Regulatory Notice 23-11

June 12, 2023

Liquidity Risk Management Program

FINRA Seeks Comment on Concept Proposal for a Liquidity Risk Management Rule

Comment Period Expires: August 11, 2023

Summary

FINRA is soliciting comment on a concept proposal to establish liquidity risk management requirements. The concept proposal describes a potential rule, labeled Rule 4610, that is intended to ensure that members have sufficient liquid assets to meet their funding needs in both normal and stressed conditions. Broadly, the proposal outlines three areas where a potential rule might address liquidity risk, including liquidity stress testing, contingent funding plans and a requirement to maintain sufficient liquidity on a current basis at all times. FINRA is issuing this concept proposal so that any feedback received can be taken into account as FINRA considers a proposed rule; any proposed rule would need to be reviewed and approved by the FINRA Board of Governors, and then filed with and approved by the Securities and Exchange Commission. FINRA welcomes comment on all aspects of the concept proposal, including comment on alternatives to the proposed approach.

The draft text of potential Rule 4610 is included as Attachment A.

Questions concerning this *Notice* should be directed to:

- William Wollman, Executive Vice President, Office of Financial and Operational Risk Policy (OFORP), at (646) 315-8496 or william.wollman@finra.org;
- Kathryn Mahoney, Senior Director, OFORP, at (646) 315-8428 or kathryn.mahoney@finra.org;
- Anthony Vinci, Director, OFORP, at (646) 315-8335 or anthony.vinci@finra.org;
- Michael MacPherson, Senior Advisor, Member Supervision, at (646) 315-8449 or michael.macpherson@finra.org; and
- Adam Arkel, Associate General Counsel, Office of General Counsel, at (202) 728-6961 or adam.arkel@finra.org.

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Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Finance
- Internal Audit
- Legal
- Operations
- Regulatory Reporting
- Risk Management Committee
- Senior Management
- Treasury

Key Topics

- Funding and Liquidity Risk Management
- Liquidity Stress Tests
- Risk Management

Referenced Rules & Notices

- CFTC Rule 1.11
- CFTC Rule 1.12
- FINRA Rule 4110
- FINRA Rule 4120
- FINRA Rule 4210
- FINRA Rule 9557
- FINRA Rule 9559
- Notice to Members 99-92
- Regulatory Notices 09-71, 10-44, 10-57, 15-33, 21-12 and 21-31
- SEA Rule 8c-1
- SEA Rule 12b-2
- SEA Rule 15c3-1
- SEA Rule 15c3-3
- SEA Rule 17a-3
- SEA Rule 17a-11

Questions concerning the Economic Impact Assessment in this *Notice* should be directed to:

- Dror Kenett, Senior Economist, Office of the Chief Economist, at (202) 728-8208 or dror.kenett@finra.org; and
- Tanakorn Makaew, Senior Economist, Office of the Chief Economist, at tanakorn.makaew@finra.org.

Action Requested

FINRA encourages all interested parties to submit comments. Comments must be received by August 11, 2023.

Comments must be submitted through one of the following methods:

- Online using FINRA's comment form for this *Notice*;
- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

  Jennifer Piorko Mitchell
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment.

Important Notes: Comments received in response to *Regulatory Notices* will be made available to the public on the FINRA website. In general, comments will be posted as they are received.[1]

Before becoming effective, a proposed rule change must be approved by the FINRA Board of Governors and filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).[2]

Background and Discussion

Broker-dealers are required to comply with several rules that in combination are designed to protect their customers and other creditors from losses in the event the broker-dealer fails. For example, broker-dealers are subject to the SEC's Net Capital Rule,[3] which is designed to ensure that they have a base of minimum capital and sufficient liquid assets to promptly satisfy their obligations to customers and other creditors. Moreover, the SEC's Customer Protection Rule[4] protects customer funds and securities held by a broker-dealer by requiring segregation of fully paid securities and funds held for customers, and prohibiting the use of those funds and securities to support the broker-dealer's proprietary activities. This rule also imposes limits on the amount of customer securities a broker-dealer may use to finance margin loans to its customers. Furthermore, the amount a broker-dealer may lend to its customers is subject to the requirements of FINRA Rule 4210 and the Federal Reserve Board's Regulation T, which work together to limit the amount of leverage that may be extended and protect the broker-dealer's capital and insulate it from customer credit losses. Moreover, the SEC's Recordkeeping Rule[5] requires a broker-dealer that meets specified thresholds to keep a record documenting the credit, market and liquidity risk management controls established and maintained by the broker-dealer to assist it in analyzing and managing the risks associated with its business activities.

In combination, these rules have worked well to limit the risk to customer assets when a broker-dealer fails. One risk that may not be sufficiently addressed by these rules, however, is liquidity risk, which is the risk that a broker-dealer will not have sufficient cash or liquid assets to meet its obligations as they come due. While the SEC's Net Capital Rule generally requires that assets be convertible to cash within 30 days, the Net Capital Rule focuses primarily on the asset side of the balance sheet and a broker-dealer's solvency rather than the characteristics of its liabilities.[6] Additionally, broker-dealers maintain some assets that are allowable for net capital but are restricted in their use for daily liquidity, such as clearing deposits. Adopting additional liquidity standards would supplement these rules by creating greater safeguards to ensure that customer and creditor claims can be met in a timely manner and may prevent a broker-dealer failure.

Effective monitoring of liquidity and funding risks is an essential element of broker-dealers' financial responsibility and is a longstanding focus for FINRA's financial supervision programs.[7] Recent events have reinforced the importance of these efforts. For example, in 2020, effective liquidity risk management practices were critically important in navigating market volatility and other stress stemming from the COVID-19 pandemic.[8] In January 2021, the extreme price volatility of certain stocks (commonly referred to as "meme stocks") again highlighted the importance of liquidity risk management.[9] The meme-stock volatility caused unprecedented calls for clearing member collateral at clearing corporations due to extreme price changes over short periods of time.[10] These examples illustrate the importance of strong liquidity risk management practices.[11]

Oversight of these risk-management practices is an important part of FINRA's regulatory program. Since the 2008 financial crisis, FINRA has incorporated reviews of liquidity risk into its examination and risk monitoring of broker-dealers that are FINRA members. Our efforts have focused on how members have managed liquidity risk as a matter of their own risk management efforts. Our reviews have centered on the members that carry and clear customer accounts and have primarily focused on those members' liquidity stress testing processes and contingency funding plans. Among other things, we assess a member's identification and understanding of their liquidity risks, a member's ability to quantify its liquidity needs in high stress situations due to market and idiosyncratic events, and the steps a member would take to address a liquidity stress scenario.[12]

Many member firms have invested considerable time and resources into carefully managing their liquidity risk, for example, by having dedicated business functions and risk management staff assigned to manage, monitor and control their liquidity risk. On the other hand, through our ongoing monitoring of liquidity, FINRA has observed instances in which members did not have sufficient liquidity risk management practices. Insufficient liquidity risk management impacts all aspects of a broker-dealer's business and puts customers, counterparties and other market participants at risk. For example, there have been instances where the Depository Trust Company (DTC) ceased to act for a member due to concerns regarding the member's levels of capital and liquidity, especially relative to its activity levels.[13] FINRA's efforts to supervise our members' liquidity risk have been limited by the absence of a dedicated rule that would facilitate our ability to take action when appropriate.

