April 20, 2015

Proposed Amendments to SEC Rule 15b9-1 Would Require Most Proprietary Trading Broker-Dealers to Become FINRA Members

INTRODUCTION

Consistent with the increased regulatory scrutiny of proprietary trading firms—and high frequency trading firms in particular—the Securities and Exchange Commission (SEC) recently proposed amendments to SEC Rule 15b9-1 (also referred to herein as the "Rule") under the Securities Exchange Act of 1934 ("Exchange Act") that would, if adopted in their current form, require virtually all proprietary trading firms that currently are registered as broker-dealers with the SEC to become members of the Financial Industry Regulatory Authority (FINRA). In particular, any registered broker-dealer that engages in "off-exchange" trading would be required to join FINRA unless one of the very narrow exemptions in the proposed amended version of the Rule applied. As set forth in greater detail below, FINRA membership would impose upon such firms a variety of new obligations and associated costs. Off-exchange trading refers to any securities transaction in an exchange-listed security:

- that is not effected, directly or indirectly, on a national securities exchange, including trading that occurs on alternative trading systems and directly with a broker-dealer, acting either as agent or principal; or
- that is effected by, or on behalf of, a registered broker-dealer on a national securities exchange of which such broker-dealer is not a member.[1]

The SEC has proposed that the contemplated amendments become effective 360 days after publication in the Federal Register of the final rules.

THE CURRENT RULE

Under Section 15(b)(8) of the Exchange Act, an SEC-registered broker-dealer may not effect transactions in, or attempt to induce the purchase or sale of, any security[2] unless the firm is a member of a registered national securities association or effects transactions in securities solely on a national securities exchange of which it is a member. FINRA currently is the only registered national securities association. However, Section 15(b)(9) of the Exchange Act allows the SEC, by rule or order, to exempt broker-dealers from the obligation to become a member of a national securities association under Section 15(b)(8). Pursuant to this

[1] The term "off-exchange" is not defined or otherwise used in the proposed amended Rule itself but is used herein, and by the SEC in the proposed rulemaking release, to describe certain trading activity that is implicated by the proposed amendments. Off-exchange does not refer to transactions in securities that are not listed on a national securities exchange.

[2] Other than commercial paper, bankers' acceptances or commercial bills.

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authority, the SEC adopted Rule 15b9-1. Currently, Rule 15b9-1exempts a broker-dealer from the obligation to become a FINRA member if it meets each of the following requirements:

1. it is a member of a national securities exchange;
2. it carries no customer accounts; and
3. it has annual gross income of no more than $1,000 that is derived from securities transactions effected otherwise than on a national securities exchange of which it is a member (the "*de minimis* allowance").

Importantly, however, income derived from trading in the broker-dealer's own account with or through another registered broker-dealer does not count toward the $1,000 *de minimis* allowance. Accordingly, a proprietary trading firm that is registered with the SEC as a broker-dealer, is a member of a national securities exchange and carries no customer accounts may engage in unlimited proprietary trading off-exchange without triggering any obligation to be a member of FINRA.

THE STATED PURPOSE OF RULE 15b9-1

The SEC takes the position that as a general matter an exchange is typically best suited to regulate trading on the exchange, and a registered national securities association (i.e., FINRA) is best suited to regulate off-exchange trading, including trading by broker-dealers on exchanges other than those of which the broker-dealer is a member. Rule 15b9-1 was adopted in accordance with these principles by exempting broker-dealers that engage only in non-customer business and exclusively (or almost exclusively) on an exchange of which they are a member, from the requirement of becoming a member of a securities association. Broadly speaking, this exemption is based on the theory that the exchange of which such a firm is a member is best-situated to effectively regulate the firm, and additional regulation by a securities association is therefore unnecessary.

Notwithstanding this general viewpoint, the SEC explains in its proposed rulemaking release[3] that the inclusion of the *de minimis* allowance in the Rule was meant to permit a firm that does only non-customer business and does virtually all of its business on an exchange of which it is a member (such as a floor broker or exchange specialist), to engage in limited off-exchange business without becoming obligated to join FINRA. For example, the Rule permits an exchange specialist to receive a nominal amount of commissions on occasional off-exchange transactions for accounts it refers to other broker-dealers. Moreover, the SEC indicates that the purpose of amending the Rule (in 1976) to exclude income derived from proprietary trading from counting toward the *de minimis* allowance was to give exchange specialists/floor brokers the flexibility to engage in off-exchange proprietary transactions to reduce their exposure (i.e., by hedging risk on the primary listing market) without worrying about whether such hedging activity might result in profits in excess of the $1,000 maximum in the *de minimis* allowance, and thereby trigger an obligation for the firm to join a national securities association.

In other words, the essential purpose of the Rule, according to the SEC, was to allow floor brokers and exchange specialists to engage in very limited off-exchange activities associated with or ancillary to their floor-based activities.

