

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-70276; File No. SR-FINRA-2013-036)

August 28, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change Relating to Wash Sale Transactions and FINRA Rule 5210 (Publication of Transactions and Quotations)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 15, 2013, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to add Supplementary Material .02 to FINRA Rule 5210 (Publication of Transactions and Quotations) to emphasize that wash sale transactions are generally non-bona fide transactions and that members have an obligation to have policies and procedures in place to review their trading activity for, and prevent, wash sale transactions.

Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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5000. SECURITIES OFFERING AND TRADING STANDARDS AND PRACTICES

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¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

5200. QUOTATION AND TRADING OBLIGATIONS AND PRACTICES

5210. Publication of Transactions and Quotations

No Change.

••• Supplementary Material: -----

.01 Manipulative and Deceptive Quotations. No Change.

.02 Wash Sales. Transactions in a security that involve no change in the beneficial ownership of the security, commonly known as “wash sales,” generally are non-bona fide transactions for purposes of Rule 5210. Members must have policies and procedures in place that are reasonably designed to review their trading activity for, and prevent, wash sale transactions. Transactions that originate from unrelated algorithms or separate and distinct trading strategies within the same firm would generally be considered bona fide transactions and would not be considered wash sales, even if the transactions did not result in a change of beneficial ownership, unless the transactions were undertaken for manipulative or other fraudulent purposes. Algorithms or trading strategies within the most discrete unit of an effective system of internal controls at a member firm are presumed to be related (e.g., within an aggregation unit, or individual trading desks within an aggregation unit separated by reasonable information barriers, as applicable). This Supplementary Material does not change members’ existing obligations under NASD Rule 3010 and FINRA Rule 2010.

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II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV

below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA is proposing to add supplementary material to FINRA Rule 5210 to address members’ obligations with respect to certain securities transactions that involve no change in the beneficial ownership of those securities, commonly known as “wash sales.”

With the recent increase in automated trading activity and the use of algorithms by firms to make trading decisions, FINRA has observed an increase in the number of transactions occurring where a single firm’s proprietary trading account is on both sides of a trade, often as a result of a firm hitting its own bid or offer. Even if these transactions were not undertaken with fraudulent or manipulative intent, they can create a misimpression of the level of legitimate trading interest and activity in the security.

FINRA recognizes that, in many situations, what may seem to be wash sale activity occurs as a result of orders that originate from the same firm, but from separate or distinct underlying trading strategies (e.g., separate “desks,” aggregation units, or algorithms) that have different—and sometimes competing—investment objectives and that deliberately do not interact with each other prior to generating orders to the market. Consequently, the proposed supplementary material does not seek to prevent all types of trading activity that happen to result from separate strategies operating within a single firm.

The proposed supplementary material is intended to address wash sales occurring due to orders sent by a single algorithm or the unintended, but in FINRA’s view preventable, interaction of multiple, related algorithms operated by a single firm. In a number of instances, FINRA has

found that these types of transactions can account for a material percentage (e.g., over 5%) of the consolidated trading volume in a security on a particular day, which can distort the market information that is publicly available for that security. Even if not purposeful, these transactions can create the misimpression of active trading in a security that could adversely impact the price discovery process. Furthermore, in these instances it appears that firms will continue to allow this type of trading to occur rather than incur the costs necessary to prevent it, even though the trading activity is resulting in instances where significant misinformation may be disseminated to the marketplace.

FINRA rules and the federal securities laws explicitly prohibit transactions in securities that do not result in a change of beneficial ownership in the securities when there is a fraudulent or manipulative purpose behind the trading activity.³ In addition, FINRA Rule 5210 provides that no member may cause to be published or circulated any report of a securities transaction unless the member knows or has reason to believe that the transaction was a bona fide transaction. Supplementary Material .01 states that “[i]t shall be deemed inconsistent with Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices) and 5210 (Publication of Transactions and Quotations) for a member to publish or circulate or cause to be published or circulated, by any means whatsoever, any report of any securities transaction or of any purchase or sale of any security unless such member knows or has reason to believe that such transaction was a bona fide transaction, purchase or sale.” Consequently, each member has an existing obligation to know, or have a basis to believe, that transactions in which it participates are bona fide. Because wash sales generally are not bona-fide transactions, a member must review its trading activity to

³ See, e.g., 15 U.S.C. 78i(a)(1); FINRA Rule 6140(b).

determine whether it is engaging in these types of transactions and make changes to minimize their occurrence.