Accordingly, FINRA is seeking comment on a concept proposal to adopt a rule that would establish liquidity risk management requirements for its members. The concept proposal is informed by best practices observed in members' existing liquidity risk management programs, including liquidity stress testing and contingency funding plans. Many of these best practices have been outlined by FINRA in previous guidance including *Regulatory Notices 10-57* and *15-33*. FINRA is considering the potential benefit of rule requirements, or other approaches, to further address the risk that insufficient liquidity risk management presents to members. For discussion purposes, we describe a potential FINRA rule (labeled Rule 4610, or the potential rule, for ease of reference) that would require each subject member to maintain a liquidity risk management program (LRMP) that is reasonably designed to assess, manage and periodically review risks to the member's liquidity.

The LRMP would require the subject member to conduct liquidity stress testing and establish and maintain a contingency funding plan. Furthermore, the potential rule would require each subject member to have available cash or liquid assets sufficient to meet its funding obligations as they come due and would enable FINRA to direct a member to take such measures as shall be necessary, including restricting or suspending its business, if it does not maintain sufficient liquidity.

Members Subject to the Potential Rule

Broadly, potential Rule 4610 is designed to apply to members with the largest customer and counterparty exposures. These firms are, for the most part, members that carry customer accounts and clear transactions for customers or other market participants. More specifically, Rule 4610 would apply to members that meet the criteria for filing with FINRA the recently adopted Supplemental Liquidity Schedule (SLS).[14] Additionally, members that carry the customer accounts of other broker-dealers, but do not otherwise meet the criteria for filing the SLS, would be subject to Rule 4610 because of the importance of these firms' role within the securities industry.

Sufficient Liquidity on a Current Basis

Under the concept proposal, members subject to potential Rule 4610 would be required at all times to have and maintain sufficient liquidity on a current basis, which means that they must have available cash and liquid assets sufficient to meet their funding obligations as they come due. In addition to the general requirement to maintain sufficient liquidity, Rule 4610 specifies conditions (in paragraphs (b)(1) through (b)(8)) that, if they occur, would result in the presumption that a member does not have sufficient liquidity on a current basis. These conditions are informed by FINRA's prior experience with members that had difficulty meeting their funding obligations as they came due. If one or more of these conditions occur, under the potential rule, FINRA may (subject to established procedural requirements, as discussed below) restrict or suspend the member's business, unless the member rebuts the presumption that it does not have sufficient current liquidity or takes corrective action to bolster its liquidity.

As discussed below, potential Rule 4610 includes a process for rebutting the presumption of insufficient liquidity on a current basis. Also, in light of the regulations that already apply to a member that is controlled by a bank holding company that is subject to enhanced prudential regulation (EPR) and complies with the Federal Reserve Board's most stringent liquidity risk management requirements (referred to in this *Notice* as an "EPR firm"), Rule 4610 includes a limited exception for such firms from the presumption of insufficient current liquidity while any of the conditions specified in paragraphs (b)(1) through (b)(8) occur. EPR firms are not excepted from the base requirement of Rule 4610(b) to at all times have and maintain sufficient liquidity on a current basis.

The conditions that would lead to the presumption of insufficient liquidity on a current basis under Rule 4610's paragraphs (b)(1) through (b)(8) are discussed in detail below, along with examples to assist members subject to those paragraphs in understanding when FINRA may conclude that the presumption has been rebutted. The burden of rebutting the presumption of insufficient liquidity on a current basis would fall on the member. The factors noted below under each condition, or any other factors presented by the member to rebut the presumption, would be evaluated considering the member's specific business activities and in conjunction with other relevant facts and circumstances at the time the condition occurs.

Conditions under paragraph (b):

1. **The member borrows funds from a non-bank affiliate, unless the member can demonstrate that the non-bank affiliate has sufficient and stable liquidity to maintain the loan for the time required to meet the member's funding obligations.**

The stability and continued availability of the source of a member's funding is critical to the member's ability to fund its obligations as they come due; therefore, it is essential that funding sources are available when the member may need them most. Concerns about the adequacy of a member's liquidity would arise when a member places significant reliance on borrowing from a non-bank affiliate to meet such funding obligations. For example, a non-bank affiliate with limited or no business operations, which is either not regulated or not required to maintain minimum amounts of liquid capital, may not be able to provide the funding for the member when the member needs such funding. As such, the affiliate may not be a reliable source of liquidity.

FINRA understands that members and their affiliates may have numerous or recurring financial transactions that appear to provide financing to the member, including routine intercompany transactions. It is not FINRA's intention for this potential rule to cause multiple triggers of the presumption of insufficient liquidity when the activity is recurring and in a normal range of scope and size. In such case, a member may approach FINRA prior to entering these recurring transactions and explain why such transactions do not place the member's liquidity position at risk and the reasons the affiliate is able to maintain the transactions without undue burden. In these types of situations, FINRA would welcome firms to discuss the facts and circumstances around the financial transactions and may accept the use of the intercompany financing on an ongoing basis without triggering the notification and rebuttal process. FINRA would consider further guidance, as appropriate, to provide further clarification.

If this presumption is triggered, FINRA would consider the following factors in determining whether the presumption of insufficient liquidity has been rebutted:

- The member can demonstrate that the amounts it borrows from a non-bank affiliate are immaterial relative to its total available financing sources and such amounts are not critical to meeting its funding obligations. FINRA would consider the sources of other material financing available to the member.
- The member records liabilities to an affiliate that relate to arrangements for shared expenses or similar obligations and the amount payable is not material to the member's liquidity (*i.e.,* the member is not reliant on the affiliate to continue funding its business activities and can easily repay the amount without hardship).
- The non-bank affiliate can secure funding via issuance of highly rated commercial paper or has access to public capital markets.
- The non-bank affiliate has permanent capital that is available and sufficient to fund the member.
- The member can show in its LRMP that the member does not rely on the amount borrowed from the non-bank affiliate.

If a member does not provide information about the non-bank affiliate's financial condition, access to its liquidity sources, including any factors that may impact such access, or its liquidity management policies, the presumption would not be rebutted.

FINRA would not consider a subordinated borrowing from a non-bank affiliate, pursuant to a satisfactory subordination agreement as defined in Appendix D of SEA Rule 15c3-1d, as relying on borrowed funds to meet daily funding obligations for purposes of paragraph (b)(1).

2. **The member borrows an amount in excess of 70 percent of its customer debit balances and such amount is secured by assets that are the property of its customers.**

SEA Rules 8c-1 and 15c3-3 specify conditions for and limits on the use of customer margin securities to finance lending to those customers. Historically, FINRA has observed that borrowing amounts in excess of 70 percent of a member's customer debit balances secured by customer assets frequently indicates liquidity stress. Members that have sufficient liquidity rarely borrow in excess of 50 percent of customer debit balances and most members have sufficient credit balances to fund their customer margin debits. Also, as members borrow amounts that approach 70 percent or more of customer margin debits, the operational strain of managing pledged collateral greatly increases. Such elevated borrowing frequently results in the creation or increase of material deposit requirements in the member's customer reserve formula computations, which creates further liquidity strain. In these cases, there is a greater risk that the member may inadvertently borrow to fund its general business operations, rather than to finance its customer debit balances (especially in cases when the member has an excess of customer credit balances that are available to fund the margin debit balances). As such, FINRA believes such borrowing is a strong indication of insufficient current liquidity.

