their floor-based activities. The Commission proposes the hedging exemption be limited to firms that trade on the floor of a national securities exchange, as the Commission understands that currently, broker-dealers that trade exclusively on a single exchange do so on a physical exchange floor.[119] Accordingly, the Commission is proposing to add the following language to Rule 15b9-1: "and, (c) Effects transactions solely on a national securities exchange of which it is a member, except that . . . (1) A dealer that conducts business on the floor of a national securities exchange may effect transactions, for the dealer's own account with or through another registered broker or dealer, that are solely for the purpose of hedging the risks of its floor-based activities, by reducing or otherwise mitigating the risks thereof. A dealer seeking to rely on this exception shall establish, maintain and enforce written policies and procedures reasonably designed to ensure and demonstrate that such hedging transactions reduce or otherwise mitigate the risks of the financial exposure the dealer incurs as a result of its floor-based activity. Such dealer shall preserve a copy of its policies and procedures in a manner consistent with 17 CFR 240.17a-4

119 Currently, NYSE Arca Options, NYSE Amex Options, NASDAQ OMX Phlx, CBOE, NYSE, and NYSE MKT have physical exchange floors.

until three years after the date the policies and procedures are replaced with updated policies and procedures."

The Commission understands that today there are some broker-dealers that continue to limit their activities to exchange floors, particularly in the options markets.[120] As discussed above, at the time Rule 15b9-1 was adopted, the circumstances under which an exchange specialist or floor broker would trade proprietarily off-exchange were quite limited, such as where a regional exchange specialist would hedge risk on the primary listing market. The Commission believes that those broker-dealers that today continue to limit their trading activities to an exchange floor may seek to hedge the risks of their floor-based activities on other markets, both on national securities exchanges and off-exchange.[121] Therefore, the Commission proposes to retain a more focused exemption from Association membership for the type of activity for which the Commission believes the exclusion for proprietary trading in Rule 15b9-1 was originally designed.[122]

The availability of the proposed hedging exemption would be limited to dealers that conduct business on the floor of a national securities exchange and are members of that exchange. Section 15(b)(8) requires Association membership for all registered broker-dealers

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120 Based on disclosures on Form BD, as of February 2015, the Commission understands that there are approximately 43 Non-Member Firms that are members of one national securities exchange and that disclose being engaged in floor activities on Form BD. The business model of these firms varies widely, and may include market making, other proprietary trading and agency business.

121 For example, a broker-dealer may operate a floor-based business on one or more options exchanges. As a result of this activity, the broker-dealer may need to mitigate the risk of its options positions, resulting from such activity, on other options markets or in the equities markets. The proposed floor member hedging exemption would allow the broker-dealer to enter into transactions on other markets solely for the purpose of hedging this risk.

122 <u>See</u> <u>supra</u> note 39 and accompanying text.

other than those that effect transactions solely on an exchange of which they are a member. Broker-dealers that limit their activities in this manner generally are specialists or floor brokers based on the floor of an individual exchange. In exercising its exemptive authority when it adopted Rule 15b8-1 in 1965, the Commission sought to accommodate off-exchange activities ancillary to that floor-based business. The Commission believes that, today, few broker-dealers limit their activities to a particular exchange. Those broker-dealers that do limit their business to an exchange floor, however, may continue to seek to hedge the risk of their floor-based activities by effecting transactions on another exchange or in the off-exchange market.

The Commission preliminarily believes that a floor-based dealer seeking to rely on the proposed hedging exemption in Rule 15b9-1 should be required to establish, maintain and enforce written policies and procedures reasonably designed to ensure and demonstrate that its off-exchange transactions are solely for the purpose of hedging the risks of its floor-based activities, by reducing or otherwise mitigating the risks thereof. Such hedging should reduce or otherwise mitigate the risks of the financial exposure the dealer incurs as a result of its business on the floor of an exchange of which it is a member. Because such hedging transactions must be solely for the purpose of hedging the risks of the dealer's floor-based activities, the transactions, of course, should not be for the purpose of increasing the aggregate risk of the dealer. The Commission notes that whether a transaction or transactions entered into to reduce or otherwise mitigate risk results in a profit or loss is not dispositive of whether or not such a transaction or transactions meets the terms of the proposed floor member hedging exemption. A floor-based dealer seeking to rely on the proposed hedging exemption would be required to preserve a copy of its policies and procedures in a manner consistent with Rule 17a-4 until three years after the date the policies and procedures are replaced with updated policies and procedures.[123]

The Commission preliminarily believes that requiring written policies and procedures, as described above, would facilitate SRO supervision of broker-dealers relying on the proposed hedging exemption, as it would provide an efficient and effective way for regulators to assess compliance with the proposed exemption. The determination of whether an off-exchange transaction by a floor-based dealer reduces or otherwise mitigates the risk of the financial exposure incurred as a result of the dealer's floor-based business may vary depending on the nature of the business of the floor-based dealer, its financial position, and the particular transactions effected. Consequently, the Commission preliminarily believes that requiring floor-based dealers to develop written policies and procedures will provide sufficient flexibility to accommodate the varying business models of floor-based dealers and appropriate hedging activities.

The Commission notes, however, that such written policies and procedures must be reasonably designed to ensure and demonstrate that the floor-based dealer's off-exchange hedging transactions reduce or otherwise mitigate the risks of the financial exposure it incurs as a result of its floor-based activity. Accordingly, a dealer seeking to rely upon the proposed hedging exemption should maintain documentation that, in the context of an SRO or Commission examination, would enable it to show how the hedging transactions it effects off the exchange reduce or otherwise mitigate the risks of its floor-based business.

The Commission notes that the exchange of which the dealer is a floor member would be responsible for enforcing compliance with the hedging exemption, including reviewing the

[123] 17 CFR 240.17a-4.

adequacy of the dealer's written policies and procedures and whether the dealer's off-exchange transactions comply with those written policies and procedures, including the requirement that the hedging transactions reduce or otherwise mitigate the risks of financial exposure the dealer incurs as a result of its floor-based activity and that the policies and procedures are reasonably designed to so demonstrate.[124]

Because the proposed hedging exemption is intended to allow a dealer to reduce or otherwise mitigate risk incurred in connection with its floor-based activities, it would be limited to transactions for the dealer's own account. In addition, because the floor-based dealer would not itself be a member of the national securities exchange on which transactions may be effected, or an Association, such transactions would need to be conducted with or through another registered broker-dealer that is a member of such other national securities exchange or a member of an Association (or both).

Finally, a dealer seeking to rely on the proposed hedging exemption would be required to preserve a copy of its policies and procedures in a manner consistent with Rule 17a-4 under the Exchange Act until three years after the date the policies and procedures are replaced with updated policies and procedures. Accordingly, a dealer must keep the policies and procedures relating to its use of the hedging exemption as part of its books and records while they are in effect, and for three years after they are updated.

The Commission requests comment on all aspects of the proposed hedging exemption in Rule 15b9-1. In particular, the Commission seeks responses to the following questions:

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[124] See 15 U.S.C. 78f(b)(1) which requires that an exchange is so organized and has the capacity to be able to carry out the purposes of the Exchange Act and to comply, and to enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange.

7. To what extent do exchange floor members that are Non-Member Firms today effect transactions in the off-exchange market to hedge the risk of their floor-based activities? What is the nature and extent of such off-exchange market activities? Do these activities tend to focus on particular products? The Commission specifically seeks data from exchange floor members that demonstrates the extent to which they trade off the exchange floor and how such off-exchange trading relates to their floor-based business, including to hedge the risks thereof, as such data may be particularly helpful in assessing a potential floor member hedging exemption when the Commission considers adoption of the proposed amendments.
8. Is the Commission's proposed description of hedging transactions appropriate? Is it sufficiently defined? If not, how should it be modified or supplemented? Is the phrase "solely for the purpose of hedging the risks of its floor-based activities," as used in the proposed amendments, sufficiently precise that broker-dealers will know what activities are allowed under the proposed floor member hedging exemption from Association membership? If not, what should be changed or what guidance should be provided?
9. Will broker-dealers seeking to rely on the floor member hedging exemption be able to evaluate whether, and demonstrate that, off-exchange transactions are "solely for the purpose of hedging the risks of floor-based activities"? Please provide specific examples. What would be the associated costs?
10. Should there be a hedging exemption at all? Why or why not?

11. Should the Commission narrow or broaden the proposed floor member hedging exemption in any way? If so, how and why?
12. Do exchange floor members that are Non-Member Firms effect transactions in the off-exchange market, or on exchanges of which they are not a member, for purposes other than hedging the risk of their floor-based activities? If so, please describe the nature and extent of such activities. Should there be an exemption for these activities? Why or why not?
13. Are there non-floor-based exchange members that today focus their business activities on a single exchange? If so, what is the nature of their business activity? Should there be an exemption for such activities? Why or why not?
14. The proposed floor member hedging exemption is limited to transactions effected with or through another registered broker-dealer. Are there circumstances where an exchange floor member that is a Non-Member Firm, might need to hedge the risk of its floor-based activities through a transaction with a non-registered broker-dealer counterparty? If so, please describe the nature and extent of such transactions and the particular reason(s) that such transactions should be covered.
15. The proposed floor member hedging exemption is limited to transactions for the dealer's own account. Are there circumstances where an exchange floor member that is a Non-Member Firm might need to hedge the risk of customer activity on the exchange, as agent, in the off-exchange market or on exchanges of which it is not a member? If so, please describe.
16. Is the proposed policies and procedures requirement appropriate for the floor member hedging exemption? What would be the costs of establishing,

maintaining and enforcing the policies and procedures, and the related record-keeping requirements? How are such costs determined? Please provide evidence of the nature, timing, and extent of such costs. Would such costs deter dealers from relying on the floor member hedging exemption? Are there more efficient and effective alternatives to a policies and procedures approach? If so, what are they? Have the transactions executed by floor members pursuant to the current Rule's exclusion for proprietary trading posed issues of regulatory compliance, market surveillance, or enforcement? If so, please describe in detail.

17. Will the proposed requirement to establish, maintain, and enforce written policies and procedures enable floor members to efficiently hedge their floor-based activities while effectively ensuring the floor member hedging exemption is used as intended? Is there another approach that would better achieve these goals?
18. Would the proposed floor member hedging exemption present compliance risks or otherwise raise concerns regarding the protection of investors or the maintenance of fair, orderly, and efficient markets? If so, please describe.
19. Would current exchange surveillance and enforcement mechanisms be effective to monitor trades that would be executed pursuant to the proposed floor member hedging exemption? Please explain.
    a. If not, should the Commission require additional reporting by registered broker-dealers acting as agent for dealers relying on the floor member hedging exemption? For example, should they report to an exchange or an Association (i) the identity of the floor member effecting the hedging transaction; and (ii) the fact that the transaction was a hedging transaction? Is such a requirement

necessary to assure the adequacy of market surveillance and compliance? Or, alternatively, is the registered broker-dealer acting as agent on behalf of the dealer subject to sufficient rules and regulations (including Rule 15c3-5 under the Exchange Act,[125] known as the Commission's "Market Access Rule")? Please explain.

b. Could a Non-Member Firm execute a hedging transaction directly with another Non-Member Firm? If so, how would the transaction be subject to surveillance? How would this activity affect the enforcement of the exemption? Please explain.

c. Would exchanges otherwise have the ability to assess compliance of broker-dealers relying on the Rule?

20. Should the proposed floor member hedging exemption be subject to any quantitative or qualitative limitations, or to special reporting obligations? Please explain.

21. Should the proposed floor member hedging exemption require the floor member to retain records demonstrating how each off-exchange transaction complies with its policies and procedures? Why or why not? What would be the associated costs, and what is the basis for those costs? Would the cost associated with recordkeeping on a transaction by transaction basis be overly burdensome, or unnecessary given the Commission's proposed policies and procedures requirement?

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125 17 CFR 240.15c3-5.

22. Should the Rule contain an anti-evasion provision to prevent floor members from attempting to circumvent the limitations in the floor member hedging exemption? Is there a better method than the proposed policies and procedures approach to ensure that floor members do not misuse the proposed floor member hedging exemption? If so, what is it? Alternatively, are the existing Commission anti-fraud and anti-manipulation rules sufficient to prevent misuse of the proposed floor member hedging exemption?
23. Should floor members have to make a certification in connection with their reliance on the floor member hedging exemption? Why or why not? If a certification should be required, what would be the key elements thereof? How frequently should the certification be made? Who should make it? What qualifications, if any, to such certification might be appropriate (e.g., reasonable basis to believe, best of my knowledge)? Should the certification be made in conjunction with an internal compliance review? If so, what type of internal compliance review should be conducted?
24. Are certifications an appropriate way to promote compliance with the hedging exemption? Do certifications bring more accountability, or do they create compliance costs and therefore a barrier to entry?
25. Is data currently available that could be used by regulators to monitor the use of the proposed floor member hedging exemption? Are there other approaches that would do more to enhance regulatory surveillance, protect investors, or ensure fair, orderly, and efficient markets?

26. Are there other mechanisms the Commission could consider to monitor compliance with the floor member hedging exemption? If so, please explain.

E. Regulation NMS Routing Exemption

The Commission proposes to eliminate a portion of subparagraphs (b)(2) and all of subparagraph (c) from Rule 15b9-1, because both contain outdated references to the "Intermarket Trading System."[126] ITS was a national market system plan ("ITS Plan") operated by the national securities exchanges and NASD that required each participant to provide electronic access to its displayed best bid and offer to other participants and provided an electronic mechanism for routing orders, called commitments to trade, to access those displayed prices.[127] This permitted ITS Plan members at each market to have limited access to the other markets for the purpose of avoiding trade-throughs[128] and locked markets.[129] However, the ITS Plan was eliminated in 2007, when it was superseded by Regulation NMS.[130] Accordingly, the Commission is proposing to eliminate the following language, which creates an additional

126 The full title of the ITS Plan was "Plan for the Purpose of Creating and Operating an Intermarket Communications Linkage Pursuant to Section 11A(c)(3)(B) of the Exchange Act of 1934." The ITS Plan was initially approved by the Commission in 1978. Exchange Act Release No. 14661 (April 14, 1978), 43 FR 17419 (April 24, 1978). All national securities exchanges that traded exchange-listed stocks and the NASD were participants in the ITS Plan.

127 Id.

128 See 17 CFR 242.600(b)(77) defining a "trade-through" under Regulation NMS.

129 A "locked market" occurs when a trading center displays an order to buy at a price equal to an order to sell, or an order to sell at a price equal to an order to buy, displayed on another trading center.

130 Notice of Filing and Immediate Effectiveness of the Twenty Fourth Amendment to the ITS Plan Relating to the Elimination of the ITS Plan, Exchange Act Release No. 55397 (March 5, 2007), 72 FR 11066 (March 12, 2007). Today, Regulation NMS contains an updated trade-through rule, and contemplates the use of private linkages by trading centers to route orders to avoid trade-throughs. 17 CFR 242.610-611.

exception to the de minimis allowance, from Rule 15b9-1 (b): "or (2) through the Intermarket Trading System." In addition, the Commission is eliminating in its entirety subparagraph (c) of the Rule, which defines the ITS as follows: "(c) For purposes of this section, the term Intermarket Trading System shall mean the intermarket communications linkage operated jointly by certain self-regulatory organizations pursuant to a plan filed with, and approved by, the Commission pursuant to §242.608 of this chapter."

Today, Rule 611 of Regulation NMS requires trading centers to establish, maintain and enforce policies and procedures reasonably designed to prevent trade-throughs in exchange-listed stocks, subject to certain exceptions.[131] In general, Rule 611 protects automated quotes that are the best bid or offer of a national securities exchange or Association.[132] To facilitate compliance with Rule 611 of Regulation NMS, national securities exchanges have developed the capability to route orders through broker-dealers (many of which are affiliated with the exchanges) to other trading centers with protected quotations.

As discussed above, the Commission understands that some broker-dealers today continue to limit their activities to exchange floors, and believes that Rule 15b9-1 should continue to accommodate transactions away from the exchange of which they are a member that are necessary to comply with regulatory requirements. A floor-based member may at times seek to effect a transaction on the exchange at a price that would trade-through a protected quotation on another trading center. In such a case, the exchange would need to route the member's order, through a routing broker-dealer, to that other trading center before it could execute any

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131 Exchange Act Rule 611 states, in part, that "a trading center shall establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of protected quotations in NMS stocks. . . ." 17 CFR 242.611.

132 Id.

remainder of the floor-based member's order on the exchange. Therefore, a broker-dealer may be required, as a necessary part of its business, to effect transactions otherwise than on the exchange of which it is a member as a consequence of the requirements of Rule 611 of Regulation NMS.

The Commission preliminarily believes that transactions effected solely to comply with Rule 611 regulatory requirements should not require membership in an Association by a broker-dealer that otherwise limits its activities to an exchange of which it is a member. Accordingly, the Commission proposes to add the following language to create a second exemption from the requirement under proposed Rule 15b9-1(c) that a broker-dealer effect transactions solely on an exchange of which it is a member: "(2) a broker or dealer may effect transactions off the exchange resulting from orders that are routed by a national securities exchange of which it is a member, to prevent trade-throughs on that national securities exchange consistent with 17 CFR 242.611." The Commission believes that permitting such routing only by a national securities exchange of which the broker-dealer is a member will provide the exchange with visibility into the routing of transactions by its members to other exchanges, and thus maintain the exchange's ability to effectively oversee the entirety of its member's activity.

The Commission requests comment on all aspects of the proposed Regulation NMS routing exemption in Rule 15b9-1. In particular, the Commission seeks responses to the following questions:

27. Is the proposed routing exemption necessary and appropriate? Why or why not?
28. Is the scope of the proposed routing exemption sufficient to provide for all off-exchange transactions that might be effected by floor members as a necessary

consequence of compliance with Rule 611 of Regulation NMS? If not, how should it be changed?

