

February 24, 2014

Ms. Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 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. The Commission published the original proposed rule change (“Proposal”) in the *Federal Register* on September 4, 2013.<sup>1</sup> The Commission received five comment letters in response to the Proposal. On December 2, 2013, FINRA submitted a response to the comment letters and Amendment No. 1 to the Proposal. On December 3, 2013, the Commission issued an order instituting proceedings under Section 19(b)(2)(B) of the Securities Exchange Act of 1934 (“Act”) to determine whether to approve or disapprove the Proposal as modified by Amendment No. 1 (“Order”).<sup>2</sup> The Commission stated in the Order that it was “concerned that the [Proposal] may not achieve its stated purpose of addressing the identified problems associated with respect to self-trades.” Consequently, the Commission stated that it believed “questions remain as to whether FINRA’s proposal is consistent with the requirements of Section 15A(b)(6) of the Act.”

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<sup>1</sup> Securities Exchange Act Release No. 70276 (August 28, 2013), 78 FR 54502 (September 4, 2013) (SR-FINRA-2013-036).

<sup>2</sup> Securities Exchange Act Release No. 70966 (December 3, 2013), 78 FR 73900 (December 9, 2013).

The Commission received three comment letters in response to the Order.<sup>3</sup> Two of the commenters, each of which previously submitted a comment letter in response to the Proposal, recommend that the Commission approve the proposed rule change, as amended by Amendment No. 1.<sup>4</sup> The third commenter states that despite its “overall support for the [proposed rule change],” it has “some concerns with FINRA’s presumption of the relationship between algorithms or strategies within the most discrete unit(s) of a firm.”<sup>5</sup> FINRA is submitting this letter to address the concerns raised by the Commission in the Order and those raised by FIA PTG.

In the Proposal, as amended by Amendment No. 1, FINRA is proposing to add supplementary material to Rule 5210 (Publication of Transactions and Quotations) to address self-trades, defined as “[t]ransactions 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.” Specifically, the proposed rule change places a more direct and specific obligation on firms regarding self-trades while recognizing that “[t]ransactions resulting from orders that originate from unrelated algorithms or separate and distinct trading strategies within the same firm” are generally bona fide self-trades. To achieve this balance, the proposed supplementary material requires firms to have policies and procedures in place that are reasonably designed to review their trading activity for, and prevent, a pattern or practice of self-trades resulting from orders originating from a single algorithm or trading desk, or related algorithms or trading desks. For purposes of the rule, algorithms or trading desks are presumed to be “related” if they are “within the most discrete unit of an effective system of internal controls” at a firm. FINRA believes that this narrowly-tailored supplementary material strikes the appropriate balance between recognizing that self-trades from unrelated algorithms or separate and distinct trading strategies within a single firm are generally bona fide while focusing a firm’s attention on the types of self-trading activity that, while unintentional, may

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<sup>3</sup> Letter to Elizabeth M. Murphy, Secretary, Commission, from Theodore R. Lazo, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated January 13, 2014 (“SIFMA”); Letter to Elizabeth M. Murphy, Secretary, Commission, from Mary Ann Burns, Chief Operating Officer, Futures Industry Association, dated January 6, 2014 (“FIA PTG”); and Letter to Elizabeth M. Murphy, Secretary, Commission, from Manisha Kimmel, Executive Director, Financial Information Forum, dated December 23, 2013 (“FIF”).

<sup>4</sup> See FIF, SIFMA.

<sup>5</sup> FIA PTG. FIA PTG had not previously submitted a comment letter on the Proposal.

nonetheless present the risk that market information and the price discovery process are compromised.<sup>6</sup>

As FINRA noted in the Proposal, the primary reason FINRA is proposing the supplementary material is to address those instances where self-trades may not reflect genuine trading interest, especially where they account for a significant amount of volume in a security and potentially adversely affect the price discovery process. FINRA believes that self-trades that result from unrelated algorithms or trading desks generally reflect genuine trading interest in the security in which the trade occurs. However, FINRA believes that self-trades by single or related algorithms or trading desks raise heightened concerns that this type of trading may not reflect genuine trading interest, particularly if there is a pattern or practice of such trades.<sup>7</sup> This type of trading becomes increasingly problematic when it accounts for a material percentage of the volume in a particular security. The supplementary material thus seeks to require firms to establish policies and procedures reasonably designed to review their trading activity for, and prevent, a pattern or practice of self-trades that result from a single algorithm or trading desk or related algorithms or trading desks. FINRA believes that the supplementary material, as amended in Amendment No. 1, is consistent with the requirements of Section 15A(b)(6) of the Act and is narrowly designed to promote just and equitable principles of trade and to protect investors and the public interest without creating impediments to the mechanism of a free and open market. Moreover, with this rule change, FINRA will be better able to deter self-trading that, while not involving fraudulent or manipulative intent, is disruptive to the marketplace. Specifically, while FINRA may pursue a supervisory violation against a firm if it has related algorithms that produce excessive amounts of self-trades, with this rule change, FINRA will have an underlying rule addressing the actual self-trades themselves.

