

**COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Part 41**

**RIN 3038-AB86**

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 240**

**[Release No. 34-44743; File No. S7-15-01]**

**RIN 3235-AI24**

**Cash Settlement and Regulatory Halt Requirements for Security Futures Products**

**AGENCIES:** Commodity Futures Trading Commission and Securities and Exchange Commission

**ACTION:** Joint Proposed Rule

**SUMMARY** The Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively "Commissions") are proposing new rules under the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") generally to provide that the listing standards of national securities exchanges and national securities associations trading security futures products establish a final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and a halt in trading in any security futures product when a regulatory halt is instituted by the national securities exchange or national securities association listing the security or securities underlying the security futures product. The rules proposed today would set forth more specifically how the exchange's or association's rules can satisfy the statutory provisions of the Commodity Futures Modernization Act of 2000 ("CFMA").

**DATES:** Comments must be received on or before [insert date that is 30 days after date of publication in the Federal Register].

**ADDRESSES:** Comments should be sent to both agencies at the addresses listed below.

**CFTC:** Comments should be sent to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21<sup>st</sup> Street, NW, Washington, DC 20581, Attention: Office of the Secretariat. Comments may be sent by facsimile transmission to (202) 418-5521, or by e-mail to [secretary@cftc.gov](mailto:secretary@cftc.gov). Reference should be made to "Cash Settlement and Regulatory Halt Requirements for Security Futures Products."

**SEC:** All comments concerning the rule proposal should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-15-01; this file number should be included on the subject line if e-mail is used. Comment letters will be available for public inspection and copying in the SEC's public reference room at the same address. Electronically submitted comment letters will be posted on the SEC's Internet web site (<http://www.sec.gov>). The SEC does not edit personal identifying information, such as names or e-mail addresses, from electronic submissions. Submit only the information you wish to make publicly available.

**FOR FURTHER INFORMATION CONTACT:**

**CFTC:** Richard A. Shilts, Acting Director, at (202) 418-5275; and Thomas M. Leahy, Jr., Financial Instruments Unit Chief, at (202) 418-5278, Commodity Futures

Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. E-mail: (RShilts@cftc.gov) or (TLeahy@cftc.gov).

**SEC:** Alton Harvey, Office Head, at (202) 942-4167; Terri Evans, Special Counsel, at (202) 942-4162; Michael Gaw, Special Counsel, at (202) 942-0158; and Cyndi Nguyen, Attorney, at (202) 942-4163, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-1001.

**SUPPLEMENTARY INFORMATION:**

The Commissions today are requesting public comment on proposed Rule 41.1,<sup>1</sup> 41.25(a)(2),<sup>2</sup> and 41.25(b)<sup>3</sup> under the CEA and proposed Rule 6h-1 under the Exchange Act,<sup>4</sup> that generally provide that the listing standards of national securities exchanges and national securities associations trading security futures products establish (i) a final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and (ii) a halt in trading in any security futures product when a regulatory halt is instituted by the national securities exchange or national securities association listing the security or securities underlying the security futures product.

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<sup>1</sup> Proposed 17 CFR 41.1, hereinafter referred to as proposed CFTC Rule 41.1.

<sup>2</sup> Proposed 17 CFR 41.25(a)(2), hereinafter referred to as proposed CFTC Rule 41.25(a)(2).

<sup>3</sup> Proposed 17 CFR 41.25(b), hereinafter referred to as proposed CFTC Rule 41.25(b).

<sup>4</sup> Proposed 17 CFR 240.6h-1, hereinafter referred to as proposed SEC Rule 6h-1.

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**I. Executive Summary**

The CFMA<sup>5</sup> authorizes the trading of futures on individual stocks and narrow-based security indexes, and puts, calls, straddles, options, or privileges thereon (collectively, "security futures products").<sup>6</sup> The CFMA defines security futures products as "securities" under the Exchange Act,<sup>7</sup> the Securities Act of 1933,<sup>8</sup> the Investment

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<sup>5</sup> Pub. L. No. 106-554, Appendix E, 114 Stat. 2763.

<sup>6</sup> However, no person may offer to enter into, enter into, or confirm the execution of any option on a security future for at least three years after the enactment of the CFMA. See Section 2(a)(1)(D)(iii) of the CEA, 7 U.S.C. 2(a)(1)(D)(iii); Section 6(h)(6) of the Exchange Act, 15 U.S.C. 78f(h)(6).

