



Financial Industry Regulatory Authority  
June 19, 2012

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: SR-FINRA-2012-023 — Proposed Rule Change Relating to FINRA's  
Trading Activity Fee Rate for Transactions in Covered Equity Securities  
— Response to Comments**

Dear Ms. Murphy:

The Financial Industry Regulatory Authority, Inc. ("FINRA") hereby responds to the comment letters received by the Securities and Exchange Commission ("Commission" or "SEC") in response to the publication in the *Federal Register* of Notice of Filing of SR-FINRA-2012-023.<sup>1</sup> The purpose of the Proposal is to adjust the rate of FINRA's Trading Activity Fee ("TAF") on transactions in covered equity securities. The Proposal also states that FINRA believes it is appropriate to file future amendments to the TAF rates under Section 19(b)(3)(A) of the Securities Exchange Act of 1934 ("Act")<sup>2</sup> and Rule 19b-4 thereunder<sup>3</sup> rather than for full notice and comment under Section 19(b)(2) of the Act.<sup>4</sup> The Commission received four comment letters on the Proposal.<sup>5</sup>

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<sup>1</sup> See Securities Exchange Act Release No. 66924 (May 4, 2012), 77 FR 27527 (May 10, 2012) (Notice of Filing of File No. SR-FINRA-2012-023) ("Proposal").

<sup>2</sup> 15 U.S.C. § 78s(b)(3)(A).

<sup>3</sup> 17 CFR § 240.19b-4. Paragraph (f)(2) of Rule 19b-4 permits a proposed rule change filed by a self-regulatory organization ("SRO") to take effect upon filing with the SEC if the SRO designates the proposed rule change as establishing or changing a due, fee, or other charge applicable only to a member. 17 CFR § 240.19b-4(f)(2). The TAF is charged only to FINRA members.

<sup>4</sup> 15 U.S.C. § 78s(b)(2).

<sup>5</sup> Letter to Elizabeth M. Murphy, Secretary, SEC, from Daniel Keegan, Managing Director, Citigroup Global Markets Inc. ("CGMI"), dated June 13, 2012; letter to Elizabeth M. Murphy, Secretary, SEC, from John C. Nagel, Managing Director and General Counsel, Citadel Securities ("Citadel"), dated June 13, 2012; letter to Elizabeth M. Murphy, Secretary, SEC, from Kimberly Unger, Executive Director, The Security Traders Association of New York,

Knight opposes the Proposal and asserts three specific problems with the proposed increase in the TAF rate for covered equity securities: (i) the structure of the TAF is fundamentally at odds with the ability of firms to pay and is an unstable source of funding for FINRA's regulatory programs; (ii) the proposed increase will have a disproportionate impact on liquidity-providing trading firms; and (iii) FINRA should consider a more stable, equitable, and transparent source of funding in lieu of the proposed increase to the TAF rate. STANY also opposes the Proposal and asserts that the proposed TAF rate increase will have a disproportionate impact on FINRA members that make markets in OTC equity securities. CGMI and Citadel state that they have reviewed Knight's and STANY's comment letters and support the concerns raised in those letters. All four commenters also oppose FINRA's proposal to file future TAF rate changes with the SEC for immediate effectiveness.

FINRA disagrees with the comments and believes that the proposed fee change is necessary, reasonable, and equitably allocated among the firms regulated by FINRA. Although FINRA is sensitive to the issues raised by the commenters, FINRA's ultimate responsibility is to protect the investing public by administering an effective and sustainable regulatory program, and FINRA believes the Proposal is necessary to continue to carry out its responsibilities effectively. The issues raised by Knight and STANY are described and responded to below.

#### The Structure of the TAF and its Stability

Knight states that it "believes that FINRA's reliance on the TAF as a primary source of revenue for its regulatory programs is fundamentally flawed," in large measure because of the volatility in equity trading volumes. Knight also states that "the irony of the Proposal is that it would increase the TAF at a time when firms are experiencing lower revenues themselves as a result of reduced volume." STANY also observes that the Proposal is being put forward when "firms are already hard-pressed."

As an initial matter, although the TAF is an important component of FINRA's funding for its regulatory program, the TAF is only one piece of FINRA's revenue for this purpose. As noted in the Proposal, FINRA's primary member regulatory pricing structure consists of the Personnel Assessment ("PA"); the Gross Income Assessment ("GIA"); and the TAF.<sup>6</sup> Each of these fees reflects one of the critical components

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Inc. ("STANY"), dated June 11, 2012; and letter to Elizabeth M. Murphy, Secretary, SEC, from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc. ("Knight"), dated June 4, 2012.