29. Does the proposed routing exemption allow transactions beyond those necessary to comply with Rule 611 of Regulation NMS? If so, is that appropriate and should it be narrowed or broadened?

30. Are there other off-exchange transactions that a floor member might need to effect in order to comply with regulatory requirements? If so, please describe those transactions and the relevant regulatory requirements.

III. Effective Date and Implementation

The Commission recognizes that firms will require time to comply with Rule 15b9-1 if the amendments are adopted in order to become a member of an Association, or modify the firm's business practices to conform to the requirements of the Rule, as amended. As noted previously, FINRA is currently the only Association. To become a FINRA member, a broker-dealer must complete FINRA's New Member Application and participate in a pre-membership interview.[133] The broker-dealer and its associated persons must comply with FINRA's registration and qualification requirements.[134] The amount of time that it takes to become a FINRA member would depend on a number of factors, including the nature of the broker-dealer's business, the level of complexity or uniqueness of the firm's business plan, the number of associated persons the firm employs, and whether the firm has an affiliate that is already a

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133 See How to Become a Member, FINRA, http://www.finra.org/Industry/Compliance/Registration/MemberApplicationProgram/HowtoBecomeaMember/index.htm (last visited on March 9, 2015).

134 See NASD Rule 1010 – Membership Proceedings, which sets out the substantive standards and procedural guidelines for the FINRA membership application and registration process.

member of FINRA.[135] The Commission understands, based on conversations with FINRA that, on average, the FINRA membership application process generally takes approximately four months.

Alternatively, if the proposed amendments are adopted, a Non-Member Firm not eligible for, or choosing not to rely on, an exemption may become a member of additional exchanges upon which it trades or otherwise modify its business model to conform with the proposed amendments to the Rule. The Non-Member Firm may also need to modify its systems or take other steps to achieve compliance.

The Commission preliminarily believes that 360 days after publication in the Federal Register of any final rules that the Commission may adopt should provide firms enough time to comply with the amended Rule. Therefore, the Commission proposes that the compliance date for the proposed amendments to Rule 15b9-1 would be 360 days after publication of the final rule in the Federal Register. The Commission solicits comment on the adequacy of this proposed implementation timeline. In particular, the Commission seeks responses to the following questions:

31. Does 360 days after publication in the Federal Register provide firms with sufficient time to comply with the revised Rule? Would firms be in a position to comply with the revised Rule earlier than 360 days after publication?
32. How long does the registration process with FINRA, should a firm decide to register, typically take? Please include the estimated time to prepare the application as well as the estimated time for FINRA to process the application.

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135 See Section V.C. discussing the costs of joining FINRA.

33. Do commenters believe that a longer or shorter period is appropriate to determine whether becoming a member of an Association is preferable to changing a firm's business model to remain within the exemptions provided by the Rule, as amended (i.e., ceasing all off-exchange activity and becoming a member of each exchange on which the firm trades, or limiting the firm's off-exchange activity to comply with the floor member hedging exemption and/or NMS routing exemption)?
34. How long does it typically take to complete the application process with a national securities exchange? Please include the estimated time to prepare the application as well as the estimated time for an exchange to process it.
35. To the extent a firm intends to rely on one or more of the proposed exemptions, how long would it take such firm to make the required systems changes to comply? Are there other steps that would need to be taken to achieve compliance? If so, what is the estimated time to accomplish those steps?

IV. General Request for Comments

The Commission seeks comment on all aspects of the proposed amendments to Rule 15b9-1. Commenters should, when possible, provide the Commission with data to support their views. Commenters suggesting alternative approaches should provide comprehensive proposals, including any conditions or limitations that they believe should apply, the reasons for their suggested approaches, and their analysis regarding why their suggested approaches would satisfy the objectives of the proposed amendments.

36. The Commission requests comment generally on whether narrowing or broadening the current exemption is appropriate. In particular, the Commission

seeks comment on whether the fact that Non-Member Firms currently must use an Association member firm to report off-exchange trades gives an Association sufficient information and jurisdiction to effectively regulate the off-exchange market. Are there off-exchange transactions between two Non-Member Firms that occur that are not reported?

37. The Commission requests comment on whether the current exemption should be eliminated entirely. What would be the benefits or drawbacks of doing so?

38. Other than the proposed hedging exemption and Regulation NMS routing exemption, are there any other exemptions that the Commission should consider?

39. Have transactions effected pursuant to the current Rule posed compliance issues in the past? If so, please describe in detail.

40. In addition, the Commission is interested in data indicating how many entities rely either on Rule 15b9-1 in its current form, or exclusively on the statutory exception in Section 15(b)(8) of the Exchange Act. Reliance on Rule 15b9-1 is currently self-effecting (i.e., does not require the reporting of such reliance to the Commission or any other regulatory authority). In lieu of the proposed amendments, should the Commission require broker-dealers relying on Rule 15b9-1 to report such reliance to the Commission or to the exchange of which the broker-dealer is a member? If so, what form should such reporting take and what information should be provided to the Commission or the exchange of which the broker-dealer is a member? If not, why not and what alternative means could be used to collect data about reliance on Rule 15b9-1?

41. If the Commission were instead to eliminate Rule 15b9-1 altogether, how many broker-dealers would: (i) restrict their business to only those national securities exchanges of which they are a member; (ii) become members of other national securities exchanges; and/or (iii) become members of an Association? Would implementation of the proposed amendments have an effect on market liquidity? If so, please estimate that effect. Could broker-dealers that currently rely on the Rule respond to its elimination in other ways to avoid Association membership? If so, please explain.

42. Should the Commission allow Non-Member Firms that conduct off-exchange trading activity to remain exempt from membership in an Association? If so, why? Would membership by Non-Member Firms in multiple exchanges prove an efficient and effective substitute for Association membership? Should the level of off-exchange activity affect the ability of a firm to be exempt from Association membership? Why or why not?

43. Should the Commission require the exchanges to engage in joint plans to ensure that the on-exchange cross-market activity of their members is effectively regulated? How might this improve the oversight of on-exchange trading activity? What problems or inefficiencies would relying on joint plans for the regulation of on-exchange trading activity by exchanges create?

44. Is Association membership an efficient or effective approach for the regulation of firms that trade across multiple exchanges but do not trade off-exchange? Are there more effective alternatives?

45. Under the proposed amendments to the Rule, a Non-Member Firm that conducts no off-exchange trading, but trades on an exchange of which it is not currently a member, would, in accordance with Section 15(b)(8), have to either join an Association or become a member of each exchange upon which it trades. Should the proposed amendments be revised to provide an exemption from Section 15(b)(8) to permit such a Non-Member Firm, with no off-exchange trading, to remain exempt from membership in an Association and continue trading on exchanges of which it is not a member, so long as certain conditions are met, such as the exchange of which it is a member entering into appropriate contractual arrangements such that the exchange is in a position to effectively surveil all of the trading activities of that firm?

46. Should the Commission consider other changes to Rule 15b9-1? If so, why? What specifically should be changed and how?

V. Economic Analysis

As discussed above, the Commission is proposing to amend Rule 15b9-1 to better align the scope of its exemption, in light of today's market activity, with Section 15(b)(8) of the Exchange Act and the Commission's original purpose in adopting Rule 15b9-1. Currently, a broker-dealer can engage in unlimited proprietary trading in the off-exchange market without becoming a member of an Association, so long as its proprietary trading activity is conducted with or through another registered broker-dealer. For a broker-dealer that trades electronically across a range of exchange and off-exchange venues, however, the individual exchanges of which the broker-dealer may be a member are not well-positioned to oversee the off-exchange activity of the broker-dealer, as was previously discussed. The Commission preliminarily believes that this oversight role can best be fulfilled by an Association, which is the SRO intended and authorized by Congress to regulate the trading activity of off-exchange market participants, monitor their financial and operational condition, and enforce their compliance with federal securities laws and Association rules.

The Commission is sensitive to the economic effects of its rule, including the costs and benefits and effects on efficiency, competition, and capital formation. Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking pursuant to the Exchange Act, and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.[136] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the effect such rules would have on competition.[137] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[138]

The Commission discusses below a number of economic effects that are likely to result from the proposed amendments. As discussed in detail below, many of the effects are difficult to quantify with any degree of certainty. Although the Commission is providing estimates of direct compliance costs where possible, the Commission also anticipates that broker-dealers affected by the proposed amendments, as well as competitors of those broker-dealers, may modify their business practices regarding the provision of liquidity in both off-exchange markets and on

136 15 U.S.C. 78c(f).

137 15 U.S.C. 78w(a)(2).

138 Id.

exchanges. Consequently, much of the discussion below is qualitative in nature, but where possible, the Commission has provided quantified estimates.[139]

A. Baseline

1. Regulatory Structure and Activity Levels of Non-Member Firms

The Exchange Act governs the way in which the U.S. securities markets and its broker-dealers operate. Section 3(a)(4)(A) of the Act generally defines a "broker" broadly as "any person engaged in the business of effecting transactions in securities for the account of others."[140] In addition, Section 3(a)(5)(A) of the Act generally defines a "dealer" as: "any person engaged in the business of buying and selling securities for . . . such person's own account through a broker or otherwise."[141] The Commission oversees approximately 4,209 broker-dealers, of which approximately 4,057 are members of FINRA, currently the only Association.[142]

Generally, any firm that interacts directly with a securities exchange must register with the Commission as a broker-dealer to gain direct access to the exchange. Consequently, there is diversity in the size and business activities of broker-dealers.[143] Carrying broker-dealers hold customer funds and securities; some of these are also clearing broker-dealers that handle the clearance and settlement aspects of customer trades, including record-keeping activities and

139 See Section V.C. for further discussion of the difficulties in estimating market quality effects likely to result from the proposed amendments.

140 15 U.S.C.78c(4)(A).

141 15 U.S.C.78c(5)(A).

142 There were approximately 4,209 broker-dealers registered with the Commission as of March 2015.

143 A firm that wishes to transact business upon an exchange without becoming a broker-dealer can do so by engaging a broker-dealer to provide market access and settlement services. While effecting transactions in the off-exchange market does not require registering as a broker-dealer, it does require obtaining the services of a broker-dealer to handle settlement at a minimum.

preparing trade confirmations.[144] However, during the fourth quarter of 2014, only 284 of the 4,184 registered broker-dealers were classified as carrying or clearing broker-dealers. Thus, the majority of broker-dealers engage in a wide range of other activities, which may or may not include handling customer accounts. These other activities include intermediating between customers and carrying/clearing brokers; dealing in government bonds; private placement of securities; effecting transactions in mutual funds that involve transferring funds directly to the issuer; writing options; acting as an exchange floor broker; and the provision of liquidity to securities markets, which includes, but is not limited to, the activities of registered market makers.

Broker-dealers are diverse in size as well as scope of activity. Most broker-dealers are small, with 67% of broker-dealers employing 10 or fewer registered individuals and only 4% of broker-dealers employing over 151 registered individuals.[145] Although the majority of broker-dealers are small, there are a few very large broker-dealers as well. Further, while there are many registered broker-dealers, a small minority of broker-dealers controls the majority of broker-dealer capital and has the ability to affect the allocation of capital to liquidity provision. As of December 31, 2014, the majority of broker-dealers each had total capital of less than $500,000, while the ten largest broker-dealers in terms of capital accounted for more than 53% of total broker-dealer capital, with each disclosing more than $10 billion in total capital.[146]

As of March 2015, 125 of the approximately 4,209 registered broker-dealers were not members of FINRA, currently the only Association. The Commission believes the majority of

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[144] Based on December 2014 FOCUS data.

[145] Id.

[146] Id.

Non-Member Firms rely on the Rule's exemption from Association membership.[147] Because of the exclusion for proprietary trading, a broker-dealer that does not carry customer accounts is not required to join an Association, even when that broker-dealer has substantial off-exchange trading activity.

Non-Member Firms are diverse in their types and activities. Of the 125 Non-Member Firms, 77 disclose engaging in floor activities on a national securities exchange, as reported on Form BD.[148]

There is significant diversity in the business models of Non-Member Firms. Some Non-Member Firms may limit their trading to a single exchange, while others trade on multiple venues possibly including off-exchange venues like ATSs. Some firms are significant contributors to both off-exchange and exchange volume. Because any off-exchange activity that involves a FINRA member firm ("Member Firm") generates certain audit trail data, FINRA and

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147 See supra note 77. Historically, these floor brokers had only incidental trading on exchanges of which they were not members, and limited off-exchange trading activity. The background and history of Rule 15b9-1 are discussed in Section I.

148 See Form BD data for Non-Member Firms during March of 2015. Of the 125 Non-Member Firms, 77 Non-Member Firms disclose engaging in floor activities on a national securities exchange; 76 firms disclose acting as a put and call broker or dealer or option writer; and 89 firms disclose trading securities for their own account. Other businesses cited by multiple Non-Member Firms include: national securities exchange commission business other than floor activities (6); making inter-dealer markets in corporate securities off-exchange (5); selling corporate debt securities (2); dealing in government securities (4); and other business (18).

Currently, a Non-Member Firm that is a member of a single exchange but is not engaged in floor-broker activity may engage in trading upon other exchanges using access provided by a broker-dealer that is an exchange member of the destination exchange. These single-exchange member Non-Member Firms may also engage in off-exchange trading with or without the intermediation of a Member Firm. Under the proposed amendments, both of these activities would be disallowed except as outlined in the Floor Member Hedging Exemption (see Section II.D.) and the Regulation NMS Routing Exemption (see Section II.E.).

the Commission are able to quantify the aggregate off-exchange activity of Non-Member Firms.[149] During the fourth quarter of 2014, there were 104.5 billion orders reported in the off-exchange market. Of these 104.5 billion orders, 36.9 billion (35.31%) were received from Non-Member Firms.[150] Non-Member Firms submitted 44.99% of all orders within ATSs in the fourth quarter of 2014.

Although the Commission can observe the aggregate off-exchange trading of Non-Member Firms, it is unable to quantify the off-exchange trading of all Non-Member Firms on an individual basis because Member Firms currently are not required to report the identifiers of Non-Member Firms with whom they transact to OATS.[151] However, some Member Firms voluntarily report the exchange-issued identifiers of the Non-Member Firms with which they

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149 Most off-exchange interactions involve a Member Firm at some point in the order audit trail for routing, and therefore produce OATS data, although identification of the firm that submits the order is not required by OATS. Interactions between Non-Member Firms without the involvement of a Member Firm are possible and would not generate audit trail data, but the Commission believes these interactions are infrequent for two reasons. First, all ATSs are operated by Member Firms, so all orders submitted to ATSs are reported to OATS. Second, although two Non-Member Firms could theoretically interact on a Non-Member Firm operated single dealer platform, the Commission is unaware of any single dealer platform that is operated by a Non-Member Firm. Such a platform would be visible in OATS data as a routing and execution destination if it were accessed by Member Firms. Although it is possible that a Non-Member Firm could approach another Non-Member Firm directly to negotiate a transaction outside of an automated venue, the Commission believes large Non-Member Firms transact with each other almost exclusively through ATSs and do not seek each other out as trading partners. Further information about off-exchange trading outside of ATSs is provided by Tuttle, Laura, 2014, Over-the-Counter Trading: Description of Non-ATS OTC Trading in National Market System Stocks, available at http://www.sec.gov/dera/staff-papers/white-papers/otc-trading-white-paper-03-2014.pdf.

150 Data provided by FINRA. This does not include activity submitted by firms not registered as broker-dealers, including data on buy-side activity because the data was screened to include only Non-Member Firms.

151 See supra note 84.

interact.[152] Using this data, the Commission can estimate the ATS activity level of the 14 Non-Member Firms that connected to ATSs directly without the intermediation of another broker-dealer during the fourth quarter of 2014.[153] Based on this data, at least 19.31% of all ATS orders is attributable to the Non-Member Firm that was the most active in ATS orders during the review period.[154] The least active of the 14 identifiable Non-Member Firms has almost no order

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152 Data provided by FINRA. This does not include activity submitted by firms not registered as broker-dealers, including data on buy-side activity. In the fourth quarter of 2014, approximately 46.42% of ATS orders from Non-Member Firms included an exchange-issued identifier that allows identification of the Non-Member Firm submitting an order. The set of ATS clients that are not FINRA members also includes substantial buy-side activity, but this analysis is limited to firms that are also registered broker-dealers: the 125 Non-Member Firms.

Although the analysis here focuses on ATS activity, Non-Member Firms interact with Member Firms outside of ATSs as well, primarily on single-dealer platforms. Across all off-exchange executions, in the fourth quarter of 2014, 3.26% of share volume (10.56% of dollar volume) was attributable to the trading of Non-Member Firms.

153 Although these 14 Non-Member Firms connect to ATSs directly without the assistance of another broker-dealer, the ATSs are operated by Member Firms and these orders are therefore permitted under the current rule.

The Commission believes that these 14 Non-Member Firms represent a subset of the largest Non-Member Firms that actively trade across multiple exchanges and off-exchange and thus may not be representative of the broader set of 125 Non-Member Firms. As such, estimates of these 14 firms' ATS activity levels and the regulatory fees that the activity would generate exceed those expected from typical Non-Member Firms.

154 Non-Member Firms submitted 32.9 billion of the 66.8 billion ATS orders during the fourth quarter of 2014. ATSs reported Non-Member MPIDs for 15.3 billion of these Non-Member Firm orders. The Non-Member Firm most frequently identified as the source of ATS orders submitted 4.9 billion ATS orders (7.30% of all orders and 39.20% of all Non-Member Firm ATS orders for which a Non-Member Firm MPID is reported). With the assumption that this firm also submitted 39.20% of the Non-Member Firm ATS orders to ATSs that do not report Non-Member Firm MPIDs, this firm would account for 19.31% of all ATS orders.

