FINRA
Financial Industry Regulatory Authority

Marcia E. Asquith
Senior Vice President
and Corporate Secretary

June 2, 2015

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Via Email to rule-comments@sec.gov

Re: Comment Letter on Securities Exchange Act Release No. 74581 – Proposed Rule Regarding Exemption for Certain Exchange Members (File No. S7-05-15)

Dear Mr. Fields:

The Financial Industry Regulatory Authority, Inc. ("FINRA")[1] appreciates this opportunity to comment on the Securities and Exchange Commission's ("Commission" or "SEC") proposed amendments to Rule 15b9-1 under the Securities Exchange Act of 1934 ("Act") as published in the *Federal Register* on April 2, 2015 ("Proposal").[2] In general, FINRA supports the Proposal and believes narrowing the exemption in Rule 15b9-1, as proposed by the Commission, will enhance market surveillance and improve investor protection.

In addition to providing FINRA's overall views on the Proposal, this letter also provides specific responses to questions raised in the Release for the Commission's consideration as it determines whether to adopt the Proposal. Specifically, FINRA addresses: (1) the regulatory benefits resulting from the Proposal; (2) the process by which broker-dealers become FINRA members and, more specifically, how FINRA anticipates this process would work if the Proposal is adopted; and (3) the costs associated with FINRA membership that broker-dealers that are not FINRA members

---

1 The comments provided in this letter are solely those of the staff of FINRA; they have not been reviewed or endorsed by the FINRA Boards of Governors. For ease of reference, this letter may use "we" and "FINRA" interchangeably, but these terms all refer only to FINRA staff.

2 See Securities Exchange Act Release No. 74581 (March 25, 2015), 80 FR 18036 (April 2, 2015) (File No. S7-05-15) ("Release").

1735 K Street, NW
Washington, DC
20006-1506

t 202 728 8831
f 202 728 8075
www.finra.org

("Non-Member Firms") could incur if they become FINRA members as a result of the Proposal.[3]

Overview of Proposed Amendments

Section 15(b)(8) of the Act requires that a registered broker-dealer be a member of a national securities association unless the broker-dealer effects transactions in securities solely on a national securities exchange of which it is a member. Rule 15b9-1 currently provides an exemption to Section 15(b)(8) if a broker-dealer:

(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, provided, however, that the gross income limitation does not apply to income derived from transactions for the dealer's own account with or through another registered broker or dealer.

Under the Proposal, the first two prongs of Rule 15b9-1 would remain; however, the third prong would be replaced with a limited exemption for off-exchange hedging activity that would allow off-exchange activity with or through another broker-dealer that is solely for the purpose of hedging the broker-dealer's floor-based activities.[4] The Proposal also would update the rule to address orders routed outside of an exchange to prevent trade-throughs consistent with Rule 611 of Regulation NMS.

Regulatory Benefits

Throughout the Release, the Commission notes that Rule 15b9-1 currently permits many broker-dealers to engage in substantial over-the-counter trading activity without being a FINRA member. As a result, these broker-dealers are not subject to various FINRA requirements, including requirements to report to FINRA either order information or over-the-counter trades in NMS stocks or OTC equity securities. As the Commission recognized, the lack of reporting obligations for these firms results in gaps in FINRA's audit trail data. For example, the Commission notes that "FINRA is unable to monitor the off-exchange market activity of Non-Member Firms, and detect potentially

---

[3] The Proposal uses the term "Non-Member Firm" to mean a broker-dealer that is not a member of a registered national securities association. See Release, supra note 2, at 18038. The term is used in the same way throughout this letter.

