Section 31 Fee Reconciliation Process

FIF Member Presentation to FINRA on Enhancing the Reconciliation Process for the FINRA Regulatory Transaction Fee (for Recoupment of Section 31 Fees)
Overview
Current challenges

• Clearing brokers that receive Regulatory Transaction Fee (RTF) invoices from FINRA do not have sufficient detail to reconcile these invoices against their trading activity and the trading activity of their correspondent firms
  • The single line item from FINRA indicating the total charge does not provide sufficient detail for reconciliation

• Executing brokers that are charged RTF pass-through fees by their clearing brokers are not able to reconcile those charges against their trading activity
  • Executing brokers receive no statements from FINRA, and FINRA does not break-out the charges to the clearing firm based on the executing broker

• Originating brokers (and their clearing firms) that are charged RTF pass-through fees by downstream intermediary brokers are not able to reconcile those charges against their trading activity
Current challenges (continued)

• Broker-dealers often collect funds from customers for trades where they are not billed by FINRA or a downstream broker-dealer, and there is a lack of available data for broker-dealers on what to do with these funds

• Due to inability to reconcile, there is often lack of clarity among broker-dealers as to when a fee should be passed through

• Firms must expend significant resources to attempt reconciliation without the necessary underlying data
FIF members request

- FIF members request that FINRA provide a monthly file to each clearing firm and executing firm identifying each execution where the firm is charged the Regulation Transaction Fee (RTF) and the amount charged per execution.

- FIF members request a call with FINRA representatives to discuss this request.

- In this presentation below, we also discuss potential alternative approaches for consideration by FINRA that seek to achieve the same objective of enabling proper reconciliation of RTF fees.
  - FIF members do not necessarily recommend these alternative approaches but believe it is helpful to consider these potential alternative approaches.
Objectives that FIF members seek to achieve

• Best practice for broker-dealer financial responsibility is reconciliation of material expenses
• Enable broker-dealers to properly reconcile RTF fees
• Significantly reduce (and potentially eliminate) the scenarios where a broker-dealer collects Section 31 fees from a customer and is not billed by FINRA or a downstream broker-dealer
• Ensure that the correct broker-dealer incurs the RTF for a trade
• Facilitate straight-through processing for the collection of RTF fees
The CAT Plan Participants plan to provide this data for CAT

• In a filing with the SEC on July 28, 2023, the CAT Operating Committee wrote
  • “The Plan Processor is building a billing warehouse that will contain every trade, and plans to make available trade-by-trade data to CAT Executing Brokers for each CAT bill upon request. Such data may assist CAT Executing Brokers with identifying and validating the applicable trades for each CAT bill.”

• In a September 28, 2023 webinar on CAT billing, FINRA CAT reported that underlying trade details for all trades invoiced will be available to CAT Executing Brokers via SFTP and the CAT Reporter Portal (see Slide 43 of the September 28 presentation)

• FIF members request that FINRA provide this same type of data when invoicing the Regulatory Transaction Fee
Notes for Scenarios
Notes for scenarios: Section 31 fees

- Technically, the Section 31 fee is charged by the SEC to FINRA, and FINRA charges a Regulatory Transaction Fee (RTF) to the clearing firm for the seller.
- Clearing firms and other industry members can then pass this fee through to correspondents, upstream routing brokers and customers.
- While these pass-throughs are not technically Section 31 fees (only the fee from the exchange to the SEC is a Section 31 fee), we refer to these pass-throughs as Section 31 fees because this is how the industry often refers to them.
Notes for scenarios: the parties

• MMZZ: the buying broker-dealer
• MMXY: the intermediary broker-dealer
• CBXY: the clearing firm for MMXY
• RBRB: broker-dealer that routes order to MMXY or MMZZ
• CBCB: the clearing firm for RBRB
• Customer: a customer of RBRB
Notes for scenarios: four scenarios

• Scenario 1: Two broker-dealers

• Scenarios 2 through 4: Three broker-dealers
  • Scenario 2: Intermediary broker-dealer trades as riskless principal
  • Scenario 3: Intermediary broker-dealer trades as agent
  • Scenario 4: Intermediary broker-dealer trades as principal
Notes for scenarios: party roles

- Scenarios 1 through 4 provide for a market maker as the executing party, but the executing party could be any firm that trades as principal.

