

MARKET REGULATION ADVISORY NOTICE

Exchange	CME, CBOT, NYMEX & COMEX
Subject	Wash Trades Prohibited
Rule References	Rule 534
Advisory Date	November 16, 2016
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Pending all relevant regulatory review periods, this Advisory Notice will supersede CME Group Market Regulation Advisory Notice RA1411-5RR from January 6, 2015. It is being issued to add additional questions and answers into the FAQ (#s 18-21) to provide additional regulatory guidance concerning circumstances that may be deemed a violation of Rule 534 (“Wash Trades Prohibited”), including activity during the pre-open on CME Globex and information on indirect wash trades. Additionally, the answer to FAQ 17 has been modified to clarify that CME Group’s self-match prevention (“SMP”) functionality does not prevent self-matches upon the opening of the market in circumstances where the orders are entered during the pre-open state on Globex.

Rule 534, set forth below, has not changed, and this Advisory Notice is being issued to provide updated guidance regarding compliance with the Rule. Member firms are strongly encouraged to ensure that all firm employees and customers are fully informed regarding Rule 534 and the guidance in this Advisory Notice.

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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Frequently Asked Questions (“FAQ”) Related to Rule 534 (“Wash Trades Prohibited”)

Q1: What is the definition of a wash trade?

A1: A wash trade is a form of fictitious trade in which a transaction or a series of transactions give the appearance that bona fide purchases and sales have been made, but where the trades have been entered into without the intent to take a bona fide market position or without the intent to execute bona fide transactions subject to market risk or price competition. Parties who initiate, execute or accommodate transactions which they know, or reasonably should know, will achieve a wash result shall be in violation of Rule 534.

A wash trade requires:

- a) that the transaction or series of transactions produces a wash result - meaning the purchase and sale of the same instrument at the same price, or a similar price, for accounts with the same beneficial ownership or for accounts with common beneficial ownership; and
- b) that the party(ies) intended to achieve a wash result. Intent may be inferred from evidence of prearrangement or from evidence that the orders or trade(s) were structured, entered or executed in a manner that the party(ies) knew, or reasonably should have known, would produce a wash result.

The prearrangement, execution or structuring of transactions in CME Group markets with the intent of negating market risk, independent of whether such transactions are entered and/or executed in compliance with other rules which permit prearrangement such as Rule 539.C. (“Pre-Execution Communications Regarding Globex Trades”) may be deemed to violate Rule 534.

Q2: What does it mean to have accounts “with the same beneficial ownership” or “with common beneficial ownership” in the context of Rule 534’s prohibition on wash trades?

A2: Accounts with the “same beneficial ownership” include accounts with identical ownership as well as accounts of different entities that are 100% wholly-owned by the same parent.

“Common beneficial ownership” is more inclusive and includes not only accounts with the same beneficial ownership, but also accounts with common beneficial ownership that is less than 100%.

Q3: May a market participant place, accept or execute simultaneous buy and sell orders for accounts with common beneficial ownership in the same product and expiration month, or option series?

A3: Any market participant who places or accepts buy and sell orders for simultaneous execution that are for accounts with common beneficial ownership, and any market participant who executes such orders, will be in violation of Rule 534 if the execution of the orders yields a wash result and the party knew, or reasonably should have known, that the trades were entered into without the intent to execute bona fide transactions subject to market risk or price competition.

Q4: When receiving simultaneous buy and sell orders placed by another party, does the market participant receiving the orders have any independent obligation to determine whether the orders are bona fide?

A4: Yes. The CFTC has held (see, for example, *In the Matter of Three Eight Corporation*) that market participants, including account executives and floor brokers, who accept simultaneous buy and sell orders for execution have an independent “duty to inquire” about the propriety of such orders.

In the absence of such inquiry, the market participant accepting the orders may be found to have engaged in wash trades if the execution of the orders produces a wash result.

Market participants receiving simultaneous buy and sell orders for execution must make inquiry sufficient to ascertain whether the orders are for accounts with common beneficial ownership. If the buy and sell orders are for an omnibus account, the market participant has a duty to inquire as to whether the orders are for different account owners within the omnibus account.

If a market participant cannot assure himself that buy and sell orders received for simultaneous execution are for accounts that do not have common beneficial ownership, the market participant may refuse to accept the orders. Accepting or executing simultaneous buy and sell orders without such assurance creates potential regulatory exposure if the execution of the orders yields a wash result.

Q5: In the event buy and sell orders for accounts with common beneficial ownership are simultaneously entered for a legitimate purpose, how should such orders be executed to comply with Rule 534?