[4] Broker-dealers relying on the hedging exemption would be required to establish, maintain, and enforce written policies and procedures to ensure off-exchange activity was so limited and comply with recordkeeping obligations to show each hedging transaction meets the requirements.

manipulative or other illegal behavior, as efficiently or effectively as it can with FINRA members" and that the "[l]ack of comprehensive reporting of off-exchange transactions to FINRA, among other things, undermines FINRA's ability to effectively surveil the off-exchange market."[5] The Commission notes its concern 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."[6]

FINRA agrees with the Commission's formulation of the current state of surveillance of Non-Member Firms' off-exchange activity and shares the Commission's concerns in this regard. As noted in the Release, if two Non-Member Firms engage in transactions off-exchange, because neither firm has a reporting obligation under FINRA rules, FINRA does not have knowledge of those transactions and is unable to include them in its market surveillance activities.[7] Similarly, because they are not reported to a FINRA trade reporting facility, they may not be properly submitted to the appropriate Securities Information Processor, and therefore, the price and volume information associated with these transactions may never be publicly disseminated through inclusion in the consolidated tape.

FINRA members also receive a substantial amount of order flow from Non-Member Firms, particularly in connection with alternative trading system ("ATS") and sponsored access activity. Currently, FINRA is not able to identify and aggregate the activity of specific Non-Member Firms in its automated surveillance programs as effectively as it can for FINRA member broker-dealers engaging in off-exchange trading. Consequently, it may be more difficult to detect through automated surveillance potential manipulative behavior coordinated by a single Non-Member Firm across multiple off-exchange venues or between off-exchange venues and exchanges.[8] Further, trading by

---

5 Release, supra note 2, at 18043 & n.85.

6 Id. at 18043.

7 See id. at 18054 ("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."). FINRA agrees with the Commission's belief that these types of interactions are likely infrequent; however, because there is no audit trail data on these trades, FINRA does not know how infrequent they may be. See id. at 18052 n.149.

8 See id. at 18066 ("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?").

non-members on exchanges with which FINRA does not have a regulatory services agreement, while currently a very small percentage of volume, cannot be evaluated as part of FINRA's cross-market surveillance activities. If such broker-dealers were members of FINRA, they would generally be required to report to FINRA's Order Audit Trail System ("OATS") orders routed to all exchanges. This OATS information would allow FINRA to determine if routing strategies across multiple exchanges were potentially problematic.

In addition to the general concerns described in the Release, the Commission specifically sought 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."[9] The Commission asked further whether "there [are] off-exchange transactions between two Non-Member Firms that occur that are not reported?"[10]

FINRA does not believe there is currently sufficient information to surveil Non-Member Firms trading off-exchange. In fact, FINRA is in the process of proposing a rule to require Non-Member Firms to be specifically identified in OATS Reports submitted by FINRA members receiving order flow from Non-Member Firms.[11] Moreover, while this change to the OATS Rules would, if approved, provide additional audit trail information that FINRA believes would improve the information available and surveillance of these Non-Member Firms, enforcement activities would remain the responsibility of the individual exchanges where broker-dealers are members. Thus, if FINRA were to identify over-the-counter activity by the Non-Member Firm it deemed problematic, FINRA would have to refer that activity to the exchange of which the broker-dealer is a member, notwithstanding that, as the SEC notes throughout the Release, an association is the SRO primarily responsible for regulating trading in the off-exchange market and is best positioned to regulate that trading.[12]

The Commission asked specifically whether it should

> 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

---

9 Id. at 18050.

10 Id.

11 See Regulatory Notice 14-51 (Nov. 2014).

12 See, e.g., Release, supra note 2, at 18066.

> as agent on behalf of the dealer subject to sufficient rules and regulations (including Rule 15c3-5 under the Exchange Act known as the Commission's "Market Access Rule")?[13]

If the Commission chooses to adopt the Proposal as proposed, FINRA supports a requirement that, when reporting information about a transaction to FINRA, the FINRA member acting as agent for a dealer relying on the floor member hedging exemption specifically identify the floor member effecting the hedging transaction and the fact that the transaction was a hedging transaction. FINRA believes that identifying this activity is necessary to properly evaluate off-exchange activity in conjunction with the related floor activity when conducting cross-market surveillance.[14]