- Scenarios 2 through 4 provide for a market maker as the intermediary, but the intermediary could be a firm (trading as principal, riskless principal or agent) that is not a market maker.
  - For example, the intermediary could be a routing firm that only trades as agent.
Notes for scenarios: fees to customers

• In the scenarios presented the originating broker-dealer (RBRB) acts on behalf of a customer, but RBRB also could be trading as principal.
• The diagrams describe CBCB, the clearing firm for RBRB, as extracting fees from an RBRB customer account.
  • If RBRB trades as principal, the clearing firm for RBRB would extract fees from an RBRB principal account.
Notes for scenarios: executing broker

• In this presentation, when we refer to the “executing broker”, we are referring to the correspondent firm of the clearing firm that is being charged for the trade

• This correspondent firm is identified by the reporting firm in the TRF report and might be the “order entry” or “OE” firm (i.e., the contra to the executing broker) rather than the executing broker

• In other words, for TRF reporting only one side is the “executing broker” while in this presentation both sides are the executing broker (similar to CAT billing terminology)
Notes for scenarios: additional scenarios

• This document covers four basic scenarios

• These scenarios are intended to be illustrative and are not intended to address all trading and settlement workflows

• More complex scenarios can be considered after there is consensus on the four scenarios in this document

• This document is focused on equity trades that are executed off-exchange and reported to a FINRA TRF or the ORF; a similar approach should be implemented for exchange-traded executions for both equities and options
  • After discussion with FINRA representatives, FIF members also plan to discuss this request with exchange representatives
Scenarios
Scenario 1: Execution Between Two Broker-Dealers

Routing Broker (RBRB) → Market Maker (MMZZ)

Order: sell 100 ABC

- RBRB books trade to customer account at CBCB
- Typically, CBCB extracts $x.xx Section 31 fee from this account when it processes the trade

TAPE report: MMZZ bought 100 ABC from RBRB

Clearing Firm (CBCB)

FINRA TRF

- Section 31 fee: $yyy,yyy.yy, charged to CBCB
- No indication it’s for RBRB

FINRA Billing

TAPE report: MMZZ bought 100 ABC from RBRB
### Scenario 1: Execution Between Two Broker-Dealers

<table>
<thead>
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<td><strong>Potential Challenges</strong></td>
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<tr>
<td>• How does CBCB validate whether it was correctly billed for this trade by FINRA (for example, how does CBCB identify the cause of a mismatch)?</td>
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<tr>
<td>• How does CBCB reconcile what it charges to RBRB against the bill from FINRA?</td>
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<td>• How does RBRB reconcile what it is charged by CBCB?</td>
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<td><strong>Industry Processes</strong></td>
</tr>
<tr>
<td>• Pass-through of Regulatory Transaction Fee does not apply</td>
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<td><strong>Request for FINRA</strong></td>
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<tr>
<td>• FINRA should provide a monthly file to each clearing firm and executing firm identifying each execution where it is charged</td>
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<tr>
<td>• This would allow CBCB and RBRB to validate that they are being billed correctly</td>
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</tbody>
</table>
Scenario 2: Intermediary Trades as Riskless Principal

Routing Broker (RBRB)

Order: sell 100 ABC

Clearing Firm (CBCB)

Typically, CBXY will send an invoice to CBCB at month-end

RBRB books trade to customer account at CBCB
Typically, CBCB extracts $x.xx Section 31 fee from this account when it processes the trade
CBCB is now holding $x.xx in its Section 31 fees account waiting for someone to claim it

