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September 27, 2022

Ms. Vanessa Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Via Email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

**Re: Comment Letter on Securities Exchange Act Release No. 95388 –  
Exemption for Certain Exchange Members (File No. S7-05-15)**

Dear Ms. Countryman:

The Financial Industry Regulatory Authority, Inc. (“FINRA”) appreciates this opportunity to comment on the Securities and Exchange Commission’s (“Commission” or “SEC”) re-proposed amendments to Rule 15b9-1<sup>1</sup> under the Securities Exchange Act of 1934 (the “Exchange Act”) (the “Re-Proposal”).<sup>2</sup> Similar to the Commission’s original 2015 proposal to amend Rule 15b9-1 (the “Original Proposal”),<sup>3</sup> the Re-Proposal effectively would require proprietary trading firms that are registered broker-dealers (“PTFs”) to become members of a national securities association (an “Association”), unless such firms limit their trading activity to transactions on exchanges of which they are members, with limited exceptions. FINRA supported the Original Proposal<sup>4</sup> and supports the Re-Proposal. FINRA believes that the Re-Proposal will enhance oversight

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<sup>1</sup> 17 CFR 240.15b9-1.

<sup>2</sup> See Securities Exchange Act Release No. 95388 (July 29, 2022), 87 FR 49930 (August 12, 2022) (“Re-Proposing Release”).

<sup>3</sup> See Securities Exchange Act Release No. 74581 (March 25, 2015), 80 FR 18036 (April 2, 2015).

<sup>4</sup> See Letter from Marcia Asquith, Senior Vice President and Corporate Secretary, FINRA, to Brent J. Fields, Secretary, SEC, dated June 2, 2015, *available at* <https://www.sec.gov/comments/s7-05-15/s70515-18.pdf>.

of key market participants and improve market integrity and investor protection in the U.S. securities markets.

FINRA's comments will discuss existing regulatory gaps and the regulatory benefits resulting from the Re-Proposal; the process by which broker-dealers become FINRA members and how FINRA anticipates this process would work if the Re-Proposal is adopted; the costs associated with initial and ongoing FINRA membership; FINRA's governance structure and regulatory resources; and that the Re-Proposal will not transform FINRA into a state actor.

## **I. Overview of Proposed Amendments**

Section 15(b)(8) of the Exchange Act<sup>5</sup> requires that a registered broker-dealer be a member of an 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 Re-Proposal, the first two prongs of Rule 15b9-1 would remain, while the third prong—the *de minimis* exception that has permitted PTFs to engage in significant cross-market and over-the-counter (“OTC”) trading activity without becoming FINRA members—would be eliminated. Instead, the Re-Proposal would provide that a broker-dealer relying on the Rule 15b9-1 exemption may effect transactions otherwise than on a national securities exchange of which it is a member in only two narrow circumstances: (i) transactions that result solely from orders routed by the exchange of which the firm is a member to prevent trade-throughs consistent with Rule 611 of Regulation NMS or the Options Order Protection and Locked/Cross Market Plan; and (ii) transactions that are solely for the purpose of executing the stock leg of a stock-option order, subject to specified conditions.

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<sup>5</sup> 15 U.S.C. 78o(b)(8).

## **II. Existing Regulatory Gaps and Regulatory Benefits of the Re-Proposal**

### **A. The current Rule 15b9-1 exemption is no longer appropriate in light of significant intervening market developments**

As the Commission notes in the Re-Proposing Release, the U.S. securities markets have “undergone a substantial transformation” since the adoption of the current *de minimis* exception to Rule 15b9-1 in 1976.<sup>6</sup> Among other significant changes, of particular relevance is the emergence and increasing prominence of broker-dealers that are not members of an Association (“Non-Member Firms”) that “effect transactions across the full range of exchange and off-exchange markets,” including firms with significant proprietary trading occurring in equities, options, and fixed income securities.<sup>7</sup> The *de minimis* prong under existing Rule 15b9-1 was adopted to accommodate exchange specialists and floor traders with floor-based businesses. However, as the Commission notes, the *de minimis* prong has come to be used primarily by PTFs that engage in substantial OTC and cross-market proprietary securities trading—including in the Treasury securities markets—with significant trading activity occurring entirely OTC.<sup>8</sup> This OTC trading by PTFs has been facilitated by the rise of alternative trading systems (“ATSs”), which are marketplaces for listed and non-listed securities that are operated in the OTC market by broker-dealers. Because the ATS typically is interposed between the PTFs and other ATS subscribers, non-member PTFs can engage in substantial OTC trading, including with orders from ATS subscribers or other broker-dealers, without technically triggering the gross income limitation. Therefore, FINRA agrees with the Commission that the existing *de minimis* exception should be eliminated, as proposed in the Re-Proposal, because it has “become dislodged from the rule’s intended purpose.”<sup>9</sup>

The substantial degree of OTC and cross-market trading that occurs today without the jurisdiction-based oversight of an Association is out of alignment with the Exchange Act statutory framework for self-regulatory organization (“SRO”) oversight of broker-dealers:

“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 utilizing the order types that may be unique or specialized within the exchange. This expertise complements

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<sup>6</sup> See Re-Proposing Release at 49935.

<sup>7</sup> See *id.* at 49935-49936.