FINRA Membership and the Membership Process

In the Release, the Commission detailed the benefits of the proposed amendment to Rule 15b9-1 and also discussed the potential costs and burdens associated with the Proposal, including the process necessary to become a member of FINRA. As part of this discussion, the Commission stated that it "understands, based on conversations with FINRA that, on average, the FINRA membership application process generally takes approximately four months."[15] The Commission also asked how long the registration process with FINRA, should a firm decide to register, typically takes and requested that responses "please include the estimated time to prepare the application as well as the estimated time for FINRA to process the application."[16]

FINRA notes that the average processing time for FINRA new member applications once received by FINRA is approximately six months; however, the FINRA membership group has a fast track/triage program ("FTT Program") that includes an initial assessment of the application that evaluates the risk, complexity, regulatory significance, completeness, scale, and scope of each incoming matter to determine if the matter is a candidate for review in the FTT Program. If a new member application is reviewed in the FTT Program, the average processing time is 60 days.

Based on the types of Non-Member Firms that are likely to become FINRA members if the Proposal is adopted (i.e., firms that are already members of an exchange and are engaged solely in proprietary trading activity), FINRA tentatively believes that

---

13 Id. at 18048.

14 FINRA notes that, if approved, the proposed changes to require the identification of Non-Member Firms in OATS reports would provide additional insight into these trading activities. See Regulatory Notice 14-51.

15 See Release, supra note 2, at 18050.

16 Id.

their applications would be candidates for the FTT Program.[17] Moreover, FINRA staff has identified additional ways to expedite the processing of these applications, depending on the exam requirements related thereto, and would seek to expedite these areas if the Proposal is adopted.[18] These areas include: granting firms access to the testing environment for trade reporting functionalities prior to the approval of their membership, providing firms with a written supervisory procedures checklist designed specifically for proprietary trading firms, and involving staff from FINRA's Department of Market Regulation in evaluating the membership applications.[19]

As the Commission noted in the Release, in addition to the time required to complete the FINRA membership process, there are also monetary fees associated with the membership process. The Release noted that, "[b]ased 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."[20]

As noted in Regulatory Notice 12-32 and set forth in Section 4(e) of Schedule A to FINRA's By-Laws, FINRA has a tiered fee structure for membership applications

---

17 There are some factors that could cause potential delays in processing new member applications, including licensure and registration requirements, inadequate written supervisory procedures regarding compliance with FINRA rules, systems changes that may be necessary to comply with FINRA reporting requirements, and timeliness in responding to FINRA staff requests for information. In addition, FINRA has identified approximately 30 firms that are not currently members of an exchange with which FINRA has a regulatory services agreement that may become FINRA members if the Proposal is adopted. Because FINRA does not currently have information on these firms, it is difficult for FINRA to predict what steps these firms may need to take to meet FINRA requirements before a membership application could be approved or to estimate the timeframe for approval.

18 FINRA notes that existing FINRA registration requirements could impact the timeframe for approving membership applications if one or more individuals must pass registration requirements before a membership application can be approved.

19 In addition to the FINRA processing times, FINRA also contacted a proprietary trading firm that recently completed the FINRA membership application process and consultants who perform work preparing membership applications for Non-Member Firms, to better gauge the time spent by firms in applying for FINRA membership. The firm indicated that it took five business days to prepare the new member filing. On average, the consultants noted it takes from two weeks to one month to prepare a membership application; however, they attributed a portion of the time to establishing bank accounts or legal entities, as well as obtaining transactional documentation. FINRA believes that these steps will likely not be required for existing Non-Member Firms that would be affected by the Proposal and are already members of at least one exchange.

20 Release, supra note 2, at 18060.

based upon the number of registered representatives for each applicant, with an additional $5,000 fee for clearing firms. The fees, which are divided into eight tiers, range from a low of $7,500 for applicants with ten or fewer registered persons to a high of $55,000 if the applicant has over 5,000 registered persons. The $12,500 fee applies to those applicants with between 11 and 100 registered persons.

