

# Alert

## The New FINRA Registration Requirement for Algorithmic Traders: Implications for Broker-Dealers and Investment Advisers

April 26, 2016

On April 7, 2016, the Securities and Exchange Commission approved the Financial Industry Regulatory Authority's proposed amendments<sup>1</sup> to NASD rule 1032 (Categories of Representative Registration).<sup>2</sup> These amendments will require FINRA members to register associated persons who are primarily responsible for the design, development or significant modification of "algorithmic trading strategies" (or for the day-to-day supervision or direction of such activities) as "Securities Traders."

### Background

The increasing automation of the securities (and futures) markets, and a number of high-profile market disruptions linked to automated trading and clearing systems<sup>3</sup> have all coalesced into a series of SEC,<sup>4</sup> CFTC,<sup>5</sup> and self-regulatory organization initiatives to regulate and control the use of systematic and algorithmic trading systems. FINRA's proposal to require the registration of algorithmic trading personnel is just one specific manifestation of this broader regulatory initiative.

Historically, associated persons of FINRA members who are involved solely in the design, development or significant modification of "algorithmic trading strategies" have not been subject to FINRA's registration requirements. As a result of the lack of any individual licensing obligation, these algorithmic trading personnel: (1) have not been required to pass any examinations; (2) have not been subject to continuing education requirements; and (3) have — in many ways — been "under the radar" when it came to FINRA's examination and inspection program.

FINRA now believes that requiring the registration of certain algorithmic trading personnel could help reduce or prevent problematic conduct caused by the widespread use of algorithmic trading strategies.

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<sup>1</sup> See File No. SR-FINRA-2016-007.

<sup>2</sup> See [Exchange Act Release No. 34-77551](#) (Apr. 7, 2016), 81 Fed. Reg. 21914 (Apr. 13, 2016) (the "Adopting Release").

<sup>3</sup> See SEC Order relating to charges that Knight Capital Americas LLC violated Exchange Act rule 15c3-5 ([Exchange Act Release No. 70694](#) (Oct. 16, 2013)). See also Findings Regarding the Market Events of May 6, 2010, Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues at <http://www.sec.gov/news/studies/2010/marketevents-report.pdf>. See also Ben Rooney, [Google Price Corrected After Trading Snafu](#), CNNMoney.com, Sept. 30, 2008, [http://money.cnn.com/2008/09/30/news/companies/google\\_nasdaq/?postversion=2008093019](http://money.cnn.com/2008/09/30/news/companies/google_nasdaq/?postversion=2008093019).

<sup>4</sup> See [Exchange Act Release No. 34-63241](#) (adopting Exchange Act rule 15c3-5 (the "Market Access Rule")); see also [Exchange Act Release No. 34-73639](#) (adopting Regulation SCI).

<sup>5</sup> See, e.g., the CFTC's recent Regulation AT proposal ([80 Fed. Reg. 78824](#)) (Dec. 17, 2015).

In February 2016, FINRA proposed a new rule that would require the registration (as Securities Traders<sup>6</sup>) of “associated persons that possess knowledge of, and responsibility for, both the design of the intended trading strategy (e.g., the arbitrage strategy) and the technological implementation of such strategy (e.g., coding)” and to make those associated persons subject to FINRA’s continuing education requirements applicable to Securities Traders.<sup>7</sup>

On April 7, 2016, the SEC approved this proposal and the new rule is expected to become effective following FINRA’s publication of a Regulatory Notice relating to the revised rule.

## **Implications for Broker-Dealers**

### **Coverage of the New Registration Requirement**

The new FINRA rule applies to associated persons who are *primarily responsible* for, or who have *day-to-day supervision or direction* over:

- The *development* of “algorithmic trading strategies”;
- The *design* of algorithmic trading strategies; or
- *Significant modification* of algorithmic trading strategies.

Each of these terms has a specified meaning under the new rule.