If this condition occurs, FINRA would consider factors such as the following in determining whether the presumption of insufficient liquidity has been rebutted:

- Evidence that the amount borrowed was needed to finance customer debit balances, does not create other liquidity concerns for the member (*e.g.,* the borrowing is not increasing the member's customer reserve formula requirement) and does not present a risk of reliance on the use of customer assets to fund the member's own business operations. For example, if the member has a concentrated customer debit balance that it would be required to exclude from the customer reserve formula computation unless it is separately and specifically funded.[15]

3. **The member performs a reserve formula computation on an ad hoc basis more than once during a rolling 90-calendar day period for the purpose of making a withdrawal from its SEA Rule 15c3-3 Special Reserve Bank Account, or the member requests extraordinary regulatory relief to make a withdrawal from such account without performing a reserve formula computation.**

For purposes of this potential rule, an ad hoc reserve formula computation would be any reserve formula computation that is not:

- a required weekly or monthly computation pursuant to SEA Rule 15c3-3(e)(3);
- a reserve formula computation that is consistently performed daily; or
- on an otherwise planned, consistent cadence (*e.g.,* the member has a policy of conducting a computation as of each Tuesday in addition to the required computation as of each Friday).

Ad hoc reserve formula computations or requests for regulatory relief to make a withdrawal without performing a reserve formula computation often signal that the member does not have sufficient liquidity to meet its current customer or other general funding obligations. In such instances, the member may perform an ad hoc customer reserve computation to make a withdrawal from its reserve account to meet its funding obligations. This practice, in addition to indicating that the member does not have sufficient liquidity on a current basis, may increase the risk of a shortfall in customer assets.

If this condition occurs, FINRA would consider factors such as the following in determining whether the presumption of insufficient liquidity has been rebutted:

- The ad hoc calculation did not result in a withdrawal from the special reserve bank account.
- The member can demonstrate that a withdrawal made as a result of an ad hoc reserve formula computation, or as a result of regulatory relief provided without requiring a reserve formula computation, was not needed or used to meet the member's funding obligations.

4. **The member's bank lines of credit, including bank loan facilities, other than intra-day credit facilities at a settlement bank, are reduced by 50 percent or more of the total of such available bank lines of credit during a rolling 90-calendar day period.**
5. **The member's total funding derived from securities financing arrangements is reduced by 50 percent or more during a rolling 90-calendar day period.**
6. **The member's intra-day credit facility at a settlement bank is reduced by 50 percent or more of its aggregate settlement bank credit facilities, or the member's central clearing counterparty (CCP) intra-day credit facility is reduced by 50 percent or more of its aggregate CCP credit facilities, during a rolling 90-calendar day period.**

Under paragraphs (b)(4) through (b)(6) of the potential rule, a significant reduction in a member's secured or unsecured borrowing sources, regardless of type or term (*e.g.,* intra-day credit facility, bank line of credit, securities financing on an overnight or term basis) could have a significant impact on a member's ability to fund its business activities. A member would not be presumed to have insufficient current liquidity if the member has replaced the funding described with the same type of funding source, for at least the same amount.

If any of the conditions in paragraphs (b)(4) through (b)(6) of the potential rule occur, FINRA would consider factors such as the following in determining whether the presumption of insufficient liquidity has been rebutted:

- The member is reducing its business or is exiting a business line (including through a transfer or sale to another firm) and will no longer need its previous level of financing to continue to fund its business.
- The member has sufficient other internal liquidity sources to replace its lost funding and can meet its funding obligations as they come due.
- The member has replaced its lost funding through alternative external liquidity sources and can meet its funding obligations as they come due.

7. **The member is notified that it has lost or will lose access to the services of one or more of its settlement banks and the member has not replaced the settlement bank 90 days prior to the termination of such access.**

A member that loses access to a settlement bank may face operational constraints or new or increased liquidity demands and funding risks that could prevent it from performing its clearance and settlement activities or fulfilling obligations to its counterparties.

If this condition occurs, FINRA may consider factors such as the following in determining whether the presumption of insufficient liquidity has been rebutted:

- The member plans to voluntarily exit the business line processed through the settlement bank or, for another reason, will no longer need the settlement bank to process the impacted business activity.
- The member has another settlement bank through which it can process the affected business activity and can shift the activity to such other settlement bank without impacting customers or counterparties.

8. **The member is subject to revocation of a CCP membership or any material restrictions by a CCP or settlement bank. A material restriction by a CCP or settlement bank includes, without limitation, imposition of an increased minimum deposit or other requirement to post collateral due to firm-specific liquidity concerns or imposition of restrictions on withdrawing excess margin if such excess margin exceeds 10 percent of excess net capital.**

A revocation of a member's CCP membership for any reason would trigger this condition. In addition, this condition would be triggered by a material restriction by a CCP or settlement bank, such as a material increase in a minimum deposit or other requirement to post collateral due to firm-specific liquidity concerns. Further, a firm-specific restriction on withdrawing excess margin held at a CCP or settlement bank, if such excess margin exceeds 10 percent of a firm's excess net capital, would also trigger this condition. These events may lead to significant disruption in the member's ability to clear securities transactions and result in an outflow of customers, counterparties and assets that may cause liquidity stress.

If this condition occurs, FINRA would consider factors such as the following in determining whether the presumption of insufficient liquidity has been rebutted:

- The member is reducing or exiting a line of business (including through a transfer or sale to another firm) that was cleared through the subject CCP or settlement bank.
- The member can shift the clearance of the affected line of business to another CCP or settlement bank without adversely impacting its business operations or liquidity needs.

Notification to FINRA and Rebuttal of the Presumption of Insufficient Liquidity on a Current Basis

If one or more of the conditions set forth in paragraphs (b)(1) through (b)(8) occur, potential Rule 4610 would require the member to notify FINRA within two business days of the condition's occurrence. The member may then provide evidence to FINRA to rebut the presumption that the occurrence of the condition is indicative of insufficient current liquidity. In such cases, Rule 4610 would require that the member's rebuttal must be submitted to FINRA in writing within five business days from the date of the notification.

FINRA would review the member's rebuttal and evaluate the member's liquidity to determine whether the member has sufficient liquidity on a current basis. The evaluation process would consider all factors relating to the presumption of insufficient current liquidity and would evaluate whether the member has provided sufficient evidence to rebut such presumption. Due to the potentially serious implications of being restricted pursuant to this potential rule, FINRA would expect that follow-up discussions with the member would be necessary to properly evaluate the full context of the member's rebuttal. As part of this evaluation, FINRA would be able to request additional information from the member.

Members Controlled by a Bank Holding Company Subject to Enhanced Prudential Regulation

Some subject members are EPR firms. Because EPR firms are controlled[16] by a bank holding company that is highly regulated for liquidity by their prudential regulator, under the potential rule these members would not be subject to the presumption of insufficient liquidity if any of the conditions in paragraph (b)(1) through (b)(8) occur. However, such members would still be subject to the requirement under the potential rule to at all times have and maintain sufficient liquidity on a current basis. As such, under the proposal, FINRA would still be able to find that such a member has not maintained sufficient liquidity on a current basis, either because one of the conditions enumerated in paragraph (b)(1) through (b)(8) has occurred or due to another reason. In the case of EPR firms, however, the burden to demonstrate that the member's current liquidity is insufficient would fall on FINRA.