Costs Associated with Maintaining FINRA Membership

In addition to the costs associated directly with the membership application process, the Commission notes that FINRA members are also subject to other FINRA fees depending upon the nature of their business activities, the size of the firm (in both personnel and branch offices),[21] and the revenue generated by the firm.[22] FINRA's fee structure has a mix of annual and variable fees that balance the regulatory costs to those members driving the most activity. Furthermore, each of FINRA's annual assessments is based on a tiered structure recognizing that all firms are not similar and should not be charged a flat rate regardless of size.

Trading Activity Fee

FINRA's Trading Activity Fee ("TAF") is a member regulatory fee that is based on trading activity and generally applies to all sales of a covered security regardless of where executed.[23] This includes both sales for the member's own account and sales on behalf of a customer. Although there are exemptions to the TAF for transactions by floor brokers and for market making transactions subject to Section 11(a) of the Act, proprietary trading firms do not act as floor brokers and may only be registered market makers in some, but not all, the securities that they trade.[24] As a result, if the Proposal is adopted by the SEC, those proprietary trading firms that would become FINRA members would be subject to the TAF for much of their trading, including trades on exchanges of which they are a member. The Commission noted in the Release that FINRA may need to reassess its fee structure, including the TAF, to assure it is fairly and equitably

---

21 FINRA charges each member a Personnel Assessment based on the number of registered persons employed by the member and a Branch Office Assessment based on the number of registered branch offices of the member. See FINRA By-Laws, Schedule A, Sections 1(e) and 4(a).

22 The Gross Income Assessment is charged annually to FINRA members based on the revenue reported by the member on its FOCUS form, not including any commodities income. See FINRA By-Laws, Schedule A, Sections 1(c) and 2.

23 See FINRA By-Laws, Schedule A, Section 1(b). "Covered securities" for purposes of the TAF include exchange-registered securities, over-the-counter equity securities, security futures, TRACE-Eligible Securities (as defined in FINRA Rule 6710), and municipal securities subject to the reporting requirements of the Municipal Securities Rulemaking Board. See FINRA By-Laws, Schedule A, Section 1(b)(1).

24 See FINRA By-Laws, Schedule A, Sections 1(b)(2)(F) and (G).

applied.[25]

FINRA agrees with the Commission's understanding of which transactions are assessable as well as the financial impact of the TAF, which these Non-Member Firms would be subject to once becoming members of FINRA. Consequently, FINRA recently reviewed the application of the TAF as it applies to members that engage only in proprietary trading activity. Based on this review, FINRA believes that the current framework could result in a significant TAF obligation for these proprietary trading firms that may be disproportionate to FINRA's anticipated costs associated with the financial monitoring and trading surveillance of these firms, in large part because these firms do not have customers. Accordingly, on May 5, 2015, FINRA published a Regulatory Notice requesting comment on a proposed exemption to the TAF for proprietary trading firms.[26] The proposed exemption would exclude from the TAF those transactions executed by proprietary trading firms on an exchange of which the firm is a member (including non-market maker trades).[27] FINRA believes the proposed exemption will result in proprietary trading firms paying an amount of TAF that bears a more equitable relationship to the costs of regulating those firms' activities, rather than the current TAF framework, which may result in a disproportionately large TAF obligation for these firms. If the proposed exemption is approved, proprietary trading firms would still incur a TAF obligation on transactions executed otherwise than on an exchange and on transactions executed on an exchange of which the firm is not a member. As proposed in the Regulatory Notice, these transactions would be subject to the TAF under the existing fee structure and at the same rates. The proposed TAF exemption would apply to current FINRA members that fall within the proposed definition of a proprietary trading firm as well as any new FINRA members as a result of the SEC's adoption of the Proposal.

---

25 See Release, supra note 2, at 18044 n.95 ("The Commission notes that FINRA may need to consider reassessing the structure of its fees, including its Trading Activity Fee, to assure that it is fairly and equitably applied to many of the Non-Member Firms that, as a result of the amendment to Rule 15b9-1, may join FINRA."); see also id. at 18054. The Commission also noted that "[u]nder the current TAF schedule, [FINRA members] may realize some cost savings because they would no longer be assessed TAF when they buy shares from a Non-Member Firm off-exchange." Id. at n.176. Given the fact that the TAF for over-the-counter trades in this scenario have been charged to and paid by current FINRA member firms, FINRA agrees that the Proposal would effectively shift the fee to these proprietary trading firms if they become FINRA members.

