MEMO# 33002

December 21, 2020

CFTC Adopts Final Rules on Electronic Trading Risk Principles for DCMs

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December 21, 2020 TO: ICI Members
Derivatives Markets Advisory Committee SUBJECTS: Derivatives
Investment Advisers
Trading and Markets RE: CFTC Adopts Final Rules on Electronic Trading Risk Principles for DCMs

The Commodity Futures Trading Commission ("Commission") recently adopted final rules ("Final Rules") amending its Part 38 regulations to address the potential risks of a designated contract market's (DCM) trading platform experiencing a market disruption or system anomaly due to electronic trading.[1] The Final Rules, which are summarized below, also include acceptable practices ("Acceptable Practices"), which provide that a DCM can comply with the electronic trading risk principles by adopting and implementing rules and risk controls reasonably designed to prevent, detect, and mitigate market disruptions and system anomalies associated with electronic trading. DCMs must be in compliance with the Final Rules within 180 calendar days after the rules are published in the *Federal Register*.

The Final Rules are substantially similar to the proposed rules[2] with one minor change, highlighted below. The Final Rules include three risk principles that will apply to DCMs, along with the Acceptable Practices, which were adopted as proposed. The Commission acknowledged that DCMs "are addressing most, if not all, of the electronic trading risks currently presented to their trading platforms" and that the risk principles therefore may not require DCMs to take additional measures.

As proposed, the Commission adopted a principles-based approach to electronic trading requirements to "provide[ ] DCMs with flexibility to adapt and evolve with changing technologies and markets." While the Commission declined to define key terms in the Final Rules, it clarified in the Adopting Release that the term "electronic trading" includes block and "exchange for related position" (EFRP) transactions if those transactions are submitted electronically to the DCM's trading platform.[3]

Risk Principle 1, Regulation 38.251(e), provides that a DCM must 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. Risk Principle 2, Regulation 38.251(f), provides that a DCM must 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. The Commission clarified in the Adopting Release that, for purposes of Risk Principles 1 and 2, a “market disruption” encompasses only disruptions that “materially impact the proper functioning of a DCM’s trading platform.” Thus, the term would not include “disruptions that have only a de minimis effect on a DCM’s trading platforms or the ability of other market participants to trade, engage in price discovery, or manage risk.”

Risk Principle 3, Regulation 38.251(g), provides that a DCM must promptly notify the Commission staff of any significant market disruptions to its electronic trading platform(s) and provide timely information on the causes and remediation. In response to comments, the Commission added “market” to the rule text to clarify the nature of the disruptions that a DCM must report, explaining that “significant market disruptions” are a subset of the market disruptions covered by Risk Principles 1 and 2.

The Commission stated that it will oversee and enforce the risk principles “in accordance with an objective reasonableness standard.” It explained that, while a DCM has discretion to determine what rules and risk controls are appropriate, the Commission will determine whether those measures are objectively reasonable “in light of the DCM’s products, volume, market participants and other factors, and how similarly positioned DCMs address similar risks.”

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endnotes

[1] The voting draft of the adopting release is *available at* https://www.cftc.gov/media/5416/votingdraft120820ETRP/download (“Adopting Release”). The final rules were adopted pursuant to a 4-1 vote, with Commissioner Behnam dissenting. *See Dissenting Statement of Commissioner Rostin Behnam Regarding Electronic Trading Risk Principles* (Dec. 8, 2020), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement120820.

[2] On June 25, 2020, the CFTC voted to formally withdraw its outstanding proposals on Regulation Automated Trading (“Reg AT”) and issued, in their place, the proposed electronic trading risk principles for DCMs. For a summary of the proposed rules, *please see* ICI Memorandum No. 32577 (July 2, 2020), *available at* https://www.ici.org/my_ici/memorandum/memo32577.

[3] The Commission noted that “DCMs should have reasonable discretion to decide what rules and controls—if any—should be applied to off-exchange transactions such as block trades and EFRPs under Risk Principles 1 and 2.”
