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Division of Clearing and Risk
Division of Market Oversight
Division of Swap Dealer and Intermediary Oversight

To: **Designated Contract Markets (DCMs), Futures Commission Merchants (FCMs), and Derivatives Clearing Organizations (DCOs)**

Subject: **Staff Advisory on Risk Management and Market Integrity under Current Market Conditions**

I. Introduction

The onset of the COVID-19 pandemic in late 2019 has adversely affected the economies of the United States and other major countries. Global markets, including those regulated by the Commodity Futures Trading Commission (the **Commission**), have been affected by both fundamental and technical factors this year as economies and industries have slowed dramatically or shut down completely—resulting in unprecedented market impacts. This economic downturn has coincided with substantially increased market volatility in key agricultural, energy, and financial sectors, including the futures and options on futures markets regulated by the Commission. The impact of fundamental and technical factors has been particularly acute for contracts that call for physical delivery of the underlying commodity as demonstrated by the unprecedented price moves in certain contracts.

The Divisions of Market Oversight (**DMO**), Swap Dealer and Intermediary Oversight (**DSIO**), and Clearing and Risk (**DCR**) (collectively, the **Divisions**) issue this advisory to remind DCMs, FCMs, and DCOs that they are expected to prepare for the possibility that certain contracts may continue to experience extreme market volatility, low liquidity and possibly negative pricing.

We note that we are issuing this advisory in the wake of unusually high volatility and negative pricing experienced in the May 2020 West Texas Intermediate (**WTI**), Light Sweet Crude Oil Futures contract on April 20 (the penultimate day of trading and expiration of the contract). The Divisions wish to emphasize that the subject of this notice applies equally to trading in other commodities, and registrants should remain vigilant and prepare accordingly.[1] In addition to considering risk controls and related issues, DCMs, FCMs, and DCOs are encouraged to ensure their customers and members have appropriate information on the risks and technical elements of contracts and trading around upcoming expirations.

In light of these considerations, the Divisions remind DCMs, FCMs, and DCOs of their obligations to assess changing market conditions and take appropriate measures in response as contracts approach expiration. Given current market conditions, DCMs, FCMs and DCOs are encouraged to regularly assess whether their risk controls and related mechanisms are reasonably designed, fit for purpose, and appropriately implemented.

We are issuing this advisory in the wake of unusually high volatility and negative pricing experienced in the May 2020 physically-delivered WTI contract, and related reference contracts, on April 20.

II. DCM Obligations to Prevent Market Disruption, Adopt Position Limits and Protect Market Participants

In periods of market volatility such as those recently experienced, it is critical that DCMs remain mindful of their obligations under the Core Principles established in the Commodity Exchange Act.[2] In particular, we remind DCMs that Core Principle 4[3] requires them to have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures. To this end, with respect to physically-delivered contracts, Commission regulation 38.252[4] requires each DCM, among other things, to: (a) monitor the convergence between the contract price and the price of the underlying commodity; and (b) monitor the supply of the commodity and its adequacy to satisfy the delivery requirements and make a good-faith effort to resolve conditions that threaten the adequacy of supplies or the delivery process.

[1] For the sake of clarity, this Advisory is issued as a prophylactic measure. This Advisory is designed to remind registrants and market participants that continued assessment, preparation and planning is warranted in times of market volatility occasioned by COVID 19. This Advisory does not suggest any element of compliance, or lack thereof, by any registrant. Similarly, this Advisory is not intended to suggest that any particular markets or contracts will experience fundamental or technical issues going forward.

[2] 7 U.S.C. §7(d).

[3] 7 U.S.C. §7(d)(4).

[4] 17 CFR 38.252; *see also* 17 CFR 38, app. B.

With respect to cash-settled contracts, Commission regulation 38.253[5] requires the DCM, among other things, to demonstrate that it monitors the pricing of the index to which the contracts will be settled and also the continued appropriateness of the methodology for deriving the index. Commission regulation 38.255[6] requires that a DCM establish and 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 market conditions prescribed by the DCM. Commission regulation 38.258[7] refers DCMs to the guidance and acceptable practices in Appendix B of Part 38 to demonstrate compliance with the requirements of Core Principle 4.[8]

Furthermore, Core Principle 5[9] requires each DCM to adopt for each contract of the board of trade, as is necessary and appropriate, position limitations or position accountability for speculators in order to reduce the potential threat of market manipulation or congestion—especially for outrights or spread trades involving the delivery month. Additionally, Core Principle 12[10] requires each DCM to establish and enforce rules to, among other things, promote fair and equitable trading on the contract market. In particular, Commission regulation 38.651[11] requires, among other things, that a DCM have and enforce rules that are designed to protect the market and market participants from abusive practices including fraudulent, noncompetitive or unfair actions, committed by any party.

Moreover, DCMs are reminded of their obligations under Core Principle 6[12] to adopt and maintain rules to provide for the exercise of emergency authority, as is necessary and appropriate, including the authority to liquidate or transfer open positions in any contract; to suspend or curtail trading in any contract; and to require market participants in any one contract to meet special margin requirements. A DCM that adopts a rule or rule amendment in response to an emergency must file such rule or amendment with the Commission prior to implementation or, if not practicable, at the earliest possi-

[5] 17 CFR 38.253.

[6] 17 CFR 38.255.

[7] 17 CFR 38.258.

[8] As to Core Principle 4, Appendix B provides that risk controls must be adapted to the unique characteristics of the markets to which they apply and must be designed to avoid disruptions without unduly interfering with that market's price discovery function.

