

# FINANCIAL INFORMATION FORUM

5 Hanover Square  
New York, New York 10004  

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212-422-8568

September 25, 2013

Elizabeth M. Murphy  
Secretary, Securities and Exchange Commission  
100 F Street, NE  
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)

Dear Ms. Murphy,

The Financial Information Forum (FIF)<sup>1</sup> would like to take this opportunity to provide comments on SR-FINRA-2013-036, the proposed rule change relating to wash sale transactions and FINRA Rule 5210 (the “Proposed Rule”). The FIF Front Office Committee (“the group”) has evaluated FINRA-2013-036 and is generally supportive of the need to clarify firms’ responsibilities with respect to unintended transactions that involve no change in beneficial ownership. However, we are concerned about the implementation impact of the Proposed Rule as discussed in more detail below.

## **Implementation Issues with the Proposed Text on Related Algorithms**

As noted in the text of the Proposed Rule, “transactions that originate from unrelated algorithms or separate and distinct trading strategies within the same firm would generally be considered bona fide transactions and would not be considered wash sales, even if the transactions did not result in a change of beneficial ownership, unless the transactions were undertaken for manipulative or other fraudulent purposes.” However, the Proposed Rule further states that “Algorithms or trading strategies within the most discrete unit of an effective system of internal controls at a member firm are presumed to be related (e.g., within an aggregation unit, or individual trading desks within an aggregation unit separated by reasonable information barriers, as applicable).

The group is concerned that the presumption that algorithms are related because they are used by traders in the same aggregation unit, or are not separated by information barriers is inconsistent with industry practice. For example, a trader may be hedging short exposure from a derivative transaction with a client by purchasing stock in a liquid security over the day using a volume-weighted average price (or “VWAP”) algorithm, while a separate trader in the aggregation unit is selling the same security acquired through a block transaction with a client using a “with volume” algorithm. Under the Proposed Rule, these orders

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<sup>1</sup> FIF ([www.fif.com](http://www.fif.com)) was formed in 1996 to provide a centralized source of information on the implementation issues that impact the financial technology industry across the order lifecycle. Our participants include trading and back office service bureaus, broker-dealers, market data vendors and exchanges. Through topic-oriented working groups, FIF participants focus on critical issues and productive solutions to technology developments, regulatory initiatives, and other industry changes.

would be presumed to be related and the Firm would have to prevent any of the individual orders from crossing in the market, even if the volume is de minimis. If adopted as is, the Proposed Rule would require linking all unrelated algorithms following separate and distinct trading strategies within an aggregation unit such that each algorithm knows the orders that other algorithms have placed in the market, and knows when such orders become marketable in order to prevent crosses. This is a substantial development effort involving multiple scenarios that may have the unintended consequences of preventing legitimate activity as described in more detail below.

### **Implementation Issues with the Prevention Standard as Proposed**

As noted in the text of the proposing release, “FINRA understands that not all wash sales, particularly those generated by trading algorithms, are avoidable. Consequently, 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. The proposed rule change requires reasonable policies and procedures and would not, therefore, apply to isolated wash sale transactions.” However, the Proposed Rule states, “Members must have policies and procedures in place that are reasonably designed to review their trading activity for, and prevent, wash sale transactions.”

The group is concerned with the Proposed Rule language calling for firms to not only “review their trading activity for” but also to “prevent” wash sale transactions. Currently, surveillance for wash sales and other forms of manipulation is done on a post-trade basis as discussed in SEC Rule 15c3-5<sup>2</sup>, moving to a prevention standard would have significant implementation challenges.

Specifically, the group is concerned with prevention of bona fide transactions from crossing agency orders. For execution quality purposes, agency orders may flow through a distributed system that offers a variety of algorithms to customers. Preventing unintended bona fide transactions from crossing is not possible given the current information available on FIX inbound orders as well as the current configuration of order flow via distributed systems. Additionally, there is no concept of aggregation units for agency order flow. Rather than adopting a prevention standard for all orders, firms should be required to monitor this activity, and 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.

Another concern is with agency brokers executing for other broker dealers or foreign brokers either on an omnibus/flip basis or in an average price account. In the case of the former, the agency broker does not know the ultimate beneficial owner and in the case of the latter, the execution and clearing broker does not know until the post trade allocation is received. In both cases, the agency brokers are unable to make a determination about a wash sale at the time of order receipt. Thus, agency broker dealers would be unable to meet the prevention standard to determine if a previously routed resting order on the opposite side of the market was for the same beneficial owner.

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<sup>2</sup> .. regulatory requirements would include, for example, pre-trade requirements such as exchange trading rules relating to special order types, trading halts, odd-lot orders, and SEC rules under Regulation SHO and Regulation NMS, as well as post-trade obligations to monitor for manipulation and other illegal activity.” ([75 FR 69798](#))

Additionally, there are many instances when a different or same desk within the same aggregation unit has customer orders on opposite sides of the market, coming in at different times of the day, with different strategies, that may cross in the market through the use of the same algorithmic system. Furthermore, the same investment advisor may be on the opposite side of the market on behalf of different beneficial owners. Preventing such matched orders prior to execution may hinder legitimate order activity from transacting. Building “blocks” or warnings that could distinguish a wash sale from a bona fide transaction with an actual change in beneficial ownership would be a significant challenge. A policy and procedure standard for post-trade review to detect a pattern or practice of effecting a material amount of wash sale transactions would enable a firm to investigate such activity and determine whether the relevant transactions involved a change in beneficial ownership, and if not to implement controls tailored to that scenario to mitigate the risk of such transactions occurring.

In conclusion, the group believes that the following modifications would preserve the policy rationale of the Rule and reduce the implementation effort:

- Remove the presumption that algorithms or trading strategies within an aggregation or information barrier are related.
- Focus the policy and procedure standard on patterns and practices of wash sale transactions with no change in beneficial ownership that result in a material amount of volume in a security based on a post-trade review of trading activity.

We would welcome the opportunity to discuss the implementation challenges discussed above in more detail prior to the adoption of the Proposed Rule.

Regards,



Manisha Kimmel  
Executive Director  
Financial Information Forum

cc: The Honorable Mary Jo White, Chairman  
The Honorable Luis A. Aguilar, Commissioner  
The Honorable Daniel J. Gallagher, Commissioner  
The Honorable Kara M. Stein, Commissioner  
The Honorable Michael S. Piwowar, Commissioner

John Ramsay, Acting Director, Division of Trading and Markets  
James R. Burns, Deputy Director, Division of Trading and Markets  
David S. Shillman, Associate Director, Division of Trading and Markets

Stephanie Dumont, Senior Vice President and Director of Capital Markets Policy, FINRA  
Brant Brown, Associate General Counsel, FINRA