<sup>8</sup> See *id.*

<sup>9</sup> See *id.* at 49937.

the expertise of an Association in supervising its members' cross-exchange and off-exchange securities trading activity. Indeed, the Exchange Act's statutory framework places SRO oversight responsibility with an Association for trading that occurs elsewhere than an exchange to which a broker or dealer belongs as a member."<sup>10</sup>

This misalignment between the SRO oversight structure and Non-Member Firm market activities has resulted in regulatory gaps that are not addressed in a comprehensive and consistent manner, even when accounting for current Rule 17d-2 plans or regulatory services agreements ("RSAs"), as discussed further below.<sup>11</sup>

**B. Today's regulatory structure has resulted in incomplete regulation of proprietary trading firms and their market activity**

As discussed in the Re-Proposing Release and noted above, FINRA and the exchanges currently play a key role in the regulation of broker-dealers.<sup>12</sup> Notably, FINRA has entered into Rule 17d-2 plans and RSAs with certain exchange SROs, and FINRA agrees with the Commission that the collective SRO efforts reflected in these arrangements have enhanced regulatory outcomes.<sup>13</sup> However, these arrangements are not without their limitations. For example, and as discussed in the Re-Proposing Release, Rule 17d-2 plans are intended to mitigate duplicative SRO oversight over firms that are common members of more than one SRO; they do not, however, confer FINRA with jurisdiction over Non-Member Firms.<sup>14</sup> FINRA and the exchanges have worked together over the years to implement a number of Commission-approved Rule 17d-2 plans that are both bilateral (between FINRA and a single exchange or group of affiliated exchanges) and multiparty (between FINRA and multiple non-affiliated exchanges). The current Rule 17d-2 plans—19 bilateral and 4 multiparty—address to varying degrees the allocation of responsibility

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<sup>10</sup> *See id.* at 49931.

<sup>11</sup> Rule 17d-2 under the Exchange Act permits SROs to propose joint plans for the allocation of regulatory responsibilities with respect to their common members. *See* Securities Exchange Act Rule 17d-2 (Program for allocation of regulatory responsibility). RSAs are contractual arrangements between FINRA and particular exchanges that provide for specified regulatory services by FINRA in connection with members of the contracting exchange, including Non-Member Firms.

<sup>12</sup> *See, e.g.*, Re-Proposing Release at 49931-32.

<sup>13</sup> *See id.* at 49938.

<sup>14</sup> *See generally id.* at 49938.

for surveillance, investigative, examination, and enforcement functions for specified common rules.<sup>15</sup>

RSAs may complement Rule 17d-2 plans and cover Non-Member Firms. However, RSAs, as privately negotiated contracts between FINRA and the relevant exchange, vary in their scope of regulatory coverage and can be terminated by the parties. FINRA examines for compliance with the rules of certain individual exchanges under RSAs and, therefore, Non-Member Firms may be subject to different exchange rules and interpretations with respect to the same activity.<sup>16</sup> In addition, RSAs do not provide FINRA with membership-based jurisdiction to directly enforce Non-Member Firms' compliance with the federal securities laws, nor do these firms become subject to FINRA rules for their OTC trading—even where that conduct may not be comprehensively addressed by exchange rules or RSAs.<sup>17</sup>

Thus, given the current broker-dealer membership landscape, neither existing Rule 17d-2 plans nor RSAs provide the full scope of regulatory coverage appropriate for comprehensive and consistent oversight of PTF activities. This limitation is not theoretical; for example, FINRA identified Non-Member Firms as potential respondents in five percent of the market regulation investigations it conducted in 2020 and 2021. The activity involved in these investigations ranged across asset types and included cross-market as well as OTC conduct. One key source of data for these investigations is FINRA's surveillance program, and FINRA provides additional detail below on the extent to which it is able to observe potentially actionable Non-Member Firm conduct in surveillance alerts—as well as areas, like in fixed income, where the current Rule 15b9-1 exemption may limit the information available to FINRA and, correspondingly, FINRA's ability to surveil Non-Member Firm conduct.

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<sup>15</sup> See *id.* at n.109 (citing to where the 17d-2 plans can be found on the Commission's website at <https://www.sec.gov/rules/sro/17d-2.htm>).

<sup>16</sup> As noted in the Re-Proposing Release, “[t]his can result in different interpretations and FINRA registration would promote consistent interpretations and efficiencies in enforcement and regulation with respect to this growing part of the market.” See *id.* at 49962.

<sup>17</sup> As the Re-Proposal notes, there are also other coordination tools employed by the SROs in addition to Rule 17d-2 plan and RSAs. For example, FINRA and the exchanges share information through the Intermarket Surveillance Group (“ISG”), and the Cross-Market Regulation Working Group of the ISG. However, while the ISG “is a valuable forum for the coordination of regulatory efforts and sharing information,” it “does not confer jurisdiction” and “does not create rules or impose disciplinary actions.” See *id.* at 49938 n.101.

Importantly, however, even where FINRA has sufficient audit trail data to surveil Non-Member Firm conduct—as FINRA now surveils 100% of the equities and options markets with Consolidated Audit Trail (“CAT”) data—there are key regulatory limitations that remain when FINRA encounters potentially problematic Non-Member Firm conduct. As the Commission notes, access to audit trail data does not confer jurisdiction on FINRA over Non-Member Firms and, as a result, FINRA does not have the independent ability to examine for, investigate, or enforce potential violations of the federal securities laws or FINRA rules with respect to Non-Member Firms it identifies through surveillance or other means.<sup>18</sup> And while FINRA may currently perform regulatory work with respect to Non-Member Firms under RSAs, FINRA echoes the Commission’s view that “performing SRO oversight in this manner is less certain and stable than direct Association oversight of such trading activity due to the discretionary nature of RSAs, and frustrates the regulatory scheme established by Congress in which an Association directly regulates broker-dealers that effect securities transactions elsewhere than exchanges where they are a member.”<sup>19</sup> Accordingly, these limitations impede comprehensive OTC and cross-market oversight in the equities, options, and fixed income markets, and they would be remedied with the adoption of the Re-Proposal by providing FINRA with membership-based jurisdiction over Non-Member Firm PTFs.

