

Self-Trades

SEC Approves FINRA Rule Concerning Self-Trades

Effective Date: August 25, 2014

Executive Summary

The SEC approved new supplementary material to FINRA Rule 5210 (Publication of Transactions and Quotations) to address 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 (self-trades). Effective August 25, 2014, firms must have policies and procedures in place that are reasonably designed to review 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. This *Notice* describes the new rule, including firms' obligations regarding self-trades and under what circumstances algorithms or trading strategies are presumed to be "related" for purposes of the rule.

The new rule text is available in the online FINRA Manual.

Questions concerning this *Notice* should be directed to Brant Brown, Associate General Counsel, Office of General Counsel, at (202) 728-6927 or brant.brown@finra.org.

Background & Discussion

FINRA Rule 5210 provides that "no member shall publish or circulate, or cause to be published or circulated, any...communication of any kind which purports to report any transaction as a purchase or sale of any security unless such member believes that such transaction was a bona fide purchase or sale of such security." On May 1, 2014, the SEC approved new Supplementary Material .02 to Rule 5210.¹ The new supplementary material becomes effective on August 25, 2014, and requires firms to adopt policies and procedures regarding "self-trades," which are defined as "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."²

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Notice Type

- ▶ Guidance
- ▶ New Rule

Suggested Routing

- ▶ Compliance
- ▶ Institutional
- ▶ Internal Audit
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Risk
- ▶ Senior Management
- ▶ Systems
- ▶ Trading

Key Topics

- ▶ Algorithmic Trading
- ▶ Information Barriers
- ▶ Self-Trades

Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ FINRA Rule 5210
- ▶ FINRA Rule 6140
- ▶ NASD Rule 3010
- ▶ Regulatory Notice 14-10

Under Rule 5210 and its supplementary material, self-trades resulting from orders that originate from unrelated algorithms or separate and distinct trading strategies within the same firm would generally be considered bona fide transactions. However, self-trades by a single algorithm or trading desk 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. This type of trading becomes increasingly problematic when it accounts for a material percentage of the volume in a particular security.³ Consequently, under new Supplementary Material .02, firms must 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. The supplementary material was adopted to address those instances where self-trades, even though unintentional, 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.

When developing their policies and procedures, firms should note that the supplementary material clarifies that algorithms or trading strategies within the most discrete unit of an effective system of internal controls at a firm are presumed to be “related” for purposes of the rule. 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. Although the rule establishes this presumption, FINRA recognizes that individual firms may organize their supervisory structure in different ways, and the rule allows for firms to attempt to rebut the presumption. For example, firms could show 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.

Endnotes

1. Securities Exchange Act Release No. 72067 (May 1, 2014), 79 FR 26293 (May 7, 2014) (Order Approving SR-FINRA-2013-036).
2. Wash sales (*i.e.*, trading involving no change in beneficial ownership that is intended to produce the false appearance of trading) continue to be strictly prohibited under both the federal securities laws and FINRA rules. *See, e.g.*, 15 U.S.C. 78i(a)(1); FINRA Rule 6140(b). In addition, Supplementary Material .02 does not change firms' existing obligations under NASD Rule 3010 and FINRA Rule 2010. The SEC recently approved moving NASD Rule 3010 into the Consolidated FINRA Rulebook as FINRA Rule 3110 with significant changes. *See* Securities Exchange Act Release No. 71179 (December 23, 2013), 78 FR 79542 (December 30, 2013) (Order Approving SR-FINRA-2013-025); *see also* [*Regulatory Notice 14-10*](#) (March 2014).
3. The rule does not establish a specific threshold below which a firm could continue to engage in unlimited self-trading. As FINRA noted throughout the rulemaking process, it recognizes that isolated self-trades are generally bona fide transactions; 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.