### **Primarily Responsible**

FINRA does not intend that “every associated person that touches or otherwise is involved in the design or development of a trading algorithm” be required to register as a Securities Trader under amended NASD rule 1032(f). Rather, the Adopting Release makes clear that the new rule only covers associated persons who are “primarily responsible” for: (1) the design; (2) the development; or (3) the significant modification of an algorithmic trading strategy.<sup>8</sup>

FINRA expects member firms to designate an appropriately registered associated person as being primarily responsible for the design and development of an algorithmic trading strategy (other than certain off-the-shelf systems purchased from third parties). In situations where this function is handled by multiple individuals or by a committee and no specific designation has been made by the member firm, FINRA may consider each individual or committee member to be “primarily responsible” for the design or significant modification of the strategy.<sup>9</sup>

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<sup>6</sup> The pre-requisite to registration as a Securities Trader is successfully passing the Series 57 (Securities Trader) examination.

<sup>7</sup> See [Exchange Act Release No. 34-77175](#) (Feb. 18, 2016), 81 Fed. Reg. 9235 (Feb. 24, 2016) (the “Proposing Release”).

<sup>8</sup> See Proposing Release, 81 FR at 9237, “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.”

<sup>9</sup> *Id.*

### Day-to-Day Supervision or Direction

Associated persons responsible for the day-to-day supervision of the design, development and substantial modification of algorithmic trading strategies must also be registered under new NASD rule 1032(f). Under the new rule, however, it is clear that a general supervisory obligation is not necessarily a registration trigger; rather, the supervisor must be personally “responsible for the day-to-day supervision or direction of” the design, development or substantial modification of the algorithmic trading strategy<sup>10</sup> (and not merely of the individuals or business units charged with the design and development obligations).

### Development and Design

The Proposing Release makes clear that FINRA considers the *development* and the *design* of algorithmic trading strategies to be two distinct tasks (although they may be performed by the same individual or group of individuals) and, accordingly, if an individual is responsible for either the development or the design of an algorithmic trading strategy, he or she will have to be registered accordingly.

For example, where a FINRA member purchases an “off-the-shelf” algorithmic trading strategy and deploys it without any significant modification, FINRA would consider the design *and* development of the algorithmic trading strategy to have been performed by the third-party provider and *not* by associated persons of the member. However, where a member firm engages a third-party to *custom-build* an algorithmic trading strategy for the member, the associated person at the member “responsible for directing the third party in the design, development or significant modification of the algorithmic trading strategy” would be considered to have *designed*, but not *developed*, the algorithmic trading strategy and, accordingly, would have to be registered as a Securities Trader under the revised rule.

Put another way, the individual responsible for planning the intended trading strategy would be considered responsible for the “design” of the algorithm, while the individual responsible for the technological implementation of such strategy (e.g., coding) would be considered responsible for the “development” of the algorithm.

### Significant Modification

Under the new rule, an associated person that has responsibility for a “significant modification” to an algorithmic trading strategy may have a registration obligation. A “significant modification” is generally defined as a coding change that impacts the logic and functioning of the trading strategy employed by the algorithm. For example, a change to a benchmark employed by the trading strategy would typically be considered a “significant modification” as it effects the trading strategy, while modifications to accommodate a new data feed or data vendor generally would not.<sup>11</sup>

### Algorithmic Trading Strategies

Generally, FINRA considers an “algorithmic trading strategy” to be an automated system that generates or routes orders or order-related messages such as routes or cancellations. This includes “a smart order

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<sup>10</sup> See Adopting Release, 81 FR at 21915.

<sup>11</sup> See Proposing Release, 81 FR at 9237.

router that breaks orders into ‘child’ orders,” as well as automated systems involved in the arbitrage and hedging strategies, under the revised rule.<sup>12</sup>

FINRA stated that it would not consider an order router that solely routes orders received in their entirety to a market center to be an algorithmic trading strategy, nor would it consider “an algorithm that solely generates trading ideas or investment allocations” to be an algorithmic trading strategy, at least to the extent the algorithm “*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)...*”<sup>13</sup>

### **Written Supervisory Procedures**

FINRA members will want to review and update their written supervisory procedures to ensure compliance with new NASD rule 1032(f); i.e., member firms should have a process designed to ensure that individuals covered by the new rule are properly registered as Securities Traders.

