FINRA
Financial Industry Regulatory Authority

December 2, 2013

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-FINRA-2013-036 (Proposed Rule Change Relating to Wash Sale Transactions and FINRA Rule 5210 (Publication of Transactions and Quotations)) – Response to Comments

Dear Ms. Murphy:

This letter is being submitted by Financial Industry Regulatory Authority, Inc. ("FINRA") in response to comments submitted to the U.S. Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing ("Proposal").[1] The Commission received five comment letters on the Proposal.[2] One commenter urged the Commission not to approve the Proposal,[3] and one commenter supported the Proposal in its entirety.[4] Three commenters suggested modifications to the Proposal.[5]

---

1 *See* Securities Exchange Act Release No. 70276 (August 28, 2013), 78 FR 54502 (September 4, 2013) (SR-FINRA-2013-036).

2 *See* Letter to Elizabeth M. Murphy, Secretary, Commission, from Phlebus Anonymous, dated September 9, 2013 ("Anonymous"); Letter to Elizabeth M. Murphy, Secretary, Commission, from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, dated September 25, 2013 ("MFA"); Letter to Elizabeth M. Murphy, Secretary, Commission, from Manisha Kimmel, Executive Director, Financial Information Forum, dated September 25, 2013 ("FIF"); Letter to Elizabeth M. Murphy, Secretary, Commission, from Theodore R. Lazo, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated October 4, 2013 ("SIFMA"); Letter to Elizabeth M. Murphy, Secretary, Commission, from William A. Jacobson, Clinical Professor of Law & Director, Securities Law Clinic, and Jimin Lee, Cornell Securities Law Clinic, dated September 25, 2013 ("CSLC").

3 *See* Anonymous.

4 *See* CSLC.

5 *See* FIF, MFA, and SIFMA.

1735 K Street, NW
Washington, DC
20006-1506
t 202 728 8000
www.finra.org

In the Proposal, FINRA proposed the addition of Supplementary Material .02 to FINRA Rule 5210 to emphasize that transactions in a security that involve no change in the beneficial ownership of the security are generally non-bona fide transactions and that members have an obligation to have policies and procedures in place to review their trading activity for, and prevent, these transactions.[6] As the Proposal noted, however, transactions originating from unrelated algorithms or separate and distinct trading strategies within the same firm would generally be considered bona fide transactions. The proposed supplementary material is intended to address trading activity occurring due to orders sent by a single algorithm or the unintended, but in FINRA's view preventable, interaction of multiple, related algorithms operated by a single firm, even if that trading activity is unintentional. In a number of instances, FINRA has found that transactions resulting from orders originating from a single algorithm or trading desk, or related algorithms or trading desks can account for a material percentage (e.g., over 5%) of the consolidated trading volume in a security on a particular day, which can distort the market information that is publicly available for that security. When these transactions account for a material percentage of volume in a security, they can create the misimpression of active trading in a security that could adversely impact the price discovery process, even if the self-trades are unintentional. The Proposal thus seeks to hold firms accountable for, and require them to take steps to prevent, self-trades that result from a single algorithm or trading desk, or related algorithms or trading desks.

The comments received by the Commission on the Proposal and FINRA's responses to the comments are discussed in detail below. FINRA is submitting Amendment No. 1 to the proposed rule change contemporaneously with this response to comments. As discussed in more detail below, the primary changes to the Proposal that FINRA is proposing in Amendment No. 1 are:

- Replacing the term "wash sale" with "self-trade" and clarifying that self-trades are transactions in a security resulting from the unintentional interaction of orders originating from the same firm that involve no change in the beneficial ownership of the security;

- Clarifying that the policies and procedures required by the rule must be reasonably designed to review trading activity for, and prevent, a pattern

---

6 The Proposal used the term "wash sale" to describe these types of transactions, regardless of whether the transactions were undertaken with manipulative or fraudulent intent. Some commenters raised concerns with the use of the term "wash sale" in this context. *See* SIFMA, at 2. As discussed below, FINRA is amending the rule text to refer to these types of transactions as "self-trades" to avoid the implication that the transactions at which the Proposal is directed require manipulative or fraudulent intent. Consequently, the term "self-trades" is generally used in this letter to reflect the change in terminology.

or practice of self-trades resulting from orders originating from a single algorithm or trading desk, or related algorithms or trading desks; and

- Removing the examples from the rule text on the types of algorithms or trading desks FINRA would presume to be related for purposes of the rule.

General Comments

Anonymous opposes the Proposal and argues that the Proposal is inconsistent with the Securities Exchange Act of 1934 ("Exchange Act") and the public interest. FINRA strongly disagrees with the commenter and believes that, as described in the Proposal, the proposed supplementary material is consistent with the requirements of the Exchange Act and will improve investor protection by taking affirmative steps to address trading activity that is generally permitted under existing laws and rules but that can potentially result in misinformation in the marketplace.

