CFTC Staff Advisory
Division of Clearing and Risk
Division of Market Oversight

To: Designated Contract Markets (DCMs) and Derivatives Clearing Organizations (DCOs)

Subject: Exchange Market Volatility Controls

The Division of Market Oversight (DMO) and the Division of Clearing and Risk (DCR) are issuing this advisory to remind DCMs and DCOs of certain Core Principle and regulatory obligations under the Commodity Exchange Act (CEA) and Commodity Futures Trading Commission (Commission) regulations related to controls designed to address market volatility.

I. DCM Volatility Controls

Market volatility controls can play an important role in mitigating market disruptions while ensuring continued price discovery in stressed or volatile market conditions. The CEA and Commission regulations provide a framework for flexible controls in a range of market conditions. Best practices developed by exchanges, industry groups, CFTC advisory committees, and others can further guide the derivatives industry towards effective volatility controls.

DCM Core Principle 4 – Prevention of Market Disruption requires DCMs 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.[1] To implement Core Principle 4, the Commission has adopted certain regulations, including regulation 38.255 which requires each DCM to 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.[2] Commission regulations 38.251(e)-(g) require each DCM to:

(1) Adopt and implement rules governing market participants subject to its jurisdiction to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading;

(2) Subject all electronic orders to exchange-based pre-trade risk controls to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading; and

[1] 7 U.S.C. § 7(d)(4).

[2] 17 CFR 38.255.

(3) Promptly notify Commission staff of any significant market disruptions on its electronic trading platform(s) and provide timely information on the causes and remediation.[3]

The Commission's Acceptable Practices for the implementation of Core Principle 4 calls for risk controls that are "adapted to the unique characteristics of the markets to which they apply and must be designed to avoid market disruptions without unduly interfering with that market's price discovery function."[4] Staff notes the Commission's focus on flexibility, with risk and volatility controls that may be different for different types of markets. The types and calibration of controls used by a DCM may vary according to product, period of the trading day, and other factors at the reasonable discretion of the exchange.

The Commission's Global Markets Advisory Committee (GMAC) has stated:

> In today's rapidly evolving financial landscape, characterized by global uncertainties and unforeseen market events, the efficient management of financial market volatility is paramount.[5]

The GMAC recommended that the Commission use the Futures Industry Association's (FIA) "Best Practices for Exchange Volatility Control Mechanisms" dated September 2023 (FIA Best Practices) as a tool for (1) understanding exchange market risk controls and (2) when engaging with global regulators and international standard setters.[6] As noted in the FIA Best Practices, geopolitical events and their associated news cycles can cause extreme and sudden market volatility.[7]

Accordingly, DMO recommends DCMs consider the FIA Best Practices in maintaining rules, policies, and controls consistent with Core Principle 4. Among other things, the FIA Best Practices addresses volatility control mechanism triggers and volatility control mechanisms in action, such as price bands on orders, daily price limits, and mechanisms to interrupt continuous trading.[8] The FIA Best Practices include certain design recommendations applicable across volatility controls, including transparency to market participants regarding the criteria for triggering controls, how the controls operate, and any changes to volatility controls.

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[3] 17 CFR 38.251. DMO reminds DCMs that notifications pursuant to Commission regulation 38.251(g) may be submitted to: RiskPrinciplesNotifications@CFTC.gov.

[4] *See* 17 CFR 38, app. B.

[5] *See* GMAC Executive Summary Recommendation (Nov. 6, 2023), available at https://www.cftc.gov/media/9736/gmac_FIAExecutiveSummary110623/download.

[6] *See* FIA, Best Practices for Exchange Volatility Control Mechanisms (Sept. 2023), available at https://www.cftc.gov/media/9581/gmac_FIA110623/download.

[7] *See id.* at 3.

[8] *See* FIA Best Practices at 6-11. The FIA Best Practices also address post-trade remediation, such as error trade policies. Commission regulation 38.157 provides requirements on DCMs regarding trade price adjustments and trade cancellations.

By way of example, controls such as price bands or reasonability limits ('fat finger' type controls) subject each order to price validation. Such controls help prevent erroneous orders from entering the market. Controls such as price limits, including hard daily price limits, set a maximum price range permitted for a futures contract in each trading session. Market halts such velocity logic, interval price limits, and dynamic circuit breakers place limits on how much a market can move within a preset time period. DCMs should consider whether similar volatility controls are appropriate for their markets in order to mitigate the impact of short-term volatility without unduly interfering with a market's price discovery function.

