ALERT

SEC Expands FINRA Oversight of Proprietary Trading Firms

September 6, 2023

SCHULTE ROTH + ZABEL

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On Aug. 23, 2023, the US Securities and Exchange Commission ("Commission") adopted amendments[1] ("Amendments") to the Securities Exchange Act of 1934 ("Exchange Act") to require certain SEC-registered dealers that were previously exempt from national securities association[2] membership to register with the Financial Industry Regulatory Authority ("FINRA").

Background and Current Regulatory Framework

Section 15(b)(8) of the Exchange Act requires SEC-registered broker-dealers to become FINRA members, unless the broker-dealer effects transactions in securities solely on an exchange of which it is a member.[3] Currently, Exchange Act Rule 15b9-1 exempts any dealer that transacts on exchanges of which it is not a member or in the off-exchange market from the FINRA membership requirement if such dealer:

1. Is a member of a national securities exchange,
2. Carries no customer accounts, and
3. Primarily earns off-member exchange income from transactions for the dealer's own account with or through another registered broker-dealer or through an Intermarket Trading System.[4]

While broker-dealers relying on current Exchange Act Rule 15b9-1 are required to limit the annual gross income they derive from securities transactions otherwise than on a national securities exchange of which they are a member to an amount no greater than $1,000, income derived from transactions for the dealer's own account with or through another registered broker or dealer do not count towards this limitation.[5]

Due to the above exclusion of transactions for a dealer's own account from the de minimis exception, Exchange Act Rule 15c9-1 is currently utilized by dozens of proprietary trading firms to reduce operational costs.

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[1] *See* Exchange Act Release 34-98202.

[2] The Financial Industry Regulatory Authority Inc. ("FINRA") is currently the only registered national securities association.

[3] *See* 15 U.S.C. § 78o(b)(8).

[4] *See* 17 CFR § 240.15b9-1.

[5] Nor, as noted above, do transactions effected through an "Intermarket Trading System," which is currently defined under Exchange Act Rule 15b9-1 as "the intermarket communications linkage operated jointly by certain self-regulatory organizations pursuant to a plan filed with, and approved by, the Commission pursuant to § 242.608…" The Amendments are eliminating references to the Intermarket Trading System as this plan has been obsolete since 2007.

Amendments to Exchange Act Rule 15b9-1

Once effective, Exchange Act Rule 15b9-1 will only apply where a broker or dealer is a member of a national securities exchange, carries no customer accounts, *and effects transactions solely on the national securities exchanges of which it is a member*, unless one of two narrow exceptions applies.

The first exemption applies to off-member-exchange securities transactions that result solely from orders that are routed by a national securities exchange of which such dealer is a member to comply with order protection regulatory requirements.[6]

The second exemption applies to off-member-exchange securities transactions that are solely for the purpose of executing the stock leg of a stock-option order. Broker-dealers relying on the second exemption will, under the amended rule, be required to establish written policies and procedures "reasonably designed to ensure and demonstrate that such transactions are solely for the purpose of executing the stock leg of a stock-option order."[7] The Adopting Release notes that the SEC anticipates self-regulatory organizations will look to these procedures and related documentation in assessing firms' compliance with this exemption.[8]

The Amendments will become effective 60 days after the date of publication in the Federal Register and the compliance date (that is, the time by which impacted firms will need to become registered with FINRA) will be one-year after the date of publication in the Federal Register.

Conclusion

By eliminating the general exclusion of transactions for a dealer's own account from Amended Exchange Act Rule 15b9-1, dozens of proprietary trading firms that regularly effect transactions through single-dealer platforms, in third-party alternative trading systems or just in over-the-counter dealer transactions that are currently not registered with FINRA, will either need to curtail their proprietary trading activities or become a FINRA member.

As a result of the adoption of the Amendments, FINRA is expected to quickly implement previously proposed amendments to its Transaction Activity Fee ("TAF") to exclude from the calculation of a firm's TAF assessment transactions by FINRA-member propriety trading firms that are executed on exchanges of which they are members.[9] FINRA-member firms that currently operate on-exchange proprietary trading strategies should evaluate separating those strategies into a newly-formed FINRA-member that exclusively engages in propriety trading activities to take advantage of FINRA's proposed TAF fee exclusions.

Additionally, Private Funds that are currently assessing the potential impact of the SEC's proposal to redefine the definition of 'Dealer' to cover certain private funds and advisors (see Schulte *Alert* here) should incorporate the elimination of most of the benefits of the Exchange Act Rule 15b9-1 exclusion from FINRA membership into their transition planning.

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[6] That is, to comply with the requirements of Exchange Act rule 611 or the Options Order Protection and Locked/Crossed Market Plan.

[7] *See* Adopting Release at p. 66.

[8] *Id*.

[9] https://www.finra.org/sites/default/files/2023-06/NOF-IMM-EFF-FINRA-2023-009.pdf

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