[9] 7 U.S.C. §7(d)(4).

[10] 7 U.S.C. §7(d)(12).

[11] 17 CFR 38.651.

[12] 7 U.S.C. §7(d)(5).

ble time after implementation, but in no event more than twenty-four hours after implementation in accordance with Commission regulation 40.6 (a)(6).[13]

Appendix B's guidance, referenced in Commission regulation 38.351[14] under Core Principle 6, provides that a DCM, "[i]n consultation and cooperation with the Commission ... should have the authority to intervene as necessary to maintain markets with fair and orderly trading and to prevent or address manipulation or disruptive trading practices, whether the need for intervention arises exclusively from the DCM's market or as part of a coordinated, cross-market intervention."[15]

III. Risk Management Program for FCMs

During periods of extreme market volatility, it is imperative that FCMs engage in robust risk management to manage effectively their activities of operating as FCMs and to protect customer funds. DSIO reminds FCMs of their obligations to maintain effective risk management programs. Commission regulation 1.11[16] requires each FCM carrying customer accounts to establish, maintain and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the FCM. Regulation 1.11 further provides an FCM's risk management program must take into account market, credit, foreign currency, liquidity, legal, operational, settlement, segregation, technology, capital, and any other applicable risks to the FCM.

As part of its risk management responsibilities, an FCM must monitor its customer accounts to ensure that the FCM is collecting appropriate levels of initial margin to protect against a customer becoming under-margined or defaulting on its positions. An FCM also must monitor the amount of residual interest that the firm maintains in customer segregated accounts to ensure that it holds sufficient funds in such accounts at all times to meet its total obligation to all customers.

Each FCM that is a clearing member of a derivatives clearing organization (**Clearing FCM**) is required by Commission regulation 1.73[17] to establish risk-based limits in proprietary and customer accounts based on position size, order size, margin requirements, or similar factors. Regulation 1.73 further requires each Clearing FCM to screen orders for compliance with the risk-based limits, and monitor for the adherence to the risk-based limits on an intra-day and overnight basis. Each Clearing FCM also is required to conduct stress tests under "extreme but plausible conditions" at least once each week on positions in its proprietary account and on positions in each customer account that

[13] 17 CFR 40.6(a)(6).

[14] 17 CFR 38.351.

[15] 17 CFR 38, app. B.

[16] 17 CFR 1.11.

[17] 17 CFR 1.73.

could pose material risk to the FCM.[18] Lastly, regulation 1.73 requires each Clearing FCM to evaluate its ability to meet initial and variation margin obligations in cash at least once per week, and to evaluate its ability to liquidate the positions in its proprietary accounts and customer accounts in an orderly manner at least quarterly.

Given the market volatility over the last several months, FCMs should assess the effectiveness of the performance of their risk management programs, including the risk management requirements under regulations 1.11 and 1.73, and make any revisions that are necessary to help ensure that risks are appropriately addressed and customer funds are properly safeguarded.

In light of recent events, DSIO reminds FCMs to be particularly diligent in monitoring and assessing risks. FCMs should prepare for the potential that certain contracts may experience significant price volatility and, possibly, negative pricing. An FCM with proprietary or customer positions in such a futures contract or options on such contract should carefully monitor the contract as it gets closer to the expiration date to ensure that the FCM and its customers can meet their respective financial obligations and fulfill their obligations to make or take delivery on the futures contract.

IV. Risk Disclosures by FCMs

Commission regulation 1.55 generally requires FCMs to provide each customer with the risk disclosure specified in paragraph (b) of such regulation prior to opening a futures trading account for such customer. Paragraph (1) of such risk disclosure states:

> *You may sustain a total loss of the funds that you deposit with your broker to establish or maintain a position in the commodity futures market, and you may incur losses beyond these amounts. If the market moves against your position, you may be called upon by your broker to deposit a substantial amount of additional margin funds, on short notice, in order to maintain your position. If you do not provide the required funds within the time required by your broker, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account.*

DSIO advises each FCM that it may be prudent to re-familiarize customers with this part of the required risk disclosure, especially the warning that customers may incur losses beyond amounts deposited with the FCM and that this may occur in the event of negative contract prices. DSIO believes it may also be prudent to ensure that customers understand the mechanics of contract settlement at negative prices.

[18] 17 CFR 1.73(a)(4).

V. Risk Management Program for DCOs

Commission regulation 39.13 requires a DCO to have the ability to manage the risks associated with discharging its responsibilities through the use of appropriate tools and procedures. In particular, Commission regulation 39.13(g)(2)(ii) requires that a DCO use models that generate initial margin requirements sufficient to cover the DCO's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the DCO estimates that it would be able to liquidate a defaulting clearing member's positions.

A DCO is required by regulation 39.13(g)(7)(i) to conduct back tests on a daily basis with respect to products that are experiencing significant market volatility—especially in contracts that call for the actual delivery of the underlying physical commodity—to test the adequacy of its initial margin requirements. In light of recent events, DCOs should prepare for the potential that certain contracts may experience significant price volatility, and that negative pricing is a possibility.

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Questions regarding this advisory can be directed towards the Division of Swap Dealer and Intermediary Oversight (Josh Beale, Associate Director (202) 418-5446), the Division of Clearing and Risk (Parisa Nouri, Associate Director (202) 418-6620), or the Division of Market Oversight (Nancy Markowitz, Deputy Director (202) 418-5453).

Issued in Washington, D.C. on May 13, 2020, by the Division of Swap Dealer and Intermediary Oversight, the Division of Clearing and Risk, and the Division of Market Oversight.

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