THE SEC'S RATIONALE FOR AMENDING THE RULE

Despite the fact that the purpose of the Rule was to accommodate limited ancillary activities of floor-based businesses, the Rule itself does not explicitly so limit its scope. Instead, the Rule as currently written allows a member of a national securities exchange that has no floor presence whatsoever to engage in unlimited off-exchange proprietary trading activity without becoming a member of a national securities association. Accordingly, as the nature of the nation's securities markets has changed over time from primarily manual to primarily automated, many broker-dealers began relying on the Rule 15b9-1 exemption. The SEC notes that these firms often engage in high-frequency trading strategies and effect transactions across the full range of exchanges and off-exchange markets by using complex electronic trading strategies and technology that generate substantial order and transaction volume on the national market system. For example, statistics cited by the SEC indicate that during 2012, 2013 and 2014, 32 percent, 40 percent, and 48 percent, respectively, of orders sent directly to alternative trading systems (ATSs) came from non-FINRA members.[4]

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[3] Exchange Act Release No. 74581 (March 25, 2015) (the Rule Release), available here.

[4] Rule Release at footnote 21.

From the SEC's perspective, many of the largest and most active cross-market proprietary trading firms, which typically have no exchange floor presence at all and that account for a substantial amount of the activity in off-exchange markets, have avoided FINRA membership.[5] As a result, these firms are not subject to oversight by FINRA and their off-exchange activities, including activities on exchanges of which they are not members, typically are not directly regulated by the exchanges of which they are members (those exchanges for the most part limit their oversight to activities on the exchange). Therefore, the SEC believes that amendment of Rule 15b9-1 is necessary "to better align the scope of its exemption, in light of today's market activity, with Section 15(b)(8) of the Exchange Act and the Commission's original purpose in adopting Rule 15b9-1, which was to accommodate broker-dealer activities ancillary to a floor-based business while preserving the traditional role of the exchange as the entity best suited to regulate member conduct on the exchange" and to provide for oversight of the significant off-exchange activities of various proprietary trading firms by the self-regulatory organization (SRO) best-suited for that role—FINRA.[6]

THE PROPOSED REVISIONS TO RULE 15b9-1

As proposed, the amended Rule will narrow the scope of off-exchange activities in which a broker-dealer may engage and still rely upon the Rule to avoid becoming a member of FINRA. The amended Rule does this by eliminating the *de minimis* allowance and replacing it with provisions limiting the off-exchange trading of a firm seeking to rely on the Rule to transactions designed to hedge risks arising from floor-based activities and transactions that prevent trade-throughs in accordance with Regulation NMS. In particular, the changes to the Rule as contemplated by the SEC proposal are reflected in the following chart:

<table>
<tr><th colspan="2">Any broker or dealer required by Section 15(b)(8) of the Exchange Act to become a member of a registered national securities association (i.e., any SEC-registered broker-dealer that effects transactions in, or attempts to induce the purchase or sale of, securities other than on an exchange of which such firm is a member) shall be exempt from such requirement if it:</th></tr>
<tr><th>Current Rule 15b9-1</th><th>Proposed Amended Rule 15b9-1</th></tr>
<tr><td>Is a member of a national securities exchange;</td><td>Is a member of a national securities exchange;</td></tr>
<tr><td>Carries no customer accounts;</td><td>Carries no customer accounts;</td></tr>
<tr><td>Has annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than $1,000, except that:
Such gross income limitation does not apply to income derived from transactions (1) for the dealer's own account with or through another registered broker or dealer or (2) through the Intermarket Trading System.[7]</td><td>Effects transactions in securities solely on a national securities exchange of which it is a member,[8] except that:
A dealer that conducts business on the floor of a national securities exchange may effect transactions off the exchange, for the dealer's own account with or through another registered broker or dealer, that are solely for the purpose of hedging the risks of its floor-based activities, by reducing or otherwise mitigating the risks thereof (the Floor Member Hedging Exception); and
A broker or dealer may effect transactions off the exchange resulting from orders that are routed by a national securities exchange of which it is a member to prevent trade-throughs on that national securities exchange consistent with Rule 611 of Regulation NMS (the Regulation NMS Routing Exception).</td></tr>
</table>

[5] The SEC estimates that there are 125 SEC-registered broker-dealers that are not also FINRA members. Rule Release at p. 25.

[6] Rule Release at pp. 11-12.

[7] The Intermarket Trading System was a national market system plan that was eliminated in 2007 and superseded by Regulation NMS.

[8] Note that the proposed Rule does not include any explicit carve-out to exclude a financing transaction as constituting a transaction that might trigger the obligation to become a FINRA member. As an example, the SEC's Rule 13h-1 (Large Trader Reporting) expressly excludes a stock loan or equity repurchase agreement from its scope.

The Floor Member Hedging Exception is narrowly tailored to satisfy the underlying purpose of the Rule as described by the SEC—that is, to allow very limited activities arising from the floor-based activities of a floor-based firm, on markets other than an exchange on which such firm is a member. Only off-exchange activities by floor brokers/exchange specialists that are solely for the purpose of reducing or mitigating the risks arising from on-floor activities would fit within this exception. A broker-dealer seeking to rely on the Floor Member Hedging Exception would be required to adopt and enforce written policies and procedures reasonably designed to:

- ensure that any such hedging transactions reduce or otherwise mitigate the risks of the financial exposure that the dealer incurs as a result of its floor-based activities;
- to maintain copies of such policies and procedures until three years after the date on which such policies and procedures are replaced; and
- should also maintain documentation that would allow it to show (in the context of an SRO examination) how its off-exchange hedging transactions reduce or otherwise mitigate such risks.