Restriction or Suspension of Business; Procedural Requirements

If any of the conditions in paragraphs (b)(1) through (b)(8) occur and the member does not submit a rebuttal with supporting evidence to FINRA, or if FINRA considers the member's rebuttal to be inadequate, the proposal provides that FINRA may direct the member to take such measures as shall be necessary, including restricting or suspending all or part of its business, to restore the sufficiency of the member's liquidity for purposes of paragraph (b) of the potential rule. In any such instance, FINRA would issue a notice pursuant to Rule 9557.[17]

Similarly, if for any other reason FINRA determines that a member subject to the potential rule does not have sufficient liquidity on a current basis (that is, without regard to the conditions specified under paragraphs (b)(1) through (b)(8)), FINRA could direct the member to take such measures as shall be necessary, including restricting or suspending all or part of its business, to restore the sufficiency of the member's liquidity for purpose of paragraph (b) of the potential rule. Again, in any such instance, FINRA would issue a notice pursuant to Rule 9557. The potential rule is modeled, in part, on the approach FINRA took in establishing Rule 4110 with regard to capital compliance, which went into effect in 2010.[18] At the time, FINRA noted that the rule carried with it procedural safeguards for members because it affords the opportunity for the expedited hearing process under Rule 9557 and Rule 9559.[19] FINRA noted its intent to apply the rule judiciously, which has been reflected in FINRA's actual practice in the years since Rule 4110 was adopted. Similarly, the concept proposal is also modeled in part on the business restriction provisions of FINRA Rule 4120, which was established at the same time as Rule 4110 and was also designed to carry the procedural protections of Rule 9557 and Rule 9559.[20]

Broadly consistent with the approach of Rule 4110 and Rule 4120, under Rule 4610, a member firm that receives a written notice pursuant to Rule 9557 would be entitled to challenge FINRA's determination that the member lacks sufficient liquidity for purposes of paragraph (b), or the measures that FINRA may direct the member to take to restore the sufficiency of its liquidity. Specifically, Rule 9557 would provide a member with the opportunity to request an expedited hearing, which would automatically stay the effectiveness of the notice.

Liquidity Risk Management Program

Under potential Rule 4610, a subject member must establish and maintain an LRMP including written policies and procedures that are reasonably designed to assess, manage and periodically review risks to the member's liquidity. The written LRMP must be provided to FINRA upon request.

Two key elements of a reasonable LRMP are liquidity stress tests and a contingency funding plan.

Liquidity Stress Tests

Liquidity stress tests (LSTs) are a key component of an effective LRMP because they provide an assessment of a member's ability to withstand adverse market and idiosyncratic events and continue to operate and fund its business activities. The potential rule would require each subject member to design and conduct LSTs for a projected rolling 30-calendar-day period based upon reasonable, data-supported assumptions. LSTs attempt to measure potential liquidity under stressed conditions; therefore, members would be expected to use data-supported assumptions that cover a range of outcomes, even if the likelihood of such outcomes is remote.

To provide clarity to members about stress-testing assumptions that would be considered reasonable, the potential rule identifies such assumptions in Supplementary Material .02 of the rule. These assumptions were informed by FINRA's reviews in connection with *Regulatory Notice 15-33* and current benchmarks used as assumptions at members. FINRA expects members to model their stress tests considering the assumptions in Supplementary Material .02; however, members may design their own assumptions, as appropriate, based on their business model and risk profile. FINRA would expect the member to be prepared to demonstrate why its assumptions are reasonable, if such assumptions are less stringent than those specified in Supplementary Material .02.

The LST would need to be performed no less than monthly, and the results must be submitted to FINRA upon request. A member would be required to inform FINRA of any LST whose results reflect a liquidity shortfall at any point during the projected rolling 30-calendar day period within two business days of the date such LST is performed.

Contingency Funding Plan

A contingency funding plan (CFP) is a key element of a well-developed LRMP because it addresses funding shortfalls in liquidity stress situations. Given the importance of a CFP to an effective LRMP, potential Rule 4610 would require each subject member to establish a CFP that is reasonably designed to assist the member in mitigating materially adverse fluctuations in its liquidity. The CFP would be required to designate responsibilities and identify guidelines and conditions for its activation.

The potential rule would require the CFP to include the types of contingency funding sources available to the member and to appropriately discount or exclude any funding sources where the availability of funding is unlikely under certain circumstances, or if restrictive covenants and material adverse change clauses make contingency funding less likely to be available in a firm-specific stress event.

The member's CFP also should include consideration of business restrictions and reductions that may be employed to counteract a liquidity strain, as well as specifying when such restrictions and reductions would be employed. Examples of business restrictions and reductions could include reducing trading positions and limiting margin lending.

Economic Impact Assessment

Effective monitoring of liquidity and funding risks (sometimes also collectively referred to as funding liquidity[21]) is an essential element of firms' financial responsibility and is a longstanding focus for FINRA's financial supervision programs. As discussed above, FINRA is describing a potential new Rule 4610 to require specified member firms to establish and maintain liquidity risk management programs. FINRA believes that the concept proposal could potentially benefit members, their customers, and the investor community, by enhancing the ability of the firms that will be subject to the potential rule to meet their obligations to customers, counterparties, and other market participants in both normal and stressed conditions.

Underlying the potential benefits of minimum standards for liquidity risk management are information asymmetries and collective action problems.[22] Robust risk management across the industry ultimately provides a benefit to all impacted parties, including counterparties and customers. It is difficult, however, for customers or members to assess the robustness of risk governance at members with which they transact.

One possible outcome, absent minimum standards, is that each firm assumes that other firms have robust liquidity risk management programs, expects protections from these programs in a stressed environment, and fails to develop a sufficiently rigorous risk management program of its own. In such a scenario, it is possible that no firm voluntarily develops a sufficiently rigorous risk management program.

In another possible outcome, member firms engage in costly bilateral due diligence to mitigate counterparty liquidity risks that may be inconsistent and in aggregate are repetitive and wasteful. FINRA believes that minimum standards may provide a useful guardrail and more efficient contracting given these incentives and potential outcomes. FINRA is therefore soliciting comment on measures to enhance and strengthen the overall liquidity risk management framework for members.

Economic Baseline

The economic baseline for potential Rule 4610 is the existing regulatory framework, industry practices relating to and compliance with existing relevant regulations, and other national and international related standards and regulatory frameworks.

FINRA met with members individually and with trade associations and industry to learn about current liquidity and stress testing industry practices, and other relevant regulators and CCPs. Through these efforts, FINRA gained further insight into the similarities and differences across the various regulatory frameworks relating to liquidity risk management and stress testing.

FINRA also obtains information about current liquidity and stress testing practices in the normal course of its supervisory work. For example, FINRA's risk monitoring and examination programs review the liquidity risk management practices of members. FINRA assesses the business activities of members, the way they approach liquidity management, the stress tests they conduct, and the availability of contingency funding lines. Also, FINRA periodically reviews members' liquidity stress tests, as well as the firm's CFP, among other things.

