CLIENT ALERT

SEC Proposes FINRA Registration for High-Frequency Traders – But at What Cost?

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On March 25, the Securities Exchange Commission (the "Commission") proposed revising Rule 15b9-1 (the "Proposed Rule"), in a move designed to require broker-dealers engaged in proprietary high-frequency trading (HFT) of securities or other applicable products to register with a regulatory association (an "Association"). Since FINRA is the only Association that currently exists, all such HFT firms would be required to register with FINRA.

The rule proposal is intended to address concerns that HFT has a significant impact on markets and that HFT firms need to be more closely regulated to avoid intentional and unintentional negative market impact.

The rule proposal does not attempt to define high frequency trading. Rather, the rule proposal focuses on eliminating an exception used by currently used by broker-dealer proprietary trading firms to avoid registering with an Association.

All persons that fall within the Exchange Act's broad definitions of "broker" or "dealer" are required to register with the SEC, but floor brokers and other persons relying on current Rule 15b9-1 are not required to become an Association member – instead, their primary SRO is the exchange of which they are a member. However, an HFT broker-dealer may do little or no trading on the exchange that is its SRO, but will often trade on other exchanges and alternative trading systems. This has therefore served to minimize regulatory oversight of these firms.

The Commission's proposal follows a series of rulemaking proposals by FINRA regarding high-speed and algorithmic trading, including proposals for registration of individuals responsible for the design and development of algorithmic trading strategies and for clear identification of their orders and trades.

Existing Rule 15b9-1 and its use

Current Rule 15b9-1 was intended to exempt from the Association registration requirement exchange floor brokers that only engage in limited off-floor transactions or introduce their customers to other brokers and want to share in the commissions from those customers. To qualify for the exemption as currently in place, a floor broker must be a member of a national exchange, carry no customer accounts, and not derive more than $1,000 in annual gross income from off-exchange transactions. The $1,000 limitation does not apply to proprietary trading conducted with or through another broker-dealer. Many HFT firms primarily conduct their trading on other exchanges utilizing a third-party broker-dealer, or on alternative trading systems which are themselves broker-dealers. They are therefore able to use Rule 15b9-1 to avoid Association registration. The Commission now proposes to limit this exemption in a way that would subject HFT broker-dealers to full Association regulatory scrutiny.

Impact of the Proposed Rule on floor traders

The Proposed Rule would narrow the currently available "floor trader" exemption from registration. The current $1,000 gross income allowance for trades on exchanges where the broker-dealer is not a member would be replaced with exemptions for two

narrower types of transactions executed off the exchange where the broker-dealer is a member: (i) transactions executed solely for the purpose of hedging the risks of its floor-based activity, and (ii) transactions resulting from orders that are routed away from the exchange of which the broker-dealer is a member to prevent trade-throughs, in compliance with Regulation NMS.

The Proposed Rule would require broker-dealers relying on the exemption to bear the burden of establishing that their transactions qualify. For example, such a broker-dealer would need to maintain policies and procedures reasonably designed to ensure that its hedging transactions reduce or mitigate its on-exchange risks, and these policies and procedures would be subject to Commission and SRO review. However, the Commission did not specify what content would need to be included in these policies and procedures, and did not at this time specify that each risk-mitigating trade be tied to a single floor trade or group of floor trades. The Commission specifically requested comment on its hedging definition, including whether the definition was sufficiently specific, and whether each hedge would need to be documented and analyzed for compliance with the risk-mitigation policies and procedures. If the documentation requirements remain vague, it is predictable that differences of opinion will arise between exempted firms and regulators about what documentation is sufficient.

Impact of the Proposed Rule on HFT firms

The remedy proposed by the Commission goes further than simply requiring clear reporting of off-exchange transactions. Rather, the rule proposal will require broker-dealer proprietary trading firms to register with FINRA (because there is currently no other Association). Full FINRA registration requires compliance with rules regarding trading practices, business conduct, financial condition and supervision. For example, newly registered FINRA members will need to ensure that all of their associated persons are properly registered and qualified by examination – and if an individual is not registered and qualified, or is not eligible for registration, his or her role will need to be limited.

The costs of FINRA membership could also be significant – the Commission estimates in the proposing release that the annual trading activity fees for some new FINRA members would be as high as $3.2 million per year. The Commission suggested that FINRA consider changing its fee structure for these newly-registered members, due to the high volume and low per-trade profits associated with HFT. FINRA has not yet made public what fee structure changes it would be amenable to implementing.