ATSs generally provide the exchange-issued MPIDs of Non-Member Firms submitting orders either for all orders or for none of the orders received directly from Non-Member Firms. For purposes of our analysis, we assume that the proportion of orders submitted by individual Non-Member Firms to ATSs that report identifiers is equal to that proportion for ATSs that do not report Non-Member Firm MPIDs. It is possible that activity. In total, five of the 14 Non-Member Firms are each responsible for 1% or more of all orders sent directly to an ATS for the review period.

The business of providing liquidity off-exchange is competitive. Off-exchange equity trading occurs across many trading venues. In May 2012, 44 ATSs actively traded NMS stocks, comprising 12.12% of NMS share volume.[155] Furthermore, 255 broker-dealers transacted a further 18.75% of NMS share volume off-exchange without the involvement of an ATS.[156] Although many market participants provide liquidity within this market, Non-Member Firms are particularly active within ATSs, as discussed above. Although Non-Member Firms may trade in

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some Non-Member Firms transact only in ATSs that do not report these identifiers to FINRA; if that is true, our estimate of the activity level of the 14 identified Non-Member Firms would be upwardly biased because we would attribute the ATS volume of the unidentified Non-Member Firms to those that have been identified. Furthermore, our estimate that 14 Non-Member Firms connect to ATSs directly would be downward biased. It is also possible that the proportions of orders attributable to individual Non-Member Firms are materially different on ATSs that do not report Non-Member Firm identifiers, although any error introduced by this would likely not be directional. Additionally, some Non-Member Firms may submit orders to Member Firms that are then routed to ATSs or elsewhere off-exchange. Such activity would cause us to underestimate the activity of these 14 Non-Member Firms within ATSs, although such activity would still be counted at the aggregate Non-Member Firm level.

155 Tuttle, Laura, October 2013, Alternative Trading Systems: Description of ATS Trading in National Market System Stocks, available at http://www.sec.gov/marketstructure/research/alternative-trading-systems-march-2014.pdf (revised March 2014).

156 Transaction volume off-exchange outside of ATSs includes internalization, in which a broker-dealer fills orders from its own inventory without interacting directly with an exchange. Tuttle, Laura, March 2014, OTC Trading: Description of Non-ATS OTC Trading in National Market System Stocks, available at http://www.sec.gov/dera/staff-papers/white-papers/otc-trading-white-paper-03-2014.pdf.

the Non-ATS segment of the off-exchange market, the Commission preliminarily believes they rarely act as liquidity suppliers outside of ATSs.[157]

While some Non-Member Firms trade actively off-exchange, some of these firms also supply and demand liquidity actively on multiple exchanges.[158] The Commission is able to identify the activity of 13 of the 14 Non-Member Firms identified as connecting directly with ATSs on exchanges operated by BATS, NASDAQ-OMX, and NYSE during May of 2014. The data show that these Non-Member Firms contribute substantially to exchange volume.[159] On these exchanges, during May 2014, these 13 large Non-Member Firms that connect directly to ATSs participate in at least 17.25% of all exchange trading volume. The highest Non-Member Firm participation rate in the data is on BATS-Y, where 27.31% of trade volume involves Non-Member Firms that also connect directly to ATSs. The lowest participation rate is on NYSE, where 5.54% of trading involves Non-Member Firms that connect directly with ATSs. One of the Non-Member Firms that connects directly with ATSs cannot be identified in exchange

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157 OATS data suggests that Non-Member Firms do not supply off-exchange liquidity to Member Firms outside of ATSs and the Commission believes that Non-Member Firms rarely transact with each other outside of ATSs. See supra note 149.

158 See Section V.D.3 for discussion of SRO cross-monitoring capabilities.

159 The estimates include only Non-Member Firms that connect directly to at least one ATS that reports Non-Member Firm MPIDs in OATS. Consequently, some Non-Member Firms are not included in these estimates. Therefore, the estimates underestimate the importance of Non-Member Firms to exchange-based activity in aggregate.

data.[160] The 13 Non-Member Firms that are observed trading on exchanges tend to trade across the majority of exchanges represented in the exchange data sample.[161]

The market for liquidity provision on equity exchanges is also competitive. For example, Nasdaq-listed equities, for which the Commission has relevant data,[162] each had 13 to 80 market makers registered to provide liquidity on Nasdaq as of December 2014. The median Nasdaq-listed equity had 36 registered market makers, and 95% of securities had 20 or more registered market makers. Because Nasdaq is not the only exchange trading its listed equities, these statistics underrepresent the number of firms in the market that provide liquidity in Nasdaq-listed equities. Although the Commission does not have readily available data to count the number of market makers in equities listed on other exchanges, the Commission preliminarily believes that the figures for Nasdaq-listed equities illustrate the magnitude of market makers in equities more generally. Additionally, the Commission notes that while the number of market makers represents the number of firms in the business of providing liquidity, it does not necessarily indicate whether each market maker is an active competitor. However, the Commission believes that many market makers actively compete to provide liquidity. The Commission currently lacks data to quantify the liquidity provision activity attributable to Non-Member Firms.

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160 Data from off-exchange markets and exchanges is matched on a firm-name basis in this analysis. It is possible that one firm that cannot be identified in the exchange data is present under a name that is not readily linked to the firm name cited in the off-exchange data.

161 Data for Nasdaq-OMX is not broken down by exchange, but is instead aggregated at the holding company level. Exchange-level data was provided by BATS and NYSE.

162 Data from Center in Research in Security Prices (CRSP).

2. Current Market Oversight

The surveillance and regulation of each broker-dealer is dependent upon its individual SRO membership status. Each SRO that operates an exchange has responsibility for overseeing trading that occurs on the exchange it operates. Because of this, SROs that operate an exchange possess expertise in supervising members who specialize in trading the products and order types that may be unique or specialized within the exchange. This expertise complements the expertise of an Association in supervising cross-exchange and off-exchange trading activity.[163] Exchanges generally have not monitored trading that their members conduct on other venues.

Approximately 68 Non-Member Firm broker-dealers are members of a single exchange that supervises their activity overall. Exchanges regulate trading by broker-dealers on their exchange and generally may focus examinations on the financial and operational requirements associated with their membership. These requirements share many commonalities across SROs, such as net capital requirements and books and records requirements. Because many broker-dealers are members of multiple SROs with similar requirements, one SRO is appointed as the broker-dealer's DEA.[164]

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[163] See Section I.B. discussing the requirement for SROs to examine for and enforce compliance with the Exchange Act, and the rules and regulations thereunder.

[164] A DEA is an SRO assigned by the SEC that has certain specific supervisory responsibility for a broker-dealer. The DEA usually performs financial and operations examination activities on behalf of all SROs of which the broker-dealer is a member, although SROs may also allocate other regulatory responsibilities under Rule 17d-2. See supra note 69. These examinations, however, do not generally extend to compliance with trading rules imposed by other SROs; nor do they facilitate surveillance for activity across market centers. DEAs therefore cannot substitute for the surveillance of cross-market and off-exchange trading provided by an Association. See 17 CFR 240.17d-1. FINRA serves as the DEA for the majority of Member Firms; there are exceptions, mostly involving firms that have specialized business models that focus on a particular exchange that is judged to be best situated to supervise the Member Firm's activity. These firms are, however, subject to the same supervision of their trading activity as

All registered broker-dealers are required to join an Association unless they comply with Section 15(b)(8) of the Act or Rule 15b9-1. The vast majority of broker-dealers join an Association and, since there is currently a single Association, with the exception of Non-Member Firms, broker-dealers are subject to relatively uniform regulatory requirements and levels of surveillance and supervision. The supervision by FINRA, which is currently the only Association, is more robust than that of individual exchange SROs because its rule set addresses its need to supervise a market that is fragmented across many trading venues and more opaque than exchange trading.[165] Specifically, FINRA's rule set has provisions related to business conduct, financial condition and operation, and supervision that may differ materially from exchange SRO rule sets.[166]

The existing Association, FINRA, serves crucial functions in the current regulatory structure.[167] FINRA has primary responsibility for overseeing off-exchange trading.[168] Furthermore, FINRA provides cross-market trading supervision of broker-dealers that the exchanges currently are not well-positioned to provide in light of the statutory framework that

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other Member Firms for whom FINRA does act as DEA. Under the proposed amendments, Non-Member Firms that join FINRA may or may not be assigned to FINRA for DEA supervision. A firm with a specialized business model focusing on a single exchange with floor activity may be able to continue trading off-exchange under the proposed floor member hedging exemption without joining FINRA.

165 Comprehensive reporting requirements for all Member Firms that trade off-exchange give FINRA information on market activity levels and market conditions off-exchange. Because most off-exchange venues do not disseminate information on the liquidity available in their systems, comprehensive information from all participants is necessary for FINRA to analyze and surveil the off-exchange market. See infra note 204 for a discussion of the off-exchange trading environment; see also Section I.B. for a discussion of the differing scope of exchange SRO and Association rule sets.

166 See supra notes 91-94 and accompanying text.

167 See Section I.A. for further discussion of the role of Associations in market oversight.

168 See Section I.B. for further discussion of the responsibilities of an Association.

places responsibility for off-exchange trading with an Association. Exchanges generally do not have a detailed set of member conduct rules and non-exchange-specific trading rules and have limited access to data,[169] thus allowing such broker-dealers and their personnel to conduct business under a less specific regulatory regime than FINRA members. On the other hand, FINRA has sought to establish a robust regulatory regime for broker-dealers, including broker-dealers conducting business in the off-exchange market, and developed surveillance technology and specialized regulatory personnel to provide surveillance, supervision, and enforcement of activity occurring off-exchange. Consequently, the current regulatory structure achieves cross-market and off-exchange supervision through the surveillance actions of FINRA and its examination of its members.

Currently, Non-Member Firms transact heavily in the course of normal business activities within venues regulated by SROs of which they are not members. This is very different from when Rule 15b9-1 was first adopted. The Act provides for regulation of exchange trading by the exchanges themselves; it further provides for supervision of off-exchange trading by an Association. Although the Act provides a limited and targeted exception to Association membership requirements for broker-dealers, its approach to effecting supervision is relatively uniform: broker-dealers must be members of the SROs that regulate the venues upon which they transact. For each trading venue, whether an exchange or the off-exchange market as a whole, the responsible SRO (an exchange SRO or FINRA) is obligated and empowered to fulfill its regulatory responsibilities through its authority to adopt rules, surveil the markets, examine its members' activities and bring enforcement actions when necessary. To the extent that the current regulatory structure undermines this functional approach, the ability of SROs to fulfill

169 See supra note 76.

their responsibilities to protect investors and promote fair and orderly markets may be compromised.

Comprehensive supervision of cross-market and off-exchange activity requires data on off-exchange activity, but this data for Non-Member Firms is often not readily available to regulators.[170] FINRA's rules require that nearly all Member Firms report order audit trail data daily.[171] This data records the origination, receipt, execution, routing, modification or cancellation of every order a Member Firm handles, with limited exceptions for certain activities including market-making. Additionally, FINRA currently has RSAs with most exchanges[172] that provide FINRA with detailed data that often allow FINRA to comprehensively identify the market-wide activity of broker-dealers, and to surveil behavior for violative activity that might otherwise go undetected on an exchange-specific surveillance basis. However, a significant amount of activity remains missing from FINRA's existing audit trail data (OATS) because it does not include the orders that otherwise would be reported by Non-Member Firms if they were members, and does not identify executions as those of a broker-dealer. Non-Member Firm activity that involves a Member Firm (such as an ATS order or an order routed through a Member Firm) does appear in OATS, although the identity of the Non-Member Firm sending the

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170 If the Commission approves the NMS Plan submitted by the SROs to create, implement, and maintain a CAT, the CAT would be able to provide the SROs and the Commission with such data on Non-Member Firms. See Exchange Act Release No. 67457 (July 19, 2012), 77 FR 45721 (August 1, 2012).

171 See generally FINRA Rule 7400 Series – Order Audit Trail System.

172 FINRA has RSAs with all exchanges operated by Intercontinental Exchange, Nasdaq-OMX, and BATS. Together, these exchanges accounted for 99.6% of exchange-based share volume in Tape A, B, and C securities during October 2014, based on data available on the BATS website. See http://www.batstrading.com/market_data/market_volume_history/ (last visited March 9, 2015).

order is not required to be reported.[173] Furthermore, some off-exchange activity that does not involve a Member Firm (and thus creates no OATS data record) may be entirely unsurveiled by FINRA and possibly not subject to rules that were intended to universally govern off-exchange activity. In particular, an off-exchange trade between two Non-Member Firms is not subject to FINRA's audit trail and trade reporting rules.

Because Non-Member Firms are not required to join an Association, they are not required to pay the costs of Association membership, which could be significant, especially for Non-Member Firms with substantial trading activity. FINRA members currently pay a TAF for all equity sales transactions that are not performed in the firm's capacity as a registered specialist or market maker upon an exchange. The Commission estimates that the annual TAF associated with ATS trading for some Non-Member Firms would be as high as $3.2 million per year.[174] Additionally, a substantial portion of Non-Member Firms' exchange-based activity may be subject to TAF as well.[175] These estimates of TAF have substantial uncertainty. As discussed previously, the Commission believes that FINRA may need to consider revising its fee structure

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173 FINRA has proposed amendments to its rules pertaining to identification of Non-Member Firms in OATS data. See supra note 84.

174 TAF incurred for off-exchange activity for Non-Member firms would be unavoidable as the fee is currently structured. FINRA assesses it directly on FINRA members. TAF is discussed further in Section V.C.2.b.

175 Schedule A of the FINRA By-Laws outlines which transactions are subject to the TAF. Generally, equity sales both on and off-exchange are subject to the TAF unless the member is acting in the capacity of a specialist or market maker on the exchange where the transaction was effected.

to reflect the business model of these firms and this may significantly affect their potential FINRA fee burden.[176]

Furthermore, FINRA currently cannot assess Non-Member Firms Section 3 fees for off-exchange trading. The Section 3 fee is the second of two primary FINRA fees (the other being TAF) that are assessed upon each off-exchange sale by or through a FINRA member. Under Section 31 of the Act,[177] SROs must pay transaction fees based on the volume of their covered sales. These fees are designed to offset the costs of regulation incurred by the government—including the Commission—for supervising and regulating the securities markets and securities professionals. FINRA obtains money to pay its Section 31 fees from its membership, in accordance with Section 3 of Schedule A to the FINRA By-Laws. FINRA assesses these Section 3 fees on the sell side of each off-exchange trade, when possible. When the sell side of an off-exchange transaction is a Non-Member Firm and the seller engages the services of a clearing broker that is a Member Firm, FINRA can assess the Section 3 fee against the Member Firm clearing broker.[178] When the seller is a Non-Member Firm that self-clears, FINRA has no authority to assess the Section 3 fee against the seller. In such case, FINRA will seek to assess the fee against the buyer, if the buyer includes a Member Firm counterparty or a Member Firm acting as clearing broker for a Non-Member Firm buy side counterparty. Given that any firm that carries customer accounts is required to be a member of an Association, firms that represent the trading of the investing public may bear the fees that would be otherwise assigned to Non-

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176 See supra note 95. Under the current TAF schedule, Member Firms may realize some cost savings because they would no longer be assessed TAF when they buy shares from a Non-Member Firm off-exchange. This is discussed further in Section V.B.3.

177 15 U.S.C. 78ee.

178 The seller's clearing broker may pass that fee on to the Non-Member Firm.

Member Firms trading proprietarily in the off-exchange market. These costs may be passed on to the investing public in whole or in part. Regardless of who ultimately bears the Section 3 fees, these Non-Member Firms may face lower off-exchange trading costs than Member Firms due to the allocation of these fees.

B. Broad Economic Considerations, Including Effects on Efficiency, Competition and Capital Formation

As discussed above, the Commission is proposing amendments to Rule 15b9-1 to address the off-exchange trading activity that may not currently be subject to effective regulatory oversight that has developed with the advent of cross-market proprietary trading. In addition to the specific, individual benefits and costs discussed below, the Commission expects the proposed amendments to have several broad economic effects, including effects on efficiency, competition, and capital formation. These effects are described in this section.

1. Effects on Regulatory Supervision

Non-Member Firms are significant contributors to off-exchange order and trade activity, yet are not under the jurisdiction of an Association that supervises off-exchange trading activity. The Commission preliminarily believes the current exemption of Non-Member Firms from Association membership undermines the effectiveness of regulatory supervision. For example, reliance by Non-Member Firms on the Rule 15b9-1 exemption leaves FINRA charged with responsibility for the off-exchange market without jurisdiction over broker-dealers that conduct a substantial amount of off-exchange trading activity. It also undermines the ability of an Association to apply a consistent set of conduct, supervisory, and other rules to off-exchange market participants, and to effectively surveil the trading activity of broker-dealers with a significant presence in the off-exchange market.[179]

As discussed further below, the Commission believes the proposed amendments will have a beneficial effect on the efficiency of regulation of the equity markets.[180] In particular, some broker-dealers are currently overseen by individual exchanges, which are not well-positioned to oversee the off-exchange and cross-market activity of the broker-dealer. Under the proposal, these broker-dealers would be supervised by an Association that has this expertise. This improvement in regulatory oversight of the off-exchange market should achieve more uniform and effective regulatory supervision of off-exchange and cross-exchange trading practices by broker-dealers.

The Commission is aware that some of the 125 Non-Member Firms trade primarily on a single exchange in a floor-based capacity. For these firms, especially those with specialized business models that operate primarily on one exchange, their current exchange (not an Association) may be best equipped to provide efficient supervision. The Commission believes that many of these firms will not need to join an Association to comply with the proposed amendments.

2. Firm Response and Effect on Market Activity

Although Non-Member Firms could seek to comply with the proposed amendments in multiple ways, each route could involve changes to firms' business models. Some Non-Member Firms limit their trading to exchanges of which they are members, and the Commission believes they do not trade off-exchange other than to hedge positions gained through floor broker activity.