**C. The Re-Proposal would help address key regulatory gaps in market oversight for equities and options**

FINRA believes that requiring most PTFs to become FINRA members would fill important gaps in regulatory oversight for equities and options that would enhance market integrity and investor protection.<sup>20</sup> Non-member PTFs trade in different financial instruments and these activities occur across multiple exchanges and OTC. As discussed in the Re-Proposing Release, for OTC executions in listed securities, in September 2021, these firms’ dollar volume was approximately \$789 billion and, in April 2022, it was \$441

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<sup>18</sup> *See id.* at 49938.

<sup>19</sup> *See id.* at 49943.

<sup>20</sup> FINRA also agrees with the Commission that the proposed exceptions to permit PTFs to engage in certain activity off an exchange of which it is a member in circumstances related to preventing trade-throughs and executing stock-option orders are appropriately tailored to accommodate these limited activities without compromising the goals of the Re-Proposal.

billion (accounting, respectively, for 9.8 percent and 4.6 percent of total off-exchange volume in listed equities executed that month).<sup>21</sup>

FINRA has invested significant resources in its technology and regulatory staff expertise to develop comprehensive cross-market and OTC surveillance programs that are designed, among other things, to identify instances where a market participant engages in potentially abusive conduct on two or more markets in an attempt to avoid detection. Direct FINRA jurisdiction would yield a number of benefits, including ensuring that PTFs are subject to FINRA rules and providing for more consistent regulatory treatment across entities engaging in similar trading activity, which would result in more thorough oversight and stronger cross-market and cross-product surveillance.<sup>22</sup>

As noted by the SEC, while FINRA can refer potential violations of the federal securities laws to the SEC, “the Exchange Act requires a robust layer of SRO oversight over broker-dealers in addition to the Commission’s regulatory role.”<sup>23</sup>

“In light of the extent to which off-member-exchange proprietary trading occurs today, the Commission believes that the SRO layer of oversight should be enhanced by ensuring, as mandated by Section 15(b)(8) of the Act, that an Association generally has direct, membership-based oversight over broker-dealers that effect securities transactions elsewhere than on an exchange where they are a member and the jurisdiction to directly enforce their compliance with Federal securities laws, Commission rules, and Association rules.”<sup>24</sup>

FINRA agrees with the Commission that direct FINRA membership is necessary to help address gaps that FINRA has observed in its cross-market and OTC surveillance programs. In addition, while Non-Member Firms do not have retail customers of their own, FINRA’s observation is that they nonetheless can have a significant role in executing customer orders routed to them by other broker-dealers. It is noteworthy that, for certain

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<sup>21</sup> See Re-Proposing Release at 49936. See also Re-Proposing Release at n.81 (discussing activity in listed options by Non-Member Firms), and Re-Proposing Release at 49955 (Table 2, Panel A: Option Dollar Volume).

<sup>22</sup> As the Commission notes, FINRA, along with the exchange SROs, is able to perform cross-market surveillance of trading activity in NMS stocks, OTC equities, and listed options using CAT data. However, as discussed above, access to CAT data does not itself address the regulatory concerns that are the subject of the Re-Proposal.

<sup>23</sup> See Re-Proposing Release at 49932.

<sup>24</sup> See *id.*

products and exchanges, some Non-Member Firm conduct may not fully be subject to exchange rules that provide for important protections in connection with the execution of customer orders (*e.g.*, not all exchanges have comparable best execution rules).

**D. The Re-Proposal would help address key regulatory gaps in market oversight for fixed income securities**

Individual fixed income securities generally are not traded on exchanges and, as such, these markets rely exclusively on FINRA oversight. In addition, neither CAT data nor the RSAs cover trading conduct in individual fixed income securities, including Treasury securities. Under existing Rule 15b9-1, PTFs may engage in substantial trading in fixed income securities with other broker-dealers or ATSS without becoming FINRA members, which has led to significant gaps in FINRA’s ability to surveil the fixed income markets.

Under FINRA rules, members are required to report secondary market transactions in fixed income securities, including Treasury securities, to FINRA’s Trade Reporting and Compliance Engine (“TRACE”).<sup>25</sup> Data reported to TRACE is used in FINRA’s surveillance and regulatory programs,<sup>26</sup> and data for TRACE-Eligible Securities,<sup>27</sup>

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<sup>25</sup> See FINRA Rule 6700 Series. In addition, in accordance with rulemaking by the Federal Reserve Board, on September 1, 2022, certain depository institutions began reporting information on transactions in Treasury securities, agency debt securities, and agency-backed mortgage-backed securities to TRACE. See 86 FR 59716 (October 28, 2021).

<sup>26</sup> With certain exceptions, most secondary market transactions reported to TRACE are also publicly disseminated, thereby enhancing fixed income market transparency. Individual transaction information for Treasury securities is not currently disseminated and is used for surveillance and regulatory purposes only. See FINRA Rule 6750. However, since March 2020, FINRA has published weekly aggregate volume information for Treasury securities based on the transaction data reported to TRACE. See Securities Exchange Act Release No. 87837 (December 20, 2019), 84 FR 71986 (December 30, 2019) (Order Approving File No. SR-FINRA-2019-028). In the near future, FINRA intends to increase the frequency of this published aggregate volume information and is also considering further modifications and enhancements to the format and content of the data (*e.g.*, adding aggregate trade count and pricing information). See Securities Exchange Act Release No. 95438 (August 5, 2022), 87 FR 49626 (August 11, 2022) (File No. SR-FINRA-2022-017).

<sup>27</sup> “TRACE-Eligible Security” is generally defined as a debt security that is U.S. dollar-denominated and is: (1) issued by a U.S. or foreign private issuer, and, if a “restricted security” as defined in Securities Act Rule 144(a)(3), sold pursuant to



including Treasury securities, is shared with the official sector to assist them with monitoring and analysis of the Treasury securities markets.<sup>28</sup> However, FINRA’s ability to conduct thorough and effective oversight in the fixed income markets is limited because Non-Member Firms are not subject to FINRA rules or jurisdiction.

