

April 14, 2016

## The SEC Approves a FINRA Rule Amendment Requiring Registration of Associated Persons Who Design or Develop Algorithmic Trading Strategies

### Introduction

On April 7, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 1032(f) which will require registration as Securities Traders of associated persons who are 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. 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, the Financial Industry Regulatory Authority (FINRA) hopes to facilitate compliance with such regulatory obligations by firms engaged in algorithmic trading activities.<sup>1</sup>

### Description of the Requirements of the Amended Rule

Under the approved amendments to NASD Rule 1032(f), associated persons of FINRA member firms will be required to pass a qualification examination and register with FINRA as Securities Traders if they are:

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.<sup>2</sup>

The amended rule defines algorithmic trading as “an automated system that generates or routes orders (or order-related messages)” and applies whether such orders and order related messages ultimately are routed (or sent to be routed) for execution in the over-the-counter market or to an exchange. Examples of algorithmic trading strategies covered by the amended rule include an automated arbitrage strategy (e.g., index or exchange-

<sup>1</sup> Notably, the amended rule also will provide FINRA 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 or regulatory obligations.

<sup>2</sup> Although the rule 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 that rule and thereby require many proprietary broker-dealers that currently are not FINRA members, to become FINRA members (see [here](#)). Upon the Rule 15b9-1 amendments becoming effective and such proprietary broker-dealers becoming FINRA members, 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) will be required to register with FINRA as well.

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traded fund arbitrage), an automated hedging or loss-limit algorithmic strategy that generates orders, or a trading strategy that generates orders based on moving reference prices. However, an automated system that solely routes orders received in their entirety to a market center is not considered an algorithmic trading strategy.<sup>3</sup>

### Examples of the Application of the Amended Rule

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 at least one associated person that possesses 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, is registered. A few examples of the application of the amended rule are set forth below:

Example	Who Must Register?
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	Only that single associated person
A trader advises a lead developer of the desired trading strategy and that developer is primarily responsible for the supervision of the development of the algorithm to be used to implement that trading strategy	<ul style="list-style-type: none"> <li>• The trader (the person primarily responsible for the design of the algorithm)</li> <li>• The lead developer (the person primarily responsible for the development of the algorithm and for the day-to-day supervision of such development)</li> <li>• 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 <b>not</b> be required to register</li> </ul>
A FINRA member firm purchases an algorithmic trading strategy off-the-shelf (i.e., a third party (non-FINRA member) designed and developed the algorithmic trading strategy without any input from the member)	No one
A third party (non-FINRA member) develops a FINRA member firm’s algorithmic trading strategy based upon input from a trader at the member firm regarding the design of the algorithm	The FINRA member firm’s trader (the person primarily responsible for the design of the algorithm)
A FINRA member firm purchases an algorithmic trading strategy off-the-shelf (i.e., a third party (non-FINRA member) designed and developed the algorithmic trading strategy without any input from the member), but subsequently, a single associated person of the member firm determines the design of a significant modification to the strategy and writes the code to implement such significant modification <sup>4</sup>	The associated person who designed and developed the significant modification

<sup>3</sup> Although an order router alone (e.g., one that routes retail orders in their entirety to a specific market center for handling and execution) does not constitute an algorithmic trading strategy under the rule, if an order router performs any additional functions (e.g., includes an order routing strategy used to determine the price or size for routed orders), it would. Similarly, an algorithm that generates trading ideas or investment allocations but that does not automatically generate orders or order-related messages does not constitute an algorithmic trading strategy for purposes of the rule.

<sup>4</sup> Generally, a “significant modification” to an algorithmic trading strategy is any change to the code of the algorithm that effects the logic and functioning of the trading strategy. For example, a data feed/data vendor change typically would not constitute a “significant modification” but a change to the benchmark relied upon by the strategy likely would.

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## Designation of Securities Traders to a Principal

Pursuant to FINRA Rule 3110(a)(5), individuals registered under the new rule as Securities Traders (like all registered personnel) must be assigned to a registered principal with the authority to carry out supervisory responsibilities of the firm. However, the amended 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 design or development process. Indeed, it may be appropriate for a firm to assign a lead algorithm developer (or other non-trader) who is required to register as a Securities Trader, to an individual who supervises trading activities (i.e., who is outside of the developer's usual reporting line), so long as the supervisor in question is registered as a Securities Trader or a Securities Trader Principal. Another registered person may be assigned to supervise the lead developer (or other non-trader) with respect to other areas applicable to registered representatives generally (e.g., outside business activities).

## Qualification Requirements

To register with FINRA as a Securities Trader, an individual must first pass the Series 57 (Securities Trader) examination. To register with FINRA as a Securities Trader Principal, an individual must qualify and register as a Securities Trader and must pass the Series 24 (General Securities Principal) examination.

## Effective Date

FINRA will announce the effective date of amended NASD Rule 1032 in a Regulatory Notice by June 6. The effective date will be no sooner than 180 days after publication of such Regulatory Notice and no later than 300 days after April 7.

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