<sup>6</sup> The GIA, the PA, and the TAF are the three member regulatory fees set out in Section 1 of Schedule A to FINRA's By-Laws. FINRA imposes other fees, such as the branch office assessment, that generate revenue as well. See FINRA By-Laws, Schedule A, § 4(a).

driving FINRA's regulatory costs with respect to a particular firm: the number of registered persons with the firm, the size of the firm, and the firm's trading activity. These fees are used to fund FINRA's regulatory activities, including examinations; financial monitoring; and FINRA's policymaking, rulemaking, and enforcement activities. In 2011, for example, FINRA received \$407 million in revenue from its member regulatory fees and assessments, only 33% of which was received from TAF revenue. As FINRA has noted in the past, the GIA, and not the TAF, is the most important component of FINRA's regulatory funding.<sup>7</sup> On a consolidated basis, TAF revenue represents less than 20% of FINRA's total revenues.

FINRA strives to operate on a cash-flow-neutral basis and budgets each year accordingly. As noted in the Proposal, by changing the TAF rate on covered equity securities, FINRA's goal is to receive a substantially similar amount in revenue from the TAF as the TAF has generated in prior years. As trading volumes decline, the TAF rate must increase to hit the revenue target; however, if trading volumes increase, FINRA will decrease the TAF rate accordingly. Although FINRA is cognizant of the fact that its member firms may be experiencing lower revenues themselves as a result of the decrease in volume, FINRA's statutory obligations continue to exist in difficult financial and market environments, and the resources needed for FINRA to effectively carry out its responsibilities do not diminish. To this point, the SEC stated the following in approving previous changes to FINRA's regulatory revenue structure:

Adequate regulatory funding is critical to FINRA's ability to meet these statutory requirements. While some member firms understandably question whether it is reasonable for FINRA to increase regulatory fees at a time when the securities industry has faced declining revenues as a result of the economic downturn, it is incumbent on FINRA to continue to support a robust regulatory program irrespective of market events.<sup>8</sup>

#### The Proposal's Impact on Liquidity-Providing Trading Firms

Knight asserts that the Proposal will disproportionately impact those FINRA members providing liquidity in covered equity securities and may inhibit the provision of liquidity or serve as a disincentive to firms considering becoming liquidity providers.<sup>9</sup> Knight notes that "[b]ecause the fee is based on share transaction volume,

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<sup>7</sup> See Securities Exchange Act Release No. 61042 (November 20, 2009), 74 FR 62616, 62617 (November 30, 2009) (Order Approving File No. SR-FINRA-2009-057).

<sup>8</sup> *Id.* at 62618.

<sup>9</sup> Although CGMI notes its support for each of the concerns Knight raises in its letter, CGMI states that it is "particularly concerned about the potential

it is paid by FINRA's trading members, with the bulk by liquidity providers." Knight also implies that the fact that most of the revenue from the TAF comes from equity trading may be inconsistent with Section 15A(b)(5) of the Act, which requires that a national securities association's reasonable dues, fees, and other charges be equitably allocated.<sup>10</sup> Knight asserts that, in its view, "imposing disproportionately high TAF payments on liquidity providing trading firms runs contrary to these principles."

STANY suggests that the Proposal will disproportionately affect firms that make markets in OTC equity securities, may discourage some firms from making markets, and may result in some firms going out of business. STANY "suggests that FINRA consider a funding scheme for its regulatory programs that more fairly allocates the financial burden of regulation across asset classes and regulated members."

When FINRA first proposed the TAF, it noted that the three critical factors used to measure regulatory costs for a member firm are the overall size of the firm, the level of a firm's trading activity, and the firm's number of registered representatives.<sup>11</sup> Since that time, FINRA has sought to measure these factors and assess fees accordingly by implementing regulatory fees that line up to each factor: the GIA, the TAF, and the PA, respectively. Because trading in the equity markets drives a significant portion of FINRA's regulatory costs, FINRA believes it is equitable to recover some of those costs from fees generated from equity trading activity.<sup>12</sup> Since the inception of the TAF, and in every proposal to amend it, FINRA has sought to ensure that the TAF is equitably allocated in a way that corresponds to FINRA's regulatory efforts. For example, when FINRA expanded the TAF to TRACE-reportable debt securities, it set the rate so that the portion of TAF revenue received on

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disproportionate impact that the proposed increase to [the TAF] may have on market makers and liquidity providing trading firms."