FINRA notes that regulatory gaps exist even where Non-Member Firms trade with current members that report the transaction to TRACE. This is the case because, for example, Non-Member Firms are not consistently identified in the TRACE audit trail across all of such firm’s activity.<sup>29</sup> Although FINRA is able to identify some Non-Member Firm activity on ATSS in Treasury securities (and FINRA confirms that Non-Member Firms’ activity accounts for a very significant portion<sup>30</sup> of trading in Treasury securities),<sup>31</sup> FINRA has no visibility into the identity of Non-Member Firms for transactions in Treasury securities that occur otherwise than on a covered ATS (or on any other non-ATS platform). FINRA currently also does not have visibility into the activity of PTFs in non-Treasury security fixed-income products.

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Securities Act Rule 144A; (2) issued or guaranteed by an “agency,” as defined in Rule 6710(k) or a “government-sponsored enterprise,” as defined in Rule 6710(n); or (3) a “U.S. Treasury Security,” as defined in Rule 6710(p). “TRACE-Eligible Security” does not include a debt security that is issued by a foreign sovereign or a “money market instrument,” as defined in Rule 6710(o). *See* FINRA Rule 6710 (“Definitions”). The SEC recently approved an amendment to FINRA’s TRACE reporting rules to expand TRACE reporting requirements to trades in U.S. dollar-denominated foreign sovereign debt securities. *See* Securities Exchange Release No. 95465 (August 10, 2022), 87 FR 50354 (August 16, 2022) (Order Approving File No. SR-FINRA-2022-011).

<sup>28</sup> The official sector includes the Treasury Department, the Federal Reserve Board, the Federal Reserve Bank of New York, the SEC, and the U.S. Commodity Futures Trading Commission.

<sup>29</sup> Under TRACE rules, a Non-Member Firm is generally identified as a “customer” in the FINRA member’s trade report. FINRA thus has no ability to distinguish a particular Non-Member Firm’s trading activity in the TRACE data, and, therefore, a wholistic view of each of these firms’ significant activity is not available.

<sup>30</sup> *See* Re-Proposing Release at 49937.

<sup>31</sup> For Treasury securities, FINRA rules require a covered ATS to identify Non-Member Firm counterparties in TRACE using FINRA-assigned identifiers. The Rule 6730.07 requirements apply to member ATSS whose volume meets specified thresholds, allowing FINRA to identify Non-Member Firms with respect to transactions in Treasury securities that occur on such ATSS. *See* Rule 6730.07.

It is important to note that the need for FINRA oversight in the fixed income space extends beyond the critical role of facilitating market transparency—FINRA also surveils and examines for activity that may be manipulative or otherwise violative of federal securities laws and FINRA rules, including self-trades, spoofing and layering.<sup>32</sup> FINRA has identified such potential misconduct in the fixed income market, including in Treasury securities, some of which has involved Non-Member Firms. For example, within the audit trail limitations noted above, FINRA observed that Non-Member Firms were identified in 17 percent of the surveillance alerts generated by its Treasuries manipulation patterns in 2020 and 2021.<sup>33</sup> However, FINRA has no jurisdiction over Non-Member Firms that engage in vast OTC trading activity in fixed income securities, and therefore FINRA has no authority to address any potential market misconduct that is identified.<sup>34</sup> Simply conditioning the Rule 15b9-1 exemption on requiring PTFs to report fixed income securities transactions to TRACE would not remedy this jurisdictional issue.

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<sup>32</sup> “Layering” is a form of market manipulation in which multiple, non-bona fide limit orders are entered on one side of the market at various price levels in order to create the appearance of a change in the levels of supply and demand, thereby artificially moving the price of the security. An order is then executed on the opposite side of the market at the artificially created price, and the non-bona fide orders are cancelled. *See* Securities Exchange Act Release No. 76361 (November 21, 2016), 81 FR 85650 (November 28, 2016) (“Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2016-043”).

“Spoofing” is a form of market manipulation that involves the market manipulator placing non-bona fide orders that are intended to trigger some type of market movement or response from other market participants, which the market manipulator is able to take advantage of by placing orders on the opposite side of the market. *See* Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2016-043.

“Self-trades” are transactions in a security resulting from the unintentional interaction of orders originating from the same firm that involve no change in the beneficial ownership of the security. *See* FINRA Rule 5210.02.

<sup>33</sup> Because Non-Member Firms are not required to be identified in TRACE for fixed income securities other than Treasuries, FINRA patterns and alerts for those securities would not specifically identify Non-Member Firms. *See supra* Section II.B.

<sup>34</sup> *See* notes 22 and 23 and accompanying text (discussing the importance of the membership-based oversight of a national securities association for OTC conduct).

### **E. PTF activity introduces significant risk to the securities markets**

Trading firms that are active in the U.S. capital markets have the potential to introduce risk to the markets, even where such entities do not have customers or employ a relatively small number of representatives. For these reasons, FINRA’s rules and regulatory programs cover a cross section of activity and risks, beyond the important focus on sales practices. For example, FINRA oversees its members’ compliance with and controls over net capital, credit risk, money laundering, fraud, operational risks, and—particularly notable in the context of PTFs—market risk (*i.e.*, the possibility of potential loss to a firm due to adverse market price movements in its trading and investment securities), market integrity risk (*e.g.*, prohibited trading practices, technology driven risk, trade reporting/transparency, best execution), and liquidity risk (*i.e.*, the possibility that a firm may be unable to meet short term financial demands due to a lack of readily accessible cash). Based on FINRA’s observations, PTFs tend to use significant amounts of margin in their trading strategies, which involves credit risk to the broker-dealer counterparties that are exposed to PTFs in connection with the PTF’s trading positions. In addition, options, along with certain other derivative products, have embedded leverage. PTFs also present credit risk to the clearing firms that clear and settle their transactions. These and other factors are relevant to an analysis of the impact of PTF activities on the markets.

