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SEC Proposes Broadening Of Broker-Dealer Registration Rules To Include Proprietary And High-Frequency Traders

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On March 25, 2015, the SEC proposed rule amendments to require high-frequency and off-exchange traders to become members of FINRA. The amendments would increase regulatory oversight over these traders.

Over the years many active cross-market proprietary trading firms have emerged, many of which engage in high-frequency trading. These firms generally rely on the broad proprietary trading exemption in rule 15b9-1 to forgo membership with, and therefore regulatory oversight by, FINRA. The rule change is specifically designed to require these high-frequency traders to become members of FINRA and submit to its review and oversight.

The proposed rule change amends Rule 15b9-1 of the Securities Exchange Act of 1934, as amended ("Exchange Act") to narrow a current exemption from FINRA membership if the broker is a member of a national securities exchange, carries no customer accounts and has annual gross income of no more than $1,000 derived from sources other than the exchange to which they are a member. Currently, income derived from proprietary trading through another broker-dealer does not count against the $1,000 limit.

Historically trading was dominated by floor-based stock exchanges and was relatively easy to monitor. Technological advances are such that much of today's trading occurs via computer algorithms and cross-market proprietary trading. As an article by Sheppard Mullin pointed out, "[T]he SEC and other market regulators have grown increasingly concerned that flawed algorithms or other technological glitches could wreak havoc in the markets or that designers could develop an algorithm that would

intentionally manipulate the market or create unfair advantages for its user." The proposed rule amendment is a prophylactic measure by increasing regulatory oversight of the traders, but does not directly regulate the trading activity itself.

The proposed rules leave in place an exemption to cover off-exchange transactions by a floor-based dealer that is solely for the purpose of hedging the risks of its floor-based activities, which the SEC states was the original purpose of the amendment. Over time, high-frequency, off-exchange traders have capitalized on the use of the amendment, creating what the SEC views as a loophole in trading regulatory oversight.

Under the proposed amendment, a broker-dealer would be exempt from FINRA membership if the broker is a member of a national securities exchange, carries no customer accounts and has annual gross income of no more than $1,000 derived from sources other than the exchange to which they are a member, subject to the following exceptions (as quoted from the SEC news release on the rule change):

(i) A dealer that conducts business on the floor of a national securities exchange could effect transactions off the exchange, for the dealer's own account with or through another registered broker-dealer, that are solely for the purpose of hedging the risks of its floor-based activities;

(ii) A dealer seeking to rely on this exception 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;

(iii) A dealer must preserve a copy of its policies and procedures for three years after the date the policies and procedures are replaced with updated policies and procedures; and

(iv) A broker-dealer could effect transactions off the exchange that result from orders that are routed by the national securities exchange of which it is a member, to prevent trade-throughs on that national securities exchange consistent with the provisions of Rule 611 Regulation NMS.

The SEC opened a 60-day comment period related to the proposed rule.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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