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FINRA Files Proposed Rule Requiring Registration of Associated Persons Who Design or Develop Algorithmic Trading Strategies

Introduction

The Financial Industry Regulatory Authority (FINRA) has filed with the Securities and Exchange Commission (SEC) a proposed rule change that would require the registration of associated persons of FINRA member firms who are 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).[1] The proposed rule is largely unchanged from the proposal initially disseminated by FINRA (see here) in early 2015. If approved by the SEC, the rule will require covered individuals to pass a qualification examination and register with FINRA as Securities Traders.

Rationale for the Proposed Rule

NASD Rule 1032(f) currently requires an associated person of a FINRA member who is included within the definition of a "representative" to register with FINRA as a Securities Trader if such person is engaged in proprietary trading, the execution of transactions on an agency basis, or the direct supervision of such activities with respect to transactions in equity, preferred or convertible debt securities effected other than on a securities exchange. FINRA takes the position that this registration requirement should be extended to individuals responsible for such trading when accomplished via an algorithmic trading strategy, particularly in light of the significant role that algorithmic trading plays in today's markets.

By requiring these individuals to pass a qualification examination (and, like all registered individuals, subsequently to take part in continuing education) concerning basic securities regulation obligations, FINRA hopes to facilitate compliance with such regulatory obligations by firms engaged in automated trading activities. As examples, FINRA noted that failures to check for order accuracy, inappropriate levels of messaging traffic, wash sales, failures to mark orders as short or perform short sale locates, and inadequate risk management controls, could be reduced or prevented in part by imposing qualification, registration and education requirements upon certain individuals involved in the design and development of algorithmic trading systems. Notably, when implemented the rule also will provide FINRA

[1] The full text of FINRA's submission to the SEC concerning the proposed rule change is available here. Also, although the proposed rule change applies only to FINRA member firms (and not, for example, to proprietary trading firms that are not FINRA members), the SEC has proposed amendments to Rule 15b9-1 under the Securities Exchange Act of 1934 that would eliminate the proprietary exemption under Rule 15b9-1 and thereby require many proprietary broker-dealers that currently are not FINRA members, to become FINRA members (see here). Coupled with the FINRA registration proposal, individuals at such firms who are primarily responsible for the design and development of algorithmic trading strategies (or for day-to-day supervision of such activities) would be required to register with FINRA as well.

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with enforcement and disciplinary authority over those registered individuals who are involved in the creation or modification of an algorithmic trading strategy that is deemed to be non-compliant with applicable legal and regulatory obligations.

"Algorithmic Trading Strategy" Defined

The proposed rule change would define an algorithmic trading strategy as "an automated system that generates or routes orders (or order-related messages) but shall not include an automated system that solely routes orders received in their entirety to a market center." A few examples provided by FINRA of automated systems falling within the scope of this definition include an arbitrage strategy (such as index or exchange-traded fund arbitrage); an automated hedging or loss-limit algorithmic strategy that generates orders; a trading strategy that generates orders based on moving reference prices; and an order generation, routing and execution program used for large-sized orders that involves dividing the order into smaller-sized orders less likely to result in market impact. Notably, while NASD Rule 1032(f) currently applies only to activity effected other than on a securities exchange, the proposed registration requirement applies to orders and order related messages whether ultimately routed (or sent to be routed) over-the-counter or to an exchange.

An order router alone (e.g., one that routes retail orders in their entirety to a specific market center for handling and execution) would not constitute an algorithmic trading strategy, but if an order router performs any additional functions (such as those set forth in the examples above), it would. Similarly, an algorithm that generates trading ideas or investment allocations, but does not automatically generate orders or order-related messages, would not constitute an algorithmic trading strategy for purposes of the proposed registration requirement.

Registration to be Required for Those Primarily Responsible for the Design, Development or Significant Modification of Algorithmic Trading Strategies

The proposed rule change would require registration as a Securities Trader of all persons associated with a FINRA member who are either (1) primarily responsible for the design, development or significant modification of an algorithmic trading strategy relating to equity (including options), preferred or convertible debt securities or (2) responsible for the day-to-day supervision or direction of such activities. FINRA has stated that it does not intend the registration requirement to apply to every associated person who touches or otherwise is involved in the design or development of a trading algorithm. Instead, the intent is to ensure that one or more associated persons that possess knowledge of (and responsibility for the design of) the intended trading strategy and the technological implementation of that strategy, sufficient to evaluate whether the system is designed to achieve regulatory compliance, are registered. In its filing with the SEC, FINRA provides examples of situations in which registration would and would not be required under the proposed rule, including as follows:

- If a single associated person determines the design of the trading strategy, writes the code to implement the strategy, and directs and executes modifications of the code going forward, then the proposed rule change would require only that associated person to register as a Securities Trader.
- Where a trader advises a lead developer of the desired trading strategy and such developer is primarily responsible for the supervision of the development of the algorithm to be used to implement that trading strategy, both the trader (i.e., the person primarily responsible for the design of the algorithm) and the lead developer (i.e., the person primarily responsible for the development of the algorithm and for the day-to-day supervision of such development) would be required to register as Securities Traders, but individuals under the developer's supervision who are not primarily responsible for the development of the strategy or for the day-to-day supervision of others on the development team, would not be required to do so.
- Where the design and development of a member firm's algorithmic trading strategy was performed ***solely*** by a third party, the proposed registration requirement would not apply to such member firm with respect to such algorithm. However, if associated persons of the FINRA member were involved in the design or development, or are able to significantly modify the algorithmic trading strategy, such persons would be required under the proposed rule change to register as Securities Traders.[2]

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[2] FINRA also noted in the rule proposal that under current rules, a member firm's trading activity must always be supervised by an appropriately registered person, so even where a firm purchases an off-the-shelf algorithm, the associated person responsible for monitoring or reviewing the performance of the algorithm must be registered under NASD Rule 1032(f).

Designation of Securities Traders to a Principal

Like all registered persons, pursuant to FINRA Rule 3110(a)(2), individuals registered under the proposed rule change as Securities Traders must be designated to a registered principal with the authority to carry out supervisory responsibilities of the firm. The proposed rule does not necessarily trigger a registration requirement 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 activities contemplated by the proposed rule change. Nonetheless, the individual(s) to whom a lead developer (or other non-trader) required to register under the proposed rule change is assigned (at least with respect to the activities of the lead developer or other non-trader that trigger the registration requirement under the proposed rule change) must be registered as a Securities Trader or a Securities Trader Principal. Another registered person (e.g., a General Securities Representative) may be assigned to supervise the lead developer (or other non-trader who must be registered as a Securities Trader) with respect to other areas applicable to registered representatives generally (e.g., outside business activities).

Submission of Comments and Ultimate Effective Date

Comments regarding the proposed rule change may be submitted to the SEC electronically or in hard-copy form, and should be submitted on or before the date 21 days after publication of the proposed rule change in the Federal Register. If the SEC approves the proposed rule change, FINRA will announce the effective date of the proposed rule change no later than 60 days following SEC approval, and the effective date of the new rule will be no sooner than 180 days and no later than 300 days following SEC approval.