



## **CIRCULAR 176-18**

November 9, 2018

(Updated January 15, 2019)<sup>1</sup>

### **FREQUENTLY ASKED QUESTIONS SELF-MATCHING OF ORDERS AND WASH TRADING (ARTICLE 7.5<sup>2</sup>)**

The Regulatory Division of the Bourse de Montréal Inc. (the "Division") often receives questions related to the self-matching of orders and whether such trading activities are to be considered wash trading, a prohibited manipulative or deceptive method of trading as per article 7.5 of the Rules of the Bourse de Montréal Inc. (the "Bourse").

This circular is intended to provide regulatory guidance to approved participants of the Bourse by answering a series of frequently asked questions (the "FAQ") on the subject. This FAQ was developed in consultation with the members of the User Group of the Regulatory Division.

#### **1. What is wash trading?**

Wash trading is a form of fictitious trading where a transaction or a series of transactions can mislead market participants by creating a false appearance that purchases and sales have been made or that of an active and/or liquid market for the derivative instrument being traded. Wash trading undermines confidence in the market mechanism that facilitates price discovery and is considered a serious violation of article 7.5 of the Rules of the Bourse prohibiting manipulative or deceptive methods of trading.

Wash trading involves simultaneous or near-simultaneous orders or transactions of the same instrument, at the same or similar price, for the same beneficial owner or accounts of the same beneficial owner or under the direction or control of the same person. In the context of assessing whether wash trading has occurred, affiliated corporations and subsidiaries of approved participants may be considered as having the same beneficial ownership<sup>3</sup>.

The unintentional and isolated matching of buy and sell orders, whether by accident or inadvertently, may not be considered wash trading. However, approved participants and approved persons who frequently enter orders on opposing sides of the market and that may

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<sup>1</sup> Updated to modify references to the Rules of the Bourse following the publication of the new version of the Rules, effective January 1, 2019

<sup>2</sup> Formerly Article 6306

<sup>3</sup> Refer to article 1.103 Affiliated Corporations and subsidiaries. For the purpose of the Rules, the expression "affiliated corporations and subsidiaries" means the following situations: (...) *d) a Person, other than a corporation, shall be deemed to beneficially own Securities held by a corporation controlled by him or by an affiliate of such corporation; e) a corporation shall be deemed to beneficially own Securities held by its affiliates.*

have a potential of self-matching should implement a functionality designed to minimize or prevent their buy and sell orders from matching each other (please refer to question 12. below).

**2. On October 30, 2017, an amended article 7.5 of the Rules of the Bourse became effective. This article now refers to "wash trading". What are the reasons for this modification?**

The purpose of the amendments to article 7.5 was to provide more certainty to market participants as to various prohibited trading practices and clarify the liability standard applicable to these prohibited practices (see [Circular 033-17](#)).

Article 7.5 of the Rules of the Bourse, provides that:

*"No Person may directly or indirectly, whether **intentionally, recklessly or with willful blindness**, use any manipulative or deceptive methods of trading on the marketplace of the Bourse. **All orders must be entered for the purpose of executing bona fide transactions.***

*Manipulative or deceptive methods of trading include, but are not limited to:*

- a) manipulating the price of any Listed Product;*
- b) **entering an order or effecting a Transaction:***
  - i) to mislead other market participants;*
  - ii) to overload, delay, or disrupt the systems of the Bourse or other market participants;*
  - iii) to disrupt the orderly conduct of trading or the fair execution of Transactions;*
  - iv) to engage in wash trading, accommodation trading money passes, or other forms of fraudulent trading; or*
  - v) with the purpose of transferring funds, assets or liabilities in contravention of legal or regulatory requirements*

According to article 7.5 of the Rules of the Bourse, "all orders must be entered for the purpose of executing bona fide transactions". Entering an order or effecting a transaction to engage in wash trading implies non bona fide transactions.

The notion of "wash trading" also implies some form of intent and/or knowledge ("whether intentionally, recklessly or with willful blindness ") whether as a single act or as a pattern.

