Self Trading in Auctions - Surveillance and Enforcement

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History of B3 and BSM's Self Trading Actions

Self Trading

Self Trading occurs when an investor is at both sides (buy and sell) of a determined trade, whether brokered by the same participant or by two different ones.

Self trading considered regular

- ✓ Results from an **operational error**
- ✓ Is performed in the first **60 seconds** of the auction in the BOVESPA segment
- ✓ Is performed in the first **30 seconds** of the auction in the BM&F segment.

Self trading considered irregular

- ✓ Is performed through **withdrawal** on the part of the investor/trader
- ✓ **Displaces** demand
- ✓ Changes **price** and **liquidity** of the asset
- ✓ **Harms** other investors

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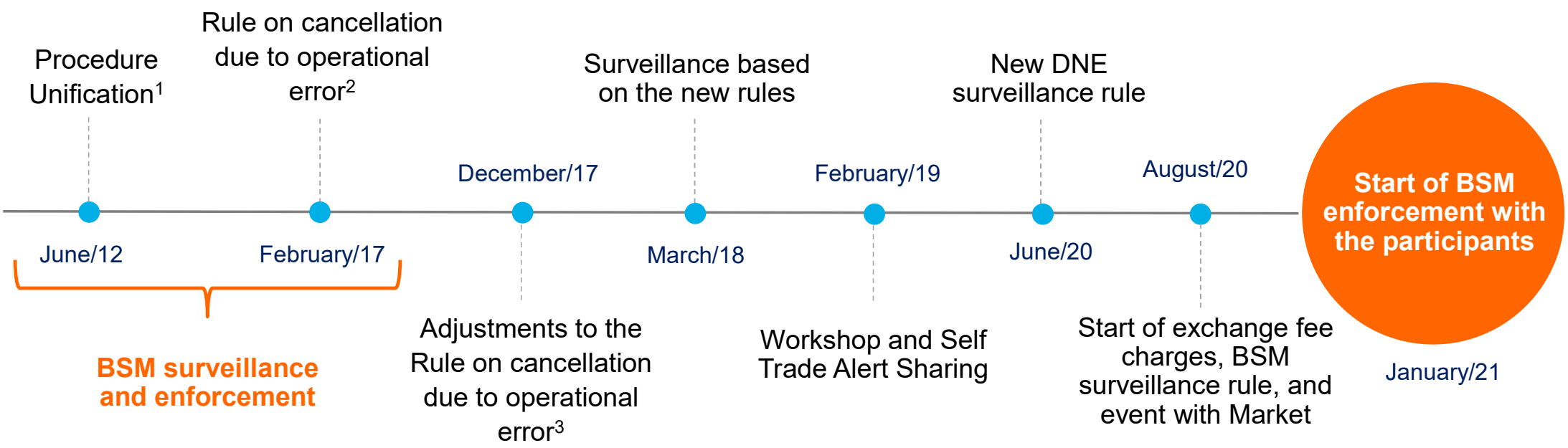
Intentional self trading surveillance - timeline



1 - B3 Circular Letter 033/2012-DP, dated June 15, 012
2 - B3 Circular Letter 016/2017-DP dated February 22, 2017
3 - B3 Circular Letter 027/2017-DO dated December 5, 2017

