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When Exchanges Change the Rules of the Game

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"You can't change the rules in the middle of the game" is one of the cardinal rules of the US futures and options markets. For contract months with open interest, the Commodity Exchange Act prohibits changes to quality or quantity requirements of the underlying commodity, delivery procedures, or anything else that "materially changes the terms and conditions" and therefore might affect the pricing or valuation of the contract. Such changes can be made only by submitting them to the CFTC beforehand, and implementing them only after receiving CFTC approval. Obtaining this CFTC approval can be a cumbersome and time-consuming process, and as a result most contract changes are applied to newly-listed months in which there is not yet any open interest.

Last week's [announcement](#) of changes to the final settlement process for the October 2013 Lean Hog contract caught many by surprise. The Lean Hog contract is cash settled to the CME Lean Hog Index, which is calculated using USDA prices; complete details are available [here](#). Due to the federal government shutdown, these USDA prices were not available for calculation of the index on certain key dates, so a weighted average of futures prices was used to calculate the final settlement price for the October 2013 contract.

The Commodity Exchange Act authorizes exchanges to act in emergency situations, and to take whatever action is necessary to address the emergency. The CME announcement cites CME Rule 701 in explaining the change for the October Lean Hog settlement:

701. DECLARATIONS OF FORCE MAJEURE

If a determination is made by the Chief Executive Officer, President or Chief Operating Officer, or their delegate, that delivery or final settlement of any contract cannot be completed as a result of Force Majeure, he shall take such action as he deems necessary under the circumstances, and his decision shall be binding upon all parties to the contract. The Exchange shall notify the CFTC of the implementation, modification or termination of any action taken pursuant to this Rule as soon as possible after taking the action.

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It shall be the duty of clearing members, members and regular facilities to notify the Exchange of any circumstances that may give rise to a declaration of Force Majeure.

Nothing in this Rule shall in any way limit the authority of the Board of Directors to act in a Force Majeure situation pursuant to Rule 230.k.

CME Rule 230.k. contains similar language and authorizes the Board of Directors to act in an emergency. It also provides additional insight into what constitutes an “emergency” and what types of actions might be taken to resolve it:

230. GENERAL

The Board shall, subject to applicable provisions in the relevant corporate charter and bylaws:

...

k. Have power to act in emergencies. In the event that the Board or a hearing panel of the Board determines that an emergency situation exists in which the free and orderly market in a commodity is likely to be disrupted, or the financial integrity of the Exchange is threatened, or the normal functioning of the Exchange has been or is likely to be disrupted, it may, upon a majority vote of the members present or upon a majority vote of the members who respond to a poll, take such action as may in the Board’s sole discretion appear necessary to prevent, correct or alleviate the emergency condition. Board members who abstain from voting on a Significant Action as defined in Rule 234 shall not be counted in determining whether such action was approved by a majority vote, but such members can be counted for the purpose of determining whether a quorum exists. Without limiting the foregoing, the Board may: (1) suspend, curtail or terminate trading in any or all contracts, (2) limit trading to liquidation of contracts only, (3) order liquidation or transfer of all or a portion of a member’s proprietary and/or customers’ accounts, (4) order liquidation of positions of which the holder is unable or unwilling to make or take delivery, (5) confine trading to a specific price range, (6) modify the trading days or hours, (7) alter conditions of delivery, (8) fix the settlement price at which contracts are to be liquidated, and (9) require additional performance bonds to be deposited with the Clearing House. All Exchange contracts shall be subject to the Board’s emergency powers and the specifications of each shall be deemed subject to this rule.

Any authority or discretion by these rules vested in the Chairman, Chief Executive Officer, President or other officer or delegated to any committee shall not be construed to deprive the Board of such authority or discretion and in the event of a conflict, the determination of the matter by the Board shall prevail.

Notice that “(7) alter conditions of delivery” and “(8) fix the settlement price at which contracts are to be liquidated” are included in the list of possible actions. The CME’s notification to the CFTC can be found [here](#).

Such action is taken only in true emergency situations, and occurs only rarely. Before this, the most recent previous emergency in the livestock contracts was in December 2003, in connection with the BSE (mad cow) discovery. In that case, the December 2003 Live Cattle futures contract was just a few days away from expiration, and the collapse in cash prices caused futures prices to lock limit-down. Daily price limits were expanded so that futures prices could resume trading and allow traders to liquidate their positions before trading ended.

All US exchanges have similar emergency provisions in their rulebooks, and likewise apply them very sparingly. Except in extreme situations when there is a serious breakdown, the collective wisdom of the marketplace can be relied upon to provide the fairest and most representative prices.