All of this would be in addition to new proposals from both FINRA and the Commission regarding reporting of off-exchange transactions. The Commission noted in the release for the Proposed Rule that the Consolidated Audit Trail (CAT) reporting mechanism is expected to be put in place over the next several years. In addition, FINRA has proposed that when a member broker-dealer reports a trade via OATS, that it identify any non-member broker-dealer that is party to the trade.

A broker-dealer, including an HFT firm, would not be required to register with FINRA if it becomes a member of all exchanges on which it trades, and does not enter into any off-exchange transactions. However, the Commission acknowledged the impracticality of this option. Membership on multiple exchanges may be just as costly as FINRA membership, and limiting a proprietary trading business to exchange-only trades would significantly reduce the number of avenues available for trading.

FINRA's HFT initiatives

In September of last year, FINRA's board approved a series of proposed rulemaking items designed to better oversee algorithmic trading by its members. These initiatives include a March 19 proposal to require registration for associated persons of FINRA

members that are primarily responsible for the creation of algorithmic trading strategies such as those used by HFT firms (the "FINRA Proposal"). The FINRA Proposal would require all individuals primarily responsible for the design, development or significant modification of algorithmic trading strategies, as well as persons supervising or directing such activities, to register as a Securities Trader. The purpose of the registration requirement is to ensure that persons responsible for HFT programs understand the rules governing permissible market behavior and the consequences of their algorithmic trading on the marketplace. FINRA's board has recently approved a proposal for the new category of Securities Trader registration, which would replace the Equity Trader registration category. Persons required to register would need to pass FINRA's new Securities Trader qualification examination, the Series 57, but would not need to pass the Series 7 or Series 62. Persons with a Series 55 license would, however, be grandfathered.

In addition, on March 26, FINRA published guidance for its members clarifying how its existing rules should be applied in connection with HFT and other types of algorithmic trading. FINRA noted in this guidance that the algorithmic strategies of some FINRA members lack appropriate controls to prevent wash sales and excessive message traffic. FINRA's HFT and algorithmic trading proposals also include the requirement that member broker-dealers report via OATS the identity of any non-member firms that are a party to trades, as well as additional transparency initiatives.

What should market participants do?

The Commission suggests that if the Proposed Rule is finalized as written, it would go into effect 360 days from publication of the final rule in the Federal Register. HFT firms and other broker-dealers currently relying on Rule 15b9-1 should consider whether their activities would require registration under the Proposed Rule. Registration would entail not only Association membership fees (which vary according to transaction volume), but also the costs of putting into place all policies and procedures required by FINRA and maintaining compliance with FINRA's capital and reporting rules. They might also consider giving up broker-dealer registration entirely and operating as investment funds.

Continuing to use the 15b9-1 exemption as revised would also give rise to additional costs, including establishing policies to ensure that off-exchange trading falls within the parameters outlined by the rule and continued monitoring for compliance with those policies.

Concerned market participants may wish to comment on the Proposed Rule to address issues regarding how the Proposed Rule would work in practice, including whether FINRA will be open to revising its fee structure for new registrants and how the proposed hedging exemption will be policed. Commenters may also wish to address whether there are alternatives to requiring registration for firms currently relying on Rule 15b9-1, such as more robust reporting of beneficial ownership of off-exchange transactions, or whether it would be a practical option to implement a limited form of registration that would provide FINRA with jurisdiction but be less burdensome on the registrants and eliminate requirements unnecessary to fulfill FINRA's surveillance and educational goals.

The full text of the release regarding the Proposed Rule can be found here. Comments must be received by June 1, 2015.

The text of the FINRA Proposal can be found here. Comments must be received by May 18. FINRA's guidance for members regarding algorithmic trading strategies can be found here.

Crowell & Moring's regulatory and public policy attorneys are available to discuss the impact of the Proposed Rule and the FINRA Proposal on market participants and to assist in providing comments. In addition, Crowell & Moring's regulatory and compliance attorneys are available to assist market participants in determining whether new registrations would be required under revised Rule 15b-9 and/or the FINRA Proposal were they to be implemented, and in ensuring a smooth registration and ongoing compliance process.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.