Approved participants and approved persons should not place orders or effect transactions to avoid taking a bona fide market position exposed to market or execution risks. Similarly, approved

participants and approved persons should not accept buy and sell orders for the same beneficial owner or accounts of the same beneficial owner or for accounts under the direction or control of the same person (please refer to question 5. below).

An approved participant or an approved person may be considered to have engaged in “wash trading” if the approved participant or approved person knows or ought reasonably to have known that:

- 1) Orders for the purchase and for the sale of the same derivative instrument are being entered on the Bourse;
- 2) The orders are for the benefit of an account or accounts which have the same beneficial owner or are under the direction or control of the same person; and
- 3) The orders have the potential of trading with each other.

All relevant circumstances and facts are to be considered when determining whether or not there is intent, recklessness or willful blindness in the assessment of a potential violation of article 7.5 of the Rules. Without limitation, the knowledge, experience and proficiency of the person involved constitute relevant information. Similarly, the explanations provided by the person executing the trades, the inquiries conducted internally (the beneficial owner of the account or accounts for which the orders were entered, the cancellation of self-matched trades), and the market conditions at the time of orders entry are to be taken into consideration.

### **3. How is wash trading different from self-matching?**

Self-matching is when orders in the same instrument match at the same or similar price for the same beneficial owner or accounts of the same beneficial owner and establish a trade.

Parties to the trade must be able to demonstrate an independent decision making process with respect to the orders and that there is a bona fide business purpose for each party to the trade. Otherwise, a self-match may be considered a wash trade.

As the case may be, the failure of an approved participant to provide the Bourse with such information may support an inference that there was a form of intent to engage in wash trading.

### **4. Are wash trades limited to transactions with no change in beneficial ownership?**

No. In addition to the notion of “same beneficial ownership”, a wash trade may also occur in accounts whose beneficial owners are different but are controlled or directed by the same person.

“Direction or control of accounts” relates to the interest or the trading authority over the accounts in the context of investment decision making. For example, a client, the beneficial owner, may have given “control” of his/her accounts to an account manager who is the person responsible for making all investments decision on a discretionary basis.

**5. Can simultaneous buy and sell orders be entered by the same approved person for accounts with the same beneficial owner in the same product and expiration month, or option series?**

To avoid the risk of wash trading, an approved person should enter and wait for the first order to execute in its entirety before entering the second order. Another approach would be to ensure there is a delay between the entries of the buy and sell orders. However, this may still not preclude them from self-matching.

In that context, evidence of entry time of orders will be required as it will provide a clear audit trail with respect to the entry of orders.

**6. Do block trades between different accounts with the same beneficial ownership violate the wash trading prohibition?**

Block trades are pre-arranged transactions only permitted in certain derivative instruments and for a quantity which meets or exceeds the minimum volume thresholds.

Before initiating a block trade or any other type of order, an approved participant or approved person is required to undertake reasonable efforts to identify the beneficial owner of the transaction. If the orders are for an omnibus account, approved participants and approved persons should determine whether the orders are for different client accounts within the omnibus account. In the absence of other suspicious facts, a written statement or an auditable declaration from the entity carrying the omnibus account stating that such orders are placed for different clients within the omnibus account could be considered a reasonable inquiry.

**7. If buy and sell orders for accounts with the same beneficial ownership are initiated by independent decision makers and self-matched, will the trade violate the wash trade prohibition?**

If the decisions to enter the orders which self-matched were made independently from each other or from independent decision-makers, and with the intent to execute bona fide transactions, the executed trade may not constitute prohibited wash trading.

Nonetheless, approved participants and approved persons should be aware that trades resulting from self-matching orders are being closely monitored by the Division and as such, subject to greater regulatory scrutiny. Parties to the trade must be able to demonstrate an independent decision making process with respect to the orders and that there is a bona fide business purpose for each party to the trade.

**8. Is it a violation of article 7.5 of the Rules of the Bourse if, independently initiated orders, originating from different traders within the same proprietary firm, match against each other?**

An approved participant conducting proprietary trading operations for which multiple traders making fully independent trading decisions enter orders for the benefit of the approved participant (one or more accounts), may have orders match each other. If these orders unintentionally and incidentally match each other, they may not be considered wash trades. To be considered unintentional, the orders must have been entered by different traders making independent decisions for the purpose of executing bona fide transactions. These trades must not be prearranged and must not be entered with knowledge of the other trader's order.