The Regulation NMS Routing Exception would replace the provision in Rule 15b9-1 stating that gross income derived from transactions through the Intermarket Trading System need not be counted for purposes of compliance with the *de minimis* allowance. Generally, Rule 611 of Regulation NMS protects automated quotes that are the bed bid or offer of a national securities exchange or registered national securities association. National securities exchanges route orders through broker-dealers to other trading centers to comply with Rule 611. Accordingly, the Regulation NMS Routing Exception would allow a broker-dealer to effect off-exchange transactions solely to comply with Rule 611 without falling outside of the Rule 15b9-1 exemption and being required to become a FINRA member.

VIRTUALLY ALL PROPRIETARY TRADING BROKER-DEALERS WOULD BE REQUIRED TO JOIN FINRA UPON ADOPTION OF THE PROPOSED RULE 15b9-1 AMENDMENTS

The proposed amendments would severely limit the scope of the Rule 15b9-1 exemption as it exists today and effectively render the exemption unavailable for proprietary broker-dealer firms. In particular, the revised exemption would apply to a broker-dealer that effects transactions other than on a national securities exchange of which it is a member only for the purpose of either: (1) hedging the risks of the firm's floor-based activities; or (2) compliance with Rule 611 of Regulation NMS. Consequently, and because there is no *de minimis* exception of any sort in the proposed rule, a single off-exchange trade, including on an exchange of which the proprietary broker-dealer firm is not a member (even if through another broker-dealer that is a member of such exchange), presumably would trigger the obligation to become a FINRA member. The FINRA membership requirement would apply regardless of whether the proprietary trading broker-dealer trades exclusively on ATSs or other off-exchange markets, on exchanges of which it is not a member or some combination of the two.

Accordingly, if the proposed Rule amendments are adopted, a proprietary trading firm likely could avoid FINRA membership only if: (1) it is not registered with the SEC as a broker-dealer (in which case Section 15(b)(8) of the Exchange Act would not apply to it); or (2) it effects transactions in securities only on national securities exchanges of which it is a member (i.e., it (a) does not effect transactions in exchange-listed securities on any market other than a national securities exchange; and (b) is a member of each national securities exchange on which it directly or indirectly effects transactions) (in which case the firm would be in compliance with Section 15(b)(8) and would not need to rely on any exemption therefrom).

With respect to the first such option, a proprietary trading firm's ability to operate without triggering an obligation to register with the SEC as a dealer requires careful consideration. Under the Exchange Act, a dealer is "any person engaged in the business of buying and selling securities ... for such person's own account through a broker or otherwise" and is required to register with the SEC as such. However, "a person that buys or sells securities ... for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business," is excluded from the definition of "dealer" under the Exchange Act.[9] An in-depth analysis of the circumstances in which a proprietary trading firm might avoid registering as a dealer is beyond the

[9] *See* Exchange Act sections 3(a)(5)(A) & (B).

scope of this advisory, but any such firm that wishes to operate without being so registered must conduct such an analysis under existing law and related SEC guidance.[10]

The second option above (i.e., conducting no activity in listed securities other than on exchanges of which the firm is a member) may not be a commercially viable business model for many proprietary trading firms.

As a result, we expect that if the SEC adopts the proposed Rule 15b9-1 amendments, most SEC-registered proprietary trading firms will be required to join FINRA.

THE FINRA APPLICATION PROCESS

The FINRA membership application process can be a time-consuming undertaking, typically requiring significantly more time than the exchange membership approval process. Generally speaking, applying for FINRA membership requires completion and submission of, at a minimum:

- Form BD;
- the FINRA New Membership Application ("Form NMA");
- Forms U4/fingerprint cards for all registered personnel;
- a detailed business plan including proposed activities, personnel and product mix;
- pro forma financials; and
- written supervisory procedures (including, *inter alia*, AML procedures, continuing education program, business continuity plan and detailed supervisory policies).

Applicants also typically are subject to a pre-membership interview conducted by FINRA staff members. The process may take up to six months or longer and often requires substantial back-and-forth with FINRA before approval is granted.

CONSEQUENCES OF FINRA MEMBERSHIP FOR PROPRIETARY TRADING FIRMS

Proprietary trading firms that are exchange members are already subject to FINRA regulatory oversight in that many exchanges outsource some or all of their regulatory, examination and/or enforcement functions to FINRA. Although this oversight relates to such firms' obligations under exchange rules (and federal securities laws) and not FINRA rules, at a minimum many proprietary trading firms already are familiar with FINRA as an examination authority.

