The SEC Proposes FINRA Regulation for High-Frequency Traders

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Executive Summary

The Securities and Exchange Commission (the "SEC") recently proposed an amendment to Rule 15b9-1 under the Securities Exchange Act of 1934 (the "Exchange Act"). The proposed amendment (the "Proposed Amendment") would require many high-frequency traders ("HFTs")[1] to become members of the Financial Industry Regulatory Authority ("FINRA").[2]

Background and Discussion

Exchange Act Section 15(b)(8) requires each SEC-registered broker or dealer, other than a broker or dealer that effects securities transactions on a national securities exchange of which it is a member,[3] to be a member of a registered national securities association (an "Association"). The SEC views Association membership as the primary means of regulating broker-dealer trading in the off-exchange market.[4] At the present time, FINRA is the only Association in existence. Accordingly, FINRA is primarily responsible for regulating trading in the off-exchange market.[5]

Current Rule 15b9-1 provides an exception from the 15(b)(8) requirement of Association membership for a broker or dealer that: (i) is a member of a national securities exchange, (ii) carries no customer accounts, and (iii) has annual gross income of no more than $1,000 that is derived from securities transactions that were not effected on a national securities exchange of which the broker or dealer is a member (the "*de minimis* allowance"). Significantly, Rule 15b9-1 does not count any income derived from transactions for the dealer's own account that are executed with or through another SEC-registered broker-dealer (*i.e.*, not with a customer) toward a dealer's $1,000 *de minimis* allowance (the "exclusion for proprietary trading").

The exception was originally intended to accommodate exchange specialists and other floor members that might need to conduct limited hedging or other off-exchange activities ancillary to their floor-based business. However, the equities markets have undergone a substantial transformation since the SEC adopted Rule 15b9-1, evolving from markets with both manual and automated features and trading volumes concentrated on the primary listing exchanges, to a highly electronic, decentralized market with substantial competition among a large number and great variety of trading venues.

[1] HFTs are proprietary trading firms that engage in high-frequency trading strategies. According to the proposing release, "[t]hese firms tend to effect transactions across the full range of exchange and off-exchange markets, including alternative trading systems ("ATSs"). They also tend to use complex electronic trading strategies and sophisticated technology to generate a large volume of orders and transactions throughout the national market system." Exchange Act Release No. 34-74581 (the "Proposing Release") at page 9.

[2] The Proposed Amendment appears to be a part of a larger regulatory focus on HFTs, as FINRA, in March 2015, released guidance on supervision and control practices for broker-dealers engaged in certain "high frequency trading strategies." See https://www.skadden.com/sites/default/files/publications/FINRA_Provides_Guidance_on_Effective_Supervision_and_Control_Practices_for_Firms_Engaging_in_Algorithmic_Trading_Strategies.pdf.

[3] Brokers and dealers that conduct transactions solely on an exchange of which they are a member already are regulated by that exchange.

[4] "Off-exchange" activity, in this context, refers to securities transactions that occur on ATSs and directly with a broker-dealer, acting either as agent or principal (*i.e.*, over-the-counter ("OTC") trading). The term "off-exchange activity," in this context, does not refer to transactions in securities that are not listed on a national securities exchange.

[5] In this regard, FINRA has developed a transparency and regulatory regime for the off-exchange market. Specifically, FINRA: (i) requires that all off-exchange trades are reported to it via its trade reporting facilities ("TRFs"), (ii) maintains a regulatory audit trail ("OATS"), which provides regulatory data on orders, quotes, routes, cancellations and executions, (iii) maintains surveillance technology and specialized regulatory personnel to provide surveillance, supervision and enforcement of activity occurring off-exchange, and (iv) maintains a detailed set of member conduct rules, which apply to all activities of a member firm, regardless of whether the activities are on- or off-exchange.

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Under the current rules, a proprietary trading firm that is a member of a national securities exchange and carries no customer accounts may engage in unlimited off-exchange proprietary trading without triggering an obligation to be a member of an Association. Many HFTs have been relying upon Rule 15b9-1 in this way.

In 2010, the SEC issued a concept release that, among other things, solicited comment on whether all proprietary trading firms should be required to register as broker-dealers and become members of FINRA to help assure that their operations were subject to full regulatory oversight.[6] After considering comments in response to the Concept Release, the SEC is proposing the Proposed Amendment. The SEC believes that HFTs are responsible for a substantial volume of orders and transactions in the off-exchange market[7] and, accordingly, views HFTs' reliance on Rule 15b9-1 as a "regulatory gap" that has in recent years permitted considerable off-exchange activity to go unregulated. The Proposed Amendment seeks to close that "gap." Specifically, the Proposed Amendment would eliminate the *de minimis* allowance and the proprietary trading exception. It would replace them with a limited exemption from Association membership for national securities exchange member broker-dealers that operate on the floor of the exchange, to the extent that they effect transactions off-exchange solely for the purpose of hedging the risks of their floor-based activities. A dealer seeking to rely on the exception created for hedging must establish, maintain and enforce written policies and procedures reasonably designed to ensure and demonstrate that such hedging transactions reduce or otherwise mitigate the risks of the financial exposure the dealer incurs as a result of its floor-based activity.

Additionally, the Proposed Amendment would exempt a broker-dealer executing orders that are routed by a national securities exchange of which it is a member to prevent trade-throughs[8] on such national security exchange consistent with the provisions of Regulation NMS.

The SEC believes the Proposed Amendment will enhance oversight of cross-market trading activity, which will allow FINRA to detect abusive trading practices more effectively. The practical result of the Proposed Amendment would be to require that: (i) each HFT that conducts off-exchange activity outside of the scope of Rule 15b9-1, as it is proposed to be amended, become a FINRA member and (ii) each HFT that does not trade off-exchange, but does trade indirectly on multiple exchanges, become a FINRA member or become a member of each exchange on which it effects transactions other than transactions to hedge the risks of its floor-based activities.

FINRA membership would impose upon HFTs a variety of new obligations and associated costs. The Proposed Amendment contemplates that HFTs would be required to become FINRA members no later than 360 days following publication of the final rule in the Federal Register. Comments to the Proposed Amendment should be received on or before June 1, 2015.

[6] See "Concept Release Concerning Equity Market Structure, Exchange Act Release No. 61358" (January 14, 2010), 75 FR 3594, 3594-3596 (January 21, 2010) ("Concept Release").

[7] In support of the Proposed Amendment, the SEC cited the following fact: During 2014, broker-dealers that are not members of an Association accounted for nearly half of 230 billion orders that were sent directly to ATSs. See Proposing Release at note 21.

[8] "Trade-throughs" under Regulation NMS are defined in 17 CFR 242.600(b)(77) as the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer.