SUPERVISION MARKETWATCH #13

Wash trades: impact in current landscape

In short This Market Watch focuses on the impact of wash trades in the current market landscape. We interpret wash trades in relation to the Market Abuse Regulation and elaborate on the required actions to be taken by market participants in case of detecting wash trades in their own market practice. Furthermore, this Market Watch contains an explanation of a complex trading strategy in which wash trades play an essential factor. In the last part of the publication, a brief "Facts & Figures" section is enclosed in which we focus on the factors that trigger trading algorithms to take their trading decisions.

1. Introduction

Financial markets are driven by information. In recent years, not only has the amount of information increased, but also the speed at which market participants process this information, whether automated or not. Market participants use information on an ongoing basis to analyse the market and determine their own trading strategy. Information may include news about an issuer, information about the order book, general market conditions or correlated financial instruments, etc. The set of available information and its interpretation by market participants determines the price of a financial instrument.

In this edition of the AFM Market Watch, the AFM discusses the signals emanating from an order book and transactions. An example of so-called 'wash trades' provides insight into the fact that trading in financial instruments can be done in various ways and through different strategies, each potentially sending different signals.

Article 15 of the Market Abuse Regulation (MAR) prohibits (attempting) to manipulate the market. Article 12 of the Market Abuse Regulation describes what is meant by market manipulation. This includes entering a transaction, placing an order to trade or any other conduct that actually or probably gives false or misleading signals as to the supply, demand, or price of a financial instrument or that actually or probably brings the price of a financial instrument to an abnormal or artificial level.

2. Signals from order book and transactions

Every order and transaction sends out several signals. For example, in general, placing a buy order sends a signal that a party is willing to buy a certain amount of a financial instrument at a certain price. Placing a sell order sends the signal that a party is willing to sell a certain amount of a financial instrument at a certain price. A transaction sends the signal that the ownership of a certain quantity of a financial instrument has been transferred from a seller to a buyer at a certain price.

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3. Wash trades

Annex I, Part A of the MAR, provides a non-exhaustive list of indicators relating to false or misleading signals and price securing at an artificial level for the purposes of the definition of market manipulation. One of these indicators is whether transactions conducted result in a change in the identity of the beneficiary owner of a financial instrument. This indicator is specified as a practice in MAR Delegated Regulation 2016/522 as follows:

'The conclusion of contracts for the purchase or sale of a financial instrument ... where there is no change in the economic interest or market risk or where the economic interest or market risk is transferred between parties acting or colluding – commonly referred to as "wash trades[1]".

In order to answer the question of whether a wash trade qualifies as market manipulation, market participants must always refer to the definition of market manipulation as set out in the introduction and in the MAR. Market participants, when carrying out or observing wash trades, must at all times analyse the signals emanating from the underlying buy and sell order as well as from the resulting transaction, and assess whether these signals are actually or likely to be incorrect or misleading.

The following practical examples show that this is not easy for market participants to determine in all cases.

4. Practice

Liquidity providers

There are market participants that operate in the market as proprietary traders (PTFs) and that execute multiple trading strategies in the same financial instrument using different algorithms. There is a possibility (and risk) that these algorithms will trade against each other, resulting in transactions in which the economic interest or market risk is not transferred to a third party, but remains within the PTF. Even though the placing of the respective buy and sell orders may represent a real genuine intention to buy or sell on the part of the individual algorithms, in this situation the AFM expects market participants to analyse whether the signal ultimately given by the resulting transaction is accurate and not misleading. There is no transfer of economic interest or market risk in such a transaction.

Commodity derivatives

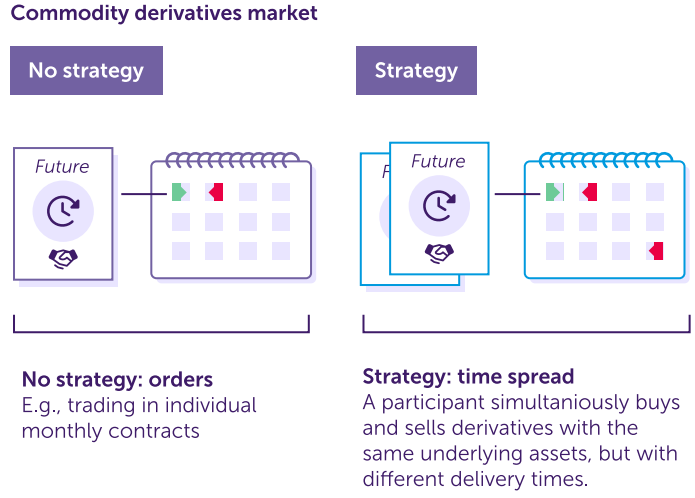
A more complex trading variant may arise in the commodity derivatives market. In derivatives markets, it may be possible to trade futures and futures contracts. In addition to, for example, trading in individual 'monthly contracts', participants can also trade in a combination of different monthly contracts, a so-called strategy transaction. An example of this is a time spread. In a time spread, a market participant simultaneously buys and sells derivatives with the same underlying asset, but with different delivery periods. This results in separate buying and selling transactions in different financial instruments with the same underlying asset. The number of transactions executed depends on the chosen (timing) strategy and can vary from two transactions to, for example, twelve in the case of an annual strategy.[2]

1 The AFM has noticed that market participants also often speak of a 'self-trade'. This means the same thing in a technical sense and because of the conformity, this document only talks about wash trades.

