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FINANCIAL MARKETS AND FUNDS ADVISORY

Broker-Dealer Proprietary Trading Groups: FINRA May Be In Your Future

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Almost all proprietary trading firms that are currently registered as broker-dealers with the Securities and Exchange Commission (SEC) would likely be required to join the Financial Industry Regulatory Authority (FINRA) under rule amendments proposed by the SEC on July 29, 2022.

Specifically, the proposed Rule would eliminate the *de minimis* allowance and the proprietary trading exclusion (both as defined below) that currently exempt certain broker-dealers from FINRA registration. The proposed amendments would require a broker-dealer to join FINRA if it effects securities transactions other than on an exchange where it is a member, unless it can rely upon one of the amended rule's narrow exemptions.

The proposed rule amendments are materially similar to amendments to SEC Rule 15b9-1 (the Rule) originally proposed by the SEC in March 2015.

Under the proposed amendments, an SEC-registered broker-dealer would be required to become a member of a national securities association (i.e., FINRA)[1] if it effects securities transactions other than on an exchange of which it is a member such as the off-exchange market,[2] unless:

- it is a member of a national securities exchange;
- it carries no customer accounts; and
- such transactions (i) result solely from orders that are routed by a national securities exchange of which the broker-dealer is a member to comply with Rule 611 of Regulation NMS or the Options Order Protection and Locked/Crossed Market Plan; or (ii) are solely for the purpose of executing the stock leg of a stock-option order.

The reason many proprietary trading firms may be subject to this rule and required to become a member of FINRA, if implemented, is that the SEC dramatically narrowed the exemptions applicable to off-exchange trading. Most such broker-dealers effect transactions on more than the national securities exchanges where they are members, particularly since ATSs and other executing broker-dealers are included in the definition of "off exchange." Further, the specified transaction exemptions are particularly limited and would likely not factor into the totality of proprietary broker-dealer trades.

The public comment period to the proposal will remain open until September 27, 2022 (which is 60 days after issuance) or 30 days after publication in the *Federal Register*, whichever period is longer.

[1] FINRA is currently the only national securities association.

[2] In this context, an "off-exchange" transaction includes any securities transaction that is covered by Section 15(b)(8) of the Securities Exchange Act of 1934, as amended (the Exchange Act) that is not effected, directly or indirectly, on a national securities exchange. Off-exchange trading includes securities transactions that occur through alternative trading systems (ATSs) or with another broker-dealer that is not a registered ATS.

The Current Rule

Under Section 15(b)(8) of the Exchange Act, an SEC-registered broker-dealer may not transact in securities unless the firm is a member of a registered national securities association (i.e., FINRA) or effects transactions in securities solely on a national securities exchange of which it is a member. The Rule allows an SEC registered broker-dealer to avoid becoming a FINRA member if it:

a) is a member of an exchange;

b) carries no customer accounts; and

c) 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").

Income derived with or through another registered broker-dealer does not count towards the *de minimis* allowance (the "proprietary trading exclusion"). As a result, a proprietary trading firm that meets the conditions above may engage in unlimited proprietary trading off-exchange without having to become a member of FINRA.

The SEC's Rationale for the Amendments

According to the SEC, the presumption of the prior *de minimis* allowance and the proprietary trading exclusion was that FINRA membership should not be required where a broker-dealer engaged in limited trading activities elsewhere than its member exchange, that were ancillary to its trading business on its members exchange. However, the SEC explained that since the Rule was adopted in 1965 and the proprietary trading exclusion was approved in 1976, the securities markets have transformed to the point where certain broker-dealer firms, in reliance on the Rule, are able to engage in substantial proprietary trading activity elsewhere than exchange(s) on which they are members without becoming FINRA members.

According to the SEC, as of April 2022, there were an estimated 65 firms that were SEC-registered broker-dealers and exchange members but not FINRA members. Of the 65 identified firms, 21 were single exchange members; 10 were members of two exchanges; 13 were members of more than two but 10 or fewer exchanges; and the remaining 21 firms were members of more than 10 exchanges but not FINRA.

The SEC noted that a large majority of the above-identified firms engage in cross-market and off-exchange proprietary securities trading, which account for a substantial portion of off-exchange securities trading and initiate a significant number of securities transactions on exchanges other than on an exchange of which they are a member. For example, of the estimated 65 firms, 43 firms executed approximately $441 billion in off-exchange listed equities in April 2022, which accounted for approximately 4.6 percent of total off-exchange volume of listed equities executed.