Consistent with the Commission's regulations, FIA's Best Practices emphasize the balance between volatility controls and functioning markets with continued price discovery. Volatility controls, including circuit breakers that temporarily pause trading, can help address rare circumstances where traded prices may briefly diverge from fundamentals. Appropriate controls can help balance prevailing market conditions with continued risk mitigation and price discovery in stressed markets. DMO encourages all DCMs to consider the role that volatility controls identified by Commission regulations, the GMAC, FIA, and those used by other DCMs, can play in their markets.

II. DCO Risk Management and Public Information Standards

In addition to the potential effects of volatility controls on trading activity and the potential mitigation of trading disruptions, volatility controls may affect the risk management practices of DCOs. These effects may be partially dependent on the form of volatility controls used by an associated exchange, with short-term mechanisms less likely to have direct consequences for standard DCO activities like daily variation settlement and the recalibration of initial margin levels (which in certain cases may be differentiated by participant group). As part of these daily activities, DCOs normally rely on traded prices as an accurate representation of the supply and demand forces of the relevant market.

In cases where volatility controls may be in effect at times critical to DCO decisions, such as the settlement period, the last traded price may or may not reflect the economic reality in the relevant market. In making their decisions in such cases at such times, DCOs should exercise careful discretion and informed judgment in identifying a settlement price that is reasonable in light of the economic factors relevant to the underlying market.[9]

DCOs may have rules[10] that allow them to determine that the settlement price derived by normal methods is not an accurate representation of the relevant market, and instead use a different

[9] *See, e.g.*, 17 CFR 39.13(e)(1) (A DCO shall "measure its credit exposure to each clearing member and mark to market such clearing member's open house and customer positions at least once each business day.")

[10] For example, Reg 39.13(g)(5) states that "A [DCO] shall have a reliable source of timely price data in order to measure the [DCO]'s credit exposure accurately."

method to set the settlement price. *See, e.g.*, CME Rule 813(6)[11], (9)[12], (11).[13] Such rules provide DCOs with an important tool to manage risk in volatile markets.

Events of this type have happened in the past, such as cases where markets were subject to daily price limits; in some notable events of this type, DCOs have used related market information to help ensure settlement prices were assigned in an informed and justifiable way.[14]

DCOs, in providing transparency with respect to the functioning of volatility controls, should make such possibilities clear to both clearing members and end-users so that their participants are prepared to meet their obligations promptly.[15]

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This Advisory is intended to remind the affected parties of their obligations under the CEA and Commission regulations. It is not intended to create any enforceable rights, any new binding rules or regulations, or to amend existing rules or regulations. This Advisory represents only the views of DMO and DCR and does not necessarily represent the views of the Commission or of any other division or office of the Commission.

Any questions regarding this advisory should be directed to DMO Acting Director Rahul Varma at 202-418-5353 and DCR Acting Director Richard Haynes at 202-418-5063.

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[11] "In the event the Exchange determines that the settlement price derived by one of the methods set forth above is not an accurate representation of the relevant market, the Exchange may determine the settlement price based on other market prices, including settlement prices for similar contracts trading on other exchanges."

[12] "Notwithstanding the above, if a settlement price in any product, as derived by the normal methodology used for that product, is inconsistent with trades, bids or offers in other months/strikes during the settlement period, or other relevant market information, or if there is no relevant market activity, an Exchange official may establish a settlement price that best reflects the true market valuation at the settlement time or during the defined settlement period."

[13] "Notwithstanding the above, in the case of inaccuracy or unavailability of a settlement price, or if a settlement price creates risk management concerns for the Clearing House, the Clearing House reserves the right to calculate settlement variation using an alternate price determined by the Clearing House."

[14] *See* STAFF REPORT ON COTTON FUTURES AND OPTION MARKET ACTIVITY DURING THE WEEK OF MARCH 3, 2008 (CFTC January 4, 2010) at 2-3 & n.6: "Because option prices were not subject to price limits, when the option price exceeded the limit up futures contract price, the use of option prices in the mark-to-market calculation process resulted in larger margin calls to market participants with short positions than if the mark-to-market calculation process had used the limit up futures price. Footnote: For instance, the difference between the March 3rd futures contract limit up price of 84.86¢ per pound and the option price of 93.90¢ per pound that was used to calculate the mark-to-market was 9.04¢ per pound. Using the option price in lieu of the futures price to calculate the mark-to-market resulted in additional margin on March 3rd of $4,520 per contract."

[15] *See* 17 CFR 39.21. *See also* FIA Best Practices at 5 ("Information on [volatility controls], including … how they operate in practice, should be publicly available and replicable.")