Statement on Final Rule Regarding Exemption for Certain Exchange Members

Commissioner Mark T. Uyeda

Aug. 23, 2023

Thank you, Chair Gensler.

Flawed Rationale in Support of the Amendments to Rule 15b9-1

Today's amendments eliminate the current exemption from the requirement to be a member in a securities association for proprietary trading firms ("PTFs") that trade off the exchange where they are members. Since FINRA is the only securities association, the implication is that PTFs must join FINRA, with all the costs that entails.

The Adopting Release underlines the importance of the regulatory consistency that it suggests only FINRA can bring.[1] For PTFs, the Commission argues that "[b]ecause such exempt firms are not subject to FINRA's direct, membership-based jurisdiction when they engage in off-member-exchange securities trading activity, there is less stability and consistency in the oversight that is applied to such activity than there would be if such firms were Association members."[2] In short, the Commission rationalizes that FINRA will provide a more consistent regulatory framework for broker-dealers, including proprietary trading firms that are not currently FINRA members. The Commission also suggests that FINRA would do a better, more efficient job at directly enforcing compliance with federal securities laws, Commission rules, and Association rules.

The Adopting Release acknowledges that these firms already have an SRO responsible for overseeing their conduct and are subject to the jurisdiction of the SEC, which can examine and enforce compliance with pertinent rules and laws. In addition, FINRA can monitor, track and surveil transactions of market participants through the Consolidated Audit Trail ("CAT"). If FINRA spots problematic activity, it can notify the responsible SRO and the SEC. Currently, effective and efficient regulation can be achieved through joint SRO plans and through regulatory service agreements where "one SRO agrees to perform regulatory services on behalf of another SRO in exchange for compensation."[3]

Nevertheless, the Commission insists that there is no substitute for direct FINRA jurisdiction that results from mandatory membership. As the Adopting Release states, FINRA "cannot apply its expertise in supervising these [non-member] firms' off-member-exchange securities trading activity and investigating potential misconduct with the same degree of autonomy that it can for FINRA members."[4] Notice the featured components of the Adopting Release's argument—the need for FINRA "autonomy" within supervision and investigation of potential misconduct, combined with FINRA's apparently unique and irreplaceable "expertise" in these matters. Yet the Adopting Release does little to describe or evaluate FINRA's ability to carry out these duties with respect to its existing members.

In contrast, the other SROs may have a comparative advantage in monitoring the business models of their specific members, while FINRA may be better in overseeing broker-dealers who have customers. Indeed, FINRA describes itself as "regulat[ing] one critical part of the securities industry—brokerage firms doing business with the public in the United States."[5] However, the proprietary trading firms do not have customers. The Economic Analysis admits that FINRA is not such a good fit in this regard and notes that such firms might be better off "forming a new Association together, which would allow the members of the new Association to be subject to rules and regulations that better fit their business practices."[6] This suggestion, however, demonstrates the inconsistency in the Adopting Release's logic on the need for a single and consistent regulator.

The key question here is whether FINRA is better at achieving the outcomes of investor protection and maintaining fair, orderly, and efficient markets when overseeing proprietary trading firms, than the other SROs. Unfortunately, the Commission's analysis amounts to only a large number of unsupported, conclusory statements. The Adopting Release presents little to no evidence that FINRA has a comparative advantage in exercising jurisdictional powers over these particular market participants than the current SROs responsible for them. It merely concludes that "the benefits the Commission anticipates from the amendments are largely qualitative and by their nature difficult to measure quantitatively."[7]

This lack of evidence creates concerns under the Administrative Procedure Act ("APA"). As the Chief Judge Srinivasan of the D.C. Circuit recently articulated in Cboe Futures Exchange v. SEC, "an agency must 'examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.'"[8] However, there is no evidence-based comparison in the Adopting Release regarding mandated FINRA membership versus continued membership of PTFs in their current SROs—only conclusory statements, often juxtaposed with the phrase "the Commission believes" that appears 57 times.

The Adopting Release argues that the current allocation of regulatory powers is not "stable" because the regulatory coverage may be subject to shifting contracts and agreements among SROs and FINRA. But the release fails to analyze whether this flexibility is an advantage of the current regulatory system. First, it provides a system of checks and balances against the monopoly power that FINRA could otherwise wield. Second, and relatedly, the current system provides an economic check on FINRA in maintaining efficiency and efficacy, in that if the pertinent SRO might find a better way to oversee its members, it can evolve in that direction subject to ongoing oversight by the SEC.