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179 See supra notes 91-94 and accompanying text.

180 See Section V.C.1.

These firms will remain exempt from the requirement to become a member of an Association, if they comply with the Rule as proposed to be amended.[181] Other firms will no longer be exempt, and will need to take action to comply with the amended rule. Under the revised Rule, a Non-Member Firm that trades off-exchange, or upon exchanges of which it is not a member, can comply in four ways. The first option would be to join an Association. This option does not require the Non-Member Firm to restrict its current trading practices beyond those necessary to comply with the rules of FINRA. The second option would be to join all exchanges upon which the Non-Member Firm wishes to trade, and to cease any off-exchange trading, other than off-exchange trading consistent with the floor-broker hedging exemption. Third, a Non-Member Firm could comply by trading solely upon those exchanges of which it is already a member, consistent with the statutory exception in Section 15(b)(8).[182] Finally, a Non-Member Firm could cease trading equity securities.

The changes Non-Member Firms make to their business model in order to comply with the amendments may affect competition in the market for off-exchange liquidity provision. In particular, Non-Member Firms may be less willing to compete to provide liquidity off-exchange, decreasing off-exchange liquidity. For example, Non-Member Firms may choose to cease their off-exchange activity rather than join an Association – although it seems likely that firms that trade heavily in the off-exchange market may find it less costly to join an Association.[183] In

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181 Changes to the exclusion for proprietary trading are discussed in Section II.C. Changes to the proposed floor member hedging exemption are discussed in Section II.D.

182 15 U.S.C. 78o(b)(8).

183 Firms that do not connect directly may trade on ATSs through a Member Firm at much lower activity levels. For firms with very limited off-exchange activity, ceasing off-exchange activity is likely to be less costly than joining an Association. The costs of joining FINRA are discussed in detail in Section V.C.2; for firms with very limited off-exchange activity, it is unlikely that the profits generated from this activity would offset

addition, Non-Member Firms that choose to join an Association may reduce their off-exchange trading because joining an Association would increase variable costs to trade in the off-exchange market, as these trades will incur TAF and possibly additional Section 3 fees.[184] An increase in cost would reduce the profitability of off-exchange trading and thus potentially reduce off-exchange trading.

The removal of this liquidity could either improve or degrade execution quality on ATSs.[185] To the extent that institutional investors transacting in ATSs are seeking institutional investor counterparties that are not proprietary trading firms for their transactions, the removal of Non-Member Firm liquidity may be seen by some institutional investors as improving liquidity quality within ATSs.[186] It is also possible that reducing the activity of Non-Member Firms

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FINRA membership costs. However, for firms that generate profits from off-exchange activities that exceed FINRA membership costs, it may be less costly for these firms to join FINRA than to cease their off-exchange activity. Firms with very low ATS activity are unlikely to directly connect to an ATS, instead accessing ATSs through a Member Firm.

The Commission is unaware of any Non-Member Firms operating single dealer platforms upon which such firms could provide liquidity to orders routed by Member Firms outside of an ATS.

184 As previously noted, FINRA may need to consider reevaluating the structure of the TAF to assure that it appropriately takes into account the business model of certain Non-Member Firms that may join FINRA as a result of the proposed amendments. See supra note 95. The Commission's analysis of TAF is based on current TAF structure as outlined in the FINRA By-Laws, Schedule A. TAF and Section 3 fees are discussed further in Section V.C.2.b. Firms will also face additional fixed costs both to establish and maintain Association membership; those costs are discussed in Section V.C.2.

185 Non-Member Firms are likely to also reduce their off-exchange trading outside of ATSs, such as on single-dealer platforms. However, Non-Member Firms can only take (not make) liquidity on these platforms. It is possible that additional off-exchange liquidity may be available outside of ATSs as a result of the proposed amendments to Rule 15b9-1 due to a reduction in Non-Member Firm trading on single dealer platforms.

186 Industry white papers sometimes discuss the concept of natural counterparties for institutional trades. These papers may explicitly or implicitly identify proprietary automated trading firms as sources of information leakage in dark pools. See e.g., Mittal,

within ATSs may result in more ATS liquidity, if Non-Member Firms are acting as net takers of liquidity within these systems.[187] Regardless, liquidity levels in ATSs may change. In addition, these firms may reduce their off-exchange trading outside of ATSs such as on single-dealer platforms. It is possible that this will result in a transfer of volume from off-exchange venues to exchanges, but it is also possible that overall market trading volume will diminish if decreased volume from off-exchange trading does not migrate to exchanges.

Changes in business models for Non-Member Firms may affect market quality on exchanges as well. In addition to trading extensively in the off-exchange market, many Non-Member Firms are among the most active participants on exchanges. Business model changes by these firms may lead to less exchange liquidity for several reasons. First, Non-Member Firms that choose not to join an Association would no longer be able to rely on the rule and trade

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Hitesh, Are You Playing in a Toxic Dark Pool? A Guide to Preventing Information Leakage, 2008 ITG white paper, available at http://www.itg.com/news_events/papers/ITGResearch_Toxic_Dark_Pool_070208.pdf, and Dark Pools and Toxicity Assessment, 2014, EY White Paper, available at http://www.ey.com/Publication/vwLUAssets/Dark_pools_and_toxicity_assessment/$FILE/Dark%20pools%20and%20toxicity%20assessment_FINAL_LR.pdf. Other industry participants describe a more benign role for automated trading firms as liquidity providers in ATSs. See High-Speed Traders Go Dark, 2012, Markets Media Commentary, available at http://marketsmedia.com/high-speed-traders-go-dark/.

187 There is some evidence that proprietary electronic trading firms are net takers of liquidity in equity markets, although the evidence is not conclusive. Using NASDAQ data from 2008-2010, Carrion estimates that these firms supply liquidity to 41.2% of trading dollar volume and take liquidity in 42.2% of trading dollar volume. See Carrion, Al, 2013, "Very fast money: High-frequency trading on the NASDAQ," Journal of Financial Markets 16, 680-711. Al Carrion currently serves as an Economic Fellow within the Division of Economic and Risk Analysis. Another study finds that electronic trading firms act as net liquidity suppliers during periods of extreme price movements. See Brogaard, Moyaert, Riordan, Shkilko and Sokolov, 2015, "High Frequency Trading and Extreme Price Movements," working paper.

indirectly on exchanges of which they are not members.[188] Second, Non-Member Firms that do not join an Association would no longer be able to access off-exchange liquidity to unwind positions acquired on exchanges, except as outlined in the floor member hedging exemption. This may reduce their willingness to provide liquidity upon exchanges.[189] Third, Non-Member Firms that choose to join an Association may be subject to additional variable costs (primarily regulatory fees) on their exchange-based trading as well as on their off-exchange trading.[190] These firms may respond by trading less actively on exchanges. Finally, Non-Member Firms may choose to cease trading equity securities rather than join an Association or change their business models. Reduced liquidity upon exchanges can result in higher spreads and increased volatility. Increased spreads on exchanges can lead to increased costs for off-exchange investors as well as investors transacting on exchanges, because most off-exchange transactions (including many retail executions) are derivatively priced with reference to prevailing exchange prices.

The Commission preliminarily believes that the proposed amendments are not likely to have an economically meaningful effect on direct capital formation (the assignment of financial resources to meet the funding requirements of a profitable capital project, in this case, the provision of liquidity to financial markets). However, the Commission believes that the changes

188 Currently, a Non-Member Firm can indirectly access an exchange of which it is not a member through a firm that is an exchange member. In light of the proposed elimination of the exclusion for proprietary trading, this activity would not be consistent with the proposed amendments, unless the floor member hedging exemption or Regulation NMS routing exemption applies.

189 These firms could unwind positions on other exchanges, but the cost to do so may be higher than if all liquidity, including off-exchange liquidity, were available.

190 It is possible Non-Member Firms that choose to join an Association may avoid some additional costs by registering as market makers on additional venues, mitigating these charges. Furthermore, they may see a reduction in fees that were formerly paid to their DEA if FINRA assumes that role.

in allocation of regulatory fees and more efficient supervision within the off-exchange market may result in improved efficiency of capital allocation by the financial industry. Currently, Non-Member Firms face lower regulatory costs and a lower degree of regulatory scrutiny of their off-exchange trading activity than Member Firms. While the Commission believes that this imposes certain costs on other market intermediaries and the investors they represent, there is another externality as well: over-commitment of liquidity both to exchanges and the off-exchange market.[191] This over-commitment is likely to have some positive effects on capital markets, such as lower quoted spreads on exchanges. In addition to lowering immediate execution costs on exchanges, lower exchange quoted spreads are likely to reduce transaction costs off-exchange as well, because off-exchange trades are typically priced with reference to quoted exchange prices. Adoption of the proposed amendments may reduce the capital commitment of Non-Member Firms to equity market liquidity provision. It is possible that in response current Member Firms may choose to commit additional capital to liquidity provision when the trading environment has more uniform regulatory requirements. These reallocations of capital may improve or degrade levels of liquidity, spreads and volatility measures on exchanges and within the off-exchange market.

The magnitude of these competitive effects is impossible for the Commission to determine at this time for a number of reasons. First, these effects involve strategic decisions by Non-Member Firms that the Commission cannot predict, and a competitive response that the Commission lacks information to anticipate. Second, even if the Commission could predict the likely changes in capital commitment by market participants, the Commission lacks information on how capital commitment by financial firms maps into market quality measures such as

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191 There is likely to be a corresponding underinvestment of capital somewhere else.

spreads, levels of liquidity, and execution costs.[192] Due to the complexity of the economic relationship between capital commitment and market quality measures, and inadequate information on individual firm's strategies, cost structures and likely competitive responses, the Commission cannot estimate the likely magnitude of these effects.

3. Competition to Provide Liquidity Is Distorted by Regulatory Costs Borne by Only a Subset of Competitors, Member Firms

Currently, Member Firms bear a number of costs not borne by Non-Member Firms including a number of regulatory fees and indirect costs that are assessed or imposed upon Member Firms. These costs include direct costs such as trading fees that are either assigned only to Member Firms, such as TAF, or in the case of Section 3 fees, Member Firms may be assigned costs that potentially could be assigned to Non-Member Firms selling securities off-exchange. There are indirect costs of disparate regulatory regimes as well. For example, Member Firms bear costs of interacting with regulators to accommodate supervision, and must comply with the rules of an Association as well as rules adopted by the Commission. This inequality in regulatory requirements may distort competitive forces in the market and these potential distortions may be mitigated by the proposed amendments to Rule 15b9-1, to the extent that Non-Member Firms join an Association and subject themselves to comparable fees and regulatory costs imposed on all other Member Firms.

192 The Commission has considered whether it is possible to model this response using current data to estimate these effects. Even if CAT data were available today, the Commission believes it would not have sufficient information for this estimation because information on the daily and perhaps intra-day change in committed capital levels is not available. Although the Commission has quarterly data on the net capital of broker-dealers, broker-dealers do not commit all of this capital to liquidity provision in equity markets. Furthermore, on a daily or more frequent basis, a liquidity provider may choose to fully or partially withdraw from the market for any reason.

The existing differential regulatory burden of Member Firms and Non-Member Firms may have consequences with respect to market quality both for exchange-based and off-exchange trading. For example, because Non-Member Firms, ceteris paribus, currently face lower variable costs of trading compared to Member Firms, Non-Member Firms may be able to provide liquidity at a lower cost than Member Firms. Because a low-cost competitor may be able to quote at a price superior to that of his competitors, investors may incur lower transaction costs than if Non-Member Firms faced the same costs as Member Firms. It may also reduce direct execution costs (such as quoted and effective spreads) for both exchange and off-exchange trades, the latter of which are normally derivatively priced with reference to prevailing exchange quotes. The differential regulatory burden, however, may also reduce depth at best prices because a Member Firm may not be able to trade profitably at a price established by a Non-Member Firm that faces lower regulatory costs. Lower liquidity at best exchange prices implies greater price effect of trades, which may increase trading costs, particularly for large orders. For example, if the best price on an exchange is associated with 100 shares of depth, a 200 share order will exhaust depth at the best price and the second 100 share lot will execute at an inferior price.[193] If depth at best price tends to be larger, it is less likely that an order will exceed the depth available at the best price. The change in best price associated with an execution that exhausts the depth available at the best price is the price effect of the trade upon the exchange. Because the Commission does not have access to consolidated audit trail data, the Commission lacks data to quantify the percent of inside depth provided by Non-Member Firms and the frequency with which only Non-Member Firms are quoting the best price on an exchange.

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193 This assumes no hidden depth at the best price. If non-displayed depth is present at the best price, the remaining 100 shares will be filled at the best price if at least 100 shares of hidden depth exists at the best price.

However, the high participation rate of Non-Member Firms in exchange trading suggests they provide a significant fraction of exchange liquidity.[194]

4. Competitive Effects on Off-Exchange Market Regulation

Currently, FINRA is the only Association. It is possible, however, for new Associations to enter the regulatory oversight market and compete with FINRA. The proposed amendments to Rule 15b9-1 may create incentives for a new Association (or Associations) to form. The large Non-Member Firms have commonalities in business models, for example, they typically do not carry customer accounts. They may consider joining an Association concurrently. Because these firms collectively conduct a significant portion of off-exchange volume, the creation of an Association tailored to these firms may be economically viable.

To be registered as an Association, in addition to requirements that parallel the requirements to be a national securities exchange, an Association must "[b]y reason of the number and geographical distribution of its members and the scope of their transactions" be able to carry out the purposes of Section 15A.[195] Additionally, for example, the Association must permit any registered broker-dealer that meets the Association's qualification standards to become a member,[196] and it must have rules regarding the form and content of quotations relating to securities sold otherwise than on a national securities exchange that are designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to

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194 Participation rates of Non-Member Firms in exchange trading are discussed more fully in Section V.A.1.

195 See 15 U.S.C. 78o-3.

196 See 15 U.S.C. 78o-3(b)(3). Section 15A of the Exchange Act specifically states that an Association shall not be registered as a national securities association unless the Commission determines, among other things, that "(3)…the rules of the association provide that any registered broker or dealer may become a member of such association and any person may become associated with a member thereof."

promote orderly procedures for collecting, distributing and publishing quotations.[197] The Association must also be so organized and have the capacity to enforce compliance by its members and persons associated with its members with, among other things, its own rules and the Exchange Act and the rules and regulations thereunder.[198]

The ability to form an Association is characterized by barriers to entry. A new Association would likely incur significant fixed costs to create the infrastructure needed to perform the surveillance and oversight requirements imposed on Associations by statute and regulation. It may also incur substantial costs, including personnel, training, travel, and other costs to provide for an effective surveillance and supervision of the off-exchange market. Indeed, as previously discussed, the only existing Association, FINRA, has resources and demonstrated expertise that enable it to surveil and supervise the off-exchange market. Duplication of that infrastructure could be costly for a new Association.

The proposed amendments may alter barriers to entry and thus affect the potential for competition among regulators of off-exchange markets. Currently the primary barrier to entry is the high fixed-cost involved in forming and operating an Association. If adopted, the amendments would bring nearly all off-exchange trading under the jurisdiction of an Association, including the trading of firms that currently are not members of an Association (Non-Member Firms). If these firms join the only existing Association, FINRA, an Association newly formed after this point may have increased difficulty attracting the members needed to support the high fixed-costs associated with forming an Association because every broker-dealer that participates in the off-exchange market would already be a FINRA member. This increased

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197 See 15 U.S.C. 78o-3(b)(11).

198 See 15 U.S.C. 78o-3(b)(2).

difficulty results because many firms may be reluctant to change Associations, either because of the costs to change compliance infrastructures or uncertainty in the regulatory environment of the new Association. Thus, if the proposal results in more firms becoming members of the existing Association, a new Association could face increased difficulties attracting members in the future.

The proposed amendments do, however, temporarily lower the barriers to entry for a competing Association. If these amendments are adopted, a number of firms with similar business models and substantial off-exchange volume could contemplate Association membership concurrently. This may provide the incentive to create and tailor a new Association to specific business models of these firms. If a competing Association limited the scope of its members or operations, it might not have to duplicate all of the surveillance and supervision functions required to be provided by an Association that does not have those limits. This may lower the costs of forming an Association and alter the barriers to entry.[199]

The existence of multiple Associations might provide benefits to the market as a whole. If a new Association could provide high quality services to members with a lower fee structure, all Associations would have incentives to reduce fees to attract members. This could result in cost savings to broker-dealers. Second, a new Association could innovate to develop different surveillance and supervision methods that could be more efficient than FINRA's methods.

Competition among Associations could also entail substantial costs. If a new Association were to form, the necessary regulatory infrastructure including Information Technology ("IT") systems and personnel would need to be duplicated in the new Association. If the market for

[199] Some limitations on Association membership or operations would require exemptive relief for the Association to register with the Commission.

Associations is characterized by economies of scale, aggregate costs for the same level of regulation would be higher in a market with two Associations than in a market with a single Association. These additional costs would ultimately be borne by Associations' broker-dealer members. Second, Associations might compete on the basis of providing "light touch" regulation, in essence surveiling less and providing less supervision. As a result, the quality of market supervision might decrease, although the Commission does itself oversee self-regulatory organizations, such as Associations, and accordingly, would not permit a "race to the bottom."[200]

C. Consideration of Costs and Benefits

This section discusses costs and benefits of the proposed amendments. While the Commission has attempted, where possible, to provide estimated quantifiable ranges, both costs and benefits are difficult to quantify for this proposal for a number of reasons. First, market participants are heterogeneous in their type, existing exchange memberships, and activity level in the off-exchange market. Consequently, compliance costs will vary across firms in a number of dimensions. Second, estimating costs is complicated by the fact that Non-Member Firms can comply with the proposal in a number of ways, and presumably each will choose to seek compliance in the manner that minimizes the sum of its direct costs (related to joining and maintaining memberships in additional SROs) and indirect costs (which include forgone opportunities to trade profitably and costs associated with revising business strategies). Furthermore, some firms are likely to remain exempt upon adoption of the proposed amendments, but the Commission lacks data to identify those firms with certainty.[201] At the

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200 See Section 19(g) and Section 19(h) of the Exchange Act.

