

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-77551; File No. SR-FINRA-2016-007)

April 7, 2016

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change to Require Registration as Securities Traders of Associated Persons Primarily Responsible for the Design, Development, Significant Modification of Algorithmic Trading Strategies or Responsible for the Day-to-Day Supervision of Such Activities

I. Introduction

On February 11, 2016, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NASD Rule 1032 (Categories of Representative Registration) to require registration as Securities Traders of associated persons primarily responsible for the design, development or significant modification of algorithmic trading strategies, or who are responsible for the day-to-day supervision or direction of such activities. The proposed rule change was published for comment in the Federal Register on February 24, 2016.³ The Commission received one comment on the proposal.⁴ This order approves the proposed rule change.

II. Description of the Proposed Rule Change

FINRA’s rules generally require each person associated with a member included within the definition of a representative to register with FINRA as a Securities Trader if, with respect to transactions in equity, preferred or convertible debt securities effected otherwise than on a

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 77175 (February 18, 2016), 81 FR 9235 (“Notice”). The Notice contains a detailed description of the proposal.

⁴ See Letter from Michele Van Tassel, President, Association of Registration Management, to Marcia E. Asquith, Office of the Corporate Secretary, Financial Industry Regulatory Authority, dated March 15, 2016 (“ARM Letter”).

securities exchange, such person is engaged in proprietary trading, the execution of transactions on an agency basis, or the direct supervision of such activities.⁵ FINRA proposes to expand the registration requirement so that associated persons who are (i) primarily responsible for the design, development or significant modification⁶ of algorithmic trading strategies, or (ii) responsible for the day-to-day supervision or direction of such activities, be required to register as Securities Traders with FINRA.⁷

For purposes of the proposal, FINRA defines an “algorithmic trading strategy” as an automated system that generates or routes orders or order-related messages – such as routes or cancellations – but does not include an automated system that solely routes orders received in their entirety to a market center. The proposed registration requirement applies to orders and order related messages whether ultimately routed or sent to be routed to an exchange or over the counter.⁸ An order router alone would not constitute an algorithmic trading strategy. However, an order router that performs any additional functions would be considered an algorithmic trading strategy.⁹ An algorithm that solely generates trading ideas or investment allocations – including an automated investment service that constructs portfolio recommendations – but that

⁵ NASD Rule 1032(f).

⁶ FINRA notes that a “significant modification” to an algorithmic trading strategy generally would be any change to the code of the algorithm that affects the logic and functioning of the trading strategy employed by the algorithm. Therefore, for example, a data feed/data vendor change generally would not be considered a “significant modification,” whereas a change to a benchmark (such as an index) used by the strategy generally would be considered a “significant modification.” See Notice, supra note 3, at 9237 n. 5.

⁷ Id. at 9237. FINRA notes, for example, while an equity trader involved in the design of an algorithmic trading strategy would currently be required to register pursuant to NASD Rule 1032(f), the developer with which the trader collaborates to create an algorithmic trading strategy, however, may not be. Id.

⁸ Id.

⁹ See Notice, supra note 3, at 9236-37.

is not equipped to automatically generate orders and order-related messages to effectuate such trading ideas into the market – whether independently or via a linked router – would not constitute an algorithmic trading strategy.

The associated persons covered by the expanded registration requirement must pass the requisite qualification examination and be subject to the same continuing education requirements that are applicable to individual Securities Traders. FINRA believes that problematic conduct stemming from algorithmic trading strategies – such as failure to check for order accuracy, inappropriate levels of messaging traffic, wash sales, failure to mark orders as “short” or perform proper short sale “locates,” and inadequate risk management controls – could be reduced or prevented, in part, through improved education regarding securities regulations for the specified individuals involved in the algorithm design and development process.¹⁰

The proposal is intended to ensure the registration of one or more associated persons that possesses knowledge of, and responsibility for, both the design of the intended trading strategy and the technological implementation of the strategy, sufficient to evaluate whether the resulting product is designed to achieve regulatory compliance in addition to business objectives.¹¹ For example, a lead developer who liaises with a head trader regarding the head trader’s desired algorithmic trading strategy and is primarily responsible for the supervision of the development of the algorithm to meet such objectives must be registered under the proposal as the associated person primarily responsible for the development of the algorithmic trading strategy and

¹⁰ See Notice, supra note 3, at 9236.

¹¹ See Notice, supra note 3, at 9237. FINRA states the registration requirement is not intended to apply to every associated person that touches or otherwise is involved in the design or development of a trading algorithm. For example, if a sole associated person determines the design of the trading strategy employed by an algorithm, writes the code to effectuate such strategy, and executes or directs the modification of such code going forward, then that person alone would be required to register as a Securities Trader under the proposal. Id.

supervising or directing the team of developers.¹² Individuals under the lead developer’s supervision would not be required to register under the proposal if they are not primarily responsible for the development of the algorithmic trading strategy or are not responsible for the day-to-day supervision or direction of others on the team.¹³ Under this scenario, the person on the business side that is primarily responsible for the design of the algorithmic trading strategy, as communicated to the lead developer, also would be required to register. In the event of a significant modification to the algorithm, members, likewise, must ensure that the associated person primarily responsible for the significant modification (or the associated person supervising or directing such activity), is registered as a Securities Trader.¹⁴

FINRA notes that FINRA Rule 3110(a)(2) generally requires that all registered persons be designated to an appropriately registered principal or principals with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker-dealer is required. With the addition of algorithmic trading activities to the Securities Trader registration category, members will be required to designate

¹² Id.

