

## Trading Activity Fee (TAF)

### FINRA Requests Comment on Proposed Exemption to the Trading Activity Fee for Proprietary Trading Firms

Comment Period Expires: June 19, 2015

#### Executive Summary

On March 25, 2015, the Securities and Exchange Commission (SEC) proposed amendments to Rule 15b9-1 under the Securities Exchange Act of 1934 (SEA or Exchange Act), which currently provides many proprietary trading firms with an exemption from membership in a national securities association.<sup>1</sup> If adopted, the amendments generally would require a proprietary trading firm relying on the current exemption to register with FINRA if the firm continues to engage in over-the-counter trading or trading on an exchange of which it is not a member. FINRA membership would, among other things, subject these firms to the existing FINRA fee structure, including the TAF. This *Notice* requests comment on a proposed exemption to exclude from the TAF transactions by a proprietary trading firm on exchanges of which the firm is a member. The proposed rule text is attached as Attachment A.

Questions concerning this *Notice* should be directed to:

- ▶ Shelly Bohlin, Vice President, Market Regulation, at (240) 386-5029;
- ▶ Carrie DiValerio, Vice President, Finance, at (240) 386-5299; or
- ▶ Brant Brown, Associate General Counsel, Office of General Counsel, at (202) 728-6927.

May 2015

#### Notice Type

- ▶ Request for Comment

#### Suggested Routing

- ▶ Compliance
- ▶ Institutional
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Trading

#### Key Topics

- ▶ Proprietary Trading Firms
- ▶ Trading Activity Fee

#### Referenced Rules & Notices

- ▶ Schedule A to FINRA By-Laws, Section 1
- ▶ SEA Rule 15b9-1

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by June 19, 2015. Comments must be submitted through one of the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.<sup>2</sup> Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Exchange Act.<sup>3</sup>

## Background & Discussion

Section 15(b)(8) of the Exchange Act requires that a registered broker-dealer be a member of a national securities association unless the broker-dealer effects transactions in securities solely on a national securities exchange of which it is a member.<sup>4</sup> SEA Rule 15b9-1, however, 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.

On March 25, 2015, the SEC unanimously approved proposing amendments to SEA Rule 15b9-1 that would significantly narrow the exemption from association membership.<sup>5</sup> If adopted, the amendments generally would require a proprietary trading firm relying on the current exemption to register with FINRA if the firm continues to engage in over-the-counter trading or trading on an exchange of which it is not a member. FINRA membership would, among other things, subject these firms to the existing FINRA fee structure.

As a general matter, FINRA has four primary Member Regulatory Fees: the Gross Income Assessment (GIA), the Personnel Assessment (PA), the TAF and the Branch Office Assessment.<sup>6</sup> The revenue from these four fees is used to recover the costs to FINRA of the supervision and regulation of members, including examinations; surveillance; financial monitoring; and FINRA's policymaking, rulemaking and enforcement activities.

The TAF is the one member regulatory fee that is based on trading activity and generally applies to all sales of a covered security regardless of where executed.<sup>7</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, proprietary trading firms do not act as floor brokers and may only be registered market makers in some, but not all, the securities that they trade.<sup>8</sup> As a result, if the proposed amendments to SEA Rule 15b9-1 are adopted by the SEC, those proprietary trading firms that would become FINRA members would be subject to the TAF for much of their trading, including trades on exchanges of which they are a member.

FINRA analyzed the potential application and impact of the TAF to proprietary trading firms and believes it could result in a significant TAF obligation for these firms that may be disproportionate to FINRA's anticipated costs associated with the financial monitoring and trading surveillance of these firms, in large part because these firms do not have customers.<sup>9</sup> For example, FINRA reviews for best execution (Rule 5310), trading ahead of customer orders (Rule 5320) and display of customer limit orders (SEA Rule 604) are directed at firms that have customers or receive orders from customers of another broker-dealer. For this reason, the SEC noted specifically when proposing the amendments to SEA Rule 15b9-1 that "FINRA may need to consider reassessing the structure of its fees, including its Trading Activity Fee, in order to assure that it is fairly and equitably applied to many of the [non-FINRA member firms] that, as a result of the amendments to [SEA] Rule 15b9-1, may join FINRA."<sup>10</sup>

Given these factors and the current TAF exemptions, FINRA is requesting comment on a proposed exemption to the TAF to address the application of the TAF to proprietary trading firms. The proposed exemption would exempt from the TAF transactions executed by proprietary trading firms on an exchange of which the firm is a member (including non-market maker trades). FINRA is proposing to define a "proprietary trading firm" as a member that trades its own capital and that does not have "customers," as that term is defined in FINRA Rule 0160(b)(4). The proposed exemption would also clarify that funds used by a proprietary trading firm must be exclusively firm funds, and all trading must be in the firm's accounts. In addition, traders must be owners of, employees of or contractors to the firm.<sup>11</sup> Even with the proposed exemption, proprietary trading firms would still incur a TAF obligation on transactions executed otherwise than on an exchange and on transactions executed on an exchange of which the firm is not a member. These transactions would be subject to the TAF under the existing fee structure and at the same rates. The proposed TAF exemption would apply to current FINRA members that fall within the proposed definition of a proprietary trading firm as well as any new FINRA members as a result of the SEC's proposed amendments.