Nonetheless, FINRA membership will impose upon proprietary trading firms new obligations that will require such firms to incur costs and modify existing processes. Prominent examples include:

- **Trading Activity Fee.** FINRA imposes upon member firms a Trading Activity Fee (TAF) that is designed to cover FINRA's costs to supervise and regulate members. The TAF is generally assessed on FINRA-member firms for all equity sales transactions that are not performed in a broker-dealer's capacity as a registered exchange specialist or market maker. Because proprietary trading firms often effect equity sales transactions in large volumes, the TAF may constitute a significant new expense to such firms upon becoming FINRA members (the SEC estimates that the annual TAF associated just with ATS trading for some such firms would be as high as $3.2 million per year; exchange-based activity may further increase that amount). In the Rule Release, however, the SEC suggests that FINRA may need to reevaluate the structure of the TAF as it applies to proprietary trading firms,[11] so it is possible that FINRA may alter the TAF structure so that it is not as economically burdensome to high-frequency traders (HFT) that would be required to join FINRA upon the amended Rule becoming effective.

[10] Notably, a proprietary trading firm that is not registered as a broker-dealer may find itself unable to access markets and/or market information with the same speed and efficiency as a registered broker-dealer (e.g., only a registered broker-dealer may be a member/trading permit holder of a national securities exchange and thereby obtain direct access to exchange matching engines, certain pricing advantages, etc.).

[11] Rule Release at footnote 95 and pp. 72-73.

- **OATS-related programming.** FINRA's Order Audit Trail System (OATS) captures order information in NMS securities and OTC equity securities reported by FINRA-member firms to provide FINRA with an accurate, time-sequenced record of orders and transactions. FINRA-member firms are obligated to submit electronic OATS reports to FINRA providing all required information whenever an order is originated, received, modified, canceled or executed.[12] Proprietary trading firms that become FINRA members likely will incur programming expenses arising from their OATS reporting obligations, and also will need to adopt written supervisory policies and procedures reasonably designed to facilitate compliance with FINRA's OATS rules.[13]
- **FINRA Rule 1017.** FINRA-member firms are obligated, under FINRA Rule 1017, to file a continuing membership application with FINRA whenever they seek to expand their operations or activities, to modify or eliminate any restrictions imposed in their FINRA membership agreement and for certain other business events as prescribed by such rule. The circumstances in which Rule 1017 applies are relatively broad and member firms typically must submit continuing membership applications in connection with most, if not all, material changes in their business activities or ownership. The Rule 1017 process is largely similar to the initial membership application process, and can require a substantial amount of time, effort and expense. Approval by FINRA is required prior to a firm engaging in any new or modified activities that otherwise require the submission of a continuing membership application.[14]

The above are just a few of the new obligations that will apply to proprietary trading firms that would be required to join FINRA if the amended Rules are adopted and implemented. Please see Appendix A to this advisory for a more detailed list of requirements related to the FINRA membership application process and to FINRA members generally.

In addition to the particular day-to-day obligations that will apply to proprietary trading firms under the FINRA Rulebook, FINRA membership also will result in such firms becoming subject to FINRA's enforcement and disciplinary jurisdiction. An important impetus to the SEC's proposal is that it will result in enhanced oversight by FINRA of cross-market trading. As described by SEC Commissioner Aguilar:

> Currently, when an HFT that is not a member of an association executes an off-exchange trade, the HFT's identity is usually not reported to [FINRA]. ... This frustrates FINRA's surveillance efforts as it cannot quickly link trades to the HFTs responsible for them. This is a serious problem because, according to FINRA's current Chairman, certain market participants disperse their trading activity across multiple markets in an attempt to hide various forms of market abuse, including layering, spoofing, algorithm gaming, and wash sales. The proposed amendments to Rule 15b9-1 will help provide FINRA and any other associations that may be formed in the future with a richer and more detailed audit trail, which will help them spot abusive trading practices more effectively.[15]

Of course, once an HFT or other proprietary trading firm becomes a FINRA member, to the extent that FINRA identifies any alleged abusive or violative conduct by such firm, it will have jurisdiction to employ the full range of its investigative and disciplinary powers to hold the firm and its registered personnel accountable.

REQUESTS FOR COMMENTS

The SEC has set a deadline of June 1, 2015 for comments on the proposed rulemaking. Throughout the Rule Release, the SEC has identified various issues and questions for which comments are sought. Primary examples include:

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[12] Required information includes, e.g., date and time the order is originated; an order ID; security ID; number of shares; buy/sell; short sale/short sale exempt; market/limit/stop/stop limit; any limit or stop price; and various other information specified. *See* FINRA Rule 7440(b).

[13] Proprietary firms that currently are members of the Nasdaq Stock Market already have an obligation to record the order information contemplated by FINRA's OATS rules. However, such firms have only a limited obligation to report such information. In particular, under Nasdaq Stock Market Rule 7450A "Proprietary Trading Firms shall be required to comply with [the FINRA order data transmission requirements] ... only when they receive a request from Nasdaq Regulation to submit order information with respect to specific time periods identified in such request." Upon becoming a FINRA member, such firms will be required to report OATS information daily in accordance with FINRA rules, and not just upon request. Also, many firms rely upon their clearing brokers to submit OATS reports on their behalf pursuant to their clearing agreements.

[14] The FINRA Continuing Membership Guide, available here, provides details concerning the process.