Moreover, the Commission's findings in favor of a mandatory expansion of FINRA membership are based largely on FINRA's own submission. But FINRA has a conflict of interest here as these amendments would benefit FINRA in terms of increased revenues.[9] As the D.C. Circuit has also recognized, "[w]e have previously rejected an attempt by the SEC to substitute 'unquestioning reliance' on a regulated entity's submissions for the 'reasoned analysis' the APA requires. … Such submissions, we explained, have '"little" supporting value' because they express 'the "self-serving views of the regulated entit[y]."'[10]

Effect on State Actor Status

As the Commission weighs the costs and benefits of these rule amendments, the Adopting Release is dismissive of any impact a near-universal mandate to join FINRA might have on the question as to whether FINRA should be considered a state actor, and fails to consider the concerns of at least one judge on the D.C. Circuit in Alpine Securities Corporation v. FINRA, which was issued last month.[11]

While the courts will ultimately decide this issue, there is a failure of the Commission to consider both statutory and constitutional boundaries as it contemplates rules relevant to the scope and exercise of power by SROs and Associations under the Exchange Act. Moving from a status quo in which SROs may fulfill regulatory responsibilities, often through contracting for FINRA's services, to mandatory FINRA membership can shift the facts and circumstances in an unfavorable manner regarding the state actor question. These amendments may further lock in FINRA's monopoly position as the only "Association" under the Exchange Act.

As then-Commissioner Dan Gallagher stated at an open Commission meeting on March 25, 2015: "When Congress created SROs in the 1930s, it didn't mandate that all broker-dealers join a single SRO. And … we

should not treat FINRA as the SEC's deputy federal regulator."[12]

Economic Analysis Indicates Significant Drawbacks

The downside risk entailed by these amendments is substantial. It could result in a reduction in liquidity, particularly in sectors of the market that can least afford it. As the Economic Analysis states: "non-FINRA member firms do not have the same regulatory costs as FINRA member firms, which may give non-FINRA member firms a competitive advantage in providing liquidity in equities, options, and fixed income markets. As such, non-FINRA member firms may be able to provide liquidity at a lower cost than FINRA member firms given that non-FINRA member firms have a lower variable cost, all else equal, for trading compared to FINRA member firms."[13] Thus, the overall cost of liquidity provision may increase, which, in turn, is apt to damage the quality of price discovery.

The Adopting Release claims that one benefit of mandated FINRA membership will be the increased reporting of Treasury transactions to the Trade Reporting and Compliance Engine ("TRACE"). However, this benefit could be obtained simply by requiring it as a condition to the current proprietary trading exemption. When considering economic logic, an opportunity cost of adopting any rule is foregoing simpler and less costly ways of achieving the same ends. Thus, the benefits of the contemplated extension of mandatory FINRA membership should exceed the costs beyond any benefits and costs attributable to the TRACE transaction reporting regime, in that the latter could readily be mandated separately.

Finally, the Economic Analysis employs CAT data to estimate the scope of the impact of the rule amendments through a quantification of aggregate off-exchange activity of non-FINRA member firms in National Market System stocks. This use of CAT data, which data is appropriately confidential and not available to the public, is problematic in terms of the requirements of the APA. The APA requires government agencies to subject their evidentiary arguments in support of rule proposals to the rigors of public comment. But in this case, the Commission has not exposed its underlying data and analysis on the grounds that the CAT data is confidential, and thus only aggregated and conclusory data has been provided. How can the public evaluate such assessments if the Commission refuses to share its underlying data? Proposing amendments which rely on undisclosed data that cannot be questioned or criticized by the public seems antithetical to the purpose of the APA's notice and comment process.

Conclusion

Given the lack of evidence supporting this mandatory extension of FINRA membership, coupled with the clear potential for the unintended negative consequence of a reduction in liquidity, I am unable to support it. I thank the staff in the Divisions of Trading and Markets and Economic and Risk Analysis as well as the Office of General Counsel for their efforts.

---

[1] Exemption for Certain Exchange Members, Release No. 34-98202, (Aug. 23, 2022) ("Adopting Release"), at 72, available at https://www.sec.gov/files/rules/final/2023/34-98202.pdf.

[2] Adopting Release at 6.

[3] See discussion and Footnote 14, Adopting Release at 8.

[4] Adopting Release at 8.

[5] See "About FINRA" section of News Release: FINRA Names Bill St. Louis as New Head of Enforcement, Aug. 21, 2023 (emphasis added), www.finra.org.

[6] Adopting Release at 105.

[7] Adopting Release at 109.

[8] Cboe Future Exchange v. SEC, July 28, 2023, No. 21-1038, at 9.

[9] See Adopting Release for discussion of costs of Association membership from 118.

[10] Cboe Future Exchange v. SEC, July 28, 2023, No. 21-1038, at 12.

[11] Alpine Securities Corporation v. Financial Industry Regulatory Authority and United States of America ("Alpine Securities"), No. 23-5129, United States Court of Appeals for the District of Colombia Circuit. On July 5, 2023, the D.C. Circuit enjoined FINRA from continuing an expedited enforcement proceeding against Alpine Securities Corporation.

[12] Statement at Open Meeting on Rule 15b9-1, Commissioner Daniel M. Gallagher, March 25, 2015.

[13] Adopting Release at 93 (underlining added).