SIG
SUSQUEHANNA INTERNATIONAL GROUP, LLP
401 CITY AVENUE, SUITE 220, BALA CYNWYD, PA 19004-1188, 610.617.2600, WWW.SIG.COM
AMSTERDAM BALA CYNWYD CHICAGO DUBLIN NEW YORK PHILADELPHIA SAN FRANCISCO SYDNEY

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OFC. OF THE SECRETARIAT

October 17, 2001

COMMENT

Mr. Jonathan Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Ms. Jean Webb, Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

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RE: File No. S7-15-01
Cash Settlement and Regulatory Halt
Requirements for Security Futures Products

Dear Mr. Katz and Ms. Webb:

I am writing this letter on behalf of Susquehanna International Group, LLP and its affiliates ("SIG")[1] to comment on proposed rules ("Proposal") issued by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") regarding cash settlement and regulatory halt requirements for security futures products. SIG is concerned that the portion of the Proposal pertaining to the final settlement price for security futures products during a halt in the underlying securities could result in substantial financial losses for market participants and in unnecessary systemic risk. We have a similar concern regarding certain aspects of current cash-settlement procedures for stock index futures and options. As we discuss below, the Proposal should be amended to require that, if the opening price for a security underlying a cash-settled security future is not readily available on an Expiration Friday, then the final settlement price of the future should use the next available opening price for the underlying security. In addition, SIG believes that the SEC and CFTC should mandate to the futures and options exchanges that if some of the component stocks of an index

[1] The Susquehanna Organization of U.S. broker-dealers include: options market maker/specialists (Susquehanna Investment Group and Susquehanna Securities); NYSE specialists and brokers (Susquehanna Specialists, Inc.and Susquehanna Brokerage, LP.); NASDAQ and OTC traders and brokers (Susquehanna Capital Group); institutional trading/sales (Susquehanna Financial Group, Inc.); and bond traders (Susquehanna Fixed Income, LP).

future or option do not trade on an Expiration Friday, then the final settlement price for the future or option should use the next available opening price for these securities.

The Proposal would require exchanges to adopt rules providing that, if an opening price is not readily available for an underlying security or constituent security of an underlying index, the final settlement price of the security futures product must fairly reflect the price of the security or securities during the most recent regular trading session.[2] The Commission believes that, if the opening price for the underlying security is not readily available, a price derived from the most recent regular trading session of that security would be an appropriate substitute. Thus, if the New York Stock Exchange ("NYSE") were closed for the entire day on an Expiration Friday, a cash-settled security future would be settled using prices from the close on the previous trading day.

SIG has substantial concern with the Proposal's requirement that security futures settlement use the prior day's closing prices when the market for the underlying securities does not open on an Expiration Friday. We presume that, with the introduction of security futures, market participants will acquire arbitrage or hedged positions involving these products and the underlying stocks or index options or futures. The use of a "look-back" settlement procedure for security futures when the prices from the primary markets for the underlying securities are unavailable on Expiration Friday would disrupt these hedged positions in an unfair and disorderly manner. The losses resulting from this artificial de-linking of hedged positions could also create havoc as market participants frantically tried to reduce their suddenly unhedged exposure. The risk to liquidity providers and clearing firms could be immense.[3]

The potential for huge losses and the resultant systemic stress resulting therefrom is not merely theoretical. The recent market shutdown during the week of September 10, 2001, demonstrates the harm that could arise from the agencies' Proposal. As stated in the OCC comment letter on S7-15-01,[4]

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2 Proposed SEC Rule 6h-1(b) and CFTC Rule 41.25(b)(1).

3 The same phenomenon could occur with a hedged position involving a narrow-based stock index option and a cash-settled security index future. For example, under the Proposal a firm that is hedging a stock index option with a cash-settled security future overlying the same index would have the option settle based on the opening prices on the next trading day and the future settle based on the closing prices from the previous trading day. The firm could be exposed to huge losses from this scenario.

4 Letter dated October 8, 2001, from William H. Navin, OCC, to Jonathan G. Katz, Secretary, SEC, and Jean Webb, Office of the Secretary, CFC, regarding S7-15-01.

> If Friday, September 14th, had been an Expiration Friday, the Commissions' proposal would have required maturing security futures to be settled based on a price derived from the regular trading session on September 10th. Traders holding short security futures positions on September 10th who thought they were hedged by owning the underlying stock would have had no opportunity to liquidate their stock position in a U.S. market before September 17th, when the prices of most stocks were dramatically lower than the closing price on September 10th. Yet the final settlement price of their security futures contracts would have been based on the higher September 10th prices, resulting in a final variation settlement on the futures contracts that would fall far short of the amount needed to compensate the holder of the short futures position for the loss in the value of the stock hedge. Such an investor would have suffered potentially heavy losses on positions that were intended to be fully hedged.

A similar potential for systemic risk from disjointed settlements exists today with stock index futures and stock index options in certain situations. The rules of the futures and options exchanges use a "look forward" settlement procedure when the primary market for the stocks underlying an index future or option does not open on an Expiration Friday, but a "look back" procedure when only some of the component stocks do not open on an Expiration Friday.[5] In other words, if the primary market for a component stock in an index does not open on an Expiration Friday, the CME and options exchanges will use for settlement purposes the opening price of that stock on the next day the primary market is open for trading.[6] If, however, the primary market for a component stock is open on Expiration Friday but the stock does not trade that day, the CME and options exchanges will use the last sale price of the stock for settlement purposes.