201 Non-Member Firms that provide liquidity on multiple exchanges and trade heavily off-exchange are unlikely to be small in terms of net capital, and are not low trading volume firms by definition. However, as discussed in Section V.A.1, many Non-Member Firms

other end of the spectrum, the minority of Non-Member Firms that are large and contribute significantly to both exchange and off-exchange trading are unlikely to remain exempt.[202] For the 14 large firms that connect directly to ATSs, the Commission believes that all will lose their exempt status, but cannot predict how those firms will seek to comply with the proposed amendments. The Commission is unable to more precisely quantify the number of Non-Member Firms that will lose their exemption from Association membership upon adoption of the proposed amendments because it is unable to estimate the level of off-exchange trading for the majority of the 125 Non-Member Firms. OATS reporting rules do not require Member Firms to disclose the identities of broker-dealers that submit orders to a Member Firm, making it infeasible to more precisely estimate non-ATS off-exchange trading for Non-Member Firms.

Quantifying costs is further complicated because Non-Member Firms do not report order audit trail data. It is difficult to measure the trading of individual firms, although their activity as a group is observable within audit trail data. Consequently, the Commission can measure the approximate overall contribution of Non-Member Firms to off-exchange volume, but cannot fully partition that volume across Non-Member Firms.

Some firms with substantial off-exchange trading activity may choose to change their business models rather than join an Association. If such firms ceased off-exchange activity, they would remain outside the supervision of an Association, and their decision to change business models may affect market quality both on and off-exchange. The Commission does not have

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are small in terms of net capital and may be members of a single exchange. Such firms are more likely to have a floor-brokerage business model, or have limited exposure to off-exchange markets. Such firms would either be exempt from the rule by virtue of having no off-exchange trading or no trading on exchanges of which they are not members, or be able to rely on the floor member hedging exemption to continue their limited off-exchange trading related to floor brokerage activities.

[202] The diversity of Non-Member Firms is discussed in Section V.A.1.

ready access to statistics on the liquidity provision of Non-Member Firms on and off exchanges. As such, the Commission cannot quantify the potential changes in transaction costs, even under broad assumptions about how Non-Member Firms will change their business models. This is discussed further in Section V.B.2.

The overall benefits of the proposed amendments relate to more comprehensive and uniform surveillance of off-exchange activity by the regulator best positioned to oversee such activity. The benefits the Commission anticipates from the amendments are largely qualitative and by their nature difficult to measure.

1. Benefits

As discussed above,[203] some of the firms using the existing Rule 15b9-1 exemption are significant participants in overall off-exchange market volume. Thus, a substantial share of off-exchange volume is conducted outside of the regulatory jurisdiction of an Association that has primary responsibility for overseeing off-exchange activity. Association membership would supplement the oversight of the exchanges, which typically do not examine the off-exchange activity of their members. This would further assist the Commission in obtaining a more complete picture of the activity that occurs on ATSs and elsewhere in the off-exchange market by entities that are not currently members of an Association. Investors and intermediaries benefit when a specialized expert regulates and oversees the off-exchange market.[204] Investors

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[203] See Section I.

[204] The off-exchange market is diverse and less transparent than exchanges. An exchange typically has a single matching engine for a given security and a limited number of order types that interact to create transactions while disseminating quote information publicly. The off-exchange market encompasses over 40 ATS matching engines while more than half of off-exchange volume occurs outside of ATSs with transactions reported by more than 200 market participants. Only a few of these ATS venues disseminate quote information. Surveillance and oversight of the off-exchange market requires proprietary

participating in the off-exchange market currently do not fully realize the benefits of such expertise and regulatory oversight.

As discussed above,[205] the Commission preliminarily believes the inclusion of more Non-Member Firms in an Association would improve such Association's ability to supervise cross-exchange trading activity. This would enhance regulators' ability and—through the information FINRA shares with the Commission—the Commission's ability to effectively oversee regulation of trading on multiple markets and of financial products.

The Commission also preliminarily believes that the proposed amendments to Rule 15b9-1 would improve supervision of Non-Member Firms. FINRA, currently the only Association, has substantial experience and expertise from overseeing a large number of broker-dealers. This makes FINRA's potential regulation of Non-Member Firms with off-exchange or cross-market trading activity particularly efficient.

The Commission preliminarily believes that this proposal provides significant benefits even in the event that the Commission approves the CAT NMS Plan.[206] The CAT eventually may address the regulatory audit trail data deficiencies discussed previously,[207] but the CAT will not address FINRA's lack of jurisdiction over Non-Member Firms participating in the off-

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data from thousands of market participants, and regulatory personnel with knowledge of the institutional detail of the workings of dozens of trading venues. At present, only FINRA possesses those resources. Further detail on off-exchange market trading is provided by Tuttle, Laura, 2014, Over-the-Counter Trading: Description of Non-ATS OTC Trading in National Market System Stocks, available at http://www.sec.gov/dera/staff-papers/white-papers/otc-trading-white-paper-03-2014.pdf.

205 See supra Section I.B.

206 See CAT Release, supra note 86.

207 See supra note 170.

exchange markets, which FINRA is charged with overseeing, and the need for that enhanced oversight.

While current members of an Association would not be directly affected by this rule, they would benefit by having a more level playing field in terms of their regulatory requirements relative to Non-Member Firms. Currently, competition in liquidity provision in equity markets is distorted by inequalities in regulatory requirements.[208] With more uniform regulatory requirements and oversight, firms may compete more equitably to supply liquidity both on exchanges and off-exchange.

2. Costs

The proposed amendments, by narrowing the existing exemption, would result in broker-dealers that no longer qualify for the exemption having to comply with Section 15(b)(8) by either limiting their trading to exchanges of which they are members or joining an Association. Under the proposed amendments, therefore, Non-Member Firms that choose to continue any off-exchange activity will be faced with choices that would involve corresponding costs. For example, Non-Member Firms may incur costs related to membership in an Association or costs necessitated by additional exchange memberships. Additionally, some Non-Member Firms may incur the costs of losing the benefits of trading in the off-exchange market if they decide not to join an Association.

Most of the costs incurred in joining an Association and maintaining membership therein are dependent on firm characteristics and activity level. Furthermore, the Commission believes that some Non-Member Firms may comply by ceasing their off-exchange trading activity, avoiding many of these costs but forgoing the opportunity to trade profitably in some venues.

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[208] See Section V.B.3.

With certain assumptions, the Commission has attempted to estimate direct compliance costs that a Non-Member Firm is likely to face to comply with the proposed amendments. The estimate applies to the 14 Non-Member Firms that connect directly to ATSs; smaller firms that choose to join an Association should face lower costs because they have less revenue and trading volume that would be subject to GIA, TAF and Section 3 fees. The 14 Non-Member Firms that connect directly to ATSs, assuming that trading volumes and gross income levels remain unchanged, would face implementation costs of approximately $3.3 million per firm, with ongoing annual costs ranging from about $2.3 million to $23 million depending on the firms' off-exchange trading volume.[209] Cost estimates (one time and annual) are broken down in the following tables and are discussed in detail below:

Table 1: Median or Average Firm Implementation Costs

Cost	**Median or Average**[210]
Application to join FINRA	$7,500

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[209] The largest contributor to the estimate of implementation and ongoing costs is the cost of OATS reporting. Estimates for OATS reporting costs are taken from the CAT NMS Plan and relate to implementing CAT reporting, which is expected to be more complex and have more stringent requirements related to technology, such as more stringent clock synchronization, than OATS reporting requires. Consequently, the Commission believes these likely are overestimates of actual costs firms will face to implement OATS reporting. See infra note 221 for further information on CAT NMS Plan cost estimates. Each of the 14 firms is assumed to have implementation costs of $3,160,000 to initiate OATS reporting, $82,500 in legal consulting costs, and an application fee ranging from $7,500 to $12,500 depending on the number of registered persons. The Commission derived these estimates from the CAT NMS Plan. See infra note 221 and accompanying text for qualifiers on these estimates.

[210] Medians are used where possible. For OATS-related costs, median values are zero, so averages are used. This data is discussed further in note 219, infra. Cost estimates are reported as ranges for legal consulting and compliance work; for these estimates, the midpoint is used.

Implement OATS reporting	$3,160,000
Legal consulting	$82,500
Total	$3,250,000

Table 2: Median or Average Firm Ongoing Annual Costs[211]

Cost	Median or Average
OATS reporting	$2,280,300
Gross Income Assessment	$113,000
Trading Activity Fee	$40,000
Personnel Assessment	$0
Section 3 fee	$212,000
Compliance work	$60,000
Total	$2,705,300

If all 14 of those Non-Member Firms that connect directly to ATSs were to join FINRA, the aggregate cost of the proposal for these firms would be $42.5 million in implementation costs and ongoing aggregate annual costs of $85.2 million, with the majority of the costs related to implementing OATS reporting.[212] While the Commission is unable to aggregate the costs of the proposal for the remaining 111 firms, the Commission believes that the aggregate costs for the

[211] TAF is underestimated because it accounts for only ATS volume. See infra note 231 and accompanying text. This TAF cost also represents a transfer from current Non-Member Firms to current Member Firms. The Section 3 fee estimate assumes that the firms currently pay no Section 3 fees. It is likely that firms that clear through a Member Firm are currently assessed these fees indirectly.

[212] See supra note 209 and infra note 221 related to OATS reporting costs derived from the CAT NMS Plan. The total cost calculation assumes range midpoint costs for FINRA application, legal consulting, and compliance work, as well as maximum costs for implementation of OATS reporting. GIA, TAF, and Section 3 fees are calculated using firm share and dollar volume activity estimates from FINRA data discussed further in Section V.A.1.

subset of 14 represent the majority of the aggregate costs, even assuming that all 125 firms will join FINRA.[213]

a. Costs of Joining an Association[214]

Based on discussions with FINRA, currently the only Association, and industry participants, the Commission preliminarily believes that the direct compliance costs on Non-Member Firms of joining FINRA are composed of the FINRA membership application fees, costs associated with adapting IT infrastructure for regulatory data reporting requirements, and any legal or consulting costs necessary for effectively completing the application to be a member of FINRA (e.g., ensuring compliance with FINRA rules including drafting policies and procedures as may be required).

The fees associated with a FINRA membership application can vary. As an initial matter, the application fee to join FINRA is tier-based according to the number of registered persons associated with the applicant. This one-time application fee ranges from $7,500 to $55,000.[215]

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213 The data provided to the Commission by FINRA describes the aggregate ATS activity level of all 125 Non-Member firms. Further firm-level data for the 14 firms that directly connect to ATSs can be inferred using exchange MPIDs that are reported by some ATSs. Because these 14 direct-connecting firms account for the majority of Non-Member Firm ATS activity, the Commission believes that the 111 remaining firms have much lower ATS (and presumably other off-exchange) activity levels. Since transacted volume is the primary driver of the variation in costs across firms that join FINRA, the Commission believes that the remaining 111 firms will face far lower costs if they choose to join FINRA.

214 The Commission recognizes that Non-Member Firms would incur compliance costs on an initial and ongoing basis to comply with the proposed amendments. See Section V.C.2.a. The Commission does not aggregate these costs across all Non-Member Firms because the Commission does not have necessary information about the majority of the Non-Member Firms and expects that costs would vary widely across firms. Where possible, however, the Commission has provided estimates based on a subset of large firms on which the Commission has sufficient information. The Commission expects that smaller firms likely will face lower costs.

215 See FINRA By-Laws, Schedule A, Section 4.

The initial membership fee for FINRA is $7,500 for firms with ten or fewer representatives registered with FINRA and $12,500 for firms with eleven to one hundred representatives registered with FINRA.[216] Based on its knowledge of the size and business models of Non-Member Firms, the Commission preliminarily believes that most Non-Member Firms would not incur FINRA application fees exceeding $12,500.[217]

Because most FINRA members have OATS reporting obligations, Non-Member Firms that choose to join FINRA will incur costs related to initiating and maintaining data reporting.[218] Costs to initiate and maintain OATS reporting[219] will vary widely among firms, depending on many factors including current IT infrastructure, complexity, and affiliation with a firm that already reports OATS data. While we are unable to quantify these costs precisely, one point of reference for the possible costs associated with OATS reporting obligations is the CAT NMS Plan, that provides estimates of these costs for reporting CAT data. There are limitations, however, to those estimates in this context in that CAT is an order audit system that will be significantly more complex and larger in scope than OATS.[220] Because the projected scope of

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216 Id.

217 Based on current FOCUS data, the Commission believes no Non-Member Firm has more than 100 registered representatives.

218 See FINRA Rule 7400 Series – Order Audit Trail System.

219 Pursuant to Rule 613 under the Exchange Act, the SROs have submitted a plan to eliminate existing rules and systems that will be rendered duplicative by the CAT. 17 CFR 242.613(a)(1)(ix). To the extent that OATS is rendered duplicative by CAT, the CAT NMS Plan proposes its elimination, and the Commission approves the CAT NMS Plan, the OATS system may eventually be eliminated. If this occurs, the costs of OATS reporting to Non-Member Firms may cease, but may be supplanted by other costs related to order and transaction reporting requirements under the CAT NMS Plan.

220 The CAT NMS Plan proposal discusses OATS reporting requirement. These requirements include having revenue of less than two million dollars. The Commission believes that large Non-Member Firms would not qualify for OATS reporting exemptions, were the Commission to approve the CAT NMS Plan as submitted on

CAT exceeds substantially the scope of OATS reporting, and implementation of CAT reporting is expected to include technical requirements such as more stringent clock synchronization requirements than OATS, the Commission believes these estimates provide (at best) an upper-bound for OATS reporting costs. Furthermore, Non-Member Firms that are members of NASDAQ or NYSE are already required to produce OATS data and report it to FINRA upon request. Consequently, implementation costs likely overstate the costs these firms would face in initiating OATS reporting because the Non-Member Firms may have already established some of the necessary infrastructure. In addition, the Commission recognizes that the CAT NMS Plan estimates are based on voluntary survey responses by a small number of broker-dealers. Finally, the CAT NMS Plan has not yet been published for comment. Nevertheless, the Commission believes that those estimates give a sense of the potential magnitude of initiating OATS reporting.

The CAT NMS Plan details cost estimates for two types of broker-dealers. The first type already reports OATS data; the second type does not. The Commission focuses on costs for large firms that do not currently report OATS data. In these estimates, the average large firm estimated CAT implementation costs are approximately \$3,160,000; average implementation costs for a small firm are estimated at approximately \$131,200. The average large firm estimated annual CAT reporting costs are \$3,160,000 annually; average small firm reporting costs are \$121,200.[221] As discussed previously, these are, at best, upper-bounds on OATS

February 27, 2015. See CAT NMS Plan, available at http://catnmsplan.com/web/groups/catnms/@catnms/documents/appsupportdocs/p602500.pdf.

221 Costs estimates are the sum of hardware/software costs, full time employee costs, and third party/outsourcing costs for firms that do not currently report to OATS. Within these firms, median implementation and annual ongoing costs were estimated at zero. The

reporting costs because of differences in complexity and technical requirements for OATS and CAT reporting.

In addition to the application fees and data reporting costs, the Commission has taken into account the cost of legal and other advising necessary for effectively completing the application to be a member of FINRA. Some firms may choose to perform this legal work internally while others may use outside counsel for the initial membership application. In making this choice, Non-Member Firms will likely take into account factors, such as the size and resources of the firm, the complexity of the firm's business model, and whether the firm previously used outside counsel to register with any exchanges. Based on conversations with industry participants that assist with FINRA membership, for Non-Member Firms that choose to employ outside counsel to assist with their FINRA membership application, the cost of such counseling ranges from approximately \$40,000 to \$125,000. Factors affecting the specific costs of a particular firm include the number of associated persons, the level of complexity or uniqueness of the firm's business plan, and whether the firm has previously completed exchange membership applications with similar requirements.

b. Costs of Maintaining an Association Membership

With respect to ongoing costs, the Commission preliminarily believes that the three components of such costs are any ongoing fees associated with FINRA membership, costs of

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CAT NMS plan discusses interpretation of the zero medians, saying "It is the participants' understanding that this is likely due to current operational practices among broker-dealers that do not differentiate between technology and headcount costs that support business functionality and regulatory reporting." Consequently, the Commission believes these estimates do not reflect the opportunity costs associated with assigning employees to regulatory reporting tasks instead of other tasks they could be performing. See the amended CAT NMS Plan, available at http://catnmsplan.com/web/groups/catnms/@catnms/documents/appsupportdocs/p602500.pdf.

legal work relating to FINRA membership, and costs associated with additional compliance activities.

The ongoing membership related fees associated with FINRA membership include the annual gross income assessment; the annual personnel assessment; and the TAF and Section 3 fees, among others. The more significant fees are discussed below.[222]

The annual Gross Income Assessment generally requires members to pay a percentage of the Member Firm's total annual revenue based on a graduated scale.[223] The magnitude of the annual Gross Income Assessment is based on the total annual revenue, excluding commodities income, reported by the Member Firm on its FOCUS Form Part II or IIA.[224] Based on FOCUS Form data from Non-Member Firms in 2014, the Commission has determined that the average annual total revenue of Non-Member Firms, excluding commodities income, is approximately

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222 There are additional fees associated with maintaining an Association membership. There is an annual Personnel Assessment fee ranging from $130 to $150 per employee that applies to principals or representatives in the FINRA member's organization. See FINRA By-Laws, Schedule A, Section 1(e). Based on 2014 FOCUS reports, the number of registered representatives of Non-Member Firms that connect directly to ATSs ranges from 0-91, with an average of 18 and a median of 0. The Commission estimates that the average Non-Member Firm would incur a Personnel Assessment fee of no more than $2,520, and the median Non-Member Firm would incur a Personnel Assessment fee of $0. The Commission further estimates that the maximum Personnel Assessment fee that one of these Non-Member Firms would incur would be $11,830. There are also additional continuing education and testing requirements which will impose costs upon firms joining an Association. Additionally, there are de minimis fees (branch registration fee and system processing fee, among others). See FINRA By-Laws, Schedule A.