<sup>10</sup> See 15 U.S.C. § 78o-3(b)(5).

<sup>11</sup> See Securities Exchange Act Release No. 46416 (August 23, 2002), 67 FR 55901, 55904 (August 30, 2002) (Notice of Filing and Immediate Effectiveness of File No. SR-NASD-2002-98).

<sup>12</sup> FINRA notes that Section 31 of the Act, which is "designed to recover the costs to the Government of the supervision and regulation of securities markets and securities professionals," similarly relies on transaction-based fees to recover costs. Unlike the TAF, however, Section 31 fees do not apply to sales involving debt securities. See 15 U.S.C. § 78ee.

debt transactions reflected FINRA's regulatory efforts in the fixed income market.<sup>13</sup> As the Commission noted in approving the TAF:

Assessing fees in relation to transactions correlates to heightened [FINRA] responsibilities regarding firms that engage in the trading. In most cases, [FINRA] has direct responsibility to oversee the firm's dealing with the public in effecting the transactions; [FINRA] may also have the responsibility to oversee the impact of the trading on the firm's financial condition.<sup>14</sup>

This observation remains as true today as it was when the TAF was originally approved. The proposed increase to the TAF rate for covered equity securities ensures that a continued equitable proportion of FINRA's overall member regulatory fees is based on securities transactions and is fully consistent with Section 15A(b)(5) of the Act.

#### Alternative Methods of Funding

Knight suggests that "FINRA and the SEC should consider alternatives that would reduce FINRA's reliance on the TAF as a means of achieving funding for its regulatory obligations . . . start[ing] with a comprehensive review of all of FINRA's funding sources . . . and a review of FINRA's regulatory costs." Knight also lobbies that "greater transparency should be afforded to members during this process."<sup>15</sup> Similarly, as noted above, STANY suggests that FINRA consider alternative funding schemes for its regulatory programs.

As discussed above, FINRA disagrees with the underlying assumption that FINRA's revenue stream relies too heavily on the TAF, which is subject to the

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<sup>13</sup> See Securities Exchange Act Release No. 49114 (January 22, 2004), 69 FR 4194 (January 28, 2004) (Notice of Filing of File No. SR-NASD-2003-201). In the first ten months the TAF applied to TRACE-eligible securities, debt trades accounted, on average, for approximately 2.22% of overall TAF revenue received each month. In the first ten months after asset-backed securities became reportable to TRACE (and thus subject to the TAF), debt trades accounted, on average, for approximately 2.94% of overall TAF revenue each month.

<sup>14</sup> Securities Exchange Act Release No. 47946 (May 30, 2003), 68 FR 34021, 34023-24 (June 6, 2003) (Order Approving File No. SR-NASD-2002-148).

<sup>15</sup> FINRA notes that it publishes an annual report each year detailing its costs and revenues. In addition, FINRA's Board of Governors, which approves changes to the TAF rate, includes nine Governors that represent member firms.

unpredictable volatility in the equity markets. Moreover, FINRA routinely reexamines its fee structure to consider alternative means to reasonably and equitably allocate fees in a method that is efficient, sustainable, and predictable. In 2009, for example, FINRA increased the PA and revised the calculation of the GIA to achieve a more consistent and predictable funding scheme to carry out FINRA's mandate.<sup>16</sup> FINRA sought these changes while also engaging in a comprehensive cost-cutting program that, at that point, had reduced expenses that did not directly impact its regulatory programs by more than \$70 million from the prior year.<sup>17</sup> Furthermore, in 2011 prior to proposing additional fee increases, FINRA further examined and implemented cost-cutting efforts that did not directly impact its regulatory programs which yielded additional savings that will total nearly \$60 million by the end of 2013.

As the SEC, and the commenters, are no doubt aware, FINRA has a diverse membership of firms that vary greatly in size and in business models. As FINRA has pointed out in the past, it is impossible for FINRA to develop a comprehensive pricing scheme that accounts for the particulars of each member, but FINRA believes that its current pricing structure is reasonable, achieves general equity across its membership, and correlates the fees assessed to members to the regulatory activities conducted.

