

MARKET REGULATION ADVISORY NOTICE

Exchange	CME & CBOT
Subject	Wash Sales Prohibited
Rule References	Rule 534
Advisory Date	December 3, 2007
Advisory Number	CME & CBOT – RA0705-3

Effective November 29, 2007, CME and CBOT adopted common rule language with respect to Rule 534 (“Wash Sales Prohibited”). The rule is presented in its entirety below and applies to both open outcry and electronic trading.

Rule 534 (“Wash Sales Prohibited”)

No person shall place for the same beneficial owner buy and sell orders for the same product and expiration month, and, for a put or call option, the same strike price, at or about the same time with the intent to avoid a bona fide market position exposed to market risk (transactions commonly known or referred to as wash sales). Buy and sell orders placed for the same beneficial owner in the same product and expiration month, and, for a put or call option, the same strike price, must be entered in good faith for the purpose of executing bona fide transactions that result in a change of ownership. Additionally, no person shall accept, execute or accommodate the execution of orders which are prohibited by this rule with knowledge of their character.

An FAQ document addressing common questions related to Rule 534 is attached to this document.

Questions regarding this advisory may be directed to the following individuals in Market Regulation:

Jennifer Baum, Associate Director, 312.341.3124

Greg Benbrook, Associate Director, 312.930.4529

Robert Sniegowski, Associate Director, 312.648.5493

FAQ Related to Rule 534 ("Wash Sales Prohibited")

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

A1- Rule 534 prohibits a person from placing, accepting or executing such orders if the person knows that the orders are for the same beneficial owner.

Rule 534 requires that all orders be entered in good faith for the purpose of executing bona fide transactions that result in a change of ownership. Opposing orders for the same account that are entered for simultaneous execution may be indicative of the person's intent to avoid the execution of bona fide transactions that result in bona fide positions exposed to market risk.

The CFTC has held that firms, firm employees and floor brokers may be found to have knowingly engaged in wash sales 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 sales.

Q2- What steps must a person take to fulfill his duty to inquire about the propriety of such orders?

A2- The firm employee and floor broker, working together or independently of each other, should determine if the orders are for the same beneficial owner. 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 also choose to obtain a written statement from the entity carrying the omnibus account that such orders are placed only for different customers within the omnibus account. While such steps generally will be sufficient to satisfy Exchange requirements, there may be circumstances in which the Exchange or the CFTC find these steps insufficient and in which the firm employee or floor broker would be expected to make further inquiries to determine whether the orders are acceptable.

If the buy and sell orders for simultaneous execution are determined to be for the same beneficial owner, Rule 534 prohibits the acceptance of these orders.

Q3- 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 clearing firm to make that inquiry?

A3- The CFTC has held that because a floor broker is prohibited from knowingly participating in wash sales, 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 clearing member representing the orders whether the orders are legally permissible and simply accepts the response of the clearing member representative. There may be circumstances which would require a floor broker to go beyond mere acceptance of the clearing member's assertion and take additional steps to ensure that the orders in question do not violate the prohibition on wash sales.

Q4- If a firm employee or floor broker cannot assure himself that buy and sell orders for the same account are for different beneficial owners, what should he do?

A4- 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. In either case, the clearing member or floor broker should report the situation to the Market Regulation Department.

Q5- 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)?

A5- 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 Rule 807 does 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.

Q6- In the event buy and sell orders for the same account are entered for a legitimate purpose, how should a firm employee or floor broker execute such orders in a manner consistent with the rules?

A6- In the open outcry market, the buy and sell orders should be time-stamped immediately upon receipt. One of the orders should then be entered into the pit, executed and time-stamped out prior to submitting the second order to the pit. The second order should be time-stamped again when it is submitted to the pit. This methodology will ensure that the orders are not executed opposite each other, and the accurate time-stamping 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 time stamped 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.

In either the open outcry or electronic 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 match with each other, the result would be a transaction without a change of ownership and may be deemed an illegal wash sale 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, or nearly the same price, may also be found to have violated the prohibition on wash sales. Similarly, a person who knowingly accommodates the execution of such trades may be found to have violated the prohibition on wash sales.

Q7- 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?

A7- If the floor broker executes the orders simultaneously or nearly simultaneously, 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 the same account, 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 pre-arranged and is executed competitively may not protect the parties from liability if the execution of the orders produces a wash result.

Q8- May a person or firm employee enter buy and sell orders for the same account if the buy and sell orders are given to different firms or to different floor brokers for execution?

A8- 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 sale.

Q9- Under what circumstances does trading with oneself on the electronic platform violate exchange rules regarding wash sales?

A9- Rule 534 provides that buy and sell orders for the same beneficial owner must be entered in good faith for the purpose of making bona fide transactions that result in a change of ownership. 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 the same beneficial ownership. Generally, an unintentional and incidental matching of buy and sell orders for the same beneficial owner 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.

Q10- 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?

A10- 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 and were not otherwise intended to match with each other, 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.

Q11- Is it considered a violation of Rule 534 if orders initiated for the same beneficial account by one or more automated trading systems match against each other?

A11- 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 that do not involve a change in ownership.