223 Id. For example, FINRA imposes a Gross Income Assessment as follows: (1) $1,200 on a Member Firm's annual gross revenue up to $1 million; (2) a charge of 0.1215% on a Member Firm's annual gross revenue between $1 million and $25 million; (3) a charge of 0.2599% on a Member Firm's annual gross revenue between $25 million and $50 million; and so on as provided in Schedule A. When a firm's annual gross revenue exceeds $25 million, the maximum of current year's revenue and average of the last three years' revenue is used as the basis for the income assessment. Id.

224 See FINRA By-Laws, Schedule A, Section 2. See also FOCUS Report Form X-17A-5, Part II and IIA.

$93 million, with a median of $86 million.[225] For the 14 large firms that connect directly to ATSs, FINRA's graduated Gross Income Assessment scale results in an average Gross Income Assessment for these Non-Member Firms of $91,784 and a median Gross Income Assessment of $113,824.[226]

The magnitude of the TAF depends on the transaction volume of a FINRA member that is covered by TAF as described in the FINRA Bylaws.[227] The Commission notes that FINRA may need to consider reevaluating the structure of the TAF to assure that it appropriately takes into account the business models of Non-Member Firms that may join FINRA as a result of the proposed amendments.[228] Although the Commission lacks the data to comprehensively estimate TAF that Non-Member Firms are likely to incur, data on ATS trading during the fourth quarter of 2014 provided by FINRA allows the Commission to estimate the fees associated with ATS activity for Non-Member Firms that connect directly to an ATS.[229] The Commission has identified 14 Non-Member Firms that traded on ATSs directly without the intermediation of a

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225 Based on 2012-2014 FOCUS data.

226 ($1,200 for the first $1 million of revenue) + (0.1215% × annual revenue greater than $1 million up to $25 million) + (0.2599% x annual revenue greater than $25 million up to $50 million) + (0.0518% of annual revenue greater than $50 million up top $100 million) + (0.0365% of annual revenue greater than $100 million to $5 billion). As discussed previously, Non-Member Firms vary in size. GIA for large firms used in these calculations (the 14 that connect directly to ATSs), is anticipated to be far larger than for the 111 remaining Non-Member Firms. See FINRA By-Laws, Schedule A, Section 1(c).

227 See FINRA By-Laws, Schedule A, Section 1(b).

228 See supra notes 95 and 184.

229 Some Non-Member Firms may trade on ATSs indirectly using the services of a Member Firm. The Commission cannot identify the magnitude of these firms' trading on an individual basis because Non-Member Firms are not required to be identified in Member Firms' OATS data. The Commission thus cannot estimate the TAF that these firms would incur as FINRA members.

Member Firm during the fourth quarter of 2014.[230] The Commission estimates that trading activity fees incurred by these 14 large Non-Member Firms due to their ATS activity would range from $0 to approximately $3.2 million annually, with a median incurred TAF of around $40,000.[231] The Commission believes that TAF for Non-Member Firms not among the 14 identified will be far lower because the median Non-Member Firm has far lower trading volume than the typical firm of the 14 identified in the data.

Some off-exchange trading that Non-Member Firms engage in currently may no longer be profitable when TAF is incurred. Consequently, Non-Member Firms may reduce their trading both on exchanges and off-exchange after joining an Association.

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230 These 14 firms do not represent typical Non-Member Firms: they represent the largest of the Non-Member Firms in terms of trading volume. Consequently, the median TAF discussed here far exceeds what the majority of Non-Member Firms would pay if they were to join FINRA.

231 Estimated TAF does not include any TAF related to firm's exchange-based trading activity, or off-exchange activity that occurs outside of an ATS. If a firm's activity on an exchange is related to normal market making operations, the activity does not incur TAF. The Commission is unable to estimate the proportion of these firms' exchange trading that would incur TAF because the Commission does not have information on what proportion of Non-Member Firm exchange activity would qualify for exemption from TAF fees under FINRA By-Laws. Because other elements of the TAF are not included in this calculation, it underestimates the actual TAF that firms would incur if they joined FINRA. The magnitude of the underestimation may be significant, but firms that join FINRA may be able to reduce their TAF cost by registering as Market Makers upon additional exchanges. (TAF is not assessed for certain trades related to registered market-making. See FINRA By Laws, Schedule A, Section (1)(b)(2)(F).) Estimates of TAF are based on the percentage of ATS orders received by Member Firms that operate an ATS and report the exchange-issued MPIDs of Non-Member Firms that place orders within that system. The calculation assumes that these proportions are representative of the trading of Non-Member Firms on all ATSs, and that the orders placed by these firms are equally likely to be executed within ATSs. It also assumes that half of all executed volume is sell volume, which incurs a TAF. The estimated TAF is equal to estimated sell volume x $0.000119. The $0 minimum is associated with a firm that has almost no ATS volume.

In addition to TAF, Non-Member Firms that choose to join FINRA may incur additional Section 3 fees. Using data on ATS trading during the fourth quarter of 2014 provided by FINRA, the Commission estimates that Section 3 fees incurred by the 14 large Non-Member Firms due to their off-exchange trading would range from $0 to approximately $16.9 million dollars annually, with a median incurred Section 3 fee[232] of $212,000.[233] As discussed in Section V.A.2 above, some of these fees may already be paid by Non-Member Firms that engage the services of a Member Firm clearing broker. However, FINRA lacks the authority to assess Section 3 fees against Non-Member Firms that self-clear, in which case FINRA may assess the fee to the Member Firm counterparty to the transaction. While these fees will represent a cost to Non-Member Firms, the cost will be largely offset to the industry as a whole by a reduction of Section 3 fees incurred by Member Firms (or clearing brokers acting on behalf of a Member Firm) when they buy from a self-clearing, Non-Member Firm.

Ongoing compliance costs would depend on the business circumstances of each firm and the types of issues that could arise. As in the case of the initial membership, some Non-Member Firms may choose to conduct ongoing compliance activities other than regulatory data reporting work (such as core accounting functions, updating policies and procedures, and updating forms

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232 These estimates do not include fees related to off-exchange trading outside of an ATS; the Commission is unable to estimate the magnitude of such fees that Non-Member Firms would incur if they were to continue trading off-exchange upon adoption of these amendments because in the absence of a consolidated audit trail, the Commission lacks data on Non-Member Firm off-exchange activity outside of ATSs.

233 Section 3 fees are estimated using Non-Member Firm off-exchange dollar volume reported by FINRA. Half of volume is assumed to be sell volume that would be subject to Section 3 fees. Aggregate estimated sell volume is estimated across firms by assuming that all non-member orders are equally likely to generate executions. For example, assume firm ABC submitted 10% of all off-exchange orders submitted by Non-Member Firms. Section 3 Fee obligation is calculated as: Non-Member Firm Dollar Volume x ½ x 10% x $18.40/$1,000,000.

filed with regulators) in-house while others may seek to outsource this work. The Commission estimates, based on discussions with industry participants, that the ongoing compliance cost for firms that outsource this work will range from $24,000 to $96,000 per year.[234] In the case of some Non-Member Firms, i.e., those that are affiliates of FINRA members, this cost is likely to be lower as they may be able to leverage compliance work already being performed.

In addition to the cost estimates discussed above, the Commission recognizes that both Non-Member Firms and SROs will incur other direct and indirect costs because of the increased regulatory requirements of the proposed amendments. Specifically, there will be compliance costs associated with regulation by FINRA.[235] Generally, the SROs that supervise Non-Member Firms are unable to provide the level of supervision of cross-market and off-exchange activity that FINRA provides to its Member Firms. Consequently, firms that join an Association will face costs associated with greater regulatory scrutiny, including the costs of comprehensive examinations of activity that was previously subject to less regulatory review. To the extent that this activity is permissible under Association rules, additional costs will be limited to those activities that are required to accommodate normal supervision and examination by an Association. To the extent that their activity does not already do so, firms will face additional costs related to bringing activity into compliance with Association rules. For the reasons

[234] For firms that choose to do this work in-house, the Commission preliminarily believes that the costs of ongoing compliance may be less than $96,000. This figure assumes Non-Member Firms may have experience in ongoing compliance work with SROs through their exchange membership(s) and, therefore, only captures the incremental cost of compliance with Association rules.

[235] However, Non-Member Firms that choose to join an Association may have FINRA assigned as their DEA. Such an assignment could eliminate separate DEA fees that the Non-Member Firms may pay to their current DEA.

discussed above, the Commission is not able to estimate these costs, although the Commission believes they will vary among Non-Member Firms.

c. Costs of Joining Additional Exchanges under the Rule as Proposed to be Amended

Non-Member Firms must be members of all exchanges upon which they transact business if they decide not to join an Association. With limited exceptions for some excluded activity previously discussed, some Non-Member Firms may choose to join additional exchanges to be excluded from the requirement to become a member of an Association. Alternatively, these firms may cease trading on exchanges of which they are not members.

Based on discussions with FINRA and industry participants, the Commission understands that completing a membership application with an additional exchange is generally less complicated and time consuming than completing a membership application with FINRA. Consequently, the Commission preliminarily believes that the compliance burden on Non-Member Firms for joining an additional exchange is likely to be significantly less than that of joining FINRA as those Non-Member Firms that choose to join an additional exchange are likely able to perform this work internally, given that they are already members of at least one exchange, and that such work should take less time than the time required to complete an application with FINRA.

In addition to the legal burden, Non-Member Firms joining additional exchanges as a result of the proposed amendments would incur membership and related fees. To the extent that Non-Member Firms choose to become members of additional exchanges, the fees associated with such memberships would vary depending on the type of access sought and the exchanges of which Non-Member Firms choose to become members.

The Commission also believes that the exchange membership fees that would apply to Non-Member Firms joining such exchanges would be those fees that apply to either introducing broker-dealers or proprietary trading firms. This assumption is consistent with the fact that any broker-dealers carrying customer accounts could not qualify for the current exemption of Rule 15b9-1. Thus, any exchange membership fees that apply to firms that provide clearing services or conduct a public business would not apply to Non-Member Firms.

Furthermore, because all Non-Member Firms are members of at least one exchange,[236] they would have already completed a Form U4, to register associated persons.[237] Although FINRA's rules regarding registration of associated persons tend to be more specific than exchange SRO rules regarding associated persons, the Commission believes Non-Member Firms will not need to register additional associated persons because the exchange SRO rules are already comprehensive in this regard. The Commission understands that all exchanges can access the Form U4 filings within the CRD which is maintained by FINRA.

In order to obtain estimates of the cost of joining additional exchanges, the Commission reviewed the membership related fee structures of all eighteen national securities exchanges. In assuming that the potential burden of joining additional exchanges would likely be less than that of joining FINRA, the Commission assumes that the costs imposed on Non-Member Firms by the proposed amendments would be membership fees, not costs relating to trading, such as

[236] For a broker-dealer to possibly be exempt from the requirement to be an Association member currently or under the proposed amendments, the broker-dealer must be a member of at least one exchange.

[237] Form U4 is the Uniform Application for Securities Industry Registration or Transfer. Representatives of broker-dealers, investment advisers, or issuers of securities use Form U4 to become registered in the appropriate jurisdictions and/or with SROs. The Commission understands that all SROs currently use Form U4. See, e.g., BATS Rule 2.5.01(c), ISE Rule 304(b), Phlx Rule 600(b).

trading permit fees and connectivity. The Commission recognizes that membership in an exchange, alone, may not guarantee the ability to trade because many exchanges charge fees for trading rights, ports, various degrees of connectivity, and floor access and equipment, should those be desired. The Commission believes that the fees associated with trading on an exchange are not the result of the proposed amendments because, under the proposed amendments, a Non-Member Firm could continue to trade through another broker-dealer on an exchange as long as that Non-Member Firm is a member of every exchange on which it trades or is a member of FINRA. In other words, the proposed amendments themselves do not impose the cost of connectivity and related fees, but only the costs associated with membership on exchanges on which Non-Member Firms will trade. To the extent, therefore, that Non-Member Firms continue to trade through other broker-dealers in a manner consistent with how they currently operate, the proposed amendments impose only the costs associated with membership.

The Commission also recognizes that connectivity fees to additional exchanges can range from the very low—approximately $500 a month for a workstation at NASDAQ—to upwards of $100,000 monthly, depending on factors such as latency, distance, bandwidth, and co-location, among others. Again, however, these costs are not a result of the proposed amendments because the proposed amendments do not impose any connectivity requirements. They simply impose membership requirements to facilitate regulatory supervision.

To arrive at preliminary estimates of the cost of joining additional exchanges, the Commission aggregated any fees associated with a firm's initial application to an exchange ("initial fee") and separately aggregated the fees associated with any monthly or annual membership costs to obtain a separate annual cost ("annual fee"). Based on these aggregations, the Commission obtained a preliminary range for both the initial fee and the annual fee across exchanges. The initial fee is as low as $0 for some exchanges. Most exchanges have an initial fee that is greater than $0 and no more than $5,000.[238]

Regarding monthly or annual membership fees, most exchanges' ongoing monthly or annual membership fees generally range from $1,500 to $7,200.[239] Again, these ongoing

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238 The BATS Exchanges do not assess any initial fees. See BATS BYX Exchange Fee Schedule, available at http://www.batstrading.com/support/fee_schedule/byx/ (last visited February 18, 2015) (omitting any mention of an initial membership fee); BATS BZX Exchange Fee Schedule, available at http://www.batstrading.com/support/fee_schedule/bzx/ (last visited February 18, 2015) (same); BATS EDGA Exchange Fee Schedule, available at http://www.batstrading.com/support/fee_schedule/edga/ (last visited February 18, 2015) (same); BATS EDGX Exchange Fee Schedule, available at http://www.batstrading.com/support/fee_schedule/edgx/ (last visited February 18, 2015) (same).

Other exchanges do have initial application fees. See, e.g., ISE Fee Schedule at 19, available at http://www.ise.com/assets/documents/OptionsExchange/legal/fee/ISE_fee_schedule.pdf (last visited February 18, 2015) (assessing a one-time application fee of $3,500 for an "Electronic Access Member"); application for NYSE and NYSE MKT Equity Membership for Non-FINRA Members at 2, available at http://usequities.nyx.com/sites/usequities.nyx.com/files/nyse__mkt_equity_membership_application_for_non-finra_members.pdf (last visited February 18, 2015) (discussing the Non-Public Firm Application Fee of $2,500); NASDAQ Price List, available at http://www.nasdaqtrader.com/Trader.aspx?id=PriceListTrading2 (last visited February 18, 2015) (discussing the NASDAQ Application Fee of $2,000); CBOE Fee Schedule at 10, available at http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf (last visited February 18, 2015) (typically assessing a trading permit holder organization application fee on all of its members of $5,000). If a firm is organized as a sole proprietorship, the application fee for CBOE is only $3,000. Id. See also CBOE TPH Organization Application Timeline and Needs List, available at https://www.cboe.org/publish/TPHForms/TPHOrganizationApplicationTimelineandNeeds.pdf (last visited February 18, 2015).

239 See, e.g., BATS BYX Exchange Fee Schedule, available at http://www.batstrading.com/support/fee_schedule/byx/ (last visited February 18, 2015) (noting an annual membership fee of $2,500); BATS EDGA Exchange Fee Schedule, http://www.batstrading.com/support/fee_schedule/edga/ (last visited February 18, 2015) (same); CHX Fee Schedule at 3, available at http://www.chx.com/_literature_119763/CHX_Fee_Schedule (last visited February 18, 2015) (assessing an annual membership fee of $7,200); MIAX Fee Schedule at 9, available at

exchange membership costs are generally lower than the annual costs estimated for being a member of FINRA.

d. Policies and Procedures Related to the Hedging Exemption

Non-Member Firms that choose not to join an Association but wish to continue to trade off-exchange (or on exchanges of which they are not members) must do so in a manner that conforms to the hedging exemption. To do so, the proposal would require Non-Member Firms to establish, maintain and enforce policies and procedures as discussed above. The Commission estimates that firms will incur a burden of 16 hours in initially preparing these policies and procedures.[240] Furthermore, the burden of maintaining and enforcing such policies and procedures, including a review of such policies at least annually, would be approximately 96 hours.[241] The Commission estimates an initial implementation cost of approximately $5,000 and an annual ongoing cost of approximately $18,000 for Non-Member Firms that wish to utilize the hedging exemption and perform this work internally; for firms that outsource this work, costs are

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http://www.miaxoptions.com/sites/default/files/MIAX_Options_Fee_Schedule_02012015.pdf (last visited February 18, 2015) (assessing a monthly trading permit fee for an "Electronic Exchange Member" of $1,500).

240 This figure is based on the following: (Compliance Manager at 10 hours) + (Compliance Attorney at 5 hours) + (Director of Compliance at 1 hour) = 16 burden hours per dealer. See infra note 271. As is discussed in more detail in the Paperwork Reduction Act discussion, the Commission based this estimate on the estimated burdens imposed by other rules applicable to broker-dealers, such as Regulation SHO. However, the Commission preliminarily believes that the policies and procedures under the proposed floor member hedging exemption will be substantially less burdensome than those required by the Amendments to Regulation SHO because those policies and procedures require certain technology and real-time monitoring components. In contrast, the policies and procedures under the proposed amendments to Rule 15b9-1 do not involve a real-time monitoring or technology component. See infra note 273.