A5: In the electronic venue, one of the orders should be entered on the electronic trading platform and executed in full prior to the entry of the second order. This 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. In this circumstance, a written and timestamped record must be made of any order that is not entered on the electronic platform immediately upon receipt.

In the open outcry venue, the buy and sell orders should be timestamped immediately upon receipt. One of the orders should be entered into the pit, executed and timestamped out prior to submitting the second order to the pit for execution. 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 either the electronic or open outcry venue, 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 trade opposite each other either directly or indirectly through a common third party, the trade may be deemed an illegal wash trade notwithstanding the fact that the orders were entered at different times.

Additionally, in certain circumstances, simultaneous buy and sell orders for accounts with common beneficial ownership that are contemporaneously executed at nearly the same price, rather than at precisely the same price, may violate the prohibition on wash trades if it is demonstrated that the orders were structured to negate market risk, for example, by requiring that the price difference between the two orders be strictly limited.

Q6: Is it acceptable to contemporaneously enter buy and sell orders for accounts with common beneficial ownership if the buy and sell orders are given to different FCMs or to different floor brokers for execution?

A6: The potential for regulatory exposure 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 orders were structured with the intent to execute a prohibited wash trade. The fact that the orders were competitively executed without prearrangement may not protect the party entering the orders from liability if the execution of the orders produces a wash result.

Q7: Is it acceptable to enter simultaneous buy and the sell orders for accounts with common beneficial ownership for execution on a discretionary (“DRT”) basis?

A7: The entry of simultaneous buy and sell orders for accounts with common beneficial ownership that are entered with instructions giving the executing party discretion over the price and/or time of execution may be viewed, depending on the circumstances, as an implicit request to the executing party to negate market risk. Should the execution of the orders produce a wash result, the parties placing, accepting and executing the orders may be liable for having engaged in an illegal wash trade.

Q8: Are market participants permitted to “freshen” position dates (i.e. liquidating and re-establishing a position) without violating the prohibition on wash trades?

A8: In those products settled via physical delivery against the oldest open long position, CME and CBOT Rule 807 (“Open Long Positions During the Delivery Month”) allow for the intraday freshening of position dates. However, trades executed to liquidate and re-establish a position in order to freshen the position’s date must be competitively executed and must be clearly independent transactions subject to market risk. Purchases and sales to freshen a position date that are prearranged or otherwise executed pursuant to an express or implied agreement will be deemed to violate the prohibition on wash trades.

Q9: Do block trades between different accounts with common beneficial ownership violate the wash trading prohibition?

A9: Block trades between different accounts with **common beneficial ownership** are prohibited unless:

- a) each party’s decision to enter into the block trade is made by an independent decision-maker;
- b) each party has a legal and independent bona fide business purpose for engaging in the block trade; and
- c) the block trade is executed at a fair and reasonable price.

In the absence of satisfying all of the aforementioned requirements, the transaction may constitute an illegal wash trade prohibited by Rule 534.

Q10: If buy and sell orders for accounts with common beneficial ownership are independently initiated by independent decision makers and coincidentally cross in the market, will the trade violate the wash trade prohibition?

A10: Buy and sell orders for accounts with common beneficial ownership that are independently initiated for legitimate and separate business purposes by independent decision makers and which coincidentally cross with each other in the competitive market are not considered wash trades provided that the trade was not prearranged and neither party had knowledge of the other’s order or otherwise intended for their order to trade against the other’s order. Market participants should be aware, however, that trades between accounts with common beneficial ownership may draw additional regulatory scrutiny and should be prepared to demonstrate that such trades are bona fide. (See also Q12, Q13 and Q14.)

Q11: Under what circumstances does trading opposite one’s own order on the electronic platform violate Rule 534?

A11: It is a violation of Rule 534 for an individual to enter an order on the electronic platform that the individual knew or reasonably should have known would trade against his own order resting on the opposite side of the market. The unintentional and incidental matching of buy and sell orders entered by an individual trader on the electronic platform generally will not be considered a violation of Rule 534. However, if such self-matching occurs on more than an incidental basis in the context of the trader's activity or in the context of the particular market's activity, such trades may be deemed to violate the prohibition on wash trades. It is recommended that individual traders who frequently enter orders on opposing sides of the market that have a tendency to self-match on more than an incidental basis employ functionality that will minimize the potential for their buy and sell orders to match with each other.

In June 2013, CME Group introduced SMP functionality on CME Globex. SMP functionality is optional functionality that, when employed, automatically blocks the matching of buy and sell orders for commonly owned accounts that are submitted to Globex with the same Executing Firm ID and the same SMP ID in the order message.

