

CAUGHT IN THE WASH

BY MAIYA KEIDAN

Traders selling, and then repurchasing, the same stock, bond, option or future, is a topic facing increasing regulatory scrutiny. For systematic hedge funds trading in the US - some of whom are shelving out seven-figure sums for internal technology or facing expensive inquiries due to accidental violations - it has proved an expensive development.

Wash sales, as they are known, are a market violation when deliberately carried out in order to change the price of a given product but managers who run several algorithms in different directions may – without meaning to – transact with one another. However, the enforcers, the regulators and the exchanges aren't sympathetic to this defence, claiming managers should have adequate wash sale blockers and other protections. "We have seen an increasingly large number of wash sale inquiries from the exchanges and the CFTC," says Zachary Brez, co-chair of the securities and futures enforcement practice at Ropes & Gray. "In the case of algorithms, folks will write code to protect against wash sales, but it can malfunction, and they still say an accident is a violation."

A hedge fund lawyer, meanwhile, who did not wish to be named because of conflicts, told HFMWeek in June that he had five clients facing wash sale enforcement cases for accidental triggering.

Bruce Mumford, partner and director at CTA 2100 Xenon Group, says although his firm is not affected, he is aware of the issue, and that managers may not want to speak about any enquiries they receive. "The CFTC is looking to penalise traders who they feel have violated the rules in a very public way because the CFTC wants people to think twice about the downside risk before engaging in wash sales," he says. He adds a manager who engages in a high volume of trading at a busy time like the close is more likely to trip the rules. "Our traders are aware of the rules, and we have the safeguards in place."

The partner and director at one Chicago-based CTA hedge fund says that the new focus was likely to mainly affect systematic traders engaging in spread trading – the simultaneous purchase and sale of something very similar. Market enforcers may mistake these trades as wash sales and therefore put forth more enquiries to these firms, although other managers HFMWeek spoke to explicitly say the risk of being contacted by regulators and exchanges is not limited to spread trading.

The CFTC has indeed been very vocal about being anti-wash sales with Commissioner Bart Chilton leading the way, as recently as 12 September telling a committee that the agency needs to ensure wash sales are prohibited and the exchanges mandate wash blocking technologies are used by traders.

Chilton had earlier said "even if wash sales are not entered into as a part of a manipulative scheme or directly harm any market participants they may undermine the price discovery function of, and public confidence in the markets". He added that "accordingly, the penalty for wash sales should be at a level, which serves as a strong deterrent".

The SEC is known to be asking firms about the issue during its 'presence exams' of newly registered investment advisers.

The Financial Industry Regulatory Authority (Finra) on 28 August updated its rules on wash sales, noting "members must have policies and procedures in place that are reasonably designed to review their trading activity for, and prevent, wash



sale transactions". The MFA was quick to respond to the Finra proposal, writing to the regulator on 25 September that the unintentional interaction of orders from one or more algorithms from a single firm should not be a violation of the rules.

The MFA also strongly supported the further development by exchanges and alternative trading systems of software functionality that will help users prevent self-matches. However, some lawyers, like Schulte Roth & Zabel's Brian Daly, have noted larger managers are – for a number of reasons – setting up internal netting systems to identify and match these trades. However, he notes: "It is expensive and challenging, and often impossible, to design a system that entirely removes the possibility that offsetting trades from a single manager running multiple algorithms will meet in the market. In fact, in some cases (like separate algorithms or for different clients) bona fide trades meeting in the marketplace offer better transparency and efficiency."

The CME Group, which came out with new guidance on wash sales on 17 June, has been accused of pushing its own blocker on those trading on its exchange. The CME, like other exchanges, has the power from the CFTC to enforce anti-wash sale rules via sending out warning letters, introducing fines and sanctions but lawyers say they're seeing more cases of the exchanges and the CFTC going after the same client. "In theory you're not supposed to get the same action from the CFTC and an exchange but we're seeing that happen increasingly," says one lawyer. "It doesn't make sense for someone to be punished twice."

Steve Decker, group manager, sell side technology, at Trading Technologies, which provides software to connect to exchanges says: "We are in a situation where our customers are increasingly coming to us to ask if we have the functionality to protect against wash sales. Clients tell us the exchanges and regulators are getting increasingly aggressive."

And when it's difficult to defend your firm's intent, as it is with wash sales, penalties instil even more fear. "It is challenging for systematic managers to respond to incoming queries and challenges because the underlying code is generally a secret and often the firm's most valuable asset," says Schulte's Daly.

However, Ropes & Gray's Brez, says managers can show a portion of code or where limits have been put in to demonstrate protections, although he agrees there are concerns around sharing any code. Even when it hasn't escalated to a fine or a sanction, a mere enquiry is a considerable drain to the firm, with in-house counsel, external lawyers and compliance officers or compliance consultancies having to be notified.

And those managers who might think themselves immune, actually may be affected. A co-founder at a systematic CTA in New York says he doesn't think his firm is affected by the issue but then says "sometimes we rebalance our positions based on new hedge ratios". He adds: "If we rebalance positions it is possible our orders could be upsetting one another but it's very small and we have not been asked."

However, Scott Moss, partner at Lowenstein Sandler, says while the rebalancing model could be a valid justification for trading, documentation needs to back this up in case the regulators or exchanges come a-knocking. "If you say a transaction is systemic rebalancing, then when did you set the target? How often do you rebalance? Is it every quarter, for example" he says. "Even when rebalancing you need to show why and how. Expect it to be brought up."

Wash blockers and internal netting systems may not be fool proof but with the regulators and exchanges increasingly proffering up burdensome enquiring after these kinds of trades, it almost seems like an investment affected managers can't afford not to take. ■