241 See Section VI.D.

likely to be higher.[242] For firms that choose to join FINRA, the hedging exemption is not relevant. They will not incur these costs.

e. Indirect Costs

In addition to possibly incurring costs related to joining exchanges, Non-Member Firms that choose not to join an Association will lose the benefits of trading in the off-exchange market, unless they meet the exemption for hedging. As mentioned above, Non-Member Firms are significant participants in ATS activity. Much of this trading is attributed to 14 Non-Member Firms, and the activity level across those firms varies widely. Assuming that order volume is proportional to trade volume, the Commission estimates that the smallest of the 14 firms executed 11 shares on ATSs during the fourth quarter of 2014.[243] The largest firm executed 13.3 billion shares. The median firm in the group of 14 large Non-Member Firms is estimated to have executed 167.6 million shares. Although these share volumes are large, the Commission does not have adequate data on these firms to estimate the proportion of their trading activity and revenues that occurs on exchanges versus off-exchange. The Commission cannot judge the

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242 For firms that perform this work internally, the initial cost estimate assumes 4 hours of work performed by a Compliance Manager at an hourly rate of $283 and 12 hours performed by Compliance Attorneys at an hourly rate of $334. The annual cost estimate assumes 48 hours of work by Compliance Clerks at an hourly rate of $64, 32 hours by Compliance Attorneys, and 16 hours by Compliance Managers. Hourly salary figure is from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

243 The composition of the list of Non-Member Firms that are identified in ATS trading data changes across time periods. It is possible that the number of Non-Member Firms trading directly on ATSs is higher than estimated here. Additional Non-Member Firms may access ATSs through Member Firms, which would also exclude them from this analysis.

To address data limitation, the Commission assumes that ATS orders from each of the 14 Non-Member Firms observable in the data are equally likely to be executed.

likelihood of these firms choosing to cease off-exchange activity rather than joining an Association.

Finally, those firms that choose not to join an Association would be limited in their ability to route their own transactions in a manner so as to comply with the requirements of Regulation NMS.[244] Their transactions would have to be routed through a broker-dealer of an exchange of which they are a member, or routed by a broker-dealer only to those exchanges of which they are members. The routing of orders of Non-Member Firms that do not join an Association will be determined by the routing broker-dealer of the exchanges of which they are members. This loss in choice could lead to higher costs for routing and costs associated with increased latency because the exchange's routing broker-dealer may have a telecommunications infrastructure that is inferior to that of the broker-dealer that previously provided connectivity to that exchange to the Non-Member Firm.[245]

D. Alternatives

1. Elimination of the Floor Member Hedging Exemption

Although the proposed amendments would eliminate the exclusion for proprietary trading activity for broker-dealers wishing to continue availing themselves of the exemption from Association membership under Rule 15b9-1, it would maintain a limited exception for hedging of floor-based activity.[246] Currently, Non-Member Firms are able to hedge their floor-based

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244 The exemption related to routing to comply with Regulation NMS is discussed in Section II.E.

245 Firms in the business of providing connectivity to exchanges are likely to compete on the basis of their technology. The Commission assumes that some firms that do not join FINRA will have some orders (those governed under the Regulation NMS provisions to prevent trade-throughs) routed using technology inferior to the technology of their firm of choice.

246 The floor member hedging exemption is discussed more fully in Section II.D.

activity through the exclusion for proprietary trading in Rule 15b9-1. The Commission does not have data to estimate the number of Non-Member Firms that use the proprietary trading exemption in this manner, or the dollar-value of trading that they hedge through the exemption.

One alternative considered by the Commission was the elimination of the hedging exemption entirely. Elimination of the floor member hedging exemption would require any firm that wished to hedge through off-exchange transactions to join an Association or become a member of each exchange on which it trades and cease off-exchange trading. This would improve the Association's ability to monitor cross-market hedging activity that was conducted off-exchange. The Commission recognizes, however, that there may be challenges for the Commission, firms, and exchanges in proving compliance with the exemption. For example, some broker-dealers may label activity as hedging activity that is not covered by the exemption. A firm could establish a limited floor-based business and then inadvertently or deliberately claim the hedging exemption covers significant trading off-exchange (and trading on exchange of which the firm is not a member) that did not reduce or otherwise mitigate the risk of its floor-based activity. Further, firms that wish to avail themselves of the hedging exemption will incur costs to establish, maintain and enforce written policies and procedures related to its use.[247] Without the hedging exemption, firms would not incur these costs, but would incur other costs. In particular, without a hedging exemption, floor brokers on some exchanges might find that hedging positions obtained through their normal activity limited to the floor of a single exchange is less cost-effective. For example, a floor broker on an options exchange is currently exempt from FINRA membership if he trades off-exchange under the exclusion for proprietary trading. After entering an options position, the floor broker can enter an offsetting equity position by

[247] See Section V.C.2.d.

trading on an exchange of which he is not a member (through a member broker-dealer) or in the off-exchange market. Under the proposed amendments without the hedging exemption, the floor broker would not be able to make such a hedging transaction without joining at least one additional SRO (FINRA or another exchange where he could transact in equities). If participants have less opportunity to hedge their positions, they may be less willing to provide liquidity in their capacity as floor brokers. Therefore, the Commission is proposing a narrow hedging exemption that covers only the activity it intends to exclude.

2. Improve Off-Exchange Supervision through Action of Other SROs with or without CAT

The Commission also considered whether an alternative approach to achieving the objectives of the proposed amendments would be to address the limitations in regulatory oversight of off-exchange activity of Non-Member Firms through exchanges that act as their DEAs or all exchanges of which they are members. The Commission preliminarily believes either of these alternatives would frustrate the regulatory structure established by Congress and would be inefficient. As discussed in detail above, exchanges traditionally have not assumed the role of regulating the totality of the trading of their member-broker-dealers, and exchanges are currently not well-positioned to assume that role, in light of the statutory framework and, among other things, their limited access to data and the lack of a proper rule set to regulate off-exchange trading.[248] Exchanges generally do not have as detailed a set of member conduct rules and do not have non-exchange-specific trading rules, thus allowing such broker-dealers and their personnel to conduct business under a less specific regulatory regime than FINRA members.[249]

[248] See supra notes 82-95 and accompanying text.

[249] See supra note 75 and accompanying text.

As discussed above, in this context and consistent with the statutory framework, the Commission preliminarily believes that an Association is better suited to regulate off-exchange trading.[250]

With respect to having Non-Member Firms' DEAs assume the regulatory oversight responsibilities, the Commission could require the Non-Member Firm's DEA to oversee the off-exchange activity of the firm. This alternative may offer some benefit in terms of providing efficient supervision. Non-Member Firms' DEAs may have specialized knowledge of Non-Member Firms' businesses and operations that would facilitate efficient supervision of their off-exchange activity.[251] Similarly, requiring all SROs to supervise the off-exchange activity of their members might bring certain benefits. First, there might be innovation in surveillance methodology because exchange SROs could need new surveillance systems and procedures tailored to current market structure and practice. Second, this could foster competition among SROs to provide regulatory services, which could lower costs to members.

However, with respect to DEAs, the supervision of trading activity is outside the scope of typical DEA oversight responsibilities[252] and the Commission believes most exchanges contract with FINRA to perform these examinations. Consequently, if exchange SROs were expected to supervise the off-exchange activities of firms assigned to them for DEA examinations, the exchanges would need to acquire the resources to provide this supervision.

Requiring all SROs to supervise their members' off-exchange trading would also entail substantial costs and create inefficiencies. As discussed previously, exchange SROs have not

250 See supra notes 82-95 and accompanying text.

251 See Allston Letter, supra note 106.

252 See supra note 164.

generally supervised their members' activity outside of the markets they operate.[253] As discussed above, FINRA has invested in the technological infrastructure, cooperative agreements with other SROs, and specialized regulatory personnel to provide surveillance and supervision of activity in off-exchange markets.[254] If each of the exchanges were required to supervise the off-exchange activities of some or all of their members, the exchanges each would need to invest in similar regulatory infrastructure. This investment would be costly to the exchanges; presumably these costs would be passed on to exchange members and ultimately the investing public through higher trading costs. In addition, assigning regulatory responsibility to an exchange SRO, which may in turn contract with FINRA to provide those services, would be costly and inefficient. Further, notwithstanding the potential benefits to innovation, the duplication in regulatory oversight would also be duplication in regulatory resources as multiple SROs would surveil the off-exchange trading of some firms. This approach also could be inconsistent with the allocation of regulatory responsibilities contemplated by Section 17(d) of the Exchange Act.[255]

Furthermore, FINRA has adopted rules that govern off-exchange trading, recognizing the complexity and opacity of the off-exchange marketplace. If exchanges were required to supervise the off-exchange activity of their members, exchanges would need to adopt rules that were tailored to the institutional detail of the off-exchange market. This could result in off-exchange trading rules that varied depending on the exchange membership status of individual participants, resulting in inconsistent rules governing the same off-exchange trading activity.

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253 See supra note 68-69 and accompanying text.

254 Id.

255 15 U.S.C. 78q(d).

Finally, the Commission has also considered whether the possibility that the exchanges could obtain additional data through the CAT, or through a FINRA rule change if implemented,[256] affects the Commission's preliminary belief that an Association is better suited to regulate off-exchange trading. Although there may thereby be additional data, these changes would not address the underlying statutory scheme and resource issues that make FINRA well-positioned to regulate off-exchange trading.

3. Exchange Membership Alternative

The proposed amendments would, in accordance with Section 15(b)(8), preclude any firm that is not a member of an Association from trading on exchanges of which it is not a member.[257] Further, under the proposed amendments, if a firm becomes a member of an Association, it would not have to become a member of each exchange upon which it trades.[258] The Commission has also considered requiring broker-dealers to become a member of every exchange on which they trade and to become a member of an Association in order to trade off-exchange ("Exchange Membership Alternative"). In other words, under this alternative, becoming a member of an Association would not alone allow firms to trade on exchanges of which they are not members (as would be permitted under the proposed amendments).

In considering the Exchange Membership Alternative, the Commission weighed whether the same issue of off-exchange activity not being subject to effective regulatory oversight that exists when a Non-Member Firm trades off-exchange is present when a Member or Non-

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256 See supra note 84.

257 The proposed amendments provide limited exemptions for hedging of floor-based activity and order routing to satisfy certain provisions of Regulation NMS.

258 In order to trade on exchanges of which it is not a member, the firm would have to trade with or through another broker-dealer that is a member of that exchange.

Member Firm trades on an exchange of which it is not a member (through a member of that exchange). The Commission preliminarily believes that the proposed amendments adequately address the issue of establishing effective oversight of off-exchange activity and that the more onerous Exchange Membership Alternative would not provide any additional regulatory benefit beyond the proposed amendments for several reasons. First, while exchanges lack the data, surveillance technology and specialized regulatory personnel to surveil their members' trading off-exchange, FINRA has these resources to surveil the activity of Member Firms both on exchanges and off-exchange. Accordingly, requiring Member Firms to also become members of each exchange on which they effect transactions, including indirectly, would be unnecessarily duplicative because FINRA can already surveil the activity of a Member Firm trading on an exchange of which it is not a member. In addition, while exchanges do not have a specialized rule set to govern their members' activity in the off-exchange market, FINRA's rules are consistent with requiring Member Firms to adhere to the trading rules of exchanges on which they transact. If a Member Firm were to violate an exchange rule on an exchange of which it is not a member, FINRA would have the jurisdiction needed to address the resulting violation. Therefore, requiring that the Member Firm also become a member of that exchange would not prevent FINRA from exercising jurisdiction over the matter.

The Commission notes that the Exchange Membership Alternative might require firms to become members of more SROs than required under the proposed amendments, which would impose additional costs. In particular, some Non-Member Firms that would become Member Firms under the Proposal would also need to become members of additional exchanges or cease trading on these exchanges. In addition, some current Member Firms would also need to become members of additional exchanges

4. Retaining the De Minimis Allowance

The Commission considered retaining the $1,000 de minimis allowance for trading other than on an exchange of which the Non-Member Firm is a member. The Commission also considered retaining the $1,000 de minimis allowance, but removing the exception for proprietary trading conducted with or through another registered broker-dealer. As discussed above,[259] the Commission believes that the magnitude of the de minimis allowance is no longer economically meaningful. Furthermore, the Commission believes that the commission sharing arrangements discussed previously[260] are rarely if ever used. However, the Commission believes that floor members on some exchanges may rely upon the exception for proprietary trading conducted with or through another registered broker-dealer to hedge risks associated with floor-based activities. Consequently, the proposed amendments include a hedging exemption for floor-based activity but no longer include a de minimis dollar amount associated with transactions that do not fall under the limited hedging exemption.

5. The Commission Assumes Regulatory Oversight Role for Non-Member Firms

The Commission considered assuming the role of providing direct primary regulatory oversight for Non-Member Firms. We do not believe, however, that this is a reasonably available alternative because of the judgments reflected in Congress's determinations over time about where to locate that oversight function and our own understanding of the entity best suited to that role. As discussed in detail above, the Exchange Act, as originally adopted in 1934, left regulation of the off-exchange market to the Commission.[261] In 1938, Congress provided for the

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259 See Section II.C.

260 Id.

261 See supra note 27 and accompanying text

creation of Associations,[262] and from 1965 until 1983, broker-dealers engaged in off-exchange trading could become members of NASD or opt to be regulated directly by the Commission under the SECO program.[263] In 1983, the Commission recommended that Congress eliminate the SECO program because, among other things, only a limited number of broker-dealers chose to be regulated under the SECO program[264] and maintaining the program disproportionately affected the Commission's resources. Congress then amended the Act to eliminate the SECO program,[265] which had the effect of making the regulation of off-exchange trading under the Exchange Act the responsibility of an Association.[266] Consistent with this, in this rulemaking the Commission is proposing to modify the Rule 15b9-1 exemption so that, with limited exceptions, the off-exchange transactions of broker-dealers will be subject to the oversight and rules of an Association, the SRO primarily responsible for regulating trading in the off-exchange market. As discussed throughout, we believe an Association is best positioned to regulate that trading. Based on the foregoing, including the Congress's determination to eliminate the SECO

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262 See supra notes 31-33 and accompanying text.

263 As previously noted, broker-dealers that traded exclusively on the floor of an exchange were exempt from broker-dealer registration with the Commission until the 1975 Amendments, which extended the Commission's SECO rulemaking authority to any exchange member trading on an exchange other than an exchange of which it was a member. See supra note 41 and accompanying text. Broker-dealers registering with the Commission as a result of the 1975 Amendments became subject to the SECO rules in 1976, but could remain exempt from such rules pursuant to Rule 15b8-1. See supra note 43 and accompanying text.

264 Because many broker-dealers chose to become members of NASD rather than participating in the SECO Program, only 12 percent of all active Commission-registered broker-dealers effecting transactions off-exchange were SECO broker-dealers by May 1982. House Comm. on Energy and Commerce, "Authorization of Appropriations for the Securities and Exchange Commission," H.R. Rep. No. 98-106, at 597 (1983).

265 Pub. L. No. 98-38, 97 Stat. 205 (1983).

266 See supra note 31 and accompanying text.

Program,[267] the Commission does not view assumption of direct responsibility for off-exchange broker-dealer oversight by the Commission as a reasonably available alternative.

E. Request for Comment on Economic Analysis

The Commission has identified above economic effects associated with the proposal and requests comment on all aspects of its preliminary economic analysis. The Commission encourages commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such economic effects. In particular, the Commission seeks comment on the following:

47. Do commenters agree with the Commission's analysis of the potential economic effects of the proposed amendments? Why or why not?
48. Do commenters agree with the Commission's assessment of the baseline for the economic effects?
49. Is the supervision and surveillance of Non-Member Firms with substantial cross-market or off-exchange trading sufficient under current rules? Why or why not?
50. How would further changes to the scope of existing Regulatory Services Agreements between SROs affect regulators' ability to effectively surveil cross-market and off-exchange trading?
51. Do commenters believe that there are additional categories of benefits or costs that could be quantified or otherwise monetized? If so, please identify these categories and, if possible, provide specific estimates or data.

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[267] The report accompanying the amendments made to the Act in 1983 cited a preference for self-regulation over direct regulation by the Commission. See supra note 46 and accompanying text.

52. Are there any additional benefits that may arise from the proposed amendments? Or are there benefits described above that would not likely result from the proposed amendments? If so, please explain these benefits or lack of benefits in detail.

53. Are there any additional costs that may arise from the proposed amendments? Are there methods by which the Commission could reduce the costs imposed by the proposed amendments enabling effective regulatory oversight of Non-Member Firms? Please explain. Are there any other potential consequences of the proposed amendments? Or are there costs described above that would not likely result from the proposed amendments? If so, please explain these costs or lack of costs in detail.

54. Does the release appropriately describe the potential effects of the proposed amendments on the promotion of efficiency, competition, and capital formation? Why or why not? If possible, commenters should provide analysis and empirical data to support their views on the competitive or anticompetitive effects, as well as the efficiency and capital formation effects, of the proposed amendments.

55. Are there alternative mechanisms for achieving the Commission’s goal of improving regulatory oversight while promoting competition and capital formation?

56. To the extent that there are reasonable alternatives to the proposed amendments, what are the potential costs and benefits of those reasonable alternatives relative to the proposed amendments? What are the potential effects on the promotion of efficiency, competition, and capital formation of those reasonable alternatives?