¹³ FINRA notes that a junior developer on the lead developer’s team presumably is not “primarily” responsible for the design, development or significant modification of an algorithmic trading strategy and, therefore, would not be required to register under the proposal. Id. By limiting the registration requirements to those persons primarily responsible for the design, development or significant modification of algorithmic trading strategies or responsible for the day-to-day supervision or direction of such activities FINRA aims to ensure that the member has identified the individuals primarily responsible for covered activities, and for the day-to-day supervision and direction of covered activities, and equip them with a basic level of familiarity with the regulatory obligations of the firm employing the algorithm. Id. FINRA expects that the competency of these associated persons will inform the behaviors of those acting under their supervision or at their direction. Id.

¹⁴ Id.

developers to a registered principal for Rule 3110(a)(2) purposes.¹⁵ In such instances, members may “assign” a lead algorithm developer (or other non-trader) engaging in covered activities to one or more other registered persons of the member that supervise trading activities outside such developer’s or other non-trader’s usual reporting line.¹⁶ Accordingly, the proposal may not necessarily trigger registration requirements for the current supervisor of algorithm design or development personnel if that supervisor is not responsible for the day-to-day supervision or direction of the specific activities covered by this proposal. However, the firm must designate an appropriately registered person to be responsible for supervising the algorithmic trading strategy activities.¹⁷

FINRA notes that a member employing an algorithm is responsible for the algorithm’s activities whether the algorithm is designed or developed in-house or by a third-party.¹⁸ Thus, in all cases, robust supervisory procedures, both before and after deployment of an algorithmic

¹⁵ See Notice, supra note 3, at 9238.

¹⁶ FINRA notes that the adequacy of a member’s supervisory structure must be evaluated on an individual firm basis, and that members are afforded a degree of flexibility in arranging for the appropriate supervision of a lead developer (or other non-trader) that engages in covered activities. See Notice, supra note 3, at 9238.

¹⁷ Id.

¹⁸ Id. FINRA also notes that an algorithmic trading strategy employed by a member may not have originated in-house and, therefore, may not have been designed or built by the member’s associated persons. In cases where the design and development of an algorithmic trading strategy was performed solely by a third-party, the proposed registration requirement would not apply to the member with regard to the design or development of such algorithm. However, FINRA notes that, to the extent associated persons were involved in the design or development, or are able to significantly modify the algorithmic trading strategy in-house, such persons must be registered as Securities Traders. In addition, members also may engage a third-party to custom-build an algorithmic trading strategy for the member. In such cases, the associated person responsible for directing the third-party in the design, development or significant modification of the algorithmic trading strategy also would be included within the scope of this proposal and must be registered as a Securities Trader. Similarly, after the member has launched the externally built algorithm, any significant modification by the member to such algorithm must be performed by a registered Securities Trader. Id.

trading strategy, are a key component in protecting against problematic behavior stemming from algorithmic trading. In addition, associated persons responsible for monitoring or reviewing the performance of an algorithmic trading strategy must be registered pursuant to NASD Rule 1032(f); a member's trading activity must always be supervised by an appropriately registered person.¹⁹ Therefore, even where a firm purchases an algorithm off-the-shelf and does not significantly modify the algorithm, the associated person responsible for monitoring or reviewing the performance of the algorithm must be registered pursuant to NASD Rule 1032(f).²⁰

III. Comment Letter

The Commission received one comment letter that supports the proposal.²¹ The commenter states "ARM understands the need to address the increased significance of algorithmic trading strategies, and therefore supports the FINRA proposal." However, the commenter requested additional information regarding the definition of "algorithmic trading" and requested that FINRA provide adequate time for member firms to identify the personnel who must register pursuant to the proposal.²² The Commission notes that 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, and the effective date will be no sooner than 180 days following publication of the Regulatory Notice but no later than 300 days following Commission approval.²³ The Commission also notes that FINRA gave a list of examples of what would be

¹⁹ Id.

²⁰ Id.

²¹ See ARM Letter, supra note 4.

²² Id.

²³ See Notice, supra note 3, at 9238.

included in the definition of an algorithmic trading strategy.²⁴ FINRA further notes that what is considered an “algorithmic trading strategy” may evolve as new trading strategies are designed and developed.²⁵ The Commission also expects that FINRA will provide more detailed guidance in connection with the implementation of the registration requirement.

IV. Discussion and Findings

After carefully considering the proposed rule change and the comment submitted the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.²⁶ In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,²⁷ which requires, among other things, that FINRA rules 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. In addition, the Commission finds that the proposed rule change is consistent with Section 15A(g)(3)(A) of the Act which authorizes FINRA to examine and verify the qualifications of an applicant to become a member, and the natural persons associated with such an applicant, in accordance with procedures established by FINRA’s rules.²⁸ The proposed rule change requires associated persons primarily responsible for the design, development or significant modification of an algorithmic trading strategy or responsible for the day-to-day supervision or direction of such activities to register and meet a minimum standard of knowledge regarding the securities rules and regulations

²⁴ See Notice, supra note 3, at 9236.

²⁵ Id.

²⁶ In approving this proposed rule change, the Commission has considered the proposed rule change’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

²⁷ 15 U.S.C. 78o-3(b)(6).

²⁸ 15 U.S.C. 78o-3(g)(3)(A).

applicable to the member employing the algorithmic trading strategy. The Commission notes that this minimum standard of knowledge is identical to the standard of knowledge currently applicable to traditional securities traders. The Commission believes that improved education of firm personnel may reduce the problematic market conduct and manipulative trading activities identified by FINRA.²⁹

V. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act³⁰ that the proposed rule change (SR-FINRA-2016-007), be and hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³¹

Robert W. Errett
Deputy Secretary

²⁹ See Notice, *supra* note 3, at 9238-39.

³⁰ 15 U.S.C. 78s(b)(2).

³¹ 17 CFR 200.30-3(a)(12).