In FINRA’s assessment, certain non-member PTFs have a significant market footprint and the scope of their activities introduces a moderate to high degree of risk to the market and market counterparties.<sup>35</sup> Jurisdiction over these firms as well as the ability to identify their activity in all of FINRA’s transaction audit trails would further enable FINRA to assess individual entities’ impacts on the market and market counterparties.<sup>36</sup> The Re-Proposal would enable FINRA to directly and more comprehensively oversee PTFs and their trading activity, which, in turn, would enhance market integrity and foster the maintenance of fair, orderly, and efficient markets.

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<sup>35</sup> FINRA also believes that consistent application of Exchange Act Rule 15c3-1 (Net Capital Rule) would also be a benefit. The Net Capital Rule requires that firms must at all times have and maintain net capital at specific levels to protect customers and creditors from monetary losses that can occur when firms fail. Exchange Act Rule 17a-11 requires firms to notify FINRA in the event their net capital falls below the “minimum amount required” by the Net Capital Rule.

<sup>36</sup> For example, FINRA rules require certain members to submit additional financial and operational information, which provides FINRA with a more complete and detailed view of a member’s business operations and enables FINRA to better assess a firm’s risk. *See* FINRA Rule 4524 (Supplemental FOCUS Information).

### **III. FINRA's New Member Application Review Process**

In the Re-Proposing Release, the Commission discusses the process necessary to become a member of FINRA.<sup>37</sup> As part of this discussion, the Commission states that it understands that, on average, the FINRA membership application process takes approximately six months.<sup>38</sup> Under FINRA Rule 1014, FINRA typically has 180 days, or approximately six months, after the filing of a new membership application (“NMA”) to issue a decision.<sup>39</sup> However, depending on the complexity, novelty, and risk of an application, FINRA may issue a decision on a “fast-track” basis. FINRA aims to process “fast-track” NMAs within 100 days.

FINRA has reviewed its NMA process and considered whether and how it could be augmented to accommodate approximately 65 new PTF members in a relatively concentrated period of time. Based on the types of Non-Member Firms that are likely to apply for FINRA membership if the Re-Proposal is adopted (*i.e.*, broker-dealers that are already members of an exchange and are engaged solely in proprietary trading activity), FINRA intends to implement an expedited membership application process for these applicants. Consistent with FINRA’s overall approach to oversight of member firms, the NMA process varies by type of firm and is focused on the risks raised by each firm’s activities.<sup>40</sup> Many FINRA rules, by their terms, will not apply to a PTF’s business. Based on FINRA’s review of the potentially impacted Non-Member Firms (*e.g.*, business descriptions, associated persons, office locations, affiliates, ownership, regulatory matter history, FOCUS reports, etc.), FINRA anticipates being able to process most of these Non-

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<sup>37</sup> See Re-Proposing Release at 49950-49951.

<sup>38</sup> See *id.* at 49950.

<sup>39</sup> See FINRA Rule 1014(c)(3).

<sup>40</sup> As the Commission notes in the Re-Proposing Release, in addition to the time required to complete the FINRA membership process, there are also monetary fees associated with the membership process. See Re-Proposing Release at 49964. The Re-Proposing Release accurately notes that the fees associated with a FINRA membership application can vary, including a one-time application fee ranging from \$7,500 to \$55,000, depending on the number of registered representatives associated with the firm. FINRA believes that most non-member PTFs would not incur application fees exceeding \$12,500.

There is also a one-time NMA surcharge of \$5,000 that is assessed if the applicant will be engaged in any clearing and carrying activity. See FINRA By-Laws, Schedule A, Section 4(e)(2). FINRA does not anticipate that this clearing surcharge would be applicable to non-member PTFs that may be required to become FINRA members under the Re-Proposal.

Member Firm NMAs pursuant to the expedited process within 60 days after submission of the application.<sup>41</sup> As such, FINRA does not anticipate any challenges with processing the membership applications of the approximately 65 Non-Member Firms that may seek to register with FINRA. FINRA expects to do so well within the proposed implementation timeframe of one year after publication of the final rule in the *Federal Register*,<sup>42</sup> so long as such firms submit their applications and respond to FINRA staff in a timely manner.

#### **IV. Costs Associated with Maintaining FINRA Membership**

As noted by the Commission, FINRA members are subject to ongoing membership-related fees.<sup>43</sup> Such fees depend upon the nature and extent of a firm's business activities, the size of the firm (in both personnel and branch offices), and the revenue generated by the firm. FINRA's fee structure has a mix of annual and variable fees that balance the regulatory costs of those members driving the most activity. These annual assessments include the annual gross income assessment ("GIA") and the personnel assessment. Variable fees include the trading activity fee ("TAF") and fees associated with use of FINRA reporting facilities, including TRACE reporting fees. FINRA generally agrees with the Commission's description of the FINRA fees that apply when applying for FINRA membership as well as ongoing fees associated with FINRA membership.<sup>44</sup>

With respect to the TAF, FINRA notes that the TAF is a member regulatory fee that is based on trading activity and generally applies to all sales of a covered security

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<sup>41</sup> Factors that may impact this anticipated timeframe include certain characteristics of the applicant, including the complexity, novelty, and risks of the firm's business, products, and profile; whether associated persons at the firm are subject to statutory disqualification; whether the application is complete; and identification of regulatory gaps that the firm would need to address to come into compliance with FINRA rules. A request to process additional business activities, business lines, or products also may impact the anticipated timeframe for processing Non-Member Firm applications.

<sup>42</sup> *See, e.g.*, Re-Proposing Release at 49951.

<sup>43</sup> *See id.* at 49964-49967.