Economic Impacts

Using quarterly FOCUS reports[23] for the period December 2019 through December 2022, FINRA expects that approximately 125 members would be subject to the potential rule.[24] Approximately 115 of these firms are currently covered by the SLS filing criteria. Approximately 40 out of these 125 firms are EPR firms. These 40 firms would not be excluded from the requirement to have sufficient liquidity on a current basis; rather, while these firms would not be rebuttably presumed to have insufficient liquidity on a current basis when any of the conditions in (b)(1) through (b)(8) of the Rule 4610 occur, they still would be required to have sufficient liquidity on a current basis and would be subject to all other requirements of the potential rule.

FINRA understands that out of all firms that will be covered by the potential rule, some may already be conducting their liquidity stress testing in accordance with its requirements.[25] FINRA staff reviewed examinations conducted related to liquidity and stress testing, for the period 2019 to 2021, for a select sample of the firms that would be subject to the potential rule. This review found that these firms were relying on the benchmark percentage haircuts identified in *Regulatory Notice 15-33* for their stress test assumptions.[26]

Anticipated Benefits

FINRA believes that the potential rule could result in benefits to members that are subject to the potential rule, members not subject to the potential rule, member firms' customers, and the investor community. Based on FINRA's analysis, some of the approximately 125 members that would be subject to the potential rule would be either partially or fully in compliance with the potential rule as discussed in this *Notice*. In particular, most of these members are believed to have some form of a LRMP, a majority of these members are subject to the SLS filing criteria and are therefore currently reporting on liquidity, and some rely on the benchmark percentage haircuts identified in *Regulatory Notice 15-33* for their stress test assumptions. FINRA does not know with certainty, however, how many of these members would be fully or partially in compliance with the different elements of the potential rule.

Members that would be subject to, and fully in compliance with, the potential rule would benefit from the additional clarity and stability in requirements that the potential rule provides, the potential reduction in related compliance costs, and the potential of the rule to level the playing field with other similar members that are not currently in full compliance. Members that would be subject to the potential rule but currently only partially compliant could at least benefit from the increase in resiliency that results from maintaining consistent minimum standards in liquidity management, regular testing, and addressing any liquidity shortfall quickly. Increased resiliency may in turn lead to an increase in profitability and a decrease in operational costs for the firm. FINRA notes that the potential rule is flexible and would allow members to produce their own stress testing assumptions using internal data to validate such assumptions. The magnitude of the benefits could therefore depend on the member's business model, stress testing practices, and the relative strictness of its stress test program.

In addition, all members—including those not subject to the potential rule—as well as their customers and the investor community would benefit from both the reduced likelihood of transacting with a firm that experiences significant liquidity problems in a stressed environment and from a generally more resilient broker-dealer industry and financial system. For members, this may increase profitability over time as they obtain a potential reduction in operational costs stemming from the potential increase to the resilience of their counterparties and the reduction of such counterparties experiencing liquidity related stress events. Individual customers may benefit from the reduced likelihood of losses or inconvenience (or both) from transacting with members that become illiquid or ultimately insolvent. Investors generally may see some reduction in fees that members charge for their services if reduced risks result in reduced costs that are, through competition, passed through to investors.

There is some recent academic research on the benefits and added value of liquidity regulation and stress testing. This work, however, has mostly focused on the banking sector and whether liquidity regulation reforms following the 2008 financial crisis provide evidence of their benefits.[27] Curfman and Kandrac (2018)[28] claim that there exists a prudential benefit of liquidity requirements in the banking system. They showed that banks subject to a higher requirement just before the financial crisis had a lower chance of failure. Schneider et al. (2020)[29] show that stress tests have a greater effect on the value of large trading banks' portfolios and that large trading banks respond to stress test outcomes by making more conservative capital plans. Abboud et al. (2021)[30] consider the economic impacts of the ongoing COVID-19 pandemic as a test of the post crisis regulatory reforms, with an emphasis on capital and liquidity requirements. The authors find that the overall robust capital and liquidity levels held by banks resulted in a resilient banking system that was able to endure the stress and changes to financial and economic conditions brought on by the pandemic.

Anticipated Costs

The potential rule is expected to impose costs on members that would be subject to the potential rule. As discussed above, covered members would incur compliance and operational costs to the extent that their baseline liquidity management practices and reporting practices do not already meet the standards of the potential rule. However, FINRA does not know with certainty how many members would not be in compliance or what would be the cost to those members of coming into full compliance with the potential rule.

Some covered members may need to update their liquidity risk management procedures. Members with policies and procedures that are less rigorous than those of the potential rule would likely incur costs to amend them as well as new ongoing supervisory and training costs on the new requirements. However, members with existing practices that are as or more restrictive than the potential rule could maintain their current policies. FINRA notes that a possible unintended consequence of the potential rule is that members with more restrictive policies and procedures may lower their standards to comply with the minimum standards that are established by the potential rule. FINRA believes that this is unlikely, given anecdotal evidence collected by FINRA staff.

FINRA believes that the potential rule's requirement with respect to the frequency of conducting and reporting the liquidity stress tests are reasonable and consistent with current industry effective practices. Moreover, FINRA notes that other rules have comparable computation and notification requirements, such as those set forth in SEA Rule 17a-11 (Notification Provisions for Brokers and Dealers).

The potential rule would require members subject to the potential rule to notify FINRA when a breach in one or more of the thresholds defined in paragraphs (b)(1) through (b)(8) would put them in a condition of insufficient liquidity. This requirement, and the members' policies and procedures that stem from it, could create potential legal and compliance risks for the members. For example, a member would need to ensure that it has an effective process in place to identify whether one of the conditions in paragraphs (b)(1) through (b)(8) have occurred and when it needs to notify FINRA.

FINRA recognizes that members may choose to adapt their business models to stay either above or below the criterion for being subject to the potential rule.[31] While choosing to stay below the threshold would allow members to reduce regulatory costs, this choice could potentially limit their growth potential, depending on their business model. Alternatively, members may choose to maintain the liquidity risk controls proposed even if they do not meet the threshold requirements if they determine the costs of lost business or changing rule requirements are more burdensome.

Moreover, it is possible that the potential rule could force some members to reconsider their business model or even leave the industry. Thus, the potential rule could potentially be costly to some members, depending on their existing processes and procedures. Such costs could include, for example, developing the means to compute several metrics on a regular basis, and meeting or satisfying the different thresholds and conditions of the potential rule. However, the potential rule is designed to provide members the ability to engage with FINRA if a presumption is triggered, and provide justifications, quantitative or otherwise, when needed and according to the facts and circumstances.

Finally, FINRA believes the potential rule may also impose indirect costs on members not covered by the potential rule. FINRA is unable to gauge the magnitude of these costs, as they depend on market conditions and the willingness of the members that would be subject to the rule to bear the direct costs stemming from the potential rule. First, the potential rule would impact carrying and clearing firms, and some of these members may pass through the costs resulting from the potential rule to customers and introducing firms. Additionally, some carrying and clearing firms might find they are unable to meet the potential rule requirements, and consequently cease providing carrying and clearing services. FINRA believes that while such outcome is theoretically possible, the probability is low that the potential rule will appreciably reduce the supply of carrying and clearing services. However, if carrying and clearing services are reduced, that could impede customer choice and potentially increase the cost of such services. Furthermore, investors could potentially be adversely impacted if the potential rule affects the ability of members to provision liquidity, even if only in the short term.