Market Maker (MMXY)

Representative order: sell 100 ABC

Market Maker (MMZZ)

- Regulatory NON-TAPE “riskless principal” report
- Has no bearing on Section 31 fees; not fed into FINRA billing system

FINRA TRF

TAPE report: MMZZ bought 100 ABC from MMXY

Order: sell 100 ABC

Clearing Firm (CBXY)

Section 31 fee: $yyy,yyy.yy, charged to CBXY
No indication it’s for RBRB or MMXY

FINRA Billing

TAPE report: MMZZ bought 100 ABC from MMXY
## Scenario 2: Intermediary Trades as Riskless Principal

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<tr>
<td>• See Scenario 1 challenges</td>
</tr>
<tr>
<td>• How does CBXY know to invoice CBCB? CBXY can only know to bill CBCB if CBXY knows that MMXY traded as riskless principal</td>
</tr>
<tr>
<td>• How does CBCB validate the invoice from CBXY?</td>
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<td>• How does CBCB reconcile the invoice from CBXY to a trade for RBRB?</td>
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<tr>
<td><strong>Industry Processes</strong></td>
</tr>
<tr>
<td>• MMXY can communicate to CBXY that MMXY is acting as riskless principal and identify RBRB and CBCB</td>
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<tr>
<td>• CBXY can provide this information to CBCB when invoicing</td>
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<td><strong>Request for FINRA</strong></td>
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<td>• FIF members request that FINRA provide a monthly file to each clearing firm and executing firm identifying each execution where it is charged</td>
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<td>• This would allow MMXY and CBXY to demonstrate to CBCB that FINRA charged them for a trade</td>
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<td>• This would allow CBCB to identify the trades where it has already been charged by FINRA and avoid getting billed twice for the same trade</td>
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Scenario 3: Intermediary Trades as Agent

- RBRB books trade to customer account at CBCB
- Typically, CBCB extracts $x.xx Section 31 fee from this account when it processes the trade
- CBCB is now holding $x.xx in its Section 31 fees account waiting for someone to claim it
## Scenario 3: Intermediary Trades as Agent

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<tr>
<td><strong>Trading Scenario</strong></td>
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<tr>
<td>RBRB routes sell order to MMXY; MMXY routes RBRB order to MMZZ; MMZZ executes against MMXY</td>
</tr>
<tr>
<td><strong>TRF Reporting</strong></td>
</tr>
<tr>
<td>MMZZ submits a tape report to FINRA</td>
</tr>
<tr>
<td><strong>Regulatory Transaction Fee</strong></td>
</tr>
<tr>
<td>FINRA charges the Regulatory Transaction Fee to CBXY (clearing firm for the selling broker-dealer)</td>
</tr>
<tr>
<td><strong>Pass-Through</strong></td>
</tr>
<tr>
<td>CBCB extracts $x.xx from RBRB when CBCB processes the trade; CBCB is now holding $x.xx in its Section 31 Fees Account, waiting for someone to claim it; typically, MMXY will send an invoice to RBRB/CBCB at month-end</td>
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## Scenario 3: Intermediary Trades as Agent

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| • See Scenario 1 challenges  
  • How does CBXY know to invoice CBCB? CBXY can only know to bill CBCB if CBXY knows that MMXY traded as agent  
  • How does CBCB validate the invoice from CBXY?  
  • How does CBCB reconcile the invoice from CBXY to a trade for RBRB? | • MMXY can communicate to CBXY that MMXY is acting as agent and identify RBRB and CBCB  
  • CBXY can provide this information to CBCB when invoicing | • FINRA should provide a monthly file to each clearing firm and executing firm identifying each execution where it is charged  
  • This would allow MMXY and CBXY to demonstrate to CBCB that FINRA charged them for a trade  
  • This would allow CBCB to identify the trades where it has already been charged by FINRA and avoid getting billed twice for the same trade |
Scenario 4: Intermediary Trades as Principal