<sup>44</sup> *See id.* at 49964 (stating "[t]he ongoing membership-related fees associated with FINRA membership include the annual GIA; and the TAF and Section 3 fees, among others"). The Re-Proposing Release also states that "[t]here are additional fees associated with maintaining a FINRA membership. There are also additional continuing education and testing requirements, which will impose costs upon firms joining FINRA." *See id.* at n.305.

regardless of where executed.<sup>45</sup> 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 Exchange Act, PTFs do not act as floor brokers and may only be registered market makers in some, but not all, of the securities that they trade. As a result, if the Re-Proposal is adopted, those PTFs that become FINRA members would be subject to the TAF for much of their trading, including trades on exchanges of which they are a member. As the Commission noted in the Re-Proposing Release, in connection with the Original Proposal, FINRA previously issued a *Regulatory Notice* requesting comment on a proposal to amend the TAF to exempt transactions by a PTF that were effected on an exchange of which the PTF is a member.<sup>46</sup> The Commission further stated that FINRA may again evaluate its TAF to ensure that it appropriately reflects the activities of, and costs of supervising, PTFs that would be required to join FINRA.<sup>47</sup> FINRA intends to issue a *Regulatory Notice* requesting comment on a proposed exemption to the TAF for PTFs.

#### V. FINRA's Regulatory Resources and Governance Structure

FINRA is confident that its ability to perform its regulatory and supervisory functions would not be adversely affected by the addition of new PTF members under the Re-Proposal. FINRA already has extensive experience with PTF activities—both because some current FINRA members have large proprietary trading business lines today, and due to FINRA's work with exchange-only members under RSAs. Notably, FINRA already conducts examinations under the RSAs for all Non-Member Firms, including trading-related examinations for a significant majority of these firms.<sup>48</sup> Nevertheless, FINRA recognizes that the Re-Proposal may necessitate that FINRA augment its regulatory

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<sup>45</sup> See FINRA By-Laws, Schedule A, Section 1(b). "Covered securities" for purposes of the TAF include exchange-registered securities, OTC 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). Among other exclusions, transactions in Treasury securities are not subject to the TAF. See FINRA By-Laws, Schedule A, Section 1(b)(2).

<sup>46</sup> Re-Proposing Release at 49965; see also FINRA *Regulatory Notice* 15-13, Trading Activity Fee (TAF) (May 2015).

<sup>47</sup> See Re-Proposing Release at 49943.

<sup>48</sup> FINRA notes here its current examination efforts for Non-Member Firms to provide additional context concerning the Re-Proposal's anticipated impacts on FINRA resources. However, as discussed throughout this letter and in the Re-Proposal, RSAs are voluntary and do not provide the same level of stable and consistent oversight as direct membership.

resources to account for the addition of approximately 65 new members. FINRA is well-positioned to dedicate the required resources to effectively oversee these additional PTFs once they become FINRA members. FINRA would incorporate any membership changes that result from the Re-Proposal into its strategic planning and ensure that adequate resources are available.

FINRA believes that PTF members would be appropriately represented within its current governance framework. FINRA's existing governance structure has broad industry representation, including representatives from firms of different sizes and dedicated seats for Public Governors, a Floor Member Governor, an Independent Dealer/Insurance Affiliate Governor, and an Investment Company Affiliate Governor.<sup>49</sup> FINRA also has a number of advisory committees composed of representatives from a cross-section of member firm sizes and business models, including a Market Regulation Committee. As noted above, FINRA membership already includes firms with significant trading activities that are represented within its existing governance and engagement structure. If the Re-Proposal is adopted, FINRA would consider adjusting or adding representatives to one or more of the advisory committees, as necessary, to ensure an adequate opportunity to obtain feedback from these specialized firms.

## **VI. The Re-Proposal Would Not Transform FINRA Into a State Actor**

Courts—and the Commission itself—have repeatedly and consistently recognized that SROs, including FINRA, are not state actors and that their conduct therefore is not subject to the requirements of the U.S. Constitution and other provisions of federal law that apply only to governmental actors. The Commission's adoption of the Re-Proposal would not alter that settled understanding by transforming FINRA into a state actor. The arguments to the contrary advanced by one commenter to the Re-Proposing Release are fundamentally flawed.<sup>50</sup>

FINRA is a private, not-for-profit corporation that is registered with the SEC as a national securities association under the Maloney Act of 1938.<sup>51</sup> It was formed in 2007, when the National Association of Securities Dealers ("NASD") and the New York Stock Exchange consolidated their member-firm regulation and enforcement functions to form FINRA.<sup>52</sup> No government official serves as a FINRA employee, and the government does

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<sup>49</sup> See FINRA By-Laws, Article VII, Section 4(a).

<sup>50</sup> See Letter from W. Hardy Callcott to Vanessa Countryman, Secretary, Commission, dated September 3, 2022 ("Comment Letter").

<sup>51</sup> 15 U.S.C. § 78o-3, *et seq.*

<sup>52</sup> See Securities Exchange Act Release No. 56145 (July 26, 2007), 72 FR 42169 (August 1, 2007) (Order Approving File No. SR-NASD-2007-023).

not appoint any FINRA board members, officers, or employees.<sup>53</sup> FINRA does not receive any state or federal funding; it is funded by registration, membership, and transaction fees charged to its members.<sup>54</sup>

These features make clear that FINRA is not a state actor. The U.S. Supreme Court has explained that a nominally private corporation is “part of the Government” and subject to constitutional scrutiny if it was “create[d]” by the government “for the furtherance of government objectives” and the government “retains for itself the permanent authority to appoint a majority of the directors of that corporation.”<sup>55</sup> Applying that standard, the Court held that Amtrak—an entity created, controlled, and funded by the federal government—is a state actor.<sup>56</sup>

FINRA does not exhibit any of those features: it was not created by the government, its board is not appointed by the government, and it does not receive federal funding. FINRA is a private entity that the federal government did not create and does not control or fund. For that reason, federal courts have repeatedly and consistently held that FINRA, its predecessor NASD, and other SROs are *not* state actors.<sup>57</sup> The Commission

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<sup>53</sup> See FINRA Board of Governors, *available at* <https://www.finra.org/about/governance/finra-board-governors> (last visited Sept. 20, 2022).