Member firms should also review FINRA Regulatory Notice 15–09 (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies) (“RN 15-09”), which addresses policies and procedures regarding the development, testing and implementation of new code, including algorithmic strategies. FINRA, in the Proposing Release, reiterated that members should employ the guidelines noted in RN 15-09 even where modification of an algorithmic trading strategy is not significant and, therefore, would not have to be performed by a registered Securities Trader under the revised rule.

### **Exchange Act Rule 15c3-5 Implications**

Exchange Act rule 15c3-5 (the “Market Access Rule”) requires that a broker-dealer that provides “market access” must employ financial and regulatory risk management controls designed to manage the financial, regulatory and other risks associated with providing market access. The rule requires that broker-dealers employ automated systems that, on a pre-order entry basis, can reject orders that exceed certain financial thresholds or fail to comply with regulatory requirements that must be satisfied on a pre-order entry basis (such systems, “RMAs”).

RMAs will not fall under the definition of “algorithmic trading strategies” as they are not involved in the generation of orders or execution of transactions. However, the Proposing and Adopting Releases indicate that FINRA views the registration requirements of amended NASD rule 1032(f) as supplementing the Market Access Rule.<sup>14</sup> Given the apparent overlapping obligations of the Market Access Rule and new NASD rule 1032(f), member firms may want to consider consolidating responsibility for the design, development and substantial modification of RMAs and algorithmic trading strategies under the same associated person.

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<sup>12</sup> See Proposing Release, 81 FR at 9240.

<sup>13</sup> See Proposing Release, 81 FR at 9237 (emphasis added).

<sup>14</sup> For instance, the Proposing Release notes that “even if an algorithm never malfunctions from a technological standpoint, its behavior nonetheless may violate securities laws if appropriate constraints were not built into the design and development phases that ensure any order generated by the algorithm observes applicable regulatory standards...”

## **Implications for Investment Advisers**

The new rule (NASD rule 1032(f)) is only applicable to registered broker-dealers and has no direct effect on investment advisers (unless the adviser is dually registered as a broker-dealer). However, systematic and other quantitative managers should review the Adopting Release and RN 15–09, as regulators may well look to them as being instructive in determining best practices for investment advisers.<sup>15</sup>

RN 15-09, in particular, lists five categories of (and 30 specific) “Suggested Effective Practices for Firms Engaging in Algorithmic Strategies” that all systematic and quantitative managers should consider reviewing and, where applicable, incorporating into their quality control processes. These five suggested practices are:

1. *General Risk Assessment and Response*: Undertaking a “holistic review of [a firm’s] trading activity” and implementing cross-disciplinary committees to continually assess the risks associated with individual algorithmic strategies;
2. *Software/Code Development and Implementation*: Implementing policies and processes that focus on the development, testing and implementation of algorithmic strategies, rather than just post-production reviews;
3. *Software Testing and System Validation*: Developing and implementing policies and procedures around the actual testing of algorithmic strategies, including modification to existing strategies;
4. *Trading Systems*: Implementing policies and procedures providing for the post-implementation review of an algorithmic strategy’s trading activity; and
5. *Compliance*: Ensuring effective communication between compliance staff and algorithmic strategy development staff.

New NASD rule 1032(f) can also be useful to legal and compliance personnel as a construct for supervisory authority and responsibility. Given the SEC examination focus on quantitative funds, systematic managers should use this FINRA guidance as an opportunity to evaluate and update their business and compliance processes.

## **Effective Date**

FINRA must announce the effective date of the proposed rule change in a Regulatory Notice published no later than 60 days from April 7, 2016, and the effective date will be no sooner than 180 days following publication of the Regulatory Notice but no later than 300 days following SEC approval.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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<sup>15</sup> See, e.g., the CFTC’s broad survey of U.S. and non-U.S. industry best practices and regulatory requirements in the Regulation AT proposing release (80 FR at 78834).

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