Wash Trade

FAQ

February 2016

1. Who is considered a market participant?

For the sole purpose of this FAQ, a market participant is defined as any person initiating or executing a transaction directly or through an intermediary, and any person for whose benefit such a transaction has been initiated or executed. A market participant also includes any individual or firm that is involved with the placement, negotiation or execution of a transaction such as a floor, firm or voice broker.

2. What is a wash trade?

A wash trade is a transaction or a series of transactions executed in the same Commodity Contract and delivery month or Option series at the same, or a similar, price or premium for accounts of the same Principal.

> The term **"Principal"** as used herein shall mean an individual or entity with a beneficial interest in an account.
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> The term "**same Principal**" as used herein shall mean accounts that are owned by the same person, entity, or a parent and its 100% wholly owned subsidiaries, or subsidiaries that are wholly owned by the same parent and *shall also include accounts that have common ownership that is less than 100%.*

A wash trade occurs when there is an act of entering into, or purporting to enter into, transactions with no intent to obtain a bona fide market position or activity that gives the false appearance of an executed transaction(s), but does not subject the Principal to any market risk or change in position or aid in price discovery. Such trades are prohibited by the Commodity Exchange Act, and Exchange Rule 4.02(c) which prohibits the execution of wash trades. Any market participant who initiates, places, accepts or accommodates a transaction in a manner such that the participant(s) knew or should have known it would result in a wash trade will be violation of Exchange Rule 4.02(c)[1].

In addition, if it is determined that simultaneous buy and sell orders are for different Principals such orders must be executed in accordance with Exchange Rule 4.02(g). This Rule, however, prohibits market participants from contemporaneously entering both buy and sell orders for the same Commodity Contract in the same delivery month or Option series via a Crossing Order ("CO") unless such orders are for different Principals.

3. Can a market participant who receives simultaneous buy and sell orders for the same Principal accept them? Is there a duty to ask if the orders are for different Principals?

Upon the receipt of simultaneous buy and sell orders, a market participant should determine if such orders are for the same Principal. If the market participant learns that the orders are for an omnibus account, the market participant, then, should determine if the orders are for different Principals whose accounts are within the omnibus account. If the orders are not for different Principals, they may not be accepted.

If such orders trade opposite one another and are ultimately for the same Principal, any of the market participants involved that knew or should have known that the activity would result in a wash trade(s) may be in violation of Exchange Rule 4.02(c).

[1] Formerly ICE Futures U.S. Rule 2.29(k)

4. Why must a market participant receiving simultaneous buy and sell orders inquire if the orders are for different Principals?

The CFTC has held that a market participant (including account executives and 3rd party brokers) may not knowingly participate in the execution of wash trades and, therefore, has an independent duty to inquire about the propriety of buy and sell orders placed for simultaneous execution. (See, *In the Matter of Three Eight Corporation*.). There may be circumstances which would require a market participant to go beyond mere acceptance of the assertion made by the party placing the orders and take additional steps to ensure that the orders in question do not violate the prohibition on wash trades.

5. What should a market participant do if he cannot determine if simultaneous buy and sell orders are for the same or different Principals?

The market participant should refuse to accept the orders. However, if the orders are accepted, and assuming the market participants have no knowledge of improper customer intent, regulatory risk may be mitigated by taking steps to ensure that they are not executed opposite each other, such as by ensuring that one order is entered and executed prior to the entry and execution of the second order.

In either case, the market participant should report the situation to the Market Regulation Department.

6. If simultaneous buy and sell orders for the same Principal are entered for a legitimate purpose, how should a market participant execute the orders to ensure compliance with Exchange rules?

If a market participant receives simultaneous buy and sell orders for the same Principal for execution on the Electronic Trading System ("ETS"), records of such orders (i.e. paper tickets, emails or IMs) must be generated upon receipt and maintained, and must include order details and evidence the time of receipt by means of an electronic time-stamp or other automated timing device. One of the orders should then be entered on the ETS and executed in full prior to the entry of the second order. A record of the second order including time of placement will be required because it was not entered on the ETS 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. For additional guidance on the appropriate recordkeeping requirements, please refer to Exchange Rules 6.07 and 6.08.