<sup>54</sup> 2021 FINRA Annual Financial Report at 1, *available at* <https://www.finra.org/sites/default/files/2022-06/2021-FINRA-Financial-Annual-Report.pdf> (last visited Sept. 20, 2022); *see also* FINRA By-Laws Schedule A, *available at* <https://www.finra.org/rules-guidance/rulebooks/corporate-organization/schedule-laws-corporation> (last visited Sept. 20, 2022).

<sup>55</sup> *Lebron v. Nat’l R.R. Passenger Corp.*, 513 U.S. 374, 399 (1995).

<sup>56</sup> *Id.*; *see also Dep’t of Transp. v. Ass’n of Am. R.Rs.*, 575 U.S. 43, 55 (2015) (holding that Amtrak is a state actor because the “political branches created Amtrak, control its Board, define its mission, specify many of its day-to-day operations, have imposed substantial transparency and accountability mechanisms, and, for all practical purposes, set and supervise its annual budget”).

<sup>57</sup> *Mohlman v. Fin. Indus. Regulatory Auth., Inc.*, No. 3:19-CV-154, 2020 WL 905269, at \*6 (S.D. Ohio Feb. 25, 2020) (“Courts have held without exception that FINRA is a private entity and not a state actor.”) (collecting cases), *aff’d sub nom. Mohlman v. Fin. Indus. Regulatory Auth.*, 977 F.3d 556 (6th Cir. 2020); *see also, e.g., D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 162 (2d Cir. 2002); *Desiderio v. NASD, Inc.*, 191 F.3d 198, 206-07 (2d Cir. 1999); *Duffield v. Robertson Stephens & Co.*, 144 F.3d 1182, 1200-02 (9th Cir. 1998), *overruled on other grounds by EEOC v. Luce, Forward, Hamilton & Scripps*, 345 F.3d 742 (9th



itself has been equally clear in its position that FINRA and other SROs are not state actors.<sup>58</sup> As the Commission recently explained, deeming SROs to be state actors “would thwart Congress’s repeated determination to retain the system of private self-regulation and ‘the flexibility and informality of SRO decision-making procedures.’”<sup>59</sup>

In the face of this overwhelming body of authority, the commenter<sup>60</sup> to the Re-Proposing Release asserts that the Supreme Court’s decision in *Free Enterprise Fund v. Public Company Accounting Oversight Board*<sup>61</sup> “compels the conclusion that FINRA, at least as to the brokers-dealers that will be required by the proposed rule to join FINRA, is a ‘part of the Government.’”<sup>62</sup> The Supreme Court drew a clear distinction, however, between the Public Company Accounting Oversight Board (“PCAOB”), the governmental entity at issue in *Free Enterprise Fund*, and SROs when deeming the PCAOB—but not SROs—to be “‘part of the Government.’”<sup>63</sup>

As the commenter<sup>64</sup> to the Re-Proposing Release recounts, the Court in *Free Enterprise Fund* explained that the PCAOB “‘was modeled on private self-regulatory organizations in the securities industry—such as the New York Stock Exchange—that investigate and discipline their own members subject to Commission oversight.’”<sup>65</sup> But the

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Cir. 2003); *Jones v. SEC*, 115 F.3d 1173, 1183 (4th Cir. 1997); *First Jersey Secs., Inc. v. Bergen*, 605 F.2d 690, 698 (3d Cir. 1979).

<sup>58</sup> See, e.g., Charles C. Fawcett, IV, Securities Exchange Act Release No. 56770, 91 S.E.C. Docket 2594 (Nov. 8, 2007) (concluding that NASD was not a state actor); Securities Exchange Act Release No. 92590 (August 6, 2021), 86 FR 44424 at 44440 (August 12, 2021) (Order Approving File No. SR-NASDAQ-2020-082) (concluding that The Nasdaq Stock Market is not a state actor).

<sup>59</sup> Br. of the Securities and Exchange Commission at 41, *Alliance for Fair Bd. Recruitment v. SEC*, No. 21-60626 (5th Cir. Apr. 7, 2022) (quoting S. Rep. No. 94-75 at 29) (alteration omitted).

<sup>60</sup> See *supra* note 50.

<sup>61</sup> 561 U.S. 477 (2010).

<sup>62</sup> See *supra* note 50 at 1 (quoting *Free Enter. Fund*, 561 U.S. at 486).

<sup>63</sup> *Free Enter. Fund*, 561 U.S. at 486 (quoting *Lebron*, 513 U.S. at 397).

<sup>64</sup> See *supra* note 50.

<sup>65</sup> See *id.* at 1 (quoting *Free Enter. Fund*, 561 U.S. at 484).

commenter<sup>66</sup> to the Re-Proposing Release fails to mention that the Court then went on to draw a sharp distinction between the PCAOB and SROs.

