Registration of Associated Persons with Algorithmic Trading Responsibilities

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On April 7, 2016, the Securities and Exchange Commission ("SEC") approved the Financial Industry Regulatory Authority's ("FINRA") proposal to amend NASD Rule 1032 (Categories of Representative Registration) to require registration as Securities Traders[1] 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.[2] The revised rule is intended to ensure the registration of associated persons who the possess the knowledge of, and responsibility for, both the design of an intended trading strategy and the technological implementation of the strategy. The registration requirement will enhance compliance related to algorithmic trading strategies because such associated persons will have the ability to evaluate whether the resulting product is designed to achieve regulatory compliance in addition to business objectives.

Definition of Algorithmic Trading Strategy. FINRA defines an "algorithmic trading strategy" as an automated system that generates or routes orders or order-related messages (*e.g.*, routes or cancellations), but does not include an automated system that solely routes orders received in their entirety to a market center. Therefore, an order router alone would not constitute an algorithmic trading strategy. Moreover, an algorithm that solely generates trading ideas or investment allocations, but that is not equipped to automatically generate orders and order-related messages to effectuate such trading ideas, would not constitute an algorithmic trading strategy.

Covered Persons. FINRA's new requirement applies to associated persons primarily responsible for the design, development or significant modification of algorithmic trading strategies, or those who are responsible for the day-to-day supervision or direction of such activities. For example, a lead developer who (1) liaises with a head trader regarding the head trader's desired algorithmic trading strategy and (2) is primarily responsible for the supervision of the development of the algorithm to meet such objectives must be registered under this new rule. In this example, the leader developer is the associated person primarily responsible for the development of the algorithmic trading strategy and for supervising or directing the team of developers. Individuals under the lead developer's supervision, such as junior developers, would not be required to register

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. 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.

Examination/Education Requirements. 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 such a requirement will reduce problematic market 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.

Supervision. In accordance with FINRA Rule 3110(a)(2), a member firm must designate an appropriately registered principal to be responsible for supervising the algorithmic trading strategy activities of the associated persons subject to these new requirements. 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. Accordingly, the revised rule 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 rule change.

Effective Date. FINRA will announce the effective date of the rule change in a Regulatory Notice to be published no later than June 13, 2016, and the effective date will be no sooner than 180 days following publication of the Regulatory Notice but no later than February 7, 2017.

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[1] *See* NASD Rule 1032(f) for the definition of "Securities Trader."

[2] Securities Exchange Act Rel. No. 77551 (Apr. 7, 2016), 81 Fed. Reg. 21914 (Apr. 13, 2016).

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