### **Economic Impacts**

FINRA believes the proposed exemption will result in proprietary trading firms paying an amount of TAF that bears a more equitable relationship to the costs of regulating those firms' activities, rather than the current TAF framework which may result in a disproportionately large TAF obligation for these firms. Accordingly, among other impacts, the proposed exemption may reduce a potential disincentive to proprietary trading firms to seek FINRA membership.

The proposed exemption excludes trades by proprietary trading firms on exchanges of which the firm is a member while applying the TAF on transactions executed on an exchange of which the firm is not a member and for over-the-counter trades. The proposed exemption may have potentially different direct economic impacts on proprietary trading firms that are not currently FINRA members, proprietary trading firms that are currently FINRA members and other firms that currently trade with or provide trading access to non-FINRA member proprietary trading firms. In addition, the proposed exemption may impact the trading strategies and behaviors of some market participants.

FINRA anticipates that the quality of FINRA's supervision of activities and conduct by new member proprietary trading firms would not differ from that experienced by current member firms, and thus this proposed exemption would not be associated with any negative impacts to the public. Further, this proposed exemption is not anticipated to have direct costs on member firms that do not engage in proprietary trading. The proposed exemption does not change the application of the TAF with respect to over-the-counter trades; however, if proprietary trading firms that currently are not FINRA members ultimately register with FINRA as a result of the SEC's rulemaking, this will result in the direct application of the TAF to those proprietary trading firms.

FINRA estimates that there are approximately 85 non-member proprietary trading firms that may opt to become FINRA members based on the proposed amendments to SEA Rule 15b9-1, but FINRA cannot determine the number of firms that may choose to become FINRA members solely on the basis of this proposed exemption.<sup>12</sup> Each of these firms will assess the costs and benefits of the options permitted by the SEC's proposed amendments.

### **Anticipated Benefits**

FINRA believes the proposed exemption to the TAF is based on a simple structure that is easy for both FINRA and the affected firms to implement. In addition, this approach directly addresses exchange activities by firms currently relying on SEA Rule 15b9-1, while continuing to assess fees on trades for which FINRA is the responsible SRO.

FINRA anticipates that by reducing the potential disincentives for proprietary trading firms to seek FINRA membership, the proposed exemption may result in more proprietary trading firms joining FINRA. Accordingly, consistent with the SEC's assessment, FINRA believes that this increase in membership may lead to more comprehensive surveillance and uniform regulation of trading activity by proprietary trading firms.<sup>13</sup> As a result, investors and intermediaries would likely benefit from the increased regulatory oversight.

Proprietary trading firms that are current FINRA members would experience a reduction in regulatory costs to the extent they currently incur the TAF on non-market making transactions executed on exchanges of which they are members. There are currently a small number of FINRA members that would meet the definition of proprietary trading firm that trade on exchanges of which they are a member, but do not always trade in the capacity of a registered market maker on such exchanges. FINRA estimates that these firms will have a reduction in their TAF assessments as a result of the proposed exemption.

### **Anticipated Costs**

Proprietary trading firms that are currently not members of FINRA may choose to alter their activities if the proposed amendments to SEA Rule 15b9-1 are adopted. As described in the SEC proposal, these firms may choose to exit from or limit their trading activities to exchanges of which they are members, elect to become a member of every SRO where they transact directly or indirectly or become a member of FINRA. If such a firm opts to become a FINRA member, the TAF would apply to the firm. It would incur initial implementation costs associated with the membership application process, installing systems and processes necessary to abide by FINRA's rules, as well as on-going costs, such as annual membership fees, costs of maintaining data reporting, and other costs associated with compliance and examination by FINRA staff.<sup>14</sup>

To avail itself of the TAF exemption proposed here, a proprietary trading firm would have to incur costs associated with exchange membership and related oversight by that exchange. FINRA anticipates that firms may evaluate the costs and benefits of exchange membership against any savings in the TAF that may accrue.

FINRA would also incur costs associated with monitoring and surveillance of the proprietary trading firms that become FINRA members as a result of the SEC's proposed amendments. FINRA anticipates that these costs would be offset by the regulatory fees collected from these new members.

### **Other Economic Impacts**

FINRA recognizes that the proposed exemption may have an impact on where proprietary trading firms seek to execute trades. Currently, FINRA members are required to pay TAF on most of their trading regardless of where the trades are executed. This proposed exemption would result in a lower TAF for trades executed on an exchange for which the proprietary trading firm is a member than a trade executed elsewhere. It is possible that some proprietary trading firms may consider altering their order submission strategies in an effort to minimize the TAF, all other things being equal. FINRA seeks comment and data on the likelihood of such a reaction to this proposed exemption and any costs or benefits that might arise from a change in the location of liquidity provision by these firms.