2 In the implementation of an annual strategy, twelve separate transactions are concluded in the (successive) individual monthly contracts.

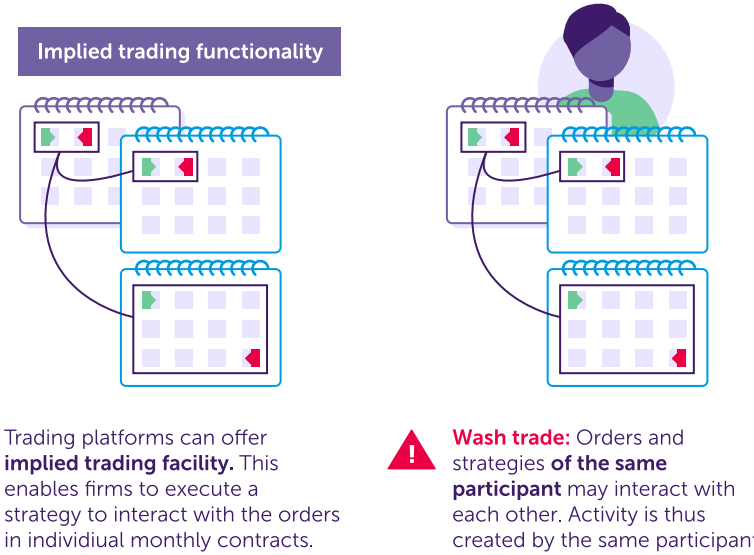
To implement these strategies as efficiently as possible, the AFM sees that trading platforms offer a so-called 'implied trading facility'. This facility makes it possible for orders to execute a strategy to interact with the orders in individual monthly contracts. There is a possibility (and risk) that opposing orders in separate monthly contracts and strategies of the same participant interact with each other. In this situation, transactions can therefore be established in which the buyer and seller are the same participant, so that no economic interest or market risk is transferred. In this case, too, the AFM expects market participants to analyse whether the signal that is given by the resulting transaction or transactions is not incorrect or misleading. This is another example of transactions where no economic interest or market risk is transferred. The impression may arise of activity in a certain monthly contract that is being created by the same participant.

Figure 1: Example of a wash trade by means of a spread trade. In Figure 1, a wash trade takes place in the May contract. The interested trader buys a spread trade in March/June and trades the May contract.



5. Responsibilities of market participants

Roughly speaking, a distinction can be made between (legal) persons active as traders in financial instruments on the one hand, and (legal) persons establishing or executing transactions in relation to these financial instruments on the other hand. The first category of (legal) persons is subject to, among other things, the obligation to comply with the prohibition to engage in market manipulation. The second category of natural persons or legal entities is subject, inter alia, to the obligation to put in place effective arrangements, systems and procedures aimed at preventing and detecting market manipulation and detecting and reporting suspicious orders and transactions.
If these orders and transactions lead to a reasonable suspicion of possible insider trading or market manipulation, or an attempt thereof, they must report these to the AFM via a Suspicious Transaction and Order Report (STOR).



6. Tools AFM

A wash trade and the orders that lead to it in themselves send false and/or misleading signals with regard to the supply of, demand for or price of a financial instrument and the wash trade thereby actually or probably brings the price to an abnormal or artificial level at that point in time and should therefore give rise to a reasonable suspicion of possible market manipulation. However the AFM considers it not necessary for market participants to submit a STOR notification to the AFM for each individual wash trade, participants should assess transactions on a case by case basis.

The number of wash trades is an indicator of the disruptive effect on the price formation process. The same applies to the extent to which wash trades take place at a different price. Apart from the qualification of the individual wash trade, the effect of the whole of orders and transactions on the market is also an element in the consideration of taking enforcement action.

The AFM advises market participants to assess on a case-by-case basis whether a STOR notification is appropriate. For example, market participants can analyse the number of wash trades (both in relative and absolute terms), the time span within which wash trades take place and the effect of the wash trades on the price of a financial instrument. It is important to emphasise that wash trades that are part of a trading strategy and are therefore systematic meet the above conditions

Facts and Figures

Academic study
The study Statistical Predictions of Trading Strategies in Electronic Markets[3] shows which factors are important in predicting the behaviour of trading algorithms on the Dutch stock market and are therefore likely to be relevant to the decisions of these algorithms. Among other things, the volume on the best quotes, the bid-ask spread, the balance in the order book and the volatility of an instrument (see Figure 1) are important. A wash trade affects each of these factors and, therefore, the behaviour of trading algorithms.

AFM study
In the 2022 AFM *study Machine Learning in Algorithmic Trading*, the AFM asked Dutch PTFs about the inputs of their trading algorithms. This shows, among other things, that the volume in the order book, the price trend, the volatility, and the balance in the order book influence the trading of algorithms. A wash trade influences each of these factors and therefore on the trading behaviour of algorithms.

3 Álvaro Cartea, Samuel N Cohen, Rob Graumans, Saad Labyad, Leandro Sánchez-Betancourt, Leon van Veldhuijzen, Statistical Predictions of Trading Strategies in Electronic Markets, *Journal of Financial Econometrics*, Volume 23, Issue 2, 2025, nbae025, https://doi.org/10.1093/jjfinec/nbae025

Figure 2: The importance of factors for trading algorithms in determining the direction (read: buy or sell) of an order, the price of an order given the direction, and the volume of an order given the direction of the order. This is calculated based on the trading behaviour of algorithms in the ASML share on Euronext Amsterdam in the period from 11 October 2021, to 20 January 2022.