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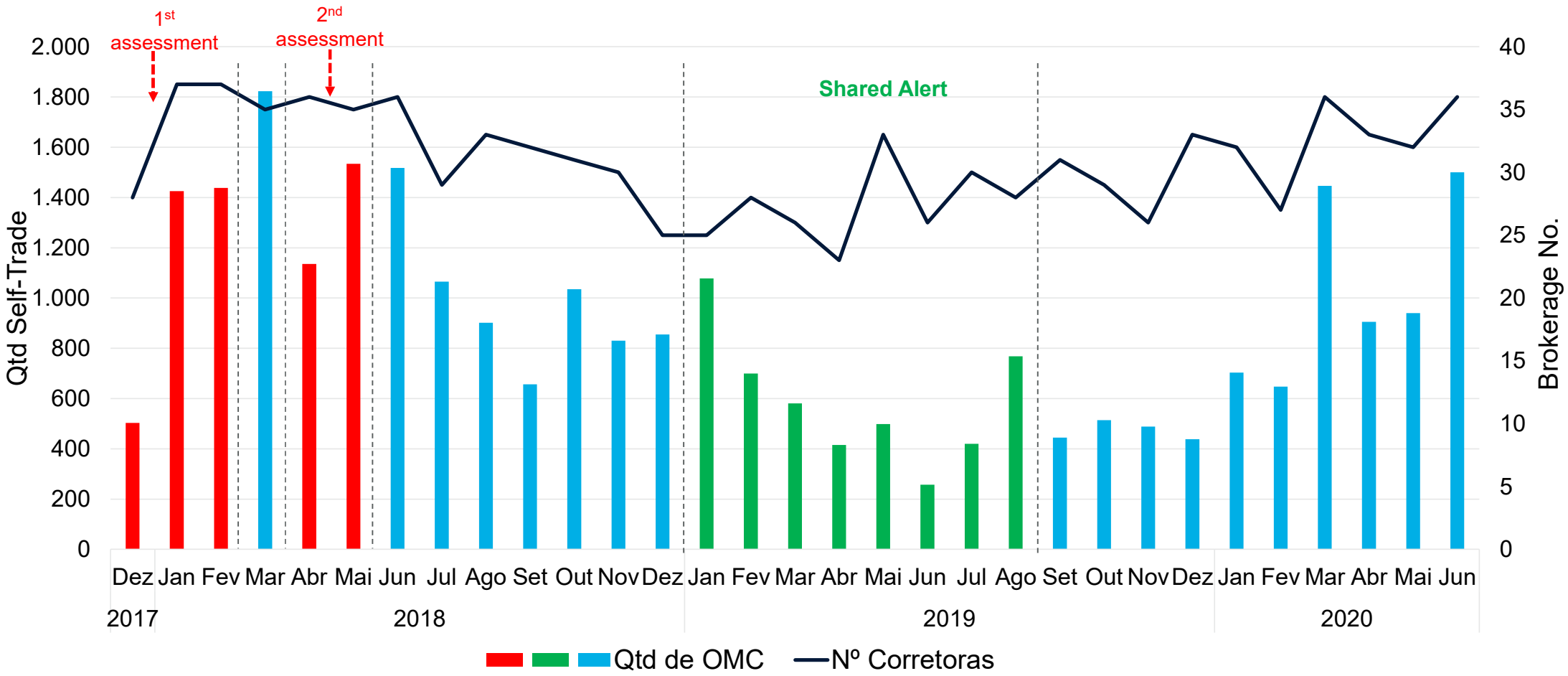
Evolution of self trading occurrences



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Example of intentional Self Trading

The client has a buy-side market order in the book for 99 equities participating in the auction and would execute a trade against the sell orders highlighted in grey.

BUY					SELL				
Brok.	Date	Time	Total Qty	Price	Price	Total Qty	Date	Time	Brok.
B	22/05/2019	09:51:05	99	MKT	43,50	10	22/05/2019	09:56:10	F
A	22/05/2019	09:55:09	99	MKT	45,00	20	22/05/2019	09:45:45	G
C	22/05/2019	09:55:12	1	MKT	48,00	42	22/05/2019	09:53:59	H
D	22/05/2019	09:55:15	99	MKT	48,87	56	22/05/2019	09:45:27	I
E	22/05/2019	09:55:22	1	MKT	48,88	10	22/05/2019	10:02:36	J

Example of intentional Self Trading

The client withdrew from the trade and entered a sell order that **provoked** an intentional **self-trade**, displacing the sellers originally met in its order.

BUY					SELL				
Brok.	Date	Time	Total Qty	Price	Price	Total Qty	Date	Time	Brok.
B	22/05/2019	09:51:05	99	MKT	MKT	99	22/05/2019	10:04:18	B
A	22/05/2019	09:55:09	99	MKT	43,50	10	22/05/2019	09:56:10	J
C	22/05/2019	09:55:12	1	MKT	45,00	20	22/05/2019	09:45:45	K
D	22/05/2019	09:55:15	99	MKT	48,00	42	22/05/2019	09:53:59	L
E	22/05/2019	09:55:22	1	MKT	48,87	56	22/05/2019	09:45:27	M
					48,88	10	22/05/2019	10:02:36	N

Clients that were harmed by the change to the order flow

Intentional self-trading is irregular as it creates artificial market conditions

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Trading Procedures Manual Regarding Intentional Self Trading in Auctions

Trading Procedures Manual

The version of B3's Trading Procedures Manual published on March 23, 2020 changed the procedure regarding the rule for self trading in auctions, which came to be allowed when:

I. The first order that originated the self-trade resulted from an **operational error** due to a:

a. **Price** different to that requested by the client.

b. **Quantity** different to that requested by the client.

c. **Side** opposite to that requested by the client.

d. **Asset** or derivative different to that requested by the client.

e. **Algorithm failure** or **error**, as long as proven to B3.