FIA PTG requests “clarification on what factors and circumstances would cause trades between unrelated algorithms or separate and distinct trading strategies *not* to be considered bona fide,” and states its belief that “when algorithms or trading strategies are otherwise unrelated it would be inappropriate and inaccurate to infer

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<sup>6</sup> Consequently, trading activity within the same firm that does not result in a change in beneficial ownership and that is undertaken with fraudulent or manipulative intent, commonly called wash sales, will continue to be subject to the same provisions in the federal securities laws and FINRA rules as is currently the case.

<sup>7</sup> FINRA understands that, on occasion, buy and sell orders from a single algorithm may execute against one another unintentionally. For example, FINRA is aware of instances where a single market-making algorithm crossed its own orders in the marketplace as a result of unintentional latency issues that arose in the algorithm.

their relatedness or the intent to self-trade based solely on a volume threshold.” FIA PTG recommends that FINRA use the wash sale interpretation recently adopted by the Chicago Mercantile Exchange Group (“CME”), which states that, “[p]rovided that the respective orders of each independent trader are entered in good faith for the purpose of executing bona fide transactions, are entered without prearrangement, and are entered without the knowledge of the other trader’s order, then such trades shall not be considered to violate the prohibition on wash trades.”<sup>8</sup>

FINRA agrees with the passage of the CME Notice quoted by FIA PTG; however, the proposed rule change is intended to address trading activity that is already unintentional and, consequently, does not affect the regulation of wash sale transactions. The proposed rule change imposes specific additional obligations on firms that engage in algorithmic trading or use multiple algorithms or trading desks as part of their trading activity. As FINRA stated in the Proposal, self-trades between unrelated algorithms or trading desks generally are bona fide; however, frequent self-trades may raise regulatory concerns that the self-trades are undertaken intentionally or for manipulative or fraudulent intent.

FIA PTG also takes issue with the presumption in the proposed supplementary material that algorithms or trading strategies within the most discrete unit of an effective system of internal controls are related and states that FINRA failed to explain why such a presumption is necessary. FIA PTG suggests that FINRA provide clear guidance on factors that would rebut the presumption of relatedness.

As FINRA noted in the Proposal, discrete units within a firm’s system of internal controls, such as aggregation units, generally pursue particular trading objectives or strategies and may not coordinate with other aggregation units. Some firms may impose information barriers between trading desks or similar limits on coordination of trading activity between units at the firm. As a general matter, FINRA believes that multiple algorithms or trading desks within a discrete unit would be permitted to communicate or would be under the supervision of the same people, and thus will be related; consequently, the supplementary material includes such a presumption. However, FINRA recognizes that individual firms may organize their supervisory structure in different ways, and the rule allows for firms to rebut the presumption of relatedness. FINRA believes this presumption provides firms with notice of FINRA’s expectations regarding when algorithms or trading desks will be considered related while providing firms with an opportunity to establish that they are not. To help rebut the presumption, firms could show, for example, that effective information barriers exist between the algorithms or desks, that different personnel are responsible for managing or supervising the algorithms or desks, or that the algorithms or desks operate independently from one another in other ways.

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<sup>8</sup> CME Group Market Regulation Advisory Notice RA1308-5 (November 19, 2013) (“CME Notice”).

Ms. Elizabeth M. Murphy

February 24, 2014

Page 5

Finally, FIA PTG states that it would improve firms' ability to comply with the proposed rule change if FINRA provides more specific guidance regarding the percentage of volume over repeated trading days that would constitute a "pattern or practice" for purposes of the rule. FINRA declines to establish a specific threshold below which a firm could continue to engage in unlimited self-trading. As FINRA noted in the Proposal and reiterated in its response to comments, it recognizes that isolated self-trades are generally bona fide; however, self-trading over time, whether of material volume, regularity, or both, would indicate a pattern or practice that firms should review their trading activity for and prevent.

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FINRA believes that the foregoing fully responds to the issues raised by the commenters and in the Commission's Order. If you have any questions, please contact me at (202) 728-6927.

Sincerely,



Brant K. Brown  
Associate General Counsel