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 and market conditions, preclude the orders from trading in whole or in part against each other. To the extent that the orders trade opposite each other, or are executed at nearly the same price the result would be a transaction that incurred no market risk or change in position and, therefore, may be deemed a violation of Rule 4.02(c) irrespective of the fact that the orders were entered at different times.

7. Is it acceptable to place simultaneous buy and sell orders for the same Principal with the same market participant for execution on a discretionary ("DRT") basis?

If the market participant placing the orders does so simultaneously or nearly simultaneously and execution of the orders results in a wash trade or if both orders are executed opposite the same third party, it is possible that the party placing the order, any party transmitting the order, the market participant executing the order and the accommodator(s) will be the subject of an enforcement action brought by either the CFTC or the Exchange for engaging in an illegal wash trade.

Depending upon the circumstances, the placement of buy and sell order for the same Principal along with giving the executing market participant discretion over price and/or time, may be viewed as an implicit request to negate the customer's market risk by directly or indirectly executing the orders against each other. 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.

8. Is it acceptable to place a buy order(s) with one market participant for execution and place a simultaneous sell order(s) for an account with the same Principal to a different market participant for execution?

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. The fact that the trade is not prearranged and is executed competitively on the ETS may not protect the parties from liability if the execution of the orders produces a wash result.

9. Under what circumstances does trading opposite your own orders on the trading platform violate Exchange rules regarding wash trades?

Market participants are prohibited from entering both buying and selling orders for the same Commodity Contract for future delivery in the same delivery month or Option series unless such orders are for different Principals. It is a violation of Exchange Rule 4.02(c) for a market participant to enter an order on the ETS that he knew or should have known would trade against a resting order on the other side of the market for the same Principal.

10. Does the Exchange provide market participants any wash trade prevention features and is it mandatory for certain market participants?

In December 2013, the Exchange introduced the Self Trade Prevention Functionality ("STPF") policy. STPF functionality resides within ICE's trading engine and provides various automated configurations to prevent self-trading of orders entered by the same direct market access ("DMA") firm or related DMA firms. The STPF functionality is customizable based on each market participant's needs and therefore can be implemented at the following levels: Authorized Trader ID, Company ID, Authorized Group ID or Account ID.

Currently, proprietary traders with DMA access who utilize algorithmic trading applications are required to utilize STPF to prohibit self-trading at any of the various levels noted above. Proprietary Traders are defined as any entities or individuals that trade for their own account, or their company's account.

For additional STPF information please refer to the Exchange's STPF FAQ.

11. Is it a violation of Rule 4.02(c) if independently initiated buy and sell orders inadvertently match against each other when placed by different independent decision-makers associated with the same Principal?

If buy and sell orders which are placed by independent decision makers for accounts that reflect the trading of separate business units of the same Principal coincidentally match each other when executed, it would not be considered a violation of Rule 4.02(c) provided that the orders were entered without prearrangement, neither person had knowledge of the other party's order and the orders were not otherwise intended to match with each other. For these types of transactions, the parties to the trade must be able to demonstrate the independent control of the accounts and that the transaction had a bona fide business purpose for each party to the trade.

The Exchange will deem a market participant to be in violation of Rule 4.02(c), if buy and sell orders for accounts with the same Principal were matched opposite each other for the purpose of transferring/moving positions amongst accounts. Any market participant involved in the initiation, placement, negotiation, execution or accommodation of a transaction that knew or should have known it was done for such purpose may be in violation of Exchange Rule 4.02(c). Market participants should be aware that the Exchange does allow the transferring of an open position(s) that involves no change in beneficial ownership, provided it complies with Exchange Rule 4.11, Transfer Transactions Not Required to Be Made Competitively.

12. Is it a violation of Rule 4.02(c) if independently initiated orders placed by different proprietary traders or Automated Trading Systems ("ATS") within the same market participant match against each other?

