Implications of the SEC's Plans to Amend Rule 15b9-1

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The overwhelming majority of SEC-registered broker-dealers must also be members of FINRA. Through a commonly overlooked exemption in SEC Rule 15b9-1, some broker-dealers that operate proprietary-only businesses are able to avoid FINRA regulation. The SEC plans to vote on a proposal to amend this rule on March 25. While it is not clear whether the SEC will seek to eliminate the exemption or narrow its availability, the rulemaking could have important implications for firms currently relying on the exemption and, more broadly, for the ongoing market structure debate.

This article explores the history of this exemption and some of the possible implications of an SEC rulemaking.

Background

Today, most SEC-registered broker-dealers are, by necessity, members of FINRA. Section 15(b)(8) of the Securities Exchange Act of 1934 (the "**Exchange Act**") requires every SEC-registered broker-dealer to become a member of an SEC-registered securities association (i.e., FINRA) unless the broker-dealer effects all of its securities transactions solely on an exchange of which it is a member. The SEC also has statutory authority to exempt broker-dealers that engage in off-exchange or over-the-counter ("**OTC**") securities transactions from the Exchange Act's requirement that such broker-dealers become FINRA members. The SEC used this authority to adopt Rule 15b9-1.

In a nutshell, Rule 15b9-1 allows a broker-dealer that is an exchange member to engage in OTC securities activities without FINRA membership if the broker-dealer: (1) carries no customer accounts and (2) has "annual gross income" derived from OTC activities of less than $1,000 (not counting income from transactions for the firm's own account with a separate broker-dealer or from transactions through the national market system).

The roots of the Rule 15b9-1 exemption trace back over a half-century to when the SEC itself performed certain self-regulatory organization ("**SRO**")-like functions with respect to some registered broker-dealers. In 1964, Congress amended the Exchange Act to require all registered broker-dealers doing OTC business to: (a) become members of an SEC-registered securities association (at that time, the National Association of Securities Dealers (the "**NASD**")) or (b) comply with an analogous regulatory program to be established by the SEC in order to provide broker-dealers with an alternative to NASD membership. In response, in the mid-1960s, the SEC created the "SEC Only" or "SEC-O" Program, which imposed procedures and requirements that closely paralleled the NASD's on those registered broker-dealers engaging in OTC securities business that chose not to join the NASD.

It was in this context that the SEC adopted the predecessors to what eventually became the current Rule 15b9-1 exemption. When it was developing the SEC-O Program, the SEC observed that "among the broker-dealers that are not members of a registered national securities association are several specialists and other floor members of national securities exchanges, some of whom introduce accounts to other members." The SEC noted further that these broker-dealers' OTC businesses "may be limited to receipt of a portion of the commissions paid on occasional [OTC] transactions in these introduced accounts, and to certain other transactions incidental to their activities as specialists." Thus it was in the context of this specialist and floor trader activity that the SEC established exemptions in the 1960s that allowed broker-dealers with limited OTC business to avoid both NASD membership and the SEC-O Program.

The SEC-O Program was eliminated in 1983 when Congress passed legislation requiring all broker-dealers engaged in OTC business to become members of an SEC-registered securities association. When the SEC rescinded its SEC-O rules, it retained—without much discussion—the exemption for exchange member firms with limited OTC activity contained in Rule 15b9-1. Since then, there has been relatively little published SEC guidance or discussion concerning the Rule 15b9-1 exemption, although from time to time the SEC has contemplated amending it. For example, in the early 2000s, under the leadership of Chairman Arthur Levitt, the SEC grew concerned about the use of the exemption by the "day trading" firms that had emerged with the advent of the Internet. The SEC did not ultimately propose to amend the exemption, however.

The current use of the exemption by firms today—many of which employ high speed automated trading strategies—is quite different than what was contemplated in earlier decades, when exchange specialists and floor traders played a central role in the markets. It is not surprising, therefore, that the SEC would seek to reexamine the exemption's appropriateness in today's marketplace. That said, in considering the impact of the exemption, it is important to note that all SEC-registered broker-dealers—regardless of the Rule 15b9-1 exemption or the exception in the statute for firms that limit their securities business to exchanges—are members of, and subject to the regulation of, one or more SROs—in addition to the regulatory oversight of the SEC and, in some cases, other SROs such as clearing agencies.

Potential Implications

The SEC's actions will be important for several reasons. First, and most directly, the elimination or narrowing of Rule 15b9-1 could significantly impact those firms that currently rely on the exemption, since FINRA membership would introduce a range of new compliance-related costs, burdens and considerations—both initially and on an ongoing basis.

Second, and more broadly, the rulemaking likely represents a first step towards the imposition of new regulation concerning high frequency trading ("**HFT**") activities. Over the last several months, SEC Chair Mary Jo White and various SEC officials have noted publicly that the SEC intends to advance an ambitious agenda of rulemakings and regulatory initiatives in response to various HFT and market structure-related concerns, including requiring unregistered, highly active proprietary traders to register with the SEC. The SEC's action on March 25 may stem in part from its desire to subject the firms that are currently relying on the Rule 15b9-1 exemption to the emerging package of equity market structure and HFT-related regulatory initiatives that FINRA is currently developing. Last week, for instance, FINRA issued a proposal that would require the registration of associated persons of FINRA members who are primarily responsible for algorithmic trading strategies. The rulemaking may also provide an interesting window into the SEC's views concerning the future role of exchanges as regulators.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Annette L. Nazareth	**202 962 7075**	**annette.nazareth@davispolk.com**
Jeffrey T. Dinwoodie	**202 962 7132**	**jeffrey.dinwoodie@davispolk.com**