Public Statements & Remarks

Statement of Commissioner Dan M. Berkovitz Regarding Risk Principles for Electronic Trading

December 08, 2020

I support today's final rule on Electronic Trading Risk Principles (Final Rule). The Final Rule addresses market disruptions associated with electronic trading through limited requirements applicable directly to designated contract markets (DCMs) and indirectly to DCM market participants. It is an incremental step that can enhance the safety and soundness of electronic trading on U.S. exchanges. I look forward to the continuing evolution of trading in our markets, and to the Commission's steady engagement with the technology and risk controls of modern trading to determine whether more may be needed in the future.

I am able to support the Final Rule because it recognizes the role of both DCMs and market participants in preventing and mitigating market disruptions, as well as the ultimate responsibility and authority of the Commission to oversee the actions of our market infrastructures and market participants. The Final Rule codifies three "Risk Principles," including new requirements in Risk Principle 1 that DCMs implement rules governing their market participants to prevent, detect, and mitigate market disruptions and system anomalies.[1] This provision, codified in Commission regulation 38.251(e), speaks directly to new risk-reducing practices and may be the most helpful of the three Risk Principles.

Market participants originate, place, and manage orders on DCMs though an array of systems that vary in sophistication and automation. Experience teaches that errors in the design, testing, implementation, operation, or supervision of such systems by a single market participant can lead to cascading effects that disrupt an entire market and the ability of all market participants to engage in price discovery and risk mitigation. Accordingly, it is crucial that market participants, DCMs, and the Commission implement and enforce the Risk Principles in meaningful ways going forward.[2]

The Commission's efforts in this regard may be aided by Risk Principle 3, which requires DCMs to "promptly notify Commission staff of any significant market disruptions" and "provide timely information on the causes and remediation."[3] I support Commission efforts to remain up-to-date as technologies evolve, new potential sources of market disruptions arise, and best practices for safeguarding markets are developed. Information provided to the Commission through Risk Principle 3 will strengthen the Commission's daily oversight of DCMs, and help educate the Commission and its staff as to the most effective risk-reducing measures.

I am also able to support the Final Rule because it recognizes and preserves the Commission's authority to interpret and enforce the standards in the Risk Principles, and because it clarifies that Risk Principles 1 and 2 are intended to address any type of market disruption arising from market participants or electronic orders that materially affects electronic trading. I thank the Chairman for working with my office to achieve these enhancements to the Final Rule.

The Final Rule includes Acceptable Practices in Appendix B to part 38 providing that a DCM can comply with Risk Principles 1 and 2 through rules and pre-trade risk controls that are "reasonably designed" to prevent, detect, and mitigate market disruptions and system anomalies. While legitimate concerns have been raised that these terms could lend themselves to excessive disputes over interpretation, the Final Rule makes clear that they are subject to an objective standard and Commission oversight. It notes specifically that "[t]he Commission will oversee and enforce the Risk Principles in accordance with an objective reasonableness standard[,]" and that the Risk Principles are "enforceable regulations."[4] I am pleased that the Final Rule clearly articulates the seriousness with which the Commission will monitor and enforce the Risk Principles.

The Final Rule also makes clear that while Risk Principle 3 addresses "significant" market disruptions, Risk Principles 1 and 2 include the broader set of "material" disruptions. As stated in the Final Rule, "the standard for a significant market disruption under Risk Principle 3 is higher than the standard for a market disruption under Risk Principles 1 and 2." Markets and market participants will benefit from the Commission's decision to resolve this potential ambiguity in the proposed rule and to implement a rigorous standard for Risk Principles 1 and 2.

Today's Final Rule addresses an issue that has remained open in the Commission's books for far too long. Electronic trading is no longer a new technology in Commission-regulated markets, and it has not been new for many years. The Risk Principles are a circumscribed but important first step in ensuring that the Commission's rules keep pace with technological changes underlying derivatives trading. The Commission must now proceed to full, effective implementation of the Risk Principles and to oversight of DCMs' own implementations. I support these efforts, combined with continued vigilance to determine whether additional steps may be needed in the future.

In the preamble to the Final Rule, the Commission stresses the potential benefits of the principles-based approach embodied in the Risk Principles. My support for the principles-based approach in this particular rulemaking, however, should not be interpreted as an endorsement of such a broad principles-based approach in other circumstances, or foreclose my support for more prescriptive measures should they become necessary with respect to risk controls. Although the markets overseen by the Commission have benefitted from the flexibility of a principles-based approach in a number of areas, in other circumstances a more prescriptive approach has provided the market with needed clarity and certainty. The appropriate choice or balance between prescriptive regulations and principles-based regulations will depend upon the circumstances being addressed by those regulations.

Whether this rulemaking will fully accomplish its objectives will depend to a large extent upon the diligence and commitment to its implementation by DCMs and market participants. If DCMs and market participants comprehensively adopt and maintain industry best practices to prevent, detect, and mitigate market disruptions and system anomalies, as well as develop and implement measures to address emerging issues as they arise, then further prescriptive action by the Commission may not be necessary.

I thank the staff of the Division of Market Oversight for their work to address a number of my concerns with the Final Rule, as well as their overall work on the Final Rule.

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[1] In addition, Risk Principle 2 requires DCMs to 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. Risk Principle 2 overlaps with existing Commission regulations, including § 38.255, which requires DCMs to "establish and maintain risk control mechanisms to prevent and reduce the potential risk of price distortions and market disruptions." DCMs should help drive an effective implementation of Risk Principle 2 by carefully examining their existing pre-trade risk controls and ensuring that such controls are fit for the types of market participants, technologies, and trading practices prevalent on their markets.

[2] I appreciate the concerns raised by some commenters that the Risk Principles may be imprecise, difficult to enforce, or provide too much deference to DCMs. As discussed below, the Final Rule helps mitigate some of these concerns by emphasizing that the Risk Principles are an objective standard and enforceable rules subject to Commission oversight. The Commission will be able to monitor DCMs' compliance with the Risk Principles through its DCM rule enforcement review program, as well as other oversight activities including review of new rule certifications, review of market disruption notifications received pursuant to Risk Principle 3, market surveillance, and other oversight tools.

[3] Risk Principle 3 is codified in new Commission regulation 38.251(g).

[4] As I articulated in my statement when the Risk Principles were first proposed, the Dodd-Frank Act amended the Commodity Exchange Act to make clear that a DCM's discretion with respect to core principle compliance is circumscribed by any rule or regulation that the Commission might adopt pursuant to a core principle. In today's Final Rule, the Commission is requiring DCMs to adopt and implement rules and pre-trade risk controls that are "reasonably designed to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading.

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