Some academic studies have claimed that liquidity regulation implemented following the 2008 financial crisis has adversely impacted liquidity in various markets.[32] Adrian et al. (2017a)[33] investigate whether post-crisis regulatory reforms, such as the Dodd-Frank Act and Basel III regulatory framework, had an adverse effect on corporate bond market liquidity. They study the changes in liquidity in the U.S. Treasury and corporate bond market, and overall do not find quantitative evidence of an overall deterioration of liquidity in both markets; however, the authors note that such regulatory reforms had an impact on broker-dealer balance sheets and business models. Furthermore, Adrian et al. (2017b) claims that institutions that faced more regulations after the crisis both reduced their overall volume of trading and had less ability to intermediate customer trades. Hoerova et al. (2018)[34] investigate the costs of the introduction and compliance of the Federal banking regulators' current Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) rules and have found these costs to be modest. Curfman and Kanrdac (2018)[35] claim that mandated increases in liquidity cause banks to reduce credit supply and depress banks' profitability. They further claim that some of the regulatory costs are ultimately passed on to the liability holders. While it is not clear the extent to which these and other outcomes might occur in the broker-dealer industry, the findings are suggestive of the possible outcomes, and the literature provides guidance on how to investigate these questions further.

Anticipated Competitive Effects

FINRA believes that the extent of the economic impacts of the potential rule could differ across the impacted members, depending on their business model and existing LRMPs. FINRA understands that such programs, and the associated firm specific policies and procedures, vary across firm size and business model.

The proposed criteria for being subject to the potential rule may, as discussed above, lead some members to change their business model to remain below the thresholds for inclusion. Members that are just above the threshold may be in competition with members that are just below the threshold and that are similar except for the compliance costs from the potential rule. These costs may also lead some member firms to change their business model to remain below the threshold.

As noted above, EPR firms are not subject to the conditions in paragraphs (b)(1) through (b)(8) of the potential rule.[36] Since EPR firms are already controlled by a bank holding company subjected to stringent capital requirements and other policy measures to mitigate liquidity risk, EPR firms may benefit from access to liquidity through their parent companies under market-wide stressed conditions. Caglio, Copeland and Martin (2021),[37] for instance, document the benefit of internal capital availability by comparing broker-dealers associated with bank holding companies to those that are not. They find that the latter had to shift from illiquid assets to more liquid government securities during the 2008 financial crisis. The potential rule would not exempt such members from the stress testing component and requires that EPR firms maintain sufficient liquidity on a current basis at all times. However, the burden to demonstrate insufficient liquidity if any of the criteria listed in the potential rule occur for such members would fall to FINRA, unlike for non-EPR firms, where the burden to rebut the insufficient liquidity presumption would fall on the member. In addition, either group of members may be deemed by FINRA to have insufficient liquidity on a current basis for reasons outside of the specified criteria of the potential rule; in such a scenario the burden of demonstrating insufficient current liquidity will fall to FINRA. In the scenario that the burden of proof and associated costs differ, the potential rule may change the competitive environment between EPR firms and other firms that are similar in size or business models but are not EPR firms. Such difference may also increase the incentives for other firms to be acquired by EPR firms, especially the firms with lower capacity to absorb the compliance costs.

Finally, the competitive impact of the potential rule on members versus non-members is unclear. For example, the National Futures Association (NFA) Compliance Rule 2-26, by incorporating Commodity Futures Trading Commission (CFTC) Rule 1.11, requires an NFA member Futures Commission Merchant (FCM) to establish, maintain and enforce a Risk Management Program, as specified under the CFTC rule.[38] Liquidity risk is considered one component of such a program. Investment advisers, asset managers and investment companies are differently situated and are subject, in part, to fundamentally different liquidity requirements.[39]

Request for Comment

FINRA requests comment on all aspects of the concept proposal. FINRA requests that commenters provide empirical data or other factual support for their comments whenever possible. FINRA specifically requests comments concerning the following:

- What alternatives exist, apart from or in addition to rulemaking, for FINRA to consider in setting liquidity standards? How would FINRA ensure that members met those standards if rules-based consequences did not exist?
- Would a rule that was more principles-based (*i.e.,* less prescriptive) be more appropriate? If yes, how should FINRA communicate its views of a member's minimum obligations? Would a more a principles-based rule lead to better outcomes? On the other hand, would a more prescriptive rule lead to better outcomes?
- **Members Subject to the Potential Rule:** Are the proposed requirements for determining what members would be subject to the potential rule appropriate? Are there alternative criteria that should be considered that would be more effective in capturing the members that should be subject to these rules? Are some members captured by the rule so small that the potential benefits do not justify the potential costs of being subject to the rule? What additional costs and benefits will be experienced because of the rule?
- **LRMP:** Does the potential rule include the appropriate minimum elements of an effective LRMP? Are there other sound liquidity risk management practices that

should be included as part of an LRMP in potential Rule 4610?

- **Sufficient Liquidity on a Current Basis:** Do the conditions set forth in paragraph (b) of the potential rule identify the appropriate factors to establish the presumption that a member does not have sufficient liquidity on a current basis? Which criteria are the strongest indicators of liquidity problems? Which criteria or risk indicators do members use for their own risk management programs to identify problems? Are the percentages and other threshold criteria (*e.g.,* day counts) set at appropriate levels? Should FINRA consider a member's leverage ratio, as discussed in *Regulatory Notice 10-44*,[40] as a condition? If so, how should a leverage ratio be considered (*e.g.,* as a standalone condition or in tandem with other conditions?) What would be considered a "high" leverage ratio? Should FINRA consider if the member is in a pattern of increased borrowing, using customer margin securities as collateral, which creates or increases a deposit requirement in a member's customer reserve computation? If so, what types of thresholds should FINRA consider?
- Under the potential rule, insufficient liquidity would be presumed if any of the conditions in paragraph (b) of the potential rule is met. What additional evidence, beyond the examples of factors noted in this *Notice*, should FINRA consider when a member seeks to rebut the presumption?
  - With respect to the condition in paragraph (b)(2), is 70 percent the appropriate level at which to set a presumption that a member may not have available cash or liquid assets sufficient to meet its current funding obligations? Why or why not?
  - With respect to conditions in paragraphs (b)(4) through (b)(6), are the specified percentages of lost funding indicative that a member does not have sufficient liquidity on a current basis? Why or why not?
- Members that are EPR firms, are not subject to the conditions in paragraphs (b)(1) through (b)(8) of the potential rule. Is this exception for EPR firms appropriate? Should FINRA consider any other type of member not to be subject to the conditions in paragraphs (b)(1) through (b)(8)? Why?
- **LST:** Is the proposed frequency of the LST appropriate? Should a member be permitted to rely exclusively on the assumptions in Supplementary Material .02? Many of the stress criteria are based on FINRA's guidance on effective practices outlined in *Regulatory Notice 15-33*; have these levels proven to be sufficient in planning for stress liquidity? Are the quantitative liquidity stress testing assumptions in Supplementary Material .02 of the potential rule set at the appropriate levels? Are the outlined qualitative liquidity stress testing assumptions appropriate? Are there additional qualitative liquidity stress testing

assumptions that would be appropriate?