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Trading Procedures Manual

II. Withdrawal:

a. During the first **60 seconds** for equities, options on single stocks, Ibovespa, IBrX-50 and ETF

b. During the first **30 seconds** for other derivatives

III. Executed due to distinct strategies executed by the same investor

Other self trading is considered irregular

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Circular Letter 0080/2020-PRE encompassing the Electronic Trading Department's trade surveillance rules

B3/Electronic Trading Department (DNE) Self Trading Surveillance

B3/DNE surveillance:

1. Will identify all self trading in auctions, weekly, and will request that intermediaries assess whether the trades were intentional or not

2. In the case of intentional self-trading, B3 will prescribe a discouragement rule within the exchange fees in each verification period (six months), being:
   a) On the first occurrence, a warning
   b) On the second occurrence, a fine to a value corresponding to five times the standard exchange fee at the buy and sell side of the self trade
   c) On the third occurrence, a fine to a value corresponding to ten times the standard exchange fee at the buy and sell side of the self trade
   d) As of the fourth occurrence, there is application of the penalties foreseen in B3's rules
   e) Intentional self-trade occurrence counting expires with each verification period change (six months).

3. The DNE will send BSM the full list of self trades weekly, with identification of intentional and unintentional trades.

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B3/Electronic Trading Department (DNE) Self Trading Surveillance

Surveillance by **B3/DNE:**

1. B3 will levy the applicable fines, monthly, which will become part of the customer's multilateral net settlement

   a) allocated final account, if the trade is executed via DMA

   b) executing participant's error account, if the trade is executed via Trading Desk or Order Conveyor.

The participant must **state the nature of the self trading fine** in their customer's account statement.

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Letter 2664/2020-DAR-BSM encompassing BSM's trade surveillance rules

BSM supervision of self trading in auctions

Phase 1: Educative surveillance in the adaptation period (August/2020 to December/2020)

1) A surveillance rule is published and Participants are informed of intentional self trading surveillance, the diligence expected from the Participants, and the stages of the punitive measures process
2) After publication of the rules, the Participants will have a five-month adaptation period in which there will be no punitive measures, but BSM will perform surveillance and send notifications of trades where Participants need to take action.

Phase 2: Surveillance with enforcement

1) Application of filters in the data base to identify intentional self trades
2) Identification of DMA clients and traders who execute more than four intentional self-trades in an auction
3) The self trading verification period will be every six months: (i) from January to June and (ii) from July to December
4) The counting of intentional self trade occurrences will expire with every change to the verification period (six months)
5) The assessment and communication to Participants criterion will be monthly

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Surveillance filtering criteria used by BSM

To identify irregular self trading executed in auctions and to assess recurrence, BSM will use four criteria:

1. **Market loss:** Clients did not have their orders met due to a self trade.

2. **Intentionality in self trade execution:** Upon order entry at the opposite side to its initial order, the trader and/or client knew it would generate a self trade.

3. **Crossing after the permitted withdrawal period:** Trades executed and settled at the same Participant.

4. **Participant's response to weekly DNE questioning:** Trades stemming from an operational error will be excluded by BSM.

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BSM enforcement and filtering criteria

- All **intentional self trades that harm the market** are **irregular** and will be submitted to CVM, with no other filtering for assessment by the regulator.

- BSM's recurrence criterion is a provision to make **combatting irregularity** more efficient with Participants, by:

1 – Enabling action by the Participants together with their professionals after the first occurrences

2 – Allowing education and persuasion of clients by the Participants

3 – Putting B3 and BSM surveillance into effect

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Recurrence in Trader/Trading Desk surveillance at BSM/SAM

- ✓ When the trader has four occurrences (four self trades), SAM will send notification about possible application of a punitive measure in the following month.
- ✓ In the case of a new self trade after notification, BSM will apply a punitive measure

Example: Trader executed four self trades in January (notification in February) and one self trade in April (PAD administrative proceedings in May)

Notification **PAD**

Month	January	February	March	April	May	June
Self Trade	4	0	0	1	0	0

Início novo ciclo

- ✓ **Trader:** Subparagraph II, item "a" of CVM Instruction 8/1979 – creation of artificial conditions
- ✓ **Participant:** Article 32 of CVM Instruction 505/2011 – surveillance failure

Recurrence in the surveillance of DMA Client at BSM/SAM

To allow Participants a period to react, SAM will notify them twice before applying the punitive measure.