Because of the increase in wash sale transactions noted above, FINRA is proposing to add Supplementary Material .02 to Rule 5210 to address specifically members' obligations with respect to wash sales that are occurring and being disseminated to the public when there is no fraudulent or manipulative motivation for the trading activity at issue.⁴ Specifically, proposed Supplementary Material .02 emphasizes that members have an obligation to have policies and procedures in place to review their trading activity for, and prevent, wash sale transactions. The proposed rule change, however, explicitly excludes those transactions that originated from unrelated algorithms or from separate and distinct trading strategies, provided these transactions are not undertaken for manipulative or other fraudulent purposes.⁵ The exclusion acknowledges the fact that some firms run multiple, separate algorithms or have trading desks that are separated by information barriers that, as a result of different or competing investment strategies within the same firm, may result in transactions where a single firm is on both sides of the trade. FINRA does not view these types of transactions as wash sales for purposes of Rule 5210, provided the trades are not undertaken with fraudulent or manipulative intent.

SEC Rule 200(f) provides that all traders within an "aggregation unit" must pursue only the particular trading objective or strategy of that aggregation unit and not coordinate that

⁴ Securities transactions that do not result in a change of beneficial ownership of the securities and that are undertaken for the purpose of creating or inducing a false or misleading appearance of activity in the securities are already prohibited by existing securities laws and FINRA rules. See supra note 3.

⁵ FINRA notes that transactions that originate from unrelated algorithms or from separate or distinct trading strategies, trading desks, or aggregation units that are frequent or numerous may raise a presumption that such transactions were undertaken with the intent that they cross and may, therefore, be intended as manipulative or fraudulent.

strategy with any other aggregation unit.⁶ It also provides that, at the time of each sale, each aggregation unit determine its net position for every security that it trades. Supplementary Material .02 provides that algorithms or trading strategies within the most discrete unit of an effective system of internal controls at a member firm (e.g., an aggregation unit, or individual trading desks within an aggregation unit separated by reasonable information barriers, as applicable), are presumed to be related.

FINRA understands that not all wash sales, particularly those generated by trading algorithms, are avoidable. Consequently, only those firms that engage in a pattern or practice of effecting wash sale transactions that result in a material percentage of the trading volume in a particular security would generally violate Rule 5210, as well as Rule 2010. The proposed rule change requires reasonable policies and procedures and would not, therefore, apply to isolated wash sale transactions.⁷

FINRA staff discussed the proposed rule change with several of its industry advisory committees in developing the approach reflected in the proposed rule change. Although these committees recognized the problem FINRA was seeking to address and were generally supportive of the proposal, they indicated the need for FINRA to recognize that not all wash sales can be prevented. The proposed rule change explicitly includes language to exclude transactions that originated from unrelated algorithms or from separate and distinct trading strategies, trading desks, or aggregation units from being considered wash sales, provided these transactions are not undertaken for manipulative or other fraudulent purposes. The committees also requested guidance on whether the proposed rule change would apply to all wash sales or a

⁶ See 17 CFR 242.200(f).

⁷ FINRA notes that the proposed rule change would not change member firms' existing obligations under NASD Rule 3010 and FINRA Rule 2010 with respect to wash sales.

subset. As noted above, only those firms that engage in a pattern or practice of effecting wash sale transactions that result in a material percentage of the trading volume in a particular security would generally violate Rule 5210, as well as Rule 2010. The proposed rule change would not, therefore, apply to isolated wash sale transactions, provided the firm's policies and procedures were reasonable.

As noted in Item 2 of this filing, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 60 days following publication of the Regulatory Notice announcing Commission approval. FINRA is providing firms with additional implementation time to ensure they have appropriate policies and procedures consistent with the proposed rule change.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁸ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will reduce the number of wash sale transactions that, while not undertaken for manipulative or fraudulent purposes, nonetheless result in misinformation being disseminated to the marketplace and the public. FINRA believes that by requiring members to have reasonable policies and procedures in place to review for, and prevent, wash sales, the quality of market data will be enhanced, thus promoting just and equitable principles of trade and increasing the protection of investors and the public interest.

⁸ 15 U.S.C. 78q-3(b)(6).

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Although some firms may need to enhance their written policies and procedures and, potentially, implement changes to technological systems to ensure compliance with the proposed rule change, FINRA believes these changes are necessary to enhance the quality of market data and will not significantly burden competition as any firm running multiple algorithms or operating multiple trading strategies will be subject to the same standard.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2013-036 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2013-036. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-FINRA-2013-036 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁹

Kevin M. O'Neill
Deputy Secretary

⁹ 17 CFR 200.30-3(a)(12).