- **CFP:** Are there other considerations that would be appropriate for incorporating into the required elements of a CFP prescribed in Supplementary Material .03 of the potential rule?
- **Notification and Reporting:** Are the notification and reporting requirements under paragraph (d) of the potential rule set at the appropriate levels in terms of timeframe and cadence? Would the proposed requirements under the potential rule cause any form of overlap with, or any other concerns with, notification or reporting under the rules or requirements of other agencies or regulatory bodies (for example, CFTC Rule 1.12(m))? If so, why?
- **Restriction or Suspension of Business:** Is the authority proposed under paragraph (e) of the potential rule reasonable in enforcing sufficiency of the member's liquidity on a current basis?
- In addition to the economic impacts identified in this concept proposal:
  - Are there other significant sources of impacts, including direct or indirect costs and benefits, of the concept proposal to members and investors?
  - What are these economic impacts and what are the factors contributing to them?
  - What would be the magnitude of these costs and benefits?
  - Would such economic impacts differ across firm size or business model?

Please provide data or other supporting evidence.

Endnotes

1. Parties should submit in their comments only personally identifiable information, such as phone numbers and addresses, that they wish to make available publicly. FINRA, however, reserves the right to redact or edit personally identifiable information from comment submissions. FINRA also reserves the right to redact, remove or decline to post comments that are inappropriate for publication, such as vulgar, abusive, or potentially fraudulent comment letters.

2. *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 take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

3. *See* SEA Rule 15c3-1.

4. *See* SEA Rule 15c3-3.

5. *See* SEA Rule 17a-3(a)(23).

6. While the Net Capital Rule addresses aggregate indebtedness, we believe that the firms that would be subject to this proposal are firms that elect not to be subject to the Aggregate Indebtedness Standard. The Net Capital Rule provides for the option to elect the Alternative Standard, which imposes a higher base minimum net capital requirement.

7. Liquidity and funding stress were significant factors in the financial crisis of 2008. *See, e.g.,* Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (January 2011). Even prior to the financial crisis, FINRA noted the importance of risk management practices. *See, e.g., Notice to Members 99-92* (November 1999) (Risk Management Practices) (setting forth a joint statement by the SEC, NASD, and NYSE on broker-dealer risk management practices). Since the financial crisis, the SEC and FINRA have looked closely at members' liquidity and funding risk management practices. The SEC Division of Examinations (DOE) Examination Priorities reports for 2016 and 2021 included evaluation of broker-dealers' liquidity risk management practices as an examination focus. *See, e.g.,* DOE Examination Priorities 2016 and 2021. FINRA has discussed liquidity risk in its Annual Report on FINRA's Examination and Risk Monitoring Program. *See, e.g.,* 2023 Report on FINRA's Examination and Risk Monitoring Program. *Regulatory Notice 10-57* expressed FINRA's expectation that members develop and maintain robust funding and liquidity risk management practices and discussed results of examinations that FINRA had conducted of the practices of selected members. *See Regulatory Notice 10-57* (November 2010) (Risk Management). *Regulatory Notice 15-33* provided guidance on liquidity risk management practices and described FINRA's review of policies and practices at selected member firms related to managing liquidity needs in a stressed environment. *See Regulatory Notice 15-33* (September 2015) (Liquidity Risk). *Regulatory Notice 21-12* provided guidance on sound liquidity practices that firms can use to meet their obligations to maintain reasonable funding and liquidity risk management. *See Regulatory Notice 21-12* (March 2021) (Customer Order Handling, Margin and Liquidity). More recently, in 2022, FINRA began receiving new Supplemental Liquidity Schedule (SLS) reports from certain member firms, which provide essential information about their sources and uses of liquidity. *See* Securities Exchange Act Release No. 92561 (August 4, 2021), 86 FR 43698 (August 10, 2021) (File No. SR-FINRA-2021-009).

The SLS information enables FINRA to better understand members' liquidity profile and monitor for events that signal an adverse change in such members' liquidity.

8. *See, e.g.,* S.P. Kothari et al., U.S. Credit Markets: Interconnectedness and the Effects of the COVID-19 Economic Shock (October 2020) (report of the SEC Division of Economic and Risk Analysis regarding market stress during the COVID-19 shock of March 2020). During the early stages of the pandemic, extreme volatility in the equity and fixed income markets coupled with significant changes in interest rates caused many member firms to experience liquidity stresses due to secured-funding margin calls, CCP requirements and demand by customers for cash withdrawals. Even securities ordinarily thought of as high-quality assets, such as agency mortgage-backed securities, traded in the to-be-announced market, experienced unprecedented price moves. Firms that had strong liquidity risk management programs in place were better prepared for these volatile markets and to meet the various demands for cash from customers and counterparties.

9. FINRA issued *Regulatory Notice 21-12* to remind member firms of their obligations during extreme market conditions with respect to handling customer orders, maintaining appropriate margin requirements and effectively managing their liquidity. *See* note 7; *see also* Acting Chair Allison Herren Lee, Commissioners Hester M. Peirce, Elad L. Roisman, and Caroline A. Crenshaw, Public Statement Regarding Recent Market Volatility (January 29, 2021).

10. *See*, for example, SEC Staff Report on Equity and Options Market Structure Conditions in Early 2021 (October 14, 2021).

11. Moreover, recent events in the banking sector, where some banks have struggled to maintain sufficient liquid assets to meet the demands of customers, has reinforced the importance of effective liquidity risk management for financial institutions in general.

12. *See* 2023 Report on FINRA's Examination and Risk Monitoring Program.

13. *See* Advance Notice of DTC Cease to Act for Lek Securities Corporation (June 10, 2022).

14. *See* *Regulatory Notice 21-31*. The SLS requirement applies to each carrying member with $25 million or more in free credit balances, as defined under SEA Rule 15c3-3(a)(8), and each member whose aggregate amount outstanding under repurchase agreements, securities loan contracts and bank loans is equal to or greater than $1 billion, as reported on the member's most recently filed FOCUS report.

15. *See* SEA Rule 15c3-3a(Note E)(5).

16. Under Supplementary Material to the proposed rule, "control" (including the terms "controlling" and "controlled by" and "under common control with") would be defined to mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. This definition is based on the definition of "control" under SEA Rule 12b-2.

17. Rule 9557, along with Rule 9559, addresses among other things notices by FINRA to members for directing compliance with certain financial and operational rules, and the related expedited hearing procedures. FINRA would make appropriate conforming amendments to current Rule 9557 to reflect the addition of potential Rule 4610 to the FINRA rulebook.

18. *See* Regulatory Notice 09-71 (December 2009) (SEC Approves Consolidated FINRA Rules Governing Financial Responsibility).

19. *See* Securities Exchange Act Release No. 59273 (February 13, 2009), 74 FR 4992 (January 28, 2009) (Notice of Filing of Proposed Rule Change To Adopt Rules Governing Financial Responsibility in the Consolidated FINRA Rulebook; File No. SR-FINRA-2008-067).

20. *See* note 19.

21. *See* the seminal discussion on funding liquidity and market liquidity, and their interdependencies, in Brunnermeier, Markus K., and Lasse H., Padersent, "Market liquidity and funding liquidity," The Review of Financial Studies, 22(6), 2009. For purposes of our discussion, the term liquidity refers to "funding liquidity."