[15] Statement at Opening Meeting by Commissioner Luis A. Aguilar, March 25, 2015 (available here).

- The SEC requests comment generally on whether narrowing or broadening the current exemption is appropriate. In particular, the SEC seeks comment on whether the fact that non-FINRA members currently must use a FINRA-member firm to report trades they effect other than on a national securities exchange gives FINRA sufficient information and jurisdiction to effectively regulate the off-exchange market. Are there off-exchange transactions between two non-FINRA member firms that occur that are not reported?
- The SEC seeks data indicating how many entities rely either on Rule 15b9-1 in its current form or exclusively on the statutory exception in Section 15(b)(8) of the Exchange Act, and asks whether in lieu of the proposed amendments, the SEC should require broker-dealers relying on Rule 15b9-1 to report such reliance to the SEC or the exchange of which the firm is a member.
- If the SEC were instead to eliminate Rule 15b9-1 altogether, how many broker-dealers would: (1) restrict their business to only those national securities exchanges of which they are a member; (2) become members of other national securities exchanges; and/or (3) become members of FINRA? Would implementation of the proposed amendments have an effect on market liquidity (and if so, what would that effect be)? Could broker-dealers that currently rely on the Rule respond to its elimination in other ways to avoid FINRA membership?
- Should the SEC allow non-FINRA-member firms that conduct off-exchange trading activity to remain exempt from membership in FINRA? If so, why? Would membership by such firms in multiple exchanges prove an efficient and effective substitute for FINRA membership? Should the level of off-exchange activity affect the ability of a firm to be exempt from FINRA membership? Why or why not?

Notably, during the open meeting concerning the proposed amended Rule, two SEC Commissioners expressed reservations regarding the need for the contemplated amendments to Rule 15b9-1. These Commissioners asked in particular that commenters address whether the benefits of the proposed amendments (such as the provision of additional trading data to FINRA) outweigh the costs (such as the increased regulatory burdens and costs upon proprietary trading firms that will have to become FINRA members under the proposed amendments), and to address whether the proposed amendments would create an additional barrier to entry for a new national securities association (as FINRA currently is the only such association in existence).[16]

CONCLUSION

By eliminating the provisions in Rule 15b9-1 that allow proprietary trading firms that are registered with the SEC to avoid becoming FINRA members, the SEC's proposal, if adopted, could significantly change the costs, burdens and regulatory risks associated with the operation of such firms. Accordingly, proprietary trading firms that are registered as broker-dealers but are not FINRA members would be well-advised to carefully consider what impact the proposal might have on them and, if appropriate, to submit comments to the SEC.

[16] *See* Statements at March 25, 2015, Open Meeting of Commissioners Gallagher (available here) and Piwowar (available here).

APPENDIX A

FINRA MEMBERSHIP APPLICATION AND GENERAL MEMBERSHIP REQUIREMENTS

A. FINRA Membership

1. The application process for Financial Industry Regulatory Authority (FINRA) membership consists of the following basic steps (addressed in greater detail below).

    a) Apply for and obtain approval from FINRA for the applicant's name.

    b) Fund the general central registration depository (WebCRD) account from which registration and application fees will be paid.

    c) Complete and submit hard copy "entitlement" forms and notarized Form BD.

    d) Access FINRA's online "Firm Gateway" upon approval of entitlement forms.

    e) Submit required registration forms, e.g., Forms U4, Form BR.

    f) Submit completed Form NMA and attachments.

2. The FINRA New Membership Application ("Form NMA") is accessible in FINRA's online "Firm Gateway." To obtain access to the "Firm Gateway," an applicant must complete and submit the required "entitlement" forms. Applicants are also required to fund, via electronic funds transfer, their online WebCRD accounts so that applicable registration and application fees can be drawn from the online account. Upon approval of the entitlement and funding of the account, applicants can begin submitting Forms U4 for all registered persons, Form BR for branch offices, and Form NMA and attachments.

3. Among the items that must be submitted in connection with the application process described above are the following items below.

    a) Completed, originally executed and notarized Form BD (hard copy)

    b) Completed and executed Form BR (identifies operating offices)

    c) Fingerprint card for each registered person and others

    d) New Member Assessment Report (hard copy)

    e) Signed "Securities Sales Activity Statement" (hard copy)

    f) FINRA Member Firm Contact Questionnaire

    g) A check to cover the application fee for FINRA membership, branch office registration and processing fees, Form U4 fees, examination fees, fingerprint processing fees and fees for each state in which registration is sought

    h) Detailed business plan (including detailed descriptions of types of securities sold, how business will be effected, etc.)