<sup>7</sup> See Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10).

<sup>8</sup> See Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b(a)(1).

Company Act of 1940,<sup>9</sup> and the Investment Advisers Act of 1940,<sup>10</sup> and as contracts of sale for future delivery of a single security or of a narrow-based security index or options thereon under the CEA.<sup>11</sup> Accordingly, the regulatory framework established by the CFMA for the markets and intermediaries trading security futures products provides the SEC and the CFTC with joint jurisdiction.

Under the Exchange Act, it is unlawful for any person to effect transactions in security futures products that are not listed on a national securities exchange<sup>12</sup> or on a national securities association registered pursuant to Section 15A(a) of the Exchange

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<sup>9</sup> See Section 2(a)(36) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(36).

<sup>10</sup> See Section 202(a)(18) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a)(18).

<sup>11</sup> See Section 1a(31) of the CEA, 7 U.S.C. 1a(31).

<sup>12</sup> Section 6(g) of the Exchange Act, 15 U.S.C. 78f(g), allows a designated contract market under Section 5 of the CEA, 7 U.S.C. 7, or a registered derivatives transaction execution facility under Section 5a of the CEA, 7 U.S.C. 7a, to register as a national securities exchange solely for the purpose of trading security futures products (“Security Futures Product Exchange”). See Securities Exchange Act Release No. 44692 (August 13, 2001), 66 FR 43721 (August 20, 2001) (adopting, in part, requirements for designated contract markets and registered derivatives transaction execution facilities to register as national securities exchanges). By definition, the phrase “national securities exchange” encompasses these notice-registered entities. For simplicity, this rulemaking will refer to national securities exchanges and national securities associations. But it should be noted that the CFTC’s rules govern designated contract markets and registered derivatives transaction execution facilities, and therefore, the rule proposed today by the CFTC contains language that differs from the rest of this proposed rulemaking.

Act.<sup>13</sup> In addition, Section 6(h)(2) of the Exchange Act<sup>14</sup> provides that such an exchange or association may trade only those security futures products that conform with listing standards filed by the exchange or association with the SEC under Section 19(b) of the Exchange Act<sup>15</sup> and that meet certain criteria specified in Section 2(a)(1)(D)(i) of the CEA<sup>16</sup> and the standards and conditions enumerated in Section 6(h)(3) of the Exchange Act.<sup>17</sup> In particular, the CEA and the Exchange Act stipulate that the listing standards of an exchange or association trading security futures products shall, among other things, require that trading in the security futures product not be readily susceptible to manipulation of the price of such security futures product, nor to causing or being used in the manipulation of the price of any underlying security or option thereon.<sup>18</sup> In addition, listing standards must require that the market on which the security futures product trades

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<sup>13</sup> 15 U.S.C. 78o-3(a). See Section 6(h)(1) of the Exchange Act, 15 U.S.C. 78f(h)(1). It should be noted that in an earlier release, the SEC stated its belief that Section 6(h)(1) is designed to ensure that a regulated national securities exchange or national securities association establish terms for security futures products and standards for the selection of underlying securities, consistent with the Exchange Act's listing standard requirements. See Securities Exchange Act Release No. 44434 (June 15, 2001), 66 FR 33283 (June 21, 2001) (order approving the Options Clearing Corporation's ("OCC") proposed rule change allowing it to clear transactions in security futures products effected on any national securities exchange or association registered under Section 6(a) or 15A(a) of the Exchange Act or any designated contract market that is registered as a national securities exchange under Section 6(g) of the Exchange Act). Further, the SEC stated its belief that, as long as the security futures products satisfy these requirements and the coordinated surveillance and trading halt protections in Section 6(h)(5), they need not be cleared by OCC or any other specific clearing organization. Id.

<sup>14</sup> 15 U.S.C. 78f(h)(2).

<sup>15</sup> 15 U.S.C. 78s(b).

<sup>16</sup> 7 U.S.C. 2(a)(1)(D)(i).

<sup>17</sup> 15 U.S.C. 78f(h)(3).