Example: DMA client performed four occurrences in January (notification in February), one occurrence in March (notification in April) and one occurrence in May (PAD in June)

1st Notification

2nd Notification

PAD

Month	January	February	March	April	May	June
Self Trade	4	0	1	0	1	0

Início novo ciclo

- ✓ **Participant:** Article 32 of CVM Instruction 505/2011 – surveillance failure
- ✓ **Client: Self trades sent to** CVM

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Use of error account by the Participants

According to item 47 of the Standard Rules: The Participant must exclusively use the Error Account or Operational Error Account to enter operational error transactions, regardless of the positive or negative result of the transaction, with it being prohibited to register any other transactions in these accounts, examples being proprietary account and those aimed at fostering securities liquidity (market maker and/or facilitation).

Examples of error account or client account use for self trading

1. **Participant/Trader operational error**:

The trader incorrectly registered the code of the client, asset, side of the transaction or executed the transaction at odds with the client's order → the transaction must be entered to the error account.

BSM will assess use of the error account in operational audits.

Use of the error account or investor's account

2. **Client's error account** (client ordered the transaction incorrectly):

   a) Client does not wish to maintain the transaction → Participant may enter a transaction in the error account or proprietary account.

   b) Client accepts maintaining the transaction → Participant may maintain the transaction in the client's account.

If opting to accept the explanation and maintain the transaction in the client's account in order to exclude the transaction from the irregular self trades group, the Participant must **analyze** the arguments submitted by the client, **register** the occurrence and **safeguard** the evidence.

BSM will assess the self trades that are explained and held in the client's account during trade surveillance.

BSM Market Surveillance may request information in any hypothesis and at any time

Expected diligence and Response to BSM notifications

Meeting the criteria established by BSM for **FILTERING + RECURRENCE**, BSM will send notification for the intermediate to explain:

1. **If regular**: when an explanation and evidence dispel the initial hypothesis, BSM will exclude the case and will exclude this transaction considering future recurrence;

2. **If irregular** continuation of the practice is prohibited:

Trader	DMA Client
1. Training with determination to cease the practice 2. Notification of BSM website content 3. Communication of the self trading rules	1. Notification & guidance to cease the practice 2. Notification of BSM website content 3. Submission of data with self trade irregularities

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Expected diligence – self trading via trading desk

1st Notification		2nd Notification
Observed	**BSM first alert assessment**	**BSM assessment of recurrence**
Trader (Infraction CVM Instruction 8 "a")	Did the trader's explanation dispel the irregularity? **Yes –** Dismissal **No –** Determination of non-recurrence of the irregular practice	Did the trader's explanation dispel the irregularity? **Yes –** Dismissal **No – Administrative Proceedings**
Transactions in accounts of a Proprietary Account Nature (Infraction CVM Instruction 8 "a")	Did the explanation dispel the irregularity? **Yes –** Dismissal **No –** Determination of non-recurrence of the irregular practice	Did the explanation dispel the irregularity? **Yes –** Dismissal **No – Administrative Proceedings**
Participant (Infraction Article 32 of CVM Instruction 505/2011)	Did the Participant's explanation dispel the irregularity? **Yes –** Dismissal **No –** Determination of non-recurrence of the irregular practice	Did the Participant's explanation dispel the irregularity? **Yes –** Dismissal **No – Administrative Proceedings**

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Expected diligence – self trading via DMA

1st Notification		2nd Notification	3rd Notification
Observed	**BSM first alert assessment**	**BSM assessment of recurrence**	
Client (Infraction CVM Instruction 8 “a”)	Did the client’s explanation dispel the irregularity? **Yes –** Dismissal **No –** Submission of case to CVM	Did the client’s explanation dispel the irregularity? **Yes –** Dismissal **No –** Submission of case to CVM	Did the client’s explanation dispel the irregularity? **Yes –** Dismissal **No – Submission of case to CVM**
Transactions in accounts of a Proprietary Account Nature (Infraction CVM Instruction 8 “a”)	Did the explanation dispel the irregularity? **Yes –** Dismissal **No –** Determination of non-recurrence of the irregular practice	Did the explanation dispel the irregularity? **Yes –** Dismissal **No – Administrative Proceedings**	
Participant (Infraction Article 32 of CVM Instruction 505/2011)	Did the Participant’s explanation dispel the irregularity? **Yes –** Dismissal **No –** Determination of non-recurrence of the irregular practice	Did the Participant’s explanation dispel the irregularity? **Yes –** Dismissal **No –** Determination of non-recurrence of the irregular practice	Did the Participant’s explanation dispel the irregularity? **Yes –** Dismissal **No – Administrative Proceedings**