Order: sell 100 ABC

Routing Broker (RBRB)

Clearing Firm (CBCB)

Order: sell 100 ABC

Market Maker (MMXY)

Clearing Firm (CBXY)

Market Maker (MMZZ)

FINRA TRF

TAPE report: MMXY bought 100 ABC from RBRB

Order: sell 100 ABC (MMXY as principal)

TAPE reports: MMZZ bought 100 ABC from MMXY

TAPE reports: MMZZ bought 100 ABC from MMXY; MMXY bought 100 ABC from RBRB

FINRA Billing

- RBRB books trade to customer account at CBCB
- Typically, CBCB extracts $x.xx Section 31 fee from this account when it processes the trade

- Section 31 fee: $yyy,yyy.yy charged to CBXY
- No indication it’s for RBRB or MMXY

- Section 31 fee: $x.xx, charged to CBCB
## Scenario 4: Intermediary Trades as Principal

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# Scenario 4: Intermediary Trades as Principal

## Intermediary Trades as Principal

| Potential Challenges | • See Scenario 1 challenges  
| Industry Processes | • MMXY can communicate to CBXY that MMXY is acting as principal  
| Request for FINRA | • FINRA should provide a monthly file to each clearing firm and executing firm identifying each execution where it is charged  
| | • This would allow CBCB to validate that it is not being double-billed by other clearing firms  

CBCB validates that it is not being double-billed for this trade by validating the communication from MMXY to CBXY that MMXY is acting as principal. CBXY can charge MMXY for the trade (the sale by MMXY). FINRA should provide a monthly file to each clearing firm and executing firm identifying each execution where it is charged. This would allow CBCB to validate that it is not being double-billed by other clearing firms.
Request for FINRA
Request for FINRA to provide monthly file

- FIF members request that FINRA provide a monthly file to each clearing firm and executing firm identifying each execution where the firm is charged the RTF and the amount charged per execution.

- This would enable all parties to reconcile what they are being charged (either directly by FINRA or by another broker-dealer) against what they should be paying.

- This would also enable an intermediary broker-dealer, for scenarios where the intermediary broker-dealer acts as riskless principal or agent, to provide back-up to the originating broker in support of the pass-through of the fee from FINRA.
Request for FINRA to provide monthly file

• The following issues would need to be considered
  • What level of detail should be provided for each trade
  • Execution identifiers that firms could use for reconciliation
  • Given the potential size of execution files, whether the report could aggregate individual trades and whether this aggregation would enable reconciliation
  • The method for transmission of these files by FINRA
Potential Alternative Approaches
Alternative 1: database of RTF charges

- In lieu of providing monthly files, FINRA could maintain a database that executing and clearing firms could query.
- Each firm would only be permissioned to query a trade where it is being charged the RTF.
- For this alternative, security issues would need to be addressed.
Alternative 2: identify executing brokers on invoices

• If FINRA is not able to provide trade-by-trade data, FINRA could break-out invoices to clearing firms based on the executing broker (i.e., broken out by MPID)
  • The exchanges currently provide this break-out (by MPID) to clearing firms upon request
• While break-out by MPID would be an improvement over the current level of detail provided by FINRA, trade-by-trade detail most likely would be required to achieve the reconciliation objectives set forth in the Overview of this presentation
Alternative 3: bill originating broker directly

- FINRA could use CAT data to bill the originating broker directly
- This presumably would require FINRA to change its by-laws
- Potential challenges with using CAT data for this purpose
  - FINRA would need to consider how to avoid double billing for riskless principal scenarios
  - FINRA would need to satisfy itself that industry members are reporting activity correctly to CAT
Alternative 4: reconsider RTF collection process

- FINRA could consider alternative approaches for collecting the Regulatory Transaction Fee (RTF), such as the approach used for collecting the Trading Activity Fee (TAF)
Contact fifinfo@fif.com with comments or questions