In particular, the Court emphasized that, “[u]nlike the self-regulatory organizations, however, the Board is a Government-created, Government-appointed entity, with expansive powers to govern an entire industry.”<sup>67</sup> As the Court explained, Congress created the PCAOB in the Sarbanes-Oxley Act of 2002, which provides that the “Board is composed of five members, appointed to staggered 5-year terms by the Securities and Exchange Commission.”<sup>68</sup> It was those features—government creation and government control—that led “the parties [to] agree” in *Free Enterprise Fund* (and the Court to express no disagreement) that the PCAOB “‘is part of the Government’ for constitutional purposes and that its members are ‘Officers of the United States’ who ‘exercise significant authority pursuant to the laws of the United States.’”<sup>69</sup> As the Court recognized, FINRA and other SROs lack those features: they are neither government-created nor government-controlled. *Free Enterprise Fund* therefore reaffirms the well-settled proposition that SROs are private actors, not “part of the Government.”<sup>70</sup>

FINRA’s status as a private, nongovernmental entity is not altered by its “expansive powers to regulate” the broker-dealer industry.<sup>71</sup> The conduct of a private entity may be considered state action where it performs a public function by “exercis[ing] powers that are traditionally the exclusive prerogative of the State.”<sup>72</sup> To “qualify as a traditional, exclusive public function within the meaning of the [Supreme Court’s] state-action

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<sup>66</sup> See *supra* note 50.

<sup>67</sup> *Free Enter. Fund*, 561 U.S. at 485 (emphasis added).

<sup>68</sup> *Id.* at 484.

<sup>69</sup> *Id.* at 486 (quoting *Lebron*, 513 U.S. at 397, and *Buckley v. Valeo*, 424 U.S. 1, 125-26 (1976) (per curiam)) (alteration and citations omitted).

<sup>70</sup> The Supreme Court’s view that SROs are not state actors is further evidenced by the Court’s omission of SROs from its discussion in *Lebron* of “the long history of corporations created and participated in by the United States for the achievement of governmental objectives.” 513 U.S. at 386; see also *id.* at 386-391 (discussing the Bank of the United States, the Panama Railroad Company, the United States Grain Corporation, the Reconstruction Finance Corporation, and the Tennessee Valley Authority, among numerous other examples).

<sup>71</sup> See *supra* note 50 at 1.

<sup>72</sup> *Blum v. Yaretsky*, 457 U.S. 991, 1005 (1982) (internal quotation marks omitted).

precedents, the government must have traditionally *and* exclusively performed the function.”<sup>73</sup>

The regulation of the securities industry historically has been a private function undertaken by exchanges and securities associations, not the government.<sup>74</sup> Indeed, until the 1930s, the federal government had no role at all in regulating exchanges or their members.<sup>75</sup> Congress left that then-century-and-a-half-old model of self-regulation in place when it enacted the Securities Exchange Act and the Maloney Act, which preserved the role of exchanges and securities associations as the front-line regulators for the securities industry, subject to oversight by the Commission.<sup>76</sup>

Because regulation of the securities industry is not a “power[ ] traditionally exclusively reserved to the State,”<sup>77</sup> FINRA’s regulation of broker-dealers is not one of the “very few” functions that fall into the category of “traditional, exclusive public

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<sup>73</sup> *Manhattan Cmty. Access Corp. v. Halleck*, 139 S. Ct. 1921, 1929 (2019); *see also* *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149, 158 (1978) (“While many functions have been traditionally performed by governments, very few have been ‘exclusively reserved to the State.’”).

<sup>74</sup> *See* Securities Exchange Act Release No. 50700, 69 FR 71256 (December 8, 2004) (“Concept Release Regarding Self-Regulation”) (“Securities industry self-regulation has a long tradition in the U.S. securities markets.”).

<sup>75</sup> *See* S. Rep. No. 73-1455, at 77 (1934) (Before the Exchange Act’s adoption in 1934, the exchanges were “subject to regulation by no governmental authority and . . . exercised unrestricted dominion over the activities of their members”).

<sup>76</sup> *See* Concept Release Regarding Self-Regulation, *supra* note 74 at 71257 (“Congress concluded that self-regulation . . . was a mutually beneficial balance between government and securities industry interests” because it allows for “supervis[ion] by an organization familiar with the nuances of securities industry operations” and “less invasive regulation,” while also allowing the government to “benefit[ ] by being able to leverage its resources through its oversight of self-regulatory organizations”). The Commission’s oversight of FINRA is not sufficient to transform it into a state actor. As the Supreme Court has repeatedly made clear, “being regulated by the State does not make one a state actor” because “the ‘being heavily regulated makes you a state actor’ theory of state action is entirely circular and would significantly endanger individual liberty and private enterprise.” *Halleck*, 139 S. Ct. at 1932; *see also* *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 350 (1974) (even where “many particulars” of a private company’s business are “subject to extensive state regulation,” it does not become a government entity).

<sup>77</sup> *Jackson*, 419 U.S. at 352.

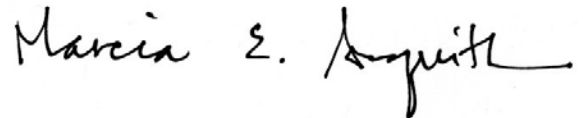
function[s].”<sup>78</sup> Accordingly, the actions that FINRA takes in furtherance of its self-regulatory responsibilities are private conduct, not governmental action.

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FINRA appreciates the opportunity to provide comments on the Re-Proposal. As discussed above, FINRA supports the re-proposed amendments to Rule 15b9-1 and believes that the Re-Proposal would enhance surveillance, oversight, and regulation across the U.S. equity, options, and fixed income markets, and would thereby improve market integrity and investor protection. FINRA stands ready, willing, and able to work with the Commission and impacted Non-Member Firms to ensure that, if the Re-Proposal is adopted, the membership process for PTFs that seek to become FINRA members is as efficient and effective as possible.

If you have any questions or would like to further discuss FINRA’s views and comments, please contact Racquel Russell, Senior Vice President and Director of Capital Markets Policy, Office of General Counsel, FINRA, at [REDACTED] or [REDACTED].

Sincerely,



Marcia E. Asquith  
Corporate Secretary, EVP  
Board and External Relations

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<sup>78</sup> *Halleck*, 139 S. Ct. at 1929 (internal quotation marks omitted).