Currently, the trading engine automatically cancels the resting order(s) and processes the aggressing order, thereby preventing orders at the same executable price level for the same SMP ID from matching with one another. On December 21, 2014, and January 11, 2015, CME Group is introducing enhancements to SMP functionality that will allow customers to dictate whether the resting or aggressing order is cancelled in the event of a self-match, and, for FIFO-only markets, orders will only be cancelled if they would match. Information on the upcoming enhancements is available at the following link:

<http://www.cmegroup.com/confluence/display/EPICSANDBOX/Self+Match+Prevention+Enhancements>

Additionally, information on CME Globex SMP functionality and the registration process to obtain SMP IDs can be found at the following link:

<http://www.cmegroup.com/globex/resources/smpfaq.html>.

Q12: Is it a violation of Rule 534 if independently initiated orders originating from different proprietary traders within the same firm match against each other?

A12: It is recognized that many firms have proprietary trading operations in which multiple traders making fully independent trading decisions enter orders for a commonly owned account (the firm's proprietary account) that may unintentionally and coincidentally match with each other on the electronic platform. Provided 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.

Similarly, orders generated by algorithms operated and controlled by fully independent traders in different trading groups that unintentionally and coincidentally match with each other will not be considered to be wash trades provided that the orders are initiated in good faith for the purpose of executing bona fide transactions, that the algorithms operate independently of one another, and that the respective trading groups do not have knowledge of one another's orders.

Firms have an obligation to supervise the trading by their employees and algorithms, must be able to demonstrate the independence of the traders/trading groups/algorithms, and should have and enforce policies and procedures that preclude the traders from having access to or knowledge of one another's orders.

Additionally, the operator ID (also called a Tag 50 ID) that is tied to the individual or team of individuals (ATS Team) responsible for the entry of the orders must be uniquely identified in

accordance with Rule 576 (“Identification of Globex Terminal Operators”) and associated Market Regulation Advisory Notices.

Q13: Is it a violation of Rule 534 if orders initiated by one or more automated trading systems that are operated and/or controlled by the same individual or the same trading group match against each other?

A13: If a particular algorithm generates buy and sell orders that would potentially match against each other and such trades occur on more than an incidental basis in the context of the algorithm’s activity or in the context of the particular market’s activity, the trades may be deemed to violate the prohibition on wash trades. It is recommended in this circumstance that the party(ies) responsible for the operation of the algorithm employ functionality that will minimize the potential for the algorithm’s buy and sell orders to match with each other.

If otherwise independent algorithms are operated and/or controlled by the same individual or team of individuals and the algorithms trade against one another on more than an incidental basis in the context of the algorithms’ activity or the particular market’s activity, then the trading between the algorithms may be deemed to violate the prohibition on wash trades. Where multiple algorithms operated or controlled by the same individual or team of individuals may generate self-match events on more than an incidental basis, it is recommended that the individual or team employ functionality to minimize or eliminate such occurrences.

Q14: Are there unique considerations with respect to Rule 534 in the context of exchange-sponsored volume incentive programs?

A14: Market participants who participate in exchange-sponsored programs with incentives tied in whole or in part to meeting specific volume thresholds should take proactive steps to prevent transactions between accounts with common beneficial ownership. These trades will draw additional regulatory scrutiny and it is recommended that participants in these types of incentive programs employ functionality to mitigate the potential for such trades to occur.

Q15: In circumstances where “more than incidental” self-matching may be deemed to violate the prohibition on wash trades, is there a prescribed threshold?

A15: In these circumstances, market participants are responsible for monitoring their trading, whether that trading is manual or automated, and are responsible for minimizing the potential for, and the occurrence of, self-match events.

The incidence of self-matching in these circumstances will be evaluated in the context of the activity of the trader, trading group, or algorithm(s), and relative to the trades and volume in the instrument traded. More than de minimis self-matching in this context will result in additional regulatory scrutiny and may be deemed to violate the prohibition on wash trades; if there is the potential for more than de minimis self-match events, market participants are expected to either adjust their trading strategies or employ functionality to mitigate the occurrence of self-match events.

Q16: Is the use of CME Group’s Self-Match Prevention functionality mandatory?

A16: Use of CME Group SMP functionality is optional and each firm has the flexibility to tailor its application of SMP functionality and its use of SMP IDs in ways that are appropriate for its particular business model and trading strategies.

Market participants are reminded, however, that the rules of all CME Group Exchanges, as well as the Commodity Exchange Act, prohibit illegal wash trades. Firms and market participants should carefully review their operations and the guidance in this Advisory Notice, and, where

appropriate, take steps necessary to minimize the potential for such trades either through the use of SMP functionality or by alternative means.