#### Filing of Future TAF Rate Changes for Immediate Effectiveness

As part of the Proposal, FINRA noted that, consistent with the recent amendments by Congress to Section 19(b)(3)(A) of the Act to clarify the authority of an SRO to file proposed rule changes establishing or changing a due, fee, or other charge imposed by the SRO for immediate effectiveness,<sup>18</sup> FINRA believes it is appropriate to file future amendments to the TAF rates under Section 19(b)(3)(A) of the Act and Rule 19b-4 thereunder rather than for full notice and comment under Section 19(b)(2) of the Act. The Proposal notes that all TAF rate changes will

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<sup>16</sup> See Securities Exchange Act Release No. 61042 (November 20, 2009), 74 FR 62616 (November 30, 2009) (Order Approving File No. SR-FINRA-2009-057).

<sup>17</sup> See Letter to Elizabeth M. Murphy, Secretary, SEC, from Philip Shaikun, Associate Vice President and Associate General Counsel, FINRA, dated November 19, 2009 (FINRA Response to Comments on File No. SR-FINRA-2009-057); *see also* Securities Exchange Act Release No. 61042 (November 20, 2009), 74 FR 62616, 62621 (November 30, 2009) (Order Approving File No. SR-FINRA-2009-057).

<sup>18</sup> Section 916 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amended Section 19(b)(3)(A) of the Act to explicitly allow SROs to file proposed rule changes for immediate effectiveness if the proposed rule change establishes or changes a due, fee, or other charge imposed by the SRO on members or non-members.

continue to be filed with the Commission, and the Commission summarily may temporarily suspend a proposed rule change changing a TAF rate filed pursuant to Section 19(b)(3)(A) of the Act within 60 days of filing “if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Act].”<sup>19</sup>

The commenters object to FINRA’s proposal to file future changes to the TAF rate for immediate effectiveness under Section 19(b)(3)(A) of the Act. Knight asserts that if FINRA files future TAF rate changes for immediate effectiveness, “the sector of the industry heavily affected by the TAF rate increases will not have the opportunity to provide the appropriate check and balance system now afforded the industry, [which] is specifically designed to avoid spiraling increases in regulatory costs and corresponding TAF rate increases.” STANY asserts that “any fee change made for non-competitive reasons should be subject to notice and comment proceedings prior to implementation” and that “transparency is in the best interests of both market participants and the public.”<sup>20</sup>

As an initial matter, both Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(2) thereunder specifically allow FINRA to file changes to fee rates applicable to a member for immediate effectiveness. As noted in the Proposal, this authority was made even more explicit and expansive in the recent amendments to Section 19 of the Act included in the Dodd-Frank Act. Filing future rate changes pursuant to specific statutory and regulatory authority does not in any way run afoul of the system of checks and balances established in the Act and the SEC’s rules thereunder. Moreover, as Knight notes in its letter, the TAF is uniquely subject to the volatility of the equity markets. FINRA can more easily and readily adjust the TAF rate (either up or down) to account for changes in market volume when the proposal is filed for immediate effectiveness pursuant to Section 19(b)(3)(A).<sup>21</sup> As noted in the Proposal, FINRA anticipates filing proposed changes to TAF rates (either to increase or to decrease a rate) only when necessary to account for changes in trading volume with the goal of

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<sup>19</sup> 15 U.S.C. § 78s(b)(3)(C).

<sup>20</sup> As noted above with respect to transparency, FINRA’s revenues and costs are fully transparent to its members and the public through the publication of FINRA’s annual report. FINRA does not believe that filing future proposals for immediate effectiveness alters the transparency of fee increases. As noted in the Proposal, all proposed changes to the TAF rate will be filed with the Commission, and these proposals will be published in the *Federal Register*.

<sup>21</sup> Because the TAF is self-reported to FINRA on a monthly basis, FINRA has not historically changed the TAF rate on equity securities during a month. See *Regulatory Notice* 12-06 (January 2012), *Regulatory Notice* 11-27 (June 2011). In keeping with this practice, FINRA anticipates that any future changes to the TAF rate would not be implemented immediately upon filing but would coincide with the beginning of a month.

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making the TAF revenue-neutral for FINRA (i.e., FINRA aims to receive a substantially similar amount in revenue from the TAF from year to year). FINRA believes that filing future rate changes for immediate effectiveness is consistent with the Act and the rules thereunder and will result in the TAF being more efficient and precise in meeting FINRA's budget needs.

FINRA believes that the foregoing fully responds to the issues raised by the commenters. Please feel free to contact me at (202) 728-6927 if you have any questions.

Sincerely,

A handwritten signature in blue ink that reads "Brant K. Brown". The signature is fluid and cursive, with the first name "Brant" and last name "Brown" clearly distinguishable.

Brant K. Brown  
Associate General Counsel