The use of a look back settlement in the event of a partial opening of the primary market for component stocks used to hedge expiring derivatives currently presents tremendous exposure to market participants holding stock index futures or options arbitrage or hedged positions. In notional terms, there are hundreds of billions of dollars in positions

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5 *See* CME Rule 4003.A and CBOE Rules 24.7(e) and 24.9(a)(4).

6 CBOE rules use the next available opening prices, except if the current index value at expiration is fixed in accordance with the rules and by-laws of The Options Clearing Corporation.

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involving cash settled index options, stock index futures, and stocks that are held going into Expiration Friday. Most of the positions are hedged or arbitrage positions where the market participants expect to unwind the positions simultaneously at stock prices that have equal value in relation to derivative settlement prices. As explained above, this equal value is achieved when the stock prices used to calculate the index settlement are the same prices that the derivatives trader receives when unwinding the stock side to the position. When one or more component stock prices are set under different market conditions in volatile circumstances and the stock hedges cannot be unwound at those prices, the settlements become disjointed and systemic financial exposure occurs.

Again, the potential for huge losses from this scenario is not merely theoretical. If Friday, September 14, 2001, had been an Expiration Friday, and the stock markets had attempted to reopen that day, it is possible that the NYSE or Nasdaq may have been able to open only some of their stocks before halting for the remainder of the day. If that had occurred, market participants would have had their S&P 500 futures based on the September 10 prices for the stocks that did not open on September 14. Imagine a scenario where 100 average S&P 500 stocks fail to open on the primary on Expiration Friday while the stock market experiences a broad 10% downturn from the day before. To calculate settlements by using the previous day's close for those 100 stocks could result in losses measured in the billions of dollars among derivative traders who did not have the chance to unwind those stocks at those closing prices.

SIG recommends that all cash settled futures and options based on securities use the next day's opening prices in the underlying securities as the basis for cash settlement when the underlying securities do not open for trading on the last day of trading before expiration. In the event that some, but not all, of the securities underlying a cash settled option or future do not open on Expiration Friday, then the cash-settlement price should use the actual prices on Expiration Friday for the stocks that open on that day and the opening prices on the following trading day for the stocks that do not open on Expiration Friday. It makes sense to use the actual prices on Expiration Friday for stocks that open that day because market participants will have had the opportunity to unwind their positions in those stocks on the opening trade.[7] Market participants will not have had that opportunity for stocks that did not trade on Expiration Friday.

We recognize that there might be some situations where, due to the *de minimis* number of stocks in an index that failed to open on an Expiration Friday, the clearinghouse might determine that it would be proper to use the most recent closing price of those securities

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7 The settlement calculations for all cash-settled derivatives that settle based on closing prices should be treated in the same manner as proposed herein for opening-print products.

in calculating the index settlement value. For example, if two of the stocks in the S&P 500 index comprising 0.25% of the weight of the index did not open for trading on Expiration Friday, then CME might determine to use the prior day's closing price for those stocks in calculating the final settlement value for the S&P 500 index futures in order to establish a final closing value before the subsequent weekend. We recommend that the clearinghouse retain that flexibility if stocks comprising two percent or less of the weighting of an index do not open for trading on Expiration Friday.

Aside from the *de minimis* situation, SIG believes it would be preferable for the look forward procedures to be fixed in the exchange and clearinghouse rules. Market participants need to know during a market disruption precisely how a cash-settled derivative will be priced. We cannot afford to be in the position on an Expiration Friday when some or all of the NYSE or Nasdaq stocks have not opened and we do not know whether our cash-settled futures and options positions will be based on Thursday's closing prices or Monday's opening prices. Similarly, it is crucial that the rules of the futures and options markets be consistent and firm on this issue. We can not afford the risk when some stocks do not open on Expiration Friday that the cash settlement pricing of futures and options on the same underlying securities will not match.

Consequently, we urge the agencies to do the following:

- First, the agencies should amend the cash settlement procedure rules for security futures to require security futures markets to use the next day's opening prices for securities underlying a security future when those underlying securities do not open for trading on the primary market on the last trading day before expiration; and
- Second, the agencies should begin a dialog with the options and futures exchanges and clearinghouses regarding the need to change settlement rules for all cash-settled stock index options and futures to use look-forward procedures when component stocks do not trade on an Expiration Friday (regardless of whether the primary market for the stocks is open that day or not).

Moreover, as noted above, the cash-settlement rules should be consistent across markets and non-discretionary. The ability to use look-forward settlement procedures for security futures and other equity index options and futures would reduce the potential for huge losses to market participants from artificial mismatches of hedged positions and reduce systemic stress in the equities markets.

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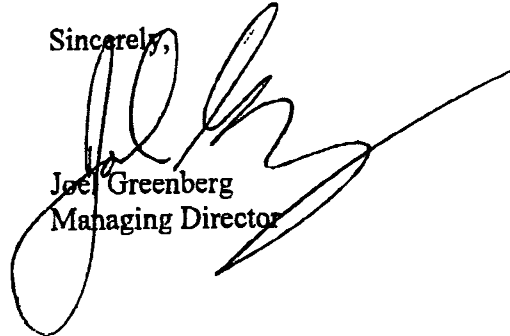
I would be happy to discuss this matter further with the staffs of the two agencies.

Sincerely,



Joel Greenberg
Managing Director

cc: Elizabeth King, SEC
Alton Harvey, SEC
Richard Shilts, CFTC
Tom Leahy, CFTC