The SEC also found that with respect to US Treasury securities trading, approximately three of the above 65 broker-dealers accounted for over $700 billion in US Treasury securities volume executed on covered ATSs that was reported to the Trade Reporting and Compliance Engine (TRACE), which accounted for approximately 2.5 percent of total TRACE-reported US Treasury securities volume traded in April 2022.

As such, the SEC concluded that the presumption behind the Rule and the proprietary trading exclusion is no longer appropriate. While broker-dealers currently exempt from FINRA membership are subject to the rules of the exchange to which they belong, the SEC argued that requiring FINRA membership will result in more consistent regulation of such trading.

If the proposed Rule amendments are adopted, many of the above-identified firms would be required to join FINRA unless they meet the amendments' narrow exceptions, as described in further detail below.

The Proposed Revisions to Rule 15b9-1

Routing Exemption

The proposed amendments provide an exemption from FINRA registration for a broker-dealer that effects securities transactions elsewhere than on an exchange of which it is a member as a consequence of routing by its exchange to comply with the requirements of Rule 611 of Regulation NMS ("Rule 611").[3] According to the SEC, the routing exemption is tailored to facilitate compliance with intermarket order protection requirements.

In addition, under the proposed amendments, the routing exemption also will extend to orders routed to comply with the Options Order Protection and Locked/Crossed Market Plan.[4] The Options Order Protection and Locked/Crossed Market Plan is a national market system plan that requires linkages between the options exchanges to protect the best-priced displayed quotes in the market and to avoid locked and crossed markets. A locked or crossed market occurs when a trading center displays an order to buy at a price equal to or higher than an order to sell, or an order to sell at a price equal to or lower than an order to buy, that is displayed on another trading center.

Stock-Option Order Exemption

The SEC also will allow a limited exemption from FINRA registration for a broker-dealer effects securities transactions with or through another broker-dealer that is a member of FINRA solely to execute the stock leg of a stock-option order (the Stock Option Order Exemption). Firms that choose to rely on the Stock Option Order Exemption must maintain appropriate records, including the requirement that the firms maintain and enforce written policies and procedures to ensure that the transactions are conducted solely to execute the stock leg of a stock options order.

[3] Rule 611 protects automated quotations that are the best bid or offer of a national securities exchange or FINRA. FINRA operates the Alternative Display Facility (ADF) for NMS stocks, which posts quotes and reports trades governed by FINRA's trade reporting rules.

[4] The Options Order Protection and Locked/Crossed Market Plan also is referred to as the Options Linkage Plan.

Comparison Chart

The below chart compares similarities and differences between the current Rule, the amendments proposed in 2015, and the re-proposed amendments:

Any broker or dealer required by Section 15(b)(8) of the Exchange Act to become a member of a registered national securities association (i.e., any SEC-registered broker-dealer that effects transactions in, or attempts to induce the purchase or sale of, securities other than on an exchange of which such firm is a member) shall be exempt from such requirement if it:

Current Rule 15b9-1	2015 Proposal	2022 Re-Proposal
Is a member of a national securities exchange;	Is a member of a national securities exchange;	Is a member of a national securities exchange;
Carries no customer accounts; and	Carries no customer accounts; and	Carries no customer accounts; and
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, except that: • Such gross income limitation does 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.[5]	Effects transactions in a securities solely on a national securities exchange of which it is a member, except that: • 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 Rule 611 of Regulation NMS. • No Stock Option Order Exemption • 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 (the Floor Member Hedging Exception).	Effects transactions in a securities solely on a national securities exchange of which it is a member, except that: • A broker or dealer may effect transactions in securities otherwise than on a national securities exchange of which the broker or dealer is a member to comply with Rule 611 of Regulation NMS or ***the Options Order Protection and Locked/ Crossed Market Plan***. • A broker or dealer may effect transactions off the exchange resulting from orders that are solely for the purpose of executing the stock leg of a stock-option order. • No Floor Member Hedging Exception

Takeaways

The SEC's re-proposed amendments to the Rule, if adopted, would remove the *de minimis* allowance and the proprietary trading exclusion, and would ultimately require proprietary trading firms registered with the SEC as broker-dealers to become FINRA members unless they meet one of the proposed amendments' narrow exceptions.

[5] The Intermarket Trading System was a national market system plan that was eliminated in 2007 and replaced by Regulation NMS.

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