    i) Statement of financial condition as of the date of filing

    j) Monthly income and expense statement projected for each of the first 12 months of operation

    k) Written supervisory procedures (a compliance manual) and completed WSP Checklist

    l) Schedule of all persons to be registered with the broker-dealer and listing any actions against them that could be a "statutory disqualification," outstanding judgments and arbitration awards, and pending litigation and arbitration

m) Computation of net capital and aggregate indebtedness as of the date of filing with supporting schedules

n) Fidelity bond

o) Organization structure chart (corporate and management)

p) Designation of Accountant pursuant to SEC Rule 17a-5(f)(2) and retainer agreement with Accountant for first year's audit

q) Description of recordkeeping system

r) Description of nature and source of capital

s) Description of financial controls

t) Evidence of registration under the LSSP system with SIC

u) First year's continuing education needs assessment for the firm element and how the firm will fulfill this

v) Documentation of regulatory actions, civil actions, Form U4 reportable complaints, criminal actions, or the like against the applicant or its associated persons

w) Copies of all drafts and final agreements relating to the applicant's proposed securities business, including agreements with banks, clearing entities and service bureaus

x) Written acknowledgement of the need for heightened supervision of persons with a history of customer complaints, regulatory investigations or regulatory actions

y) Biography of each of the proposed principals showing his or her qualifications to be a principal

z) Copies of all corporate formation documents for applicant and all controlled affiliated entities

4. Description of the Anti-Money Laundering Compliance Program approved by a senior officer and designation of the Anti-Money Laundering Compliance Officer.

B. Principals

1. *Definition.* Each officer, partner and director who is actively engaged in the management of the firm's investment banking or securities business, including supervision, solicitation, conduct of business, or the training of persons associated with the firm for any of the foregoing functions, is a principal and must register as such with FINRA. In assessing the adequacy of the principals designated as supervisors, FINRA requires that each principal have at least one year of supervisory experience or two years of related experience.

2. *Proficiency Examinations.* Each principal must pass the required FINRA examinations. Depending on the nature of the principal's involvement and duties for the broker-dealer, the principal will be required to pass either the Series 24 examination (General Securities Principal) and/or the Series 27 examination (Financial and Operations Principal). The Series 7 examination is a prerequisite to taking the Series 24 examination. An applicant must designate a Financial and Operations Principal, who may also be a General Securities Principal, who has passed the Series 27 examination. Registration in a state will also require that at least one principal and any representatives being registered in that state have taken and passed the Series 63 or Series 66 examination.

3. *Two Principals Requirement.* FINRA applicants must have at least two officers or partners who are registered as General Securities Principals, unless a waiver has been granted (generally obtainable for firms with 10 or fewer registered persons). FINRA may grant a waiver of the two principal requirements upon request if the applicant can demonstrate that only one person should be required to register under the circumstances. (*See* NASD Rule 1021(e).) Waiver requests are filed with the FINRA District Office with copies to FINRA's general counsel's office in Washington, DC.

4. *Financial and Operations Principal.* A FINRA applicant, unless exempt based on the limited nature of its activities, must designate at least one officer or partner as its Financial and Operations Principal. Only this person or another person who has passed the Financial and Operations Principal examination may be the applicant's Chief Financial Officer. A written request seeking an exemption should be filed with FINRA's general counsel's office in Washington, DC. and a copy included in the FINRA application materials. Any person whose duties include responsibility for preparing or approving financial reports submitted to any regulatory body, supervising individuals who assist in the preparation of such reports, or any other duties involving the financial and operational management of the firm must be designated and registered as a Financial and Operations Principal. A Financial and Operations Principal can serve more than one firm. Several individuals who are qualified as Financial and Operations Principals offer their services to smaller firms.

5. *Options Personnel Requirements.* A firm that will engage in over-the-counter put and call options activity must designate at least one Registered Options Principal. All Options Principals must pass the FINRA Series 4 examination.

    a) *FINRA Executive Representative.* A firm must designate one executive as the Executive Representative to represent the member broker-dealer in all FINRA affairs and to receive all compliance-related and other information distributed to the firm by FINRA. The Executive Representative must be a member of senior management and a registered principal of the firm.

    b) *Anti-Money Laundering Requirements.* FINRA Rule 3310 requires firms to designate an individual or individuals responsible for implementing and monitoring the day-to-day operations of the required anti-money laundering program and to report to FINRA this person's name, address, telephone number, fax number and email address.

C. Representatives

1. *Definition.* A representative is a person associated with a FINRA-member firm, including an assistant officer, other than a principal, who is engaged in the investment banking or securities business for the member firm, including the functions of supervision, solicitation, or conduct of business in securities or who is engaged in the training of persons associated with a member firm for any of the foregoing functions.

2. *Registration.* All representatives of a FINRA-member firm must be registered as such with FINRA. Each representative must pass the FINRA Series 7 examination and the Series 63 or Series 66 examination for registration in any of the states. The Series 55 examination is required for each person on the equity trading desk involved in trading equity securities or supervising such activities.

D. Directors That Are Not Principals

1. It is not unusual that major holders of an applicant's equity are not and do not seek to be registered with FINRA as principals. Such persons may serve on the applicant's board of directors but must not be active in the applicant's day-to-day business. Several FINRA District Offices require such persons to submit an undertaking to that effect.

2. Directors who are not registered principals need to complete and submit Forms U4 completing Questions 9, 10, 11, 12, 13, and the signature page. These persons will also need to complete and submit fingerprint cards.