## Request for Comment

FINRA requests comment on all aspects of the proposed exemption. In addition, FINRA specifically requests comment on the following issues:

- ▶ Proprietary trading firms engaging in high frequency trading may have very high order-to-execution ratios and, as a result, have a very large data footprint that drives a portion of FINRA's costs. Given this activity, is a tiered fee structure approach based on a firm's market data footprint, such as OATS order event volume, a better approach to addressing the TAF for these firms? Would implementing a cap on a firm's TAF obligation be more appropriate? Would these approaches be significantly more complicated or burdensome to implement? Are there other alternative approaches FINRA should consider to accomplish the goals described in the proposal? If so, what are those alternatives and why could they be better suited? What are the potential costs and benefits of those alternatives relative to the proposed approach?
- ▶ Is the proposed definition of "proprietary trading firm" appropriate? Is it under-inclusive or over-inclusive?
- ▶ What are the relevant economic impacts associated with the proposed exemption? Please provide any data or evidence of the size and distributions of these costs, benefits and other impacts.
- ▶ Are proprietary trading firms likely to alter their trading practices or business models based on this proposed exemption? If so, how would these firms alter their activity across trading venues? What are the economic impacts associated with any change in trading strategy or practice that might occur?
- ▶ Is the proposed TAF exemption for trades on an exchange of which the proprietary trading firm is a member appropriate? Should all exchange trades by proprietary trading firms be exempt from the TAF? If all exchange trades were exempt, would that influence proprietary trading firms' trading practices (e.g., would they shift their trading activities from the over-the-counter market to exchanges to avoid incurring the TAF)?
- ▶ Do FINRA member firms currently, partially or fully pass on the TAF to non-FINRA member proprietary trading firms for the transactions executed on an ATS or through a FINRA member today?

FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible.

## Endnotes

1. See Exchange Act Release No. 74581 (March 25, 2015), 80 FR 18036 (April 2, 2015) (File. No. S7-05-10) (SEC proposal).
2. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
3. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
4. FINRA is currently the only registered national securities association.
5. See SEC proposal. Specifically, the proposed amendments eliminate the \$1,000 *de minimis* allowance and replace it with a provision that exempts from association membership exchange member broker-dealers that operate on the floor of an exchange to the extent they effect transactions off-exchange solely for the purpose of hedging the risks of their floor-based activities. See SEC proposal at 38, 80 FR at 18045-46.
6. See FINRA By-Laws, Schedule A, Section 1.
7. "Covered securities" for purposes of the TAF include exchange-registered securities, over-the-counter 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).
8. FINRA By-Laws, Schedule A, Section 1(b)(2)(F) and (G).
9. Although FINRA does not, and cannot, directly align particular fee revenue to direct costs, FINRA has a statutory obligation to ensure that its rules provide for the equitable allocation of reasonable dues, fees and other charges among its members. See SEA § 15A(b)(5).
10. See SEC proposal at 31 n.95, 80 FR at 18044 n.95; see also SEC proposal at 99, 80 FR at 18061.
11. These requirements are based largely on existing exchange definitions of proprietary trading firms. See, e.g., NYSE Rule 7410(p); CBOE Rule 3.6A, Interpretation .07.
12. While there are approximately 125 broker-dealers that are not members of FINRA, FINRA estimates that only approximately 85 of these would meet the definition of "proprietary trading firm" under this proposed exemption.
13. See SEC proposal at 89-91, 80 FR at 18058-59.
14. See SEC proposal at 91-102, 80 FR at 18059-62. These firms may experience a reduction in membership fees on the exchange that currently serves as their designated examining authority (DEA), if FINRA assumes that role.

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## Attachment A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

\* \* \* \* \*

### SCHEDULE A TO THE BY-LAWS OF THE CORPORATION

\* \* \* \* \*

#### Section 1—Member Regulatory Fees

(a) No Change.

(b) Each member shall be assessed a Trading Activity Fee for the sale of covered securities.

(1) No Change.

(2) Transactions exempt from the fee. The following shall be exempt from the Trading Activity Fee:

(A) through (I) No Change.

(J) Transactions in security futures held in futures accounts; [and]

(K) Proprietary transactions by a firm that is a member of both FINRA and a national securities exchange, effected in its capacity as an exchange specialist or market maker, that are subject to Securities Exchange Act of 1934, Section 11(a) and Rule 11a1-1(T)(a) thereunder; however, this exemption does not apply to other transactions permitted by Section 11(a) such as bona fide arbitrage or hedge transactions; and[.]

(L) Transactions by a Proprietary Trading Firm effected on a national securities exchange of which the Proprietary Trading Firm is a member. For purposes of this paragraph, a "Proprietary Trading Firm" shall mean a member that trades its own capital and that does not have "customers," as that term is defined in FINRA Rule 0160(b)(4). The funds used by a Proprietary Trading Firm must be exclusively firm funds, and all trading must be in the firm's accounts. Traders must be owners of, employees of, or contractors to the firm.

(3) through (4) No Change.

(c) through (e) No Change.

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