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CLIENT MEMORANDUM

SEC Proposes the First of Several Anticipated Reforms to Address Equity Markets Issues

April 2, 2015

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In response to a widespread focus on active trading firms, including high-frequency traders, last June, Mary Jo White, Chairwoman of the Securities and Exchange Commission (the "SEC"), announced plans for a set of rulemaking initiatives designed to enhance equity market structure, including "a rule to clarify the status of unregistered active proprietary traders to subject them to our rules as dealers; and . . . a rule eliminating an exception from [the membership requirements of the Financial Industry Regulatory Authority, Inc. ("FINRA")] for dealers that trade in off-exchange venues."[1] On March 25, 2015, the SEC published the first of these measures. The SEC announced a proposed rule (the "Proposal") to amend Rule 15b9-1 under Section 15(b)(9) of the Securities Exchange Act of 1934 (the "Exchange Act")[2] to eliminate the exception from FINRA membership for exchange members that engage in proprietary trading in the off-exchange markets.

1 Chairwoman Mary Jo White, "Enhancing Our Equity Market Structure," Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference, New York, NY (June 5, 2014), *available here*.

2 *See* Exemption for Certain Exchange Members, Exchange Act Release No. 74581 (March 25, 2015), *available here*.

Current Rule 15b9-1 (the "Rule") provides the SEC with authority to exempt any broker-dealer from the requirement that broker-dealers become members of FINRA. The Rule applies to exchange specialists, floor brokers and other exchange members that do not carry customer accounts. It exempts a broker-dealer from the requirement that it become a member of a registered national securities association[3] so long as it has annual gross income of no more than $1,000 that is derived from securities transactions effected otherwise than on the national securities exchange of which it is a member. The Rule also excludes from this allowance income generated from proprietary trading in non-exchange venues.

The Proposal is aimed at proprietary trading firms that become members of exchanges solely to satisfy the current requirement in the Exchange Act that every broker-dealer be a member of at least one self-regulatory organization. The Rule currently provides a means for such firms to avoid FINRA membership, even though the majority of trading they engage in is off the exchange of which they are members. In his statement at the SEC's open meeting,[4] Commissioner Luis Aguilar indicated that the Proposal is designed to ensure that high-frequency traders, which, he noted, account for almost half of all trading that takes place on alternative trading systems, are subject to FINRA supervision and enforcement authority. Notwithstanding the significant market presence of these firms, Commissioner Aguilar indicated that FINRA has been unable to effectively oversee the activity of a number of high-frequency trading firms due to the Rule.

The proposing release points out that inclusion of high-frequency trading firms in national securities association memberships will ensure that the costs associated with monitoring the market through FINRA will be borne equally by these firms, which are active participants in the market. The SEC estimates that the registration of even the small number of firms thought to be affected by the Proposal (estimated to be 125 firms) would generate annual revenues of approximately $85 million for FINRA.

The Proposal would provide two narrow exceptions to the requirement that a broker-dealer trade solely on an exchange of which it is a member. First, a broker-dealer that conducts business on the floor of an exchange could effect transactions off the exchange so long as the transactions are for the sole purpose of hedging the risk of its floor-based activities. A broker-dealer seeking to rely on this exception must also establish and follow written policies and procedures designed to ensure that such transactions reduce or mitigate risks related to its floor-based activities and must preserve those policies and procedures for three years after they are replaced with more updated versions. Second, a broker-dealer could effect transactions off the exchange as a result of orders that are routed by the exchange to another exchange or venue in order to prevent trade-throughs on the exchange consistent with Rule 611 of Regulation NMS under the Exchange Act. Exchange specialists and floor brokers, in practical terms, would likely be the only types of broker-dealers able to rely on these targeted exemptions, as the Proposal eliminates the existing $1,000 allowance and the exclusion for proprietary trading. A firm that engages in trading other than on the exchange of which it is a member would be required under the

[3] Currently, FINRA is the only registered national securities association.

[4] Hon. Luis A. Aguilar, "Enhancing Oversight of Our Equities and Options Markets," (March 25, 2015), *available here*.

Proposal to either (i) register with FINRA as a member or (ii) register with each of the exchanges on which the firm transacts and not effect any off-exchange transactions.

If adopted, the Proposal would require compliance with the proposed registration requirements within one year after publication of the final rule in the Federal Register. Comments on the Proposal are due within 60 days after publication in the Federal Register.

If you have any questions about this memorandum or would like additional information, please contact P. Georgia Bullitt (212 728-8250, gbullitt@willkie.com), James R. Burns (202 303-1241, jburns@willkie.com), Howard L. Kramer (202 303-1208, hkramer@willkie.com), Jed E. Doench (212 728-8687, jdoench@willkie.com) or the Willkie attorney with whom you regularly work.

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