

## MARKET REGULATION ADVISORY NOTICE

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<b>Exchange</b>	<b>CME, CBOT, NYMEX &amp; COMEX</b>
<b>Subject</b>	<b>Wash Trades Prohibited</b>
<b>Rule References</b>	<b>Rule 534</b>
<b>Advisory Date</b>	<b>November 3, 2009</b>
<b>Advisory Number</b>	<b>CME Group RA0913-5</b>

This Advisory Notice supersedes CME Group Market Regulation Advisory Notice RA0904-5 from August 4, 2009, and is being reissued based on today's adoption of revisions to CME, CBOT and NYMEX Rule 534 ("Wash Trades Prohibited"). The amended rule and the FAQ contained in this Advisory Notice have been revised to clarify the following:

- It is impermissible to place, accept or execute buy and sell orders for accounts with common beneficial ownership opposite each other, either directly or indirectly, if the person knows, or reasonably should know, that the intent of the orders is to avoid taking a bona fide market position exposed to market risk. Additionally, the fact that there is a delay between the entry of the buy and sell orders does not eliminate regulatory exposure if the execution achieves a wash result.
- Buy and sell orders for different accounts with common beneficial ownership (which includes accounts with less than 100% common ownership) will be deemed to be wash trades if orders are entered with the intent to negate market risk or price competition.
- Knowingly accommodating the execution of wash trades is a violation of the rule.

The revised rule is presented in its entirety below.

### **Rule 534 ("Wash Trades Prohibited")**

No person shall place or accept buy and sell orders in the same product and expiration month, and, for a put or call option, the same strike price, where the person knows or reasonably should know that the purpose of the orders is to avoid taking a bona fide market position exposed to market risk (transactions commonly known or referred to as wash trades or wash sales). Buy and sell orders for different accounts with common beneficial ownership that are entered with the intent to negate market risk or price competition shall also be deemed to violate the prohibition on wash trades. Additionally, no person shall knowingly execute or accommodate the execution of such orders by direct or indirect means.

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**FAQ Related to Rule 534 (“Wash Trades Prohibited”)**

**Q1- May a firm employee or floor broker accept buy and sell orders for simultaneous execution in the same product and expiration month, or in the case of options, the same put or call option and strike price?**

A1- Rule 534 effectively requires that all orders be entered in good faith for the purpose of executing bona fide transactions. A firm employee or floor broker should not accept such orders if he knows, or reasonably should know, that the orders are for the same account owner and the purpose of the orders is to avoid taking a bona fide market position exposed to market risk. Similarly, a firm employee or floor broker should not accept buy and sell orders for different accounts with common beneficial ownership that are entered with the intent to negate market risk or price competition.

The CFTC has held that firms, firm employees and floor brokers may be found to have knowingly engaged in wash trades if they facilitate a wash result without having made sufficient inquiry as to the propriety of such orders prior to their execution. The failure of a firm employee or floor broker to undertake such inquiry may support an inference of knowing participation in wash trades.

**Q2- Does the prohibition in the rule apply in circumstances where the underlying beneficial ownership of the accounts is common but not identical?**

A2- Where the two accounts share common ownership, but less than 100% common ownership, the prohibitions in Rule 534 nonetheless apply if the intent of the orders is to negate market risk or price competition.

**Q3- What steps must a person take to fulfill his duty to inquire about the propriety of the orders described in questions 1 and 2 above?**

A3- The firm employee and floor broker, working together or independently of each other, should determine if the orders are for accounts with common beneficial ownership.

If the orders are for an omnibus account, they should determine whether the orders are for different customer accounts within the omnibus account. The firm employee or floor broker may choose to obtain a written statement from the entity carrying the omnibus account that states that such orders are placed only for different customers within the omnibus account. However, while this approach generally will be sufficient to satisfy Exchange requirements, there may be circumstances in which the Exchange or the CFTC find this approach insufficient and would expect the firm employee or floor broker to make further inquiries to determine whether the orders are for different owners.

**Q4- Why does a floor broker have to make any inquiry into the placement of buy and sell orders for simultaneous execution as opposed to relying on the member firm to make that inquiry?**

A4- The CFTC has held that because a floor broker is prohibited from knowingly participating in wash trades, he has an independent duty to inquire as to the propriety of such orders. (See, for example, *In the Matter of Three Eight Corporation*.)

It is not clear that the CFTC would find that the floor broker met his obligations in this regard if he asks the member firm representing the orders whether the orders are legally permissible and simply accepts the response of the member firm representative. There may be circumstances which would require a floor broker to go beyond mere acceptance of the member firm’s assertion and take additional steps to ensure that the orders in question do not violate the prohibition on wash trades.

**Q5- If a firm employee or floor broker cannot assure himself that buy and sell orders are for accounts with different beneficial ownership, what should he do?**

A5- The firm employee or floor broker may refuse to accept the orders. If the orders are accepted, and assuming the parties have no knowledge of improper customer intent, regulatory risk may be mitigated by ensuring that there is a reasonable interval between the entry and execution of each order.

**Q6- May a firm employee or floor broker accept a person's instruction directing that his position be liquidated and then re-established (i.e. freshening of position dates)?**

A6- Provided that the customer does not require that the liquidation and re-establishment of the position be executed simultaneously, such orders may be accepted.

