A Friendly Reminder: CFTC Staff Encourages Exchanges, Futures Brokers and Clearinghouses to Ensure Their Risk Controls and Disclosures Address COVID-19-Related Market Volatility and Negative Prices

May 13, 2020

Responding to recent COVID-19-related volatility in futures and options markets and their related agricultural, energy and financial cash markets, and the expectation that such volatility will continue, staff from the three operating divisions of the Commodity Futures Trading Commission (CFTC) jointly issued an advisory on May 13 (Advisory),[1] to remind designated contract markets (DCMs), futures commission merchants (FCMs) and derivatives clearing organizations (DCOs) of certain of their respective regulatory obligations.

The CFTC's Division of Clearing and Risk, Division of Market Oversight and Division of Swap Dealer and Intermediate Oversight (collectively, the Divisions) issued the Advisory solely as a "prophylactic measure." The Divisions cited the unusually high market volatility and negative prices experienced in the physically-delivered, May 2020 West Texas Intermediate, Light Sweet Crude Oil Futures contract on the New York Mercantile Exchange on April 20 as the impetus for the joint action. The Divisions made clear that the Advisory was not meant as a suggestion of "compliance, or lack thereof" by any CFTC registrant related to past events.

In the Advisory's four substantive sections (one section each for DCMs and DCOs, and two sections for FCMs), the Divisions encouraged the relevant CFTC registered entity or registrant to consider whether, especially in light of the recent pandemic-related market volatility, its risk controls and related mechanisms are "reasonably designed, fit for purpose and appropriately implemented." In addition, the Divisions encouraged the registered entity or registrant to communicate appropriate information to its respective customers or members on the risks and technical elements of contracts and trading around upcoming expirations.

For each registration type, we have prepared a bulleted summary of some of the key regulatory obligations with which the Divisions expect compliance today and going forward.

DCMs (Exchanges)

- Among other things, DCMs that offer a physically-settled contract must continually monitor the convergence between the contract price and the price of the underlying commodity, as well as the supply of the commodity and its adequacy to satisfy the delivery requirements. DCMs also must make a good faith effort to resolve conditions that threaten the adequacy of supplies or the delivery process.[2]

[1] *See* CFTC Staff Letter No. 20-17 (May 13, 2020), available at: https://www.cftc.gov/csl/20-17/download.

[2] *See* CFTC Regulation 38.252.

- Among other things, DCMs that offer a cash-settled contract must continually monitor "the pricing of the index to which the contract will be settled and also the continued appropriateness of the methodology for deriving the index."[3]
- DCMs must maintain risk control mechanisms to prevent and reduce the potential risk of price distortions and market disruptions, including (but not limited to) market restrictions that pause or halt trading in light of market conditions as determined by the DCMs.[4]
- DCMs must adopt and maintain rules to provide for the exercise of emergency authority to suspend or curtail trading in any contract, and to require market participants in any one contract to meet special margin calls.[5] A DCM that adopts a rule or rule amendment in response to an emergency must file such rule or amendment with the CFTC prior to implementation or, if impracticable, the earliest time after implementation but no later than 24 hours after implementation.[6]

FCMs

- FCMs are reminded of their "imperative" obligations to manage effectively their FCM-related activities and, importantly, to protect customer funds. Among other things, FCMs must ensure they are collecting "appropriate levels of initial margin to protect against a customer becoming undermargined or defaulting on its positions."[7]
- Each clearing FCM also is required to conduct stress tests under "extreme but plausible conditions" at least once weekly on positions in its proprietary account and each customer account that could pose a material risk to the FCM.[8]
- FCMs should assess the effectiveness of their risk management programs' performance and make any appropriate revisions in light of the potential that certain contracts may experience significant price volatility and possibly negative pricing. To that end, each FCM should carefully monitor contracts as they move closer to expiration in order to ensure that the FCM and its customers can meet their respective financial obligations to make or take delivery.
- FCMs should "re-familiarize" customers with CFTC Regulation 1.55 risk disclosure language, reminding customers that they may incur losses exceeding the amounts deposited with the FCM. FCMs should also ensure that their customers understand the "mechanics of contract settlement at negative prices."

DCOs (Clearinghouses)

- DCOs are required, on a daily basis, to test for the adequacy of their initial margin requirements. In light of recent events, DCOs also should prepare for the potential that certain contracts may experience significant price volatility, including negative pricing.[9]

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[3] *Id*.

[4] *See* CFTC Regulations 38.255, 38.258; App. B of Pt. 38.

[5] *See* DCM Core Principle 6, 7 U.S.C. 7(d)(5).

[6] *See* CFTC Regulation 40.6(a)(6).

[7] CFTC Regulation 1.11.

[8] *See* CFTC Regulation 1.73.

[9] *See* CFTC Regulation 39.13(g)(7)(i).

CONTACTS

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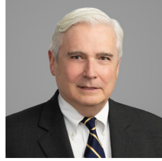

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