22. Investors and financial institutions generally have less information about the financial condition of member firms than do the firms themselves. This asymmetry can make it difficult for financially sound member firms to distinguish themselves from less sound member firms and obtain short-term funding when needed. Further, even financially sound member firms will not generally consider how their own financial distress may contribute to an industry-wide liquidity problem. Minimum standards for liquidity risk may help incentivize prudent behavior by member firms from the industry-wide perspective.

23. Financial and Operational Combined Uniform Single (FOCUS) Report. *See* FINRA's FOCUS information page.

24. Generally, the proposed rule is designed so that carrying firms and firms that engage in significant financing activity would be subject to the proposal. Viewed strictly in terms of their number of registered representatives (as categorized under the FINRA By-Laws), of the firms that would be subject to the proposal, 45 percent are small firms (of which 73 percent are carrying firms), 15 percent are mid-size firms (of which 67 percent are carrying firms), and 40 percent are large firms (of which 92 percent are carrying firms). Across all FINRA members, again as categorized based on the number of registered representatives, approximately 90 percent of FINRA member firms are small firms, 5 percent are mid-size firms, and 5 percent are large firms. Of these (that is, across all FINRA members), 2 percent of the small firms, 10 percent of the mid-size firms and 30 percent of the large firms would be subject to the proposal. We note that the financial significance and liquidity risk of a firm's balance sheet and activity do not necessarily correlate with the number of a firm's registered representatives.

25. Of the approximately 125 members to which the proposal would apply, about one third of those are controlled by Bank Holding Companies (BHC). This subset of member firms is covered by the Federal Reserve Board's Enhanced Prudential Standards (Regulation YY). As such, this subset of members is covered by additional enterprise-wide liquidity regulation and monitoring frameworks. Some academic literature suggests that broker-dealers affiliated or controlled by a BHC might have access to liquidity through the parent company during stress events. *See* Caglio, Cecilia, Adam M. Copeland, and Antoine Martin, "The Value of Internal Sources of Funding Liquidity: US Broker-Dealers and the Financial Crisis," Federal Reserve

Board of New York Staff Report 969, 2021; and Correa, Ricardo, Wenxin Du, and Gordon Y. Liao, "US banks and global liquidity," No. w27491, National Bureau of Economic Research, 2020.

26. *See* *Regulatory Notice 15-33*. *Regulatory Notice 15-33* discusses the outcomes of an exercise FINRA conducted in 2014, with a select sample of members. FINRA conducted a review of the policies and practices at 43 members related to managing liquidity needs in a stressed environment. The review had two broad purposes: to understand better members' liquidity risk-management practices and to raise awareness of the need for liquidity stress planning and testing. The review included assessing firm management's knowledge and understanding of the liquidity risks that their firm faced, the firm's ability to measure liquidity needs in stress situations, management's preparedness, and plans for addressing such a scenario should it arise, and the specific steps the firm would take to address its needs. Key deliverables of the exercise included a review of effective and ineffective practices, and an overview of key benchmarks to be used as assumptions in firm's stress testing exercise. The benchmarks presented in *Regulatory Notice 15-33* are percentage based, and specific per asset class. FINRA is requesting comment in this *Notice* on the applicability of the benchmarks in *Regulatory Notice 15-33*.

27. Academic literature on the effects of liquidity regulation and stress testing on broker-dealers is sparse. FINRA acknowledges the limitations of making inferences on broker-dealers based on evidence from banks, as broker-dealers and banks differ along multiple dimensions, including regulatory environments, business models, and funding sources.

28. *See* Curfman, Christopher J and Kandrac, John, "The Costs and Benefits of Liquidity Regulations: Lessons from An Idle Monetary Policy Tool," November 3, 2018.

29. *See* Schneider, Thomas Ian, Philip E. Strahan, and Jun Yang, "Bank Stress Testing: Public Interest or Regulatory Capture?," *Review of Finance*, 27(2), 2023.

30. *See* Abboud, Alice, Elizabeth Duncan, Akos Horvath, Diana Iercosan, Bert Loudis, Francis Martinez, Timothy Mooney, Ben Ranish, Ke Wang, Missaka Warusawitharana, and Carlo Wix, "COVID-19 as a Stress Test: Assessing the Bank Regulatory Framework," *Journal of Financial Stability*, 61, 2022.

31. For additional discussion on this issue, *see* for example Leuz, Christian, and Peter D. Wysocki, "The economics of disclosure and financial reporting regulation: Evidence and suggestions for future research," *Journal of Accounting Research*, 54(2), 2016; Ballew, Hailey, Michael Iselin, and Allison Nicoletti, "Accounting-based thresholds and growth decisions in the banking industry," *Review of Accounting Studies*, 2021; and Ewens, Michael, Kairong Xiao, and Ting Xu, "Regulatory costs of being public: Evidence from bunching estimation," No. w29143, National Bureau of Economic Research, 2021.

32. *See* note 27.

33. *See* Adrian, Tobias, Michael Fleming, Or Shachar, and Erik Vogt, "Market liquidity after the financial crisis," *Annual Review of Financial Economics*, 9 (2017a): 43-83; and Adrian, Tobias, Nina Boyarchenko, and Or Shachar, "Dealer balance sheets and bond liquidity provision," *Journal of Monetary Economics*, 89 (2017b): 92-109.

34. *See* Hoerova, Marie and Mendicino, Caterina and Nikolov, Kalin and Schepens, Glenn and Schepens, Glenn and Van den Heuvel, Skander, "Benefits and Costs of Liquidity Regulation," July 13, 2018, European Central Bank (ECB) Working Paper No. 2169.

35. *See* Curfman, Christopher J and Kandrac, John, "The Costs and Benefits of Liquidity Regulations: Lessons from An Idle Monetary Policy Tool," *Review of Finance*, 26(2), 2022.

36. In principle, the set of banks that are classified as EPR firms may vary over business cycles and other economic conditions. For example, if banks tend to be more interconnected or have more complex operations over time, FINRA staff expects that more banks will become EPR firms in the future.

37. *See* Caglio et al., note 25.

38. *See* NFA Compliance Rule 2-26. Rule 2-26 provides in part that a violation of CFTC Rule 1.11 is deemed a violation of NFA requirements. CFTC Rule 1.11 requires in part that each FCM must establish, maintain, and enforce a system of risk management policies and procedures (referred to under the rule as a "Risk Management Program") designed to monitor and manage the risks associated with the activities of the FCM as such. *See* CFTC Rule 1.11.

39. U.S. investment adviser firms that are not broker-dealers or do not custody customer funds or securities do not currently have liquidity risk management requirements that are similar to the potential rule. U.S. investment adviser firms that do custody customer funds or securities are subject to specified requirements under Investment Advisers Act Rule 206(4)-2, which broadly requires the use of qualified custodians, for example, broker-dealers or banks, but does not independently impose separate liquidity requirements. For U.S. investment companies, a liquidity risk management framework is required through Investment Company Act Rule 22e-4, adopted in 2016 (Investment Company Liquidity Risk Management Programs). While some similarities exist with the potential rule, Rule 22e-4 focuses more on issues of disclosure and market liquidity.

40. *See Regulatory Notice 10-44*.