E. Name Reservation

The name of the firm may be cleared and reserved with FINRA. FINRA rules prohibit the use of a name similar to that of another FINRA member. A written request is required for clearance and reservation of a firm name. Name availability may be checked by calling FINRA.

F. FINRA Membership Application

1. *Form BD.* One originally signed and notarized Form BD and the appropriate schedules must be filed with FINRA.

2. *Statement of Financial Condition.* One copy of the Statement of Financial Condition must be filed with FINRA. This may be an unaudited financial statement certified by the principal in charge of financial matters and includes a trial balance, a

balance sheet, an income statement, a net capital computation and a computation of aggregate indebtedness. Securities of the broker-dealer, or securities in which the broker-dealer has an interest, must be listed in a separate schedule and, if a ready market for the securities exists, such securities must be valued at the market price with an indication of the market based on which such valuation is made. The statement must contain a computation of the firm's aggregate indebtedness and net capital showing compliance with the requirements of SEC Rule 15c3-1.

3. *Form U4 (Uniform Application for Securities Industry Registration).* A Form U4 must be completed and filed for all personnel required to be registered as principals or representatives of the broker-dealer. Form U4 requires information with regard to residential and employment histories, disciplinary actions, and securities-related litigation. Registration for examinations is also accomplished through Form U4. The Form U4 for a person must be certified by another person associated with the applicant and requires that the person certifying states he has contacted the subject person's employers for the past three years. As noted above, the Form U4 for all personnel to be registered will be filed electronically after the application is filed and WebCRD access has been granted.

4. *Fingerprint Cards.* SEC Rule 17f-2 generally requires fingerprinting of all partners and employees of the broker-dealer who have access to the firm's funds, books of original entry and securities. An exemption is provided for any person who is not engaged in the sale of securities or who does not regularly have access to the keeping, handling, or processing of securities, money, or the original books and records relating to the securities or money of the broker-dealer, and does not have direct supervisory responsibility over persons engaged in such activities. Nonregistered personnel should submit their fingerprint cards with a FINRA Fingerprint Record Transmittal Form.

5. *Securities Sales Activity Statement.* An applicant is required to submit an executed copy of the "Securities Sales Activity Statement," attesting that the applicant has not previously conducted a securities business, is not then currently engaged in a securities business and will refrain from conducting a securities business until it has become a FINRA member.

6. *FINRA Fees.*

    a) Applicants are required to fund, via electronic funds transfer, their online WebCRD account. Application fees and examination, state and other registration fees will be drawn from this online account.

    b) Membership application fee:

        (i) Self-Clearing Firms - $5,000

        (ii) All Others - $3,000

    c) Principal/Representative registration - $85 per applicant plus a $95 per applicant processing fee.

    d) Branch office registration - $75 per branch office plus a $20 per branch office processing fee. This also includes the firm's main office.

    e) FINRA qualifications examination fees:

        (i) General Securities Representative (Series 7) - $200 per applicant;

        (ii) General Securities Principal (Series 24) - $75 per applicant;

        (iii) Financial and Operations Principal (Series 27) - $75 per applicant; and

        (iv) Registered Options Principal (Series 4) - $75 per applicant.

    f) Fingerprint card processing fee - $30.25 per card.

7. *FINRA New Member Assessment Report.* The applicant must file one copy of this report, which provides the basis for FINRA's annual assessment.

    a) The annual assessment is comprised of the following:

        (i) An amount equal to the greater of $1,200 or 0.125 percent of annual gross income from all securities activities other than trades on a national securities exchange.

        (ii) An amount equal to $10 for each principal and representative.

        (iii) A schedule of credits that members may receive against the annual assessment is set forth in Section 1 of Schedule A to the FINRA By-Laws. This may be accessed here.

    b) New members are assessed based upon income generated in the portion of the calendar year during which they are admitted. All others are assessed based on the prior calendar year's revenue.

8. *Written Supervisory Procedures.* FINRA rules require that each member firm establish, maintain and enforce written procedures that will enable it to properly supervise its employees' activities and comply with applicable securities laws and regulations and FINRA rules.

    a) The FINRA WSP Checklist lists the items FINRA expects to be covered in the Compliance Manual. If an item is not covered, the transmittal letter for the application should explain why it was not covered.

    b) To satisfy the FINRA requirement of establishing supervisory procedures and for prudent business practice, a broker-dealer must have a compliance manual for its personnel. A manual would provide a basis for training and supervising employees and would establish grounds for defending certain types of actions.

9. *Fidelity Bond.* FINRA rules require that every FINRA member required to be a member of the Securities Investor Protection Corporation (SIPC) carry a blanket fidelity bond covering officers and employees, and which provides coverage against loss and has agreements covering fidelity, on premises, in transit, misplacement, forgery and alteration (including checks), securities loss (including forgery) and fraudulent trading. There also must be a cancellation rider providing that the insurance carrier will attempt to notify FINRA in the event the bond is cancelled, terminated or substantially modified. Minimum coverage for all insuring agreements may not be less than $25,000, and minimum coverage for fidelity, on premises, in transit, misplacement, forgery and alteration must be not less than 120 percent of the firm's required net capital under SEC Rule 15c3-1, up to a maximum of $600,000. Minimum coverage for required net capital in excess of $600,000 is determined by reference to a table in FINRA Rule 3020. Fraudulent trading and securities forgery coverage have different limits, which are also set forth in Rule 3020. A deductible of the greater of $5,000 or 10 percent of the coverage is permitted.