Similarly, orders generated by algorithms operated and controlled by fully independent traders in different trading groups that unintentionally and incidentally match with each other may not be considered wash trades as long as the respective trading groups do not have knowledge of one another's orders or algorithms.

**9. Is it a violation of article 7.5 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?**

Approved participants are responsible for monitoring their trading, whether that trading is manual or automated.

If a particular or more than one algorithm or system generate buy and sell orders that could potentially match each other and such trades occur on more than on an incidental basis, the trades may be considered wash trades. It is recommended that the person or the trading group responsible for the operation of the algorithm either adjust their trading strategies or employ a functionality that prevents or reduces the potential for self-matching orders. Otherwise, if self-matching of these orders occurs more than on an incidental basis, these transactions may be considered wash trades.

**10. Where "more than incidental" self-matching may be considered to violate the prohibition on wash trades, is there a prescribed threshold?**

No, there is no prescribed threshold. Approved participants are expected to prevent or reduce the potential for, and the occurrence of, self-matching orders, by employing a reasonably designed system (article 3.100<sup>4</sup> of the Rules of the Bourse). The incidence of self-matching should be assessed notably in the context of the activities of the trader, trading group, or algorithm, relative to the trades and volume of the instrument traded.

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<sup>4</sup> Formerly Article 3011

**11. Does the Regulatory Division grant *de minimis* exemptions for self-matching trading?**

No. *De minimis* exemptions for self-matching trading is not granted by the Division. Approved participants are expected to either adjust their trading strategies or implement functionalities to prevent or reduce the occurrence of self-matched orders.

**12. What are the functionalities offered to approved participants to prevent or reduce self-matching orders?**

Preventing self-matching orders should ensure that there is no misleading appearance of potentially manipulative trading. On July 10, 2015, the Bourse made available to all approved participants an anti-wash trade functionality. This functionality enables approved participants to include an anti-wash ID within their orders and therefore prevents or reduces the occurrence of involuntary trading by the firms and their customers against their respective resting orders or quotes.

To benefit from this functionality, approved participants should contact their independent software vendor or include this feature in their proprietary order management system.

**13. Is it a violation of article 7.5 if orders match against each other due to the limitations of the anti-wash functionality offered by the Bourse?**

Approved participants are expected to either adjust their trading strategies or implement functionalities to prevent or reduce the occurrence of self-match orders. In the circumstances where the self-matched transactions result from the limitation of the anti-wash functionality offered by the Bourse, approved participants may not be considered being in violation of the wash trading prohibition.

**14. What steps can an approved participant take to reduce the risk of engaging in wash trading activities in light of article 7.5 of the Rules?**

Approved participants have an obligation to supervise the trading activities of their employees or clients including the algorithms used to trade. Therefore, they must be able to demonstrate the independence of the traders, trading groups or algorithms, and should have policies and procedures that prevent the traders from having access to or knowledge of one another's orders, and enforce them when applicable.

If self-matching of orders occurs more than on an incidental basis, while being bona fide transactions, approved participants are expected to either adjust their trading strategies or to put a system in place that is reasonably designed to prevent or reduce the frequency of their occurrence.



An approved participant or approved person may also be found to have engaged in wash trading if it failed to have made reasonable inquiries as to the beneficial owner of the orders prior to their execution. Such failure to undertake the required inquiry may infer recklessness or willful blindness on the part of the approved participant. Therefore, approved participants and approved persons are expected to be able to provide more information about self-matching orders when (i) requested by the Division or (ii) when reporting a possible violation under article 3.105<sup>5</sup> of the Rules. More specifically, they should be able to provide a detailed explanation of each order's decision process, as well as the business rationale underlying their justification as bona fide orders.

For more information, please contact the Regulatory Division by telephone at 514 787-6530 or toll-free at 1-800-361-5353, ext. 46530, or by email at [info.mxr@tmx.com](mailto:info.mxr@tmx.com).

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<sup>5</sup> Formerly Article 4002