Q17: Does employing CME Group Self-Match Prevention functionality prevent all potential self-match events?

A17: CME Group's SMP functionality will block the matching of buy and sell orders that contain the same SMP ID within the same Executing Firm, including in circumstances where the orders are entered through different iLink Sessions. SMP functionality will not, however, prevent self-matches in markets operating with implied spread functionality if the trade involves an implied order. Absent evidence to the contrary, self-match events involving implied orders will be deemed unintentional by the CME Group Exchanges. Additionally, SMP functionality does not operate during the Globex pre-open nor does it prevent self-matches of orders entered during the pre-open state when the market opens.

Q18: Is it a violation of Rule 534 if resting orders in the order book entered during the Globex pre-open match opposite one another once the market opens?

A18: Yes, if a self-match occurs when the market opens as a result of orders entered during the Globex pre-open state that a party knew or should have known would match, then the party has violated Rule 534. Parties should have a reasonable expectation that their resting buy and sell orders may match when the market opens if the buy orders are priced at or above the price of their resting sell orders or the sell orders are priced at or below the price of their resting buy orders.

During a market's pre-open state on Globex, an Indicative Opening Price ("IOP") is calculated. As described in Rule 573 ("Globex Opening"), the IOP reflects the price between the buying and selling pressure at which the largest volume of trading can occur and is based on the Globex equilibrium price algorithm and all pending orders that may be executed when Globex opens. During the "No Cancel" period of the pre-open, new order entry is allowed but order modifications and cancellations are not.

Notwithstanding the above, if the orders entered during the pre-open state had the potential to match and did not result in a self-match when the market opened, but were entered with the intent to negate market risk or in an effort to circumvent the "No Cancel" period during the market's pre-open state, such orders may be deemed a violation of other Exchange Rules, including but not limited to Rule 575 ("Disruptive Practices") and Rule 432 ("General Offenses").

Q19: What is an indirect wash trade?

A19: One or more purchases (sales) opposite a counterparty followed by a sale (purchase) at the same or similar price opposite the same or different counterparties may be deemed an "indirect wash trade" in violation of Rule 534 if the orders are entered with the intent to negate or strictly limit market risk. Such intent exists if the party knew or should have known that the orders would negate or strictly limit market risk. Additionally, no person is permitted to accept, execute or accommodate the execution of such orders with knowledge of their character. For additional information on indirect wash trades, please see the examples following the answer to FAQ 21 at the end of this Advisory Notice.

Q20: Does an indirect wash trade have to be prearranged in order to constitute a violation of Rule 534?

A20: No. An indirect wash trade does not require prearrangement to constitute a violation of Rule 534 if 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.

Q21: What are serial indirect wash trades and do such trades violate Rule 534?

A21: A series of trades executed among a group of market participants where order entry and trade activity is concentrated in discrete and limited periods of time may be deemed “serial indirect wash transactions” in violation of Rule 534 to the extent that the parties know or reasonably should know that the purpose of the trades is to avoid taking a bona fide market position exposed to market risk.

Examples of Prohibited Indirect Wash Activity

- Participant A and B hold open long positions in the same physically deliverable commodity in the delivery month where delivery takes place against the oldest open long position. To reduce the risk of being stopped for delivery, Participant A and B pre-arrange the execution of transactions that have the effect of offsetting and re-establishing one or both of their long positions, thus freshening the position dates. For example, in an initial transaction, Participants A and B knowingly trade opposite each other in the market. In a subsequent transaction, typically close in time to the initial transaction, Participants A and B knowingly execute an offsetting transaction opposite each other at or near the same price as the initial transaction. In this transaction set, the sells had the effect of offsetting the pre-existing long positions and the buys had the effect of re-establishing the long positions with newer position dates. Due to the manner in which the transactions were orchestrated, Participants A and B negated or strictly limited market risk. This set of transactions constitutes an indirect wash in violation of Rule 534.
- Participants A, B, and C participate in an incentive or rebate program where terms or conditions of the program require each participant to meet a volume threshold (e.g. average daily volume; monthly volume; passively traded volume; etc.). *With or without pre-arrangement*, Participants A, B, and/or C execute a series of transactions, typically in close time proximity, where they buy and sell similar quantities at the same or similar prices opposite each other and where, at the conclusion of the transaction series, the participants had no net change in position. Based on factors including, but not limited to, prior trading activity, market circumstances, market knowledge, or prearrangement the participants know or have reason to know the transactions would not be exposed to price competition or the positions exposed to market risk. Transactions executed for the purpose of increasing volume, while knowing or having reason to know the transactions would not be exposed to price competition or the positions exposed to market risk, are considered indirect wash trades in violation of Rule 534.