57. Would the cost of FINRA or exchange membership cause some Non-Member Firms to alter their activities in any way? If so, how would Non-Member Firms alter their business? How would these changes affect competition and market efficiency? How would these changes affect market quality?
58. Would the proposed amendments cause Non-Member Firms to exit the marketplace? If so, how many Non-Member Firms would elect to restrict their operations rather that become members of FINRA or one or more exchanges? How would these changes affect competition and market efficiency? How would these changes affect market quality? What would be the effect on liquidity of Non-Members Firms exiting the marketplace?
59. Are there costs related to FINRA membership for Non-Member Firms that the Commission has not considered? What are these costs? Please be specific.
60. For Non-Member Firms, how much will the cost of FINRA membership vary? Will the cost of FINRA membership cause some firms to change the scope of their business? If so, in what manner?
61. Do commenters agree with the assumptions underlying the Commission's estimates of the range for membership costs for exchanges?
62. Do commenters agree with the Commission's preliminarily belief that the TAF collected by FINRA would not be expected to materially change if the proposed amendments were adopted? What would the effect of the proposed amendments be on the TAF assessed to current FINRA members? What would the effect of the proposed amendments be on the TAF assessed to Non-Member Firms that choose to become FINRA members?

63. Has the Commission properly accounted for the compliance cost burden required to achieve the access to exchanges necessary to comply with the proposed amendments? Would any costs beyond basic membership be the direct result of the proposed amendments?

64. If Non-Member Firms were to elect to join additional exchanges rather than becoming members of FINRA, how many exchanges would they expect to join?

65. Is the Commission correct in assuming that the cost of membership is the relevant compliance cost burden and that connectivity or trading related costs are optional for most to all of the exchanges? Are there any exchanges on which connectivity or trading rights costs are mandatory even if a broker-dealer trades through another member broker-dealer that is paying the connectivity or trading rights costs?

66. Are the Commission's assumptions on the manner in which Section 3 fees are allocated in off-exchange transactions with Non-Member Firms correct? Are there mechanisms in place already that result in these fees being passed on to Non-Member Firms that transact in ATSs, or elsewhere in the off-exchange market?

67. Would a Non-Member Firm elect to become a member of one or more exchanges rather than become a member of FINRA? If so, please discuss in detail why a Non-Member Firm would make such an election. Which exchanges, in particular, are Non-Member Firms likely to join, if they join additional exchanges, as a result of the proposed amendments? How would these changes affect competition and market efficiency? How would these changes affect market quality?

68. Has the Commission articulated all reasonable alternatives for the proposed rule? If not, please provide additional alternatives and how their costs and benefits would compare to the proposed rule. For the alternatives described above, has the Commission accurately described the costs and benefits? If not, please provide more accurate costs and benefits, including any data or statistics that support those costs and benefits.

69. One alternative discussed is to effect improved off-exchange supervision through the action of exchanges. Is this alternative practical? What resources would exchanges have to acquire to provide efficient and effective supervision of their members' off-exchange trading activity?

70. What effects could the proposed amendments have on FINRA's oversight of the off-exchange market? How could FINRA's revenues and cost of regulation be affected? What changes should FINRA consider implementing should the Commission approve the proposed amendments to Rule 15b9-1? Please be specific.

71. Would the proposed amendments create a barrier to entry for new prospective Associations? Would there be benefits to competition among Associations?

VI. Paperwork Reduction Act

Certain provisions of these proposed amendments to Rule 15b9-1 contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[268] As discussed in Part II.D, the proposed amendments to Rule 15b9-1 would require dealers relying on the floor member hedging exemption under Rule 15b9-1 to establish,

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[268] 44 U.S.C. 3501 et seq.

maintain, and enforce certain written policies and procedures. Compliance with these collections of information requirements would be mandatory for firms relying on the rule. The Commission is submitting these collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title of new collection of information is "Rule 15b9-1 Floor Member Hedging Exemption." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the agency displays a currently valid control number.

A. Summary of Collection of Information

The proposed amendments to Rule 15b9-1 would include a collection of information within the meaning of the PRA for broker-dealers relying on the floor member hedging exemption under the proposed Rule. The floor member hedging exemption under the proposed amendments to Rule 15b9-1 would permit a qualifying dealer[269] that conducts business on the floor of a national securities exchange to effect transactions for its own account with or through another registered broker or dealer that are solely for the purpose of hedging the risks of its floor-based activities, by reducing or otherwise mitigating the risks thereof. Broker-dealers relying on the floor member hedging exemption must establish, maintain, and enforce written policies and procedures reasonably designed to ensure and demonstrate that such hedging transactions reduce or otherwise mitigate the risks of the financial exposure the dealer incurs as a result of its floor-based activity. In addition, such dealers would be required to preserve a copy of their policies

[269] A broker-dealer would have to meet the threshold requirements of proposed Rule 15b9-1. Specifically, such broker-dealer would have to: (1) be a member of a national securities exchange; (2) carry no customer accounts; and (3) effect transactions in securities solely on a national securities exchange of which it is a member, except for transactions complying with the floor member hedging exemption or the Regulation NMS routing exemption.

and procedures in a manner consistent with Rule 17a-4 until three years after the date the policies and procedures are replaced with updated policies and procedures.

B. Proposed Use of Information

The policies and procedures required under Rule 15b9-1 would be used by the Commission and SROs to understand how dealers relying on the floor member hedging exemption evaluate whether their off-exchange transactions are conducted solely for the purpose of hedging risks incurred from the dealer's floor-based business and that such dealers are complying with the requirements of Rule 15b9-1. These policies and procedures will be used generally by the Commission as part of its ongoing efforts to monitor and enforce compliance with the federal securities laws, including Section 15(b)(8) and Rule 15b9-1 thereunder. In addition, SROs may use the information to monitor and enforce compliance by their members with applicable SRO rules and the federal securities laws.

C. Respondents

The Commission estimates that up to 100 dealers may rely on the floor member hedging exemption contained in Rule 15b9-1. The Commission notes that, based on publicly available information reviewed in the first quarter of 2015, there are currently 125 broker-dealers registered with the Commission that are not members of an Association. Of those 125 broker-dealers, 77 broker-dealers currently disclose being an exchange member engaged in floor activities on Form BD.[270] The Commission believes that while not all of these dealers will

[270] Of the approximately 4,209 total registered broker-dealers as of March 2015, 182 broker-dealers in total disclose being an exchange member engaged in floor activities on Form BD (note: the 182 broker-dealers includes the 77 broker-dealers engaged in floor activities that are not members of an Association). The Commission preliminarily believes that broker-dealers engaged in floor activities that are currently members of an Association are unlikely to withdraw from Association membership and begin relying on the floor member hedging exemption because such broker-dealers have already elected to

choose to avail themselves of the floor member hedging exemption contained in Rule 15b9-1 because the exemption restricts off-exchange transactions solely to those that hedge risks incurred as a result of their floor-based activity, some firms not included in this number may decide to avail themselves of the floor member hedging exemption. The Commission preliminarily believes, however, that more of these firms are likely to want the ability to engage in off-exchange transactions other than those that hedge the risk of their floor-based activity, and may, accordingly, choose to join an Association as a result of the proposed amendments to Rule 15b9-1.

D. Total Initial and Annual Reporting and Recordkeeping Burdens

The Commission estimates that the one-time, initial burden for a dealer to establish written policies and procedures as required under Rule 15b9-1 would be approximately 16 hours.[271] This figure is based on the estimated number of hours to develop a set of written policies and procedures, including review and approval by appropriate legal personnel. The Commission notes that the policies and procedures required by the proposed Rule are limited to hedging transactions that reduce or otherwise mitigate the risks of the financial exposure the dealer incurs as a result of its floor-based activity. In addition, the Commission estimates the annual burden of maintaining and enforcing such policies and procedures, including a review of such policies at least annually, would be approximately 96 hours for each dealer.[272] This figure

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join an Association and reliance on the floor member hedging exemption would limit their permissible off-exchange activity solely to hedging risks incurred as a result of their floor-based business.

[271] This figure is based on the following: (Compliance Manager at 10 hours) + (Compliance Attorney at 5 hours) + (Director of Compliance at 1 hour) = 16 burden hours per dealer.

[272] This figure is based on the following: (Compliance Manager at 60 hours) + (Compliance Attorney at 24 hours) + (Director of Compliance at 12 hours) = 96 burden hours per dealer.

includes an estimate of hours related to reviewing existing policies and procedures, making necessary updates, conducting ongoing training, maintaining relevant systems and internal controls, performing necessary testing and monitoring of off-exchange hedging transactions as they relate to the broker-dealer's floor-based activities and maintaining copies of the policies and procedures for the period of time required by the proposed rule.

The Commission estimates that the initial burden associated with Rule 15b9-1 would be 112 hours per dealer, which corresponds to an initial aggregate burden of 11,200 hours.[273] The Commission estimates that the ongoing annualized burden associated with Rule 15b9-1 would be

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273 This figure is based on the following: ((16 burden hours per dealer) + (96 burden hours per dealer)) x (100 dealers) = 11,200 burden hours during the first year. In estimating these burden hours, the Commission examined the estimated burdens imposed by other rules applicable to broker-dealers. For example, amendments to Regulation SHO adopted in 2010 required broker-dealers to establish, maintain, and enforce written policies and procedures relating to Rule 201(c) and Rule 201(d)(6) to ensure short-sale orders are, among other things, properly marked, are submitted at the proper price, or are properly off-set (in the case of Rule 201(d)(6). See Exchange Act Release No. 61595 (February 26, 2010) 75 FR 11232, 11286 (March 10, 2010) ("Amendments to Regulation SHO"). The policies and procedures relating to Rule 201(c) and Rule 201(d)(6) required under the Amendments to Regulation SHO estimated an average initial one-time burden of 160 burden hours per broker-dealer and ongoing compliance cost of 60 hours annually to ensure the policies and procedures are up-to-date and remain in compliance as well as an additional 336 hours annual to monitor, surveil, and enforce trading in compliance with Rule 201. Id. The Commission preliminarily believes that the policies and procedures under the proposed floor member hedging exemption will be substantially less burdensome than those required by the Amendments to Regulation SHO because those policies and procedures require certain technology and real-time monitoring components. For example, under the Amendments to Regulation SHO described above, broker-dealers' policies and procedures must be reasonably designed to enable a broker-dealer to monitor, on a real-time basis, the national best bid so as to determine the price at which a broker-dealer may submit a short sale order to a trading center in compliance with Rule 201(c), and off-setting transactions under the riskless principal provision under Rule 201(d)(6) must be allocated to a riskless principal or customer account within 60 seconds of execution. Id. at 11284. In contrast, the policies and procedures under the proposed amendments to Rule 15b9-1 do not involve a real-time monitoring or technology component.

96 hours per dealer, which corresponds to an ongoing annualized aggregate burden of 9,600 hours.[274]

E. Collection of Information is Mandatory

All of the collection of information discussed above would be mandatory.

F. Confidentiality of Responses to Collection of Information

To the extent that the Commission receives confidential information pursuant to the collection of information, such information will be kept confidential, subject to the provisions of applicable law.[275]

G. Retention Period for Recordkeeping Requirements

Dealers seeking to take advantage of the proposed hedging exemption would be required to preserve a copy of their policies and procedures in a manner consistent with Rule 17a-4[276]

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274 This figure is based on the following: (96 burden hours per dealer) x (100 dealers) = 9,600 ongoing, annualized aggregate burden hours. In estimating these burden hours, the Commission also examined the estimated initial and ongoing burden hours imposed on registered security-based swap dealers under Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information. See Exchange Act Release No. 74244 (February 11, 2015) 80 FR 14564, 14683 (March 19, 2015) ("Regulation SBSR"). Regulation SBSR requires registered security-based swap dealers to establish, maintain, and enforce written policies and procedures that are reasonably designed to ensure compliance with any security-based swap transaction reporting obligations. Id. The estimated initial and ongoing compliance burden on registered security-based swap dealers under Regulation SBSR were 216 burden hours and 120 burden hours respectively. Id. The Commission preliminarily believes that the initial and ongoing burden hours under the proposed floor member hedging exemption will be substantially less than for registered security-based swap dealers under Regulation SBSR, because the policies and procedures under Regulation SBSR require programing certain systems for transaction reporting and performing testing of such systems. Id. In contrast, the proposed floor member hedging exemption would not necessarily require programming or testing of certain systems and is a much more discrete set of policies and procedures as compared to the more comprehensive policies and procedures required by Regulation SBSR, which cover, among other things, the full scope of reporting security-based swap transactions by registered security-based swap dealers and others.

275 See, e.g., 5 U.S.C. 552 et seq.; 15 U.S.C. 78x (governing the public availability of information obtained by the Commission).

until three years after the date the policies and procedures are replaced with updated policies and procedures.

H. Request for Comments

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comment to:

72. Evaluate whether the proposed collection of information is necessary for the proper performance of our functions, including whether the information shall have practical utility;
73. Evaluate the accuracy of our estimate of the burden of the proposed collection of information;
74. Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
75. Evaluate whether there are ways to minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Brent J. Fields, Secretary, Securities and

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[276] 17 CFR 240.17a-4. Registered brokers and dealers are already subject to existing recordkeeping and retention requirements under Rule 17a-4. However, proposed Rule 15b9-1 contains a requirement that a dealer relying on the floor member hedging exemption preserve a copy of its policies and procedures in a manner consistent with Rule 17a-4 until three years after the date the policies and procedures are replaced with updated policies and procedures. The burdens associated with this recordkeeping obligation have been accounted for in the burden estimates discussed above for Rule 15b9-1.

Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File Number [ ]. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File Number [ ] and be submitted to the Securities and Exchange Commission, Office of FOIA/PA Services, 100 F Street NE., Washington, DC 20549-2736. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VII. Consideration of Impact on Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[277] the Commission requests comment on the potential effect of the proposed amendments to Rule 15b9-1 on the United States economy on an annual basis. The Commission also requests comment on any potential increases in costs or prices for consumers or individual industries, and any potential effect on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VIII. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act of 1980[278] ("RFA") requires the Commission to undertake an initial regulatory flexibility analysis of the impact of the proposed rule amendments on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.[279] For

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277 5 U.S.C. 603.

278 5 U.S.C. 603(a).

279 5 U.S.C. 605(b).

purposes of Commission rulemaking in connection with the RFA, [280] a small entity includes a broker or dealer that: (1) had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,[281] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[282] With regard to exchanges, a small entity is an exchange that has been exempt from the reporting requirements of Rule 601 under Regulation NMS, and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[283]

The Commission examined recent FOCUS data for the 125 Non-Member Firms and concluded that at most 11 of the affected entities have net capital of $500,000 or less, and some of those might not be small entities because they might be affiliates of larger organizations.

Although the Commission lacks the data to quantify these firms' off-exchange activity, it does have FOCUS information on the firms' disclosed activities. Based on this disclosure, the Commission believes that many of these firms may be able to trade off-exchange under the

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[280] Although Section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term "small entity" for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10 under the Exchange Act, 17 CFR 240.0-10. See Exchange Act Release No. 18451 (January 28, 1982), 47 FR 5215 (February 4, 1982) (File No. AS-305).

[281] 17 CFR 240.17a-5(d).

[282] See 17 CFR 240.0-10(c).

[283] See 17 CFR 240.0-10(e).

proposed floor member hedging exemption for a number of reasons. First, a number of firms disclose floor-based activity that may allow them to trade off-exchange under the floor member hedging exemption: five report writing options and six disclose floor activity.[284] Second, one discloses only trading in government debt securities, so is unlikely to be affected by the proposed amendments. Finally, only two of the eleven firms disclose proprietary trading activity. These firms would be affected only by the elimination of the de minimis allowance, unless the firms can rely on the floor member hedging exemption for such activity.[285] Therefore, the Commission certifies that the proposed amendments to Rule 15b9-1 would not, if adopted, have a significant economic impact on a substantial number of small entities.

76. We encourage written comments regarding this certification. We solicit comment as to whether the proposed amendments could have impacts on small entities that have not been considered. We request that commenters describe the nature of any impacts on small entities and provide empirical data to support the extent of such effect.

Such comments will be placed in the same public file as comments on the proposed amendments to Rule 15b9-1. Persons wishing to submit written comments should refer to the instructions for submitting comments in the front of this release.

IX. Statutory Authority – Text of the Proposed Amendments

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly Sections 3, 15(b)(9), 15A, 17, 19, 23, and 36 thereof, the Commission is proposing amendments to Title 17, Chapter II of the Code of Federal Regulations as follows.

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284 Firms often disclose multiple activities, so the number of disclosed activities in this discussion exceeds the number of firms.

285 Hedging activity is proprietary trading activity.

List of Subjects in 17 CFR Part 240

Brokers, Dealers, Registration, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201, et seq.; and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111-203, 939A, 124 Stat. 1376 (2010), unless otherwise noted.

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2. Section 240.15b9-1 is revised to read as follows:

§240.15b9-1 Exemption for certain exchange members.

Any broker or dealer required by section 15(b)(8) of the Act (15 U.S.C. 78o(b)(8)) to become a member of a registered national securities association shall be exempt from such requirement if it:

(a) Is a member of a national securities exchange;

(b) Carries no customer accounts; and

(c) Effects transactions in securities solely on a national securities exchange of which it is a member, except that with respect to this paragraph (c):

(1) A dealer that conducts business on the floor of a national securities exchange may effect transactions off the exchange, for the dealer's own account with or through another registered broker or dealer, that are solely for the purpose of hedging the risks of its floor-based activities, by reducing or otherwise mitigating the risks thereof. A dealer seeking to rely on this exception shall establish, maintain and enforce written policies and procedures reasonably designed to ensure and demonstrate that such hedging transactions reduce or otherwise mitigate the risks of the financial exposure the dealer incurs as a result of its floor-based activity. Such dealer shall preserve a copy of its policies and procedures in a manner consistent with 17 CFR 240.17a-4 until three years after the date the policies and procedures are replaced with updated policies and procedures; and

(2) A broker or dealer may effect transactions off the exchange resulting from orders that are routed by a national securities exchange of which it is a member, to prevent trade-throughs on that national securities exchange consistent with 17 CFR 242.611.

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By the Commission.

Brent J. Fields
Secretary

Dated: March 25, 2015