The Exchange recognizes that certain market participants have various proprietary trading operations composed of individual traders or a team of traders who, through fully independent trading decisions, manually place orders or operate ATS's. These strategies, although for the same Principal, may coincidentally match with each other when executed. If, however, the orders were entered without prearrangement and were not otherwise intended to match with each other and did not cause price or volume aberrations, such trades are not considered to be in violation of Rule 4.02(c), provided that the Market Participants can demonstrate such independence.

Market participants should have and enforce policies to preclude affiliated traders who enter orders for the same Principal and have access to, or knowledge of each other's orders from trading opposite each other. Additionally, market participants are also responsible for monitoring their ATS's and for employing trading algorithms that minimize the potential for the execution of transactions that do not involve a change in ownership.

13. If orders entered for a single ATS or various ATS's controlled by the same individual trader or for the same team of traders ultimately match opposite one another, would the Exchange consider the trade to be a wash trade?

In these scenarios, such trades may be considered to be in violation of Rule 4.02(c) or other Exchange rules, such as Rule 4.04, if they occur on more than an infrequent basis. It is recommended in this circumstance that the market participant employ functionality that will minimize the potential for the ATS's buy and sell orders to match with each other.

Market participants should also ensure that each strategy's Authorized Trader ID's ("ATID") are appropriately registered to the individual or group of individuals that operate the ATS. If multiple ATS strategies are operated/ controlled by the same individual or team, submit orders in the same instrument and may potentially trade opposite themselves, each strategy should have its own unique ATID.

14. Under what circumstances does unintentional or incidental matching of buy and sell orders from the same Principal violate Rule 4.02(c) or other Exchange rules such as Rule 4.04?

Unintentional and incidental matching of buy and sell orders for the same Principal generally will not be considered a violation <u>unless</u> such activity causes price or volume aberrations, or occurs other than on an incidental basis. The frequency of incidental self-matching for the same Principal in any circumstance will be evaluated in the context of the activity of the trader, trading group, or algorithm(s), and relative to the activity in the instrument traded. More than de minimis self-trading in this context will result in additional regulatory scrutiny and may be deemed to violate the prohibition on wash trades.

As such, market participants are responsible for monitoring their trading, whether that trading is manual or automated, and are strongly encouraged to adjust their trading strategies or employ functionality designed to minimize or eliminate their buy and sell orders from matching with activity opposite other proprietary traders, ATS's or independent decision makers associated with the same Principal.

15. Does the wash trade prohibition only apply to transactions entered or executed on the ETS?

No. The Exchange prohibits wash trading for all trade types, including but not limited to Block Trades and Exchange for Related Positions ("EFRP's"). However, some exclusion may apply for Off-Exchange transactions which are detailed below:

1) **Block Trades** - The Exchange permits block trades in all futures and options contracts between accounts of affiliated parties, and would not deem a wash trade to have occurred provided that it can be demonstrated that each block trade meets the following requirements:

    i. the block trade price must be executed at a fair and reasonable market price;
    ii. each party must have a separate and independent legal bona fide business purpose for engaging in the trades; **and**
    iii. each party's decision to enter into the block trade must be made by a separate and independent decision-maker.

2) **EFRP's** - The accounts involved in the execution of an EFRP transaction must be:

    i. Independently controlled with different beneficial ownership; or
    ii. Independently controlled accounts of separate legal entities with the same beneficial ownership; or
    iii. Independently controlled accounts within the same legal entity, provided that the account controllers operate in separate business units.

    "Independently controlled" means that the parties have separate accounts with separate operations (whose positions, even when exactly opposite, cannot be offset except by trading on the electronic platform) and that there is independent control of decision making with respect to transactions for such accounts.

If the Block or EFRP trade(s) do not meet all of the requirements set forth above, the transaction may constitute an illegal Wash trade prohibited by Rule 4.02(c). Please refer to IFUS' Block Trade FAQ and EFRP FAQs for additional guidance.

16. Are there unique considerations with respect to Rule 4.02(c) in the context of exchange-sponsored volume incentive programs?

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 of the same Principal and utilize the STPF offered by the Exchange.