As an initial matter, FINRA believes that Anonymous has turned FINRA's motivation for the Proposal on its head. Anonymous asserts that the Proposal is intended "to permit 'inadvertent' wash sales." In fact, as laid out in the Proposal, the reason FINRA submitted the Proposal to the SEC is to place limits on ongoing trading activity that is not necessarily prohibited under existing laws and rules. As FINRA noted in the Proposal, existing FINRA rules and the federal securities laws prohibit transactions in securities that do not result in a change of beneficial ownership in the securities *when there is a fraudulent or manipulative purpose behind the trading activity.*[7] The Proposal goes beyond this and requires that members avoid engaging in, and undertake efforts to prevent, transactions in securities that do not result in a change of beneficial ownership under certain circumstances, even though there may be no fraudulent or manipulative intent behind the trading activity.

Anonymous also takes issue with FINRA's conclusion that not all self-trades are avoidable, and appears to take the position that any self-trade is per se fraudulent or manipulative. FINRA rejects this position, and the existing prohibitions on wash

---

[7] The Proposal cites Section 9(a)(1) of the Exchange Act and FINRA Rule 6140(b), both of which require a finding that the person engaged in wash sales did so for the purpose of creating a false or misleading appearance of trading activity. The commenter's assertion that the Proposal's "premise is that it is acceptable under the Exchange Act for the Firms to artificially inflate reported volume in securities traded by their algorithms" has absolutely no basis. Such activity would already be covered by existing laws and rules. In fact, if the Commission rejects the Proposal, as advocated by Anonymous, because it does not go far enough, the result will be less protection for investors from self-trading activity that may affect the market.

sales (all of which require manipulative intent) also indicate a recognition that a change in beneficial ownership is not the sine qua non of a legitimate trade. An individual transaction that is reported with a single firm on both sides of the trade is not per se illegitimate, and FINRA believes that a failure to recognize this important point would impose a significant deterrent to legitimate trading activity.[8] Consequently, the proposed rule change states that self-trades, as defined in the supplementary material, are generally bona fide transactions. However, firms must review their trading activity for, and prevent, a pattern or practice of self-trades from a single algorithm or trading desk, or related algorithms or trading desks. As noted in the Proposal, "FINRA recognizes that, in many situations, what may seem to be wash sale activity occurs as a result of orders that originate from the same firm, but from separate or distinct underlying trading strategies (e.g., separate "desks," aggregation units, or algorithms) that have different—and sometimes competing—investment objectives and that deliberately do not interact with each other prior to generating orders into the market. Consequently, the proposed supplementary material does not seek to prevent all types of trading activity that happen to result from separate strategies operating within a single firm."

The Proposal attempts to recognize this reality: certain firms may have multiple trading desks (or algorithms) with completely different trading strategies that operate independently from one another and, in many instances, do not communicate with one another before submitting orders to the market. FINRA believes that the Proposal strikes an appropriate balance between allowing a single firm to engage in separate trading activities and strategies even though that trading may, at times, result in self-trades while also ensuring that firms are taking appropriate steps to identify and prevent patterns and practices of self-trades that may materially distort reported trade volume.

Specific Comments

Three commenters suggested various modifications to the Proposal, which are discussed below.

1. "Related" Presumption

Three commenters suggested removing the presumption that algorithms are related if they are within the same aggregation unit or most discrete unit of internal controls within a firm.[9] MFA stated that unrelated algorithms may be in the same aggregation unit because they share common oversight staff, even though the strategies are different and requested that FINRA clarify that "algorithms are not

---

8 Several commenters also note that imposing a rule that is too broad risks preventing legitimate trading activity. *See* FIF, at 2; SIFMA, at 2.

9 *See* FIF, MFA, SIFMA.

'related' merely because they share common infrastructure, inputs such as market data or certain characteristics of a security, or had common quantitative researchers." FIF asserted that the presumption is inconsistent with current industry practice and would require substantial development effort to link those algorithms so that crosses can be prevented (which could also have the unintended consequence of preventing legitimate trading activity). SIFMA also requested that FINRA remove the presumption from the proposed rule or, in the alternative, that FINRA clarify "that the exclusion for unrelated algorithms is a non-exclusive safe harbor in which member firms may demonstrate their compliance by those means that best reflect their organization, rather than be limited to information barriers alone."

FINRA understands the commenters' concerns; however, FINRA believes there should continue to be a rebuttable presumption that algorithms within the most discrete unit of a firm's internal controls are related.[10] FINRA agrees that firms should be able to attempt to demonstrate their compliance and rebut such a presumption. By referencing examples such as aggregation units or information barriers, FINRA did not intend to limit the rule to those examples. To avoid confusion, FINRA is proposing to remove the examples. At the same time, FINRA believes it is unlikely that in such situations firms will be able to rebut the presumption that algorithms are "related." FINRA also clarifies that, notwithstanding a presumption that such algorithms are "related," firms are permitted to attempt to demonstrate that two or more algorithms within the most discrete unit of a firm's internal controls, such as an aggregation unit, are not "related."