    Many companies provide such bonds (including FINRA itself, via the FINRA Group Fidelity Bond Program). FINRA sponsors two group buying programs to provide members with the required fidelity and surety bonds. The administrator of both programs is Marsh & McLennan, Inc.

10. *Business Plan.* This is a description of the firm's business plan for at least the first 12 months of its operations. Attached to it should be a month-by-month projected income and expense statement. Care should be taken so that the cumulative losses during the start-up period do not cause the firm to violate the net capital requirements. Otherwise, there should be included a description of projected capital contributions (see below). The business plan also should include: the applicant's office locations (approximate square footage, copy of lease, business to be conducted there, number of personnel and person in charge); the securities to be offered and sold, and whether retail or institutional customers will be solicited; a description of methods and media to be employed to develop a customer base and to offer and sell products and services to customers, including any telephone, Internet, mailings and seminars; the number of markets to be made, the type and volatility of the products and anticipated maximum inventory positions; any contracted underwriting or securities activities contemplated; any plans to distribute or maintain securities products or proprietary

positions, and their risks, volatility, degree of liquidity and speculative nature; and a description of the communications and operations systems that will be employed, plans and procedures to ensure business continuity, system redundancies, disaster recovery plans, system security, and applicable supervisory and protection measures for customers with system access.

11. *Personnel.* A description of each person who will be active in the day-to-day business of the applicant also is required. This should include his or her prior experience including any securities industry experience, any disciplinary history, terminations from other brokerage firms, litigation and arbitration involving customers, and a description of the person's other experiences that qualify him or her. FINRA staff often confirms a person's securities industry experience by contacting the person's former employer(s).

12. *Bank and Clearing Agreements.* If the firm will clear on a fully disclosed basis through another firm, a copy of the proposed fully disclosed clearing agreement must be provided. If the firm will self-clear some or all of its trades, a description of how this will be done and how the firm will comply with SEC Rule 15c3-3 must be included. If the firm will not handle customer money or securities and will not clear through a broker-dealer on a fully disclosed basis, a bank account established under Rule 15c3-3(k)(2)(i) must be established and proof of its existence included in the membership application.

13. *Nature and Source of Capital.* If all the required capital will be infused up front, a statement to that effect is necessary. If the business plan or other considerations (e.g., self-clearing, anticipated business growth, or losses reflected in the business plan) imply the need for future capital infusions, a description of the probable sources and amounts of additional capital and its type (subordinated debt, subordinated accounts, equity issuances or keepwell agreement) should be included. Where capital is or will be supplied by individuals or closely held companies, FINRA frequently asks for their bank statements reflecting the sources for such capital contributions and the cancelled checks for the contributions.

14. *Description of Recordkeeping System.* A brief description of the manual of accounts that the firm will maintain and how it will be maintained is called for.

15. *Organization Structure.* A brief description of the firm's organizational structure all the way up to the ultimately controlling shareholder(s) should be included. This includes a chain of command.

16. *Continuing Education.* A description of the firm's needs assessment and the type of continuing education program for the firm element that the firm will conduct in its first year of operation and how it will conduct such program must be included in the application. A description of how the firm will monitor compliance by its registered personnel with the regulatory element of the Continuing Education Program also should be included.

17. *Financial Controls.* A brief description of how the firm will exercise control over its finances and financial condition should be included.

18. *Supervisory/Principal Biographies.* A biography or resume for each person who will serve as a principal needs to be included in the application. Each person's biography should show either two years' relevant experience in the areas that person will supervise, or one year's direct supervisory experience.

19. *WebCRD Entitlement Request.* FINRA requires completed forms identifying the people who are authorized to file electronically with CRD, amendments to the firm's Form BD, Form BR, Forms U4 and U5 and amendments thereto for registered personnel, and the FOCUS Report of financial condition.

G. Post Application Processing.

1. *Additional Requests.* After the membership application is submitted, it is typical for the FINRA examiner to request additional information or documents. Applicants have 30 days from receipt of a request to reply. It is not uncommon to receive more than one request.

2. *Membership Interview.* After the application has been processed, the principals of the firm will be called in for a membership interview at the District Office. The interview usually covers: (i) a review of the applicant's proposed business and how it will operate; (ii) introduction of the District Office personnel who will oversee the applicant's reports and supervise inspections of the firm; and (iii) a chance for the applicant's personnel to ask any questions they may have. FINRA may ask for additional information and documents based upon the interview or renew requests that are outstanding.

3. *Membership Agreement*. The final step in the process is the execution by the applicant of a Membership Agreement. The Agreement includes: (i) a description of the applicant's proposed business; (ii) the number of registered persons the applicant will have; (iii) where the applicant will conduct its business; (iv) an agreement to comply with the federal securities law and FINRA's rules; and (v) an agreement to pay FINRA's dues, fees, and assessments.

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