FINRA Issues Regulatory Notices on Algorithmic Trading Strategies

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The Financial Industry Regulatory Authority ("**FINRA**") recently issued two Regulatory Notices concerning algorithmic trading as part of a larger package of market structure initiatives. The first Regulatory Notice, which was released on March 19, requests comment on a **proposal** to require the registration of persons who are primarily responsible for the design, development or significant modification of algorithmic trading strategies or directing or supervising such activities ("**Covered Individuals**"). The second document, which was issued on March 26, contains **guidance** concerning supervision and control practices for the development and deployment of algorithmic trading programs.

The Registration Proposal

FINRA believes that the prevalence of algorithmic trading in the marketplace has heightened the risks that arise when such strategies are poorly designed. In FINRA's view, such risks may be reduced if key individuals who are responsible for a firm's algorithmic trading strategies are subject to the same minimum competency standards that are applicable to individual traders. Current FINRA rules generally require associated persons of member firms to register with FINRA as "Equity Traders" if, with respect to certain off-exchange transactions in equity securities, they engage in proprietary trading or the execution of transactions on an agency basis, or directly supervise such activities. FINRA's proposal would expand the Equity Trader registration category to also include Covered Individuals. Junior developers and those who merely write code to implement trading strategies at the direction of others, and supervisors not involved in the day-to-day supervision of the development process, would not be required to register.

FINRA proposes to treat as an algorithmic trading strategy any program that generates and routes (or sends for routing) orders, cancellations or other order-related messages on an automated basis. However, a firm's use of standard order routers for best execution or other regulatory compliance purposes, and not to implement a particular strategy, would not be considered an algorithmic trading strategy.

If the proposal is ultimately adopted, member firms that engage in automated trading would need to determine which of their Covered Individuals are not already registered as Equity Traders and ensure that they pass the Series 55 examination and register with FINRA (although FINRA notes that it may, separately, seek to replace the Series 55 Equity Trader qualification with new Securities Trader and Securities Trader Principal qualifications). In addition, such firms would need to establish and implement new policies and procedures to monitor and ensure ongoing compliance with the new registration requirement.

While FINRA provides examples of the persons whom they would expect to register and types of programs that they believe would constitute algorithmic trading strategies, there are a number of ambiguities relating to the definition of persons "principally engaged" in the relevant activities and which supervisors are meant to be covered. As a result, FINRA member firms may have some difficulty in identifying with precision (both initially and on an ongoing basis) the universe of individuals to be registered, and in documenting their determinations and the underlying rationales.

More fundamentally, member firms will likely be concerned that this proposal, if adopted, will make it more difficult for them to recruit and retain talented developers and other professionals because of the incremental burden of having to pass and maintain a professional qualification, and a perception of heightened risk of personal responsibility for errors and supervisory failures.

FINRA has requested comments on the proposal by May 18, 2015. If FINRA proceeds with the proposal, it would need to be submitted for approval to the Securities and Exchange Commission, which would publish the proposal for a further round of comments before acting on it.

Suggested Effective Practices

Based upon its findings in numerous examinations and investigations pertaining to systems-related issues at member firms engaged in algorithmic trading, FINRA is concerned that some firms lack appropriate supervisory controls and procedures related to the creation, modification, usage and testing of trading algorithms, and may not adequately safeguard against wash sales, excessive levels of message traffic and other problematic activities. FINRA believes that the risk of systems issues will be reduced if firms adopt various practices in connection with their development, supervision and deployment of algorithmic trading strategies.

FINRA's guidance focuses on the following broad areas:

- *General Risk Assessment*. After undertaking a "holistic review" of their trading activity, member firms should consider creating cross-disciplinary committees to assess risks imposed by algorithmic trading.
- *Software / Code Development and Implementation*. Firms should: implement a development and change management process for new trading code and material changes to existing code (with appropriate test result monitoring and approval protocols); employ multiple systems validations before deploying new code; archive code versions in a retrievable manner; maintain summary descriptions of algorithmic strategies that outline the intended function of the algorithms; implement procedures to quickly disable algorithms; and, where feasible, introduce new algorithms on a limited pilot basis.
- *Software Testing and System Validation*. FINRA suggests that its members: validate that core code components operate as intended; ensure that testing is independent of code development and is conducted in an environment that is segregated from production; periodically evaluate test controls; implement data integrity, accuracy and work flow validation testing programs; and maintain records of testing procedures and results.
- *Trading Systems*. Member firms should: implement (and periodically evaluate) controls, alerts and reconciliation processes to identify quickly whether a trading algorithm is experiencing unintended results; record and track systems problems; document and review risk controls and parameters; monitor downstream market impacts; make systems appropriately scalable; implement appropriate access entitlements and safeguards against overwriting of code or evasion of controls; and institute parameters to control outbound message traffic.
- *Compliance*. Compliance monitoring tools should be capable of detecting activity that may result from the interaction of multiple algorithms, such as wash sales or self-trades. Member firms should review staffing levels and supervision and conduct training to ensure that there is appropriate staffing and expertise with respect to responding to regulatory inquiries and conducting surveillance for compliance with applicable laws, regulations and self-regulatory organization rules.

FINRA's guidance does not purport to introduce new substantive requirements, and most firms engaged in algorithmic trading are likely to have these processes and others suggested by FINRA already in place. However, FINRA member firms should consider formally evaluating their development, compliance and supervisory practices against FINRA's guidance in light of the priority that FINRA is currently placing on this area.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Annette L. Nazareth	**202 962 7075**	**annette.nazareth@davispolk.com**
Lanny A. Schwartz	**212 450 4174**	**lanny.schwartz@davispolk.com**
Hilary S. Seo	**212 450 4178**	**hilary.seo@davispolk.com**
Kimberly N. Chehardy	**202 962 7037**	**kimberly.chehardy@davispolk.com**
Jeffrey T. Dinwoodie	**202 962 7132**	**jeffrey.dinwoodie@davispolk.com**
Zachary J. Zweihorn	**202 962 7136**	**zachary.zweihorn@davispolk.com**