2. Terminology

One commenter specifically recommended that FINRA replace the phrase "wash sale" with "self-trades" because "wash sales" are generally understood to be transactions that are knowingly effected with manipulative intent.[11] Another commenter, although not specifically making the same recommendation, used the phrase "self-matches" throughout its comment letter.[12] FINRA has determined to change the use of the term "wash sale" to "self-trade" to avoid the implication that the types of trading activity addressed in the supplementary material are limited to trading that is undertaken with manipulative intent.[13] FINRA is proposing to define "self-

---

10 Of course, algorithms could be "related" in other ways as well (e.g., an algorithm that directly interacts with another algorithm, an algorithm that factors in another algorithm's activity when making investment decisions).

11 *See* SIFMA, at 2.

12 *See* MFA.

13 FINRA notes that the term "self-trade" is currently used by the New York Stock Exchange in the context of allowing firms to place modifiers on orders to prevent executions between opposite-side orders from the same market

trade" for purposes of the rule as a transaction in a security resulting from the unintentional interaction of orders originating from the same firm that involves no change in the beneficial ownership of the security. FINRA notes, however, that the use of the term "self-trade" in this context does not change members' existing obligations with respect to the prevention of wash sales under NASD Rule 3010 and FINRA Rule 2010.

3. Material Percentage

In the Proposal, FINRA noted that "only those firms that engage in a pattern or practice of effecting wash sale transactions that result in a material percentage of the trading volume in a particular security would generally violate Rule 5210, as well as Rule 2010." Two commenters suggested including a material percentage of the market qualification in the rule itself.[14] FIF suggested that the rule text should not require firms to "prevent" wash sales but should be required to "implement controls where such activity demonstrates a pattern or practice of effecting wash sale transactions that result in a material percentage of the volume in a security." SIFMA suggested amending the rule "to require policies and procedures reasonably designed to monitor for and prevent the otherwise unintentional transactions that result in no change in beneficial ownership that constitutes [sic.] a material percentage of consolidated trading volume in a subject security on a particular day." Thus, firms would violate the rule only if they engage in a pattern or practice of otherwise unintentional self-trades that account for a material amount of volume.

FINRA does not believe that the rule text should be limited to only those self-trades that have a material effect on the market because, in many instances, firms will not be able to know the ultimate effect self-trading has as it occurs. Rather, a firm's obligation is to review its trading activity to assess any self-trading in which the firm has engaged and, where necessary, take appropriate actions to prevent a pattern or practice of such activity from occurring going forward. This is the case because, as noted above, isolated self-trades are generally bona fide transactions; it is only when that type of trading activity accounts for a material percentage of the volume in a particular security that the self-trading activity results in potential misinformation that can adversely affect the price discovery process. FINRA is therefore most concerned with those firms that engage in a pattern or practice of effecting self-trades resulting from orders originating from a single algorithm or trading desk, or related algorithms or trading desks. To more accurately reflect this concern, FINRA is proposing to add

---

participant identifier (referred to as "Self Trade Prevention Modifiers"). *See* NYSE Rule 13.

14 *See* FIF, SIFMA.

language to the rule that notes firms' obligations are to prevent a pattern or practice of self-trades, not all self-trades.[15]

4. Scope of Securities

One commenter suggested limiting the proposed rule to U.S. equity transactions that are publicly reported.[16] FINRA does not believe the rule should be limited to equity securities because self-trades in fixed-income transactions can present the same concerns raised by equity transactions.

5. Existing Software

One commenter requested that "FINRA clarify that [firms] will be deemed in compliance with Rule 5210 by utilizing anti-internalization functionality, such as self-trade prevention modifiers, offered by exchanges."[17] Another commenter requested that FINRA "encourage" marketplaces and members to use and develop this type of functionality.[18] Although FINRA does not believe there should be a safe harbor for firms using existing exchange mechanisms to prevent self-trading, a firm's use of these functionalities and regular review of their effectiveness could be one potential consideration in an analysis of whether the firm's policies and procedures are reasonably designed to prevent a pattern or practice of self-trading and could also be relevant in determining whether any self-trading was conducted with manipulative intent.

FINRA believes that the foregoing fully responds to the issues raised by the commenters. If you have any questions, please contact me at 202-728-6927.

Sincerely,

Brant K. Brown

Brant K. Brown

---

15 FINRA is not proposing to change the word "prevent" in the rule text. As noted by some commenters, some exchanges, for example, already provide functionalities and tools to help firms prevent self-trades. *See* MFA, at 3; SIFMA, at note 7.

16 *See* MFA, at 2.

17 *See* SIFMA, at note 7.

18 MFA, at 3.