26 See Regulatory Notice 15-13 (May 2015). Comments on the proposed TAF exemption are due by June 19, 2015.

27 FINRA is proposing to define a "proprietary trading firm" as a member that trades its own capital and that does not have "customers," as that term is defined in FINRA Rule 0160(b)(4). The proposed exemption would also clarify that funds used by a proprietary trading firm must be exclusively firm funds, and all trading must be in the firm's accounts. In addition, traders must be owners of, employees of or contractors to the firm. See Regulatory Notice 15-13.

OATS Compliance Costs

In addition to the costs outlined by the Commission due to the imposition of FINRA fees, the Commission also noted that new FINRA members incur "[c]osts to initiate and maintain OATS reporting[, which] will vary widely among firms, depending on many factors including current IT infrastructure, complexity, and affiliation with a firm that already reports OATS data."[28] The Commission correctly notes further that "Non-Member Firms that are members of NASDAQ or NYSE are already required to produce OATS data and report it to FINRA upon request."[29]

FINRA believes that, of the approximately 125 Non-Member Firms identified by the Commission, approximately 40 Non-Member Firms are currently subject to OATS reporting pursuant to exchange rules. As such, these broker-dealers are already registered with OATS and periodically submit data to FINRA upon request. For these firms, FINRA believes the start-up costs for OATS compliance have largely already been incurred. Similarly, other Non-Member Firms have affiliates that are FINRA members, which likely have existing OATS infrastructure that the Non-Member Firms may be able to leverage to meet such requirements. Finally, FINRA believes that using the cost estimates for reporting CAT data in the CAT NMS Plan to provide "(at best) an upper-bound for OATS reporting costs" is misplaced because it substantially overstates the costs that may be incurred for firms to report to OATS.[30] As the Commission notes, among other significant differences, CAT will require for the first time that customer-specific information be collected and reported and will apply to options orders and transactions. These significant differences, coupled with numerous other requirements in CAT that require more complex and granular reporting, result in CAT compliance costs that will likely far exceed the costs to record and report to OATS.

* * * * *

FINRA appreciates the opportunity to provide comments on the Proposal. As set out above, FINRA supports the proposed amendments to Rule 15b9-1 and believes that the Proposal would enhance the regulation of the US equity markets and improve investor

---

28 Release, supra note 2, at 18060. As noted in the Release, becoming a FINRA member necessarily brings with it ongoing compliance costs in addition to OATS. See id. at 18062. The extent of each firm's compliance costs depends upon the nature of the firm's business; however, many FINRA rules apply to firms' relationships with their customers, and most proprietary trading firms do not have customer relationships for purposes of applying FINRA rules. Thus many FINRA rules, by their terms, will not apply to a proprietary trading firm's business. In addition, FINRA endeavors to ensure that firms with different business models, such as proprietary trading firms, are represented on FINRA's committees so that FINRA rulemaking is informed at its earliest stages by firms with a broad spectrum of business models.

29 Id. at 18060.

30 See id.

protection. FINRA also stands ready to work with the Commission and Non-Member Firms to ensure that the membership process for firms that may choose to become FINRA members if the Proposal is adopted is as efficient and effective as possible. Please contact Stephanie Dumont, Senior Vice President and Director of Capital Markets Policy, at [redacted] or Brant Brown, Associate General Counsel at [redacted], if you would like to discuss FINRA's comments or have any questions.

Sincerely,

Marcia Asquith
Senior Vice President and
Corporate Secretary

cc: Stephen I. Luparello, Director, Division of Trading and Markets
Gary L. Goldsholle, Deputy Director, Division of Trading and Markets
David S. Shillman, Associate Director, Division of Trading and Markets