Note that CME Rule 807 ("Open Long Positions During Delivery Month") states that beginning on the day following the first day on which longs may be assigned delivery, all purchases and sales made in one day in the expiring contract by a person holding a long position in that contract must first be netted out as day trades with only the excess buys considered new longs or the excess sales being offsets of the long position. CBOT and NYMEX Rule 807 do not have a similar restriction regarding the freshening of dates during the delivery period. However, all such trades must be bona fide transactions executed competitively in the market and without prearrangement.

**Q7- In the event buy and sell orders for accounts with common beneficial ownership are entered for a legitimate purpose, how should a firm employee or floor broker execute such orders in a manner consistent with the rules?**

A7- In the open outcry market, the buy and sell orders should be timestamped immediately upon receipt. One of the orders should then be entered into the pit, executed and timestamped out prior to submitting the second order to the pit. The second order should be timestamped again when it is submitted to the pit. This methodology will ensure that the orders are not executed opposite each other, and the accurate timestamping will provide evidence that the orders were not entered for simultaneous execution.

In the electronic market, one of the orders should be entered on the electronic trading platform and executed in full prior to the entry of the second order. A written and timestamped record of the second order will be required because it was not entered on the electronic platform immediately upon receipt. This again will ensure that the orders are not executed opposite each other and will provide a clear audit trail with respect to the entry and execution of the orders.

**Q8- Is regulatory risk mitigated by ensuring that there is a delay between the entry of buy and sell orders for accounts with common beneficial ownership?**

A8- No. Simply ensuring that there is a delay between the entry of the buy and sell orders may not, depending on the terms of the orders, preclude the orders from trading in whole or in part against each other. To the extent that the orders match with each other, the result may be deemed an illegal wash trade irrespective of the fact that the orders were entered at different times.

A floor broker who executes such orders by buying and selling opposite the same party at the same price may also be found to have violated the prohibition on wash trades. Similarly, a person who knowingly accommodates the execution of such trades, either directly or indirectly may be found to have violated the prohibition on wash trades. Additionally, in certain circumstances such orders executed at nearly the same price, rather than at the same price, may violate the prohibition if it is demonstrated that the orders were structured to negate risk, for example by requiring that the price difference between the two orders be strictly limited.

**Q9- Is it acceptable for a firm employee to give both the buy order and the sell order to the same floor broker on a “DRT” basis?**

A9- If the floor broker executes the orders simultaneously or nearly simultaneously and achieves a wash result, it is possible that the firm, its employee and the floor broker will be the subject of an enforcement action brought by either the CFTC or the Exchange.

The entry of buy and sell orders for accounts with common beneficial ownership, coupled with discretion over the timing, may be viewed as an implicit request to the floor broker to negate the customer’s market risk by directly or indirectly crossing the orders. The fact that the trade is not prearranged and is executed competitively may not protect the parties from liability if the execution of the orders produces a wash result.

**Q10- May a person or firm employee enter buy and sell orders for accounts with common beneficial ownership if the buy and sell orders are given to different firms or to different floor brokers for execution?**

A10- The potential for liability in this situation is significant. If the orders trade against each other in whole or in part, or if both orders are executed opposite the same third party, an inference may be drawn that there was intent to execute a prohibited wash trade.

**Q11- Under what circumstances is trading with oneself on the electronic platform a violation of exchange rules regarding wash trading?**

A11- Rule 534 provides that buy and sell orders for accounts with common beneficial ownership must be entered in good faith for the purpose of making bona fide transactions. Thus, it is a violation of 534 for a market participant to enter an order on the electronic system that he knew or should have known would match with a resting order on the other side of the market for an account with common beneficial ownership. Generally, an unintentional and incidental matching of such buy and sell orders will not be considered a violation of Rule 534. However, active traders who frequently enter orders on opposing sides of the market which may have a tendency to cross are strongly encouraged to employ functionality designed to minimize or eliminate their buy and sell orders from matching with each other.

**Q12- Is it considered a violation of Rule 534 if orders that are independently initiated by different proprietary traders within the same firm match against each other?**

A12- It is recognized that certain firms have proprietary trading operations in which various traders making fully independent trading decisions enter orders for the same beneficial owner (the firm’s proprietary account) that coincidentally match with each other in the market. If the orders are entered without prearrangement such trades are not considered to be in violation of Rule 534. Firms should have and enforce policies to preclude affiliated traders trading for the same beneficial account who have knowledge of one another’s orders from knowingly trading opposite one another’s orders.

**Q13- Is it considered a violation of Rule 534 if orders initiated for accounts with common beneficial ownership by one or more automated trading systems match against each other?**

A13- If different automated trading algorithms for the same trading entity are operating in the same instrument and potentially may trade with one another, each such algorithm should be identified with a unique operator ID (also called a Tag 50 ID) tied to the individual or team of individuals that operate the system/algorithms. While it is not prohibited to run potentially conflicting algorithms simultaneously, if such trades cause price or volume aberrations, or occur frequently, the trading may be subject to particular scrutiny and may be deemed to violate Rule 534. Market participants

are responsible for monitoring their automated trading systems and for employing trading algorithms that minimize the potential for the execution of transactions which are not exposed to market risk.

**Q14- Do block trades between accounts of affiliated parties violate the wash trading prohibition?**

A14- Block trades between the accounts of affiliated parties are permitted provided that 1) the block trade is executed at a fair and reasonable price; 2) each party has a legal and independent bona fide business purpose for engaging in the trade; and 3) each party's decision to enter into the block trade is made by an independent decision-maker. In the absence of satisfying the requirements above, the transaction may constitute an illegal wash trade prohibited by Rule 534.