<sup>18</sup> See Section 2(a)(1)(D)(i)(VII) of the CEA, 7 U.S.C. 2(a)(1)(D)(i)(VII); Section 6(h)(3)(H) of the Exchange Act, 15 U.S.C. 78f(h)(3)(H).

has in place procedures to coordinate trading halts between such market and any market on which any security underlying the security futures product is traded and other markets on which any related security is traded.<sup>19</sup> The rule proposed today would set forth more specifically how the exchange's or association's rules can satisfy these statutory provisions.<sup>20</sup>

#### **A. Settlement Prices for Cash-Settled Security Futures Products**

In the mid-1980s, the closing-price settlement procedures used by cash-settled stock index futures and options<sup>21</sup> often severely strained the liquidity of the securities markets and raised concerns that such liquidity constraints could provide opportunities for manipulative or abusive trading practices. Consequently, markets trading the most actively traded futures contracts and many stock index option contracts moved to

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<sup>19</sup> See Section 2(a)(1)(D)(i)(X) of the CEA, 7 U.S.C. 2(a)(1)(D)(i)(X); Section 6(h)(3)(K) of the Exchange Act, 15 U.S.C. 78f(h)(3)(K).

<sup>20</sup> Section 9(b) of the Exchange Act states in part that “[i]t shall be unlawful for any person to effect, by use of any facility of a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors (1) any transaction in connection with any security whereby any party to such transaction acquires . . . any security futures product on the security; or (2) any transaction in connection with any security with relation to which he has, directly or indirectly, any interest in any . . . such security futures product; or (3) any transaction in any security for the account of any person who he has reason to believe has, and who actually has, directly or indirectly, any interest in any . . . such security futures product with relation to such security.” 15 U.S.C. 78i(b). In addition, Section 9(h)(1) of the Exchange Act states that “[i]t shall be unlawful for any person . . . to use or employ any act or practice in connection with the purchase or sale of any equity security in contravention of such rules or regulations as the Commission may adopt, consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets to prescribe means reasonably designed to prevent manipulation of price levels of the equity securities market or a substantial segment thereof.” The SEC believes that the proposed rule is necessary in the public interest, for the protection of investors, and the maintenance of fair and orderly markets.

<sup>21</sup> Index products are cash-settled, not physically settled.

opening-price settlement procedures. To avert similar liquidity constraints and to minimize opportunities for manipulative and abusive trading practices, the Commissions preliminarily believe that cash-settled security futures products should be required to use opening-price settlement procedures. Moreover, the Commissions preliminarily believe that opening-price settlement procedures are consistent with the provisions of Section 2(a)(1)(D)(i)(VII) of the CEA<sup>22</sup> and Section 6(h)(3)(H) of the Exchange Act,<sup>23</sup> because they would permit a national securities exchange or a national securities association registered pursuant to Section 15A(a) of the Exchange Act<sup>24</sup> to trade only security futures products that conform to listing standards that, among other things, require that trading in a security futures product not be readily susceptible to manipulation of the price of such product, nor to causing or being used in the manipulation of the price of any underlying security, option on such security, or option on a group or index including such securities.<sup>25</sup> Accordingly, proposed SEC Rule 6h-1(b) and CFTC Rule 41.25(b)(1) would require that the final settlement price of a cash-settled security futures product based on a single security fairly reflect the opening price of the underlying security. Similarly, proposed SEC Rule 6h-1(c) and CFTC Rule 41.25(b)(2) would require that the final settlement price of a cash-settled security futures product based on a narrow-based security index fairly reflect the opening prices in the index's underlying securities. The

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<sup>22</sup> 7 U.S.C. 2(a)(1)(D)(i)(VII).

<sup>23</sup> 15 U.S.C. 78f(h)(3)(H).

<sup>24</sup> 15 U.S.C. 78o-3(a).

<sup>25</sup> See proposed SEC Rule 6h-1(f) and proposed CFTC Rule 41.25(b)(3), and *infra* discussion at Section II.B, Settlement Prices for Cash-Settled Security Futures Products.

Commissions also are proposing that they may grant exemptions to national securities exchanges or national securities associations from such requirements.

## **B. Regulatory Halts**

The securities markets have long-established procedures that require cross-market trading halts in an equity security, related equity securities, and related options whenever the market trading and listing the equity security ("listing market") imposes a regulatory halt in that security.<sup>26</sup> The most common type of regulatory halt is one that prevents trading in an equity security for a short time (usually less than an hour) while material news about the security's issuer is disseminated to investors. The markets coordinate cross-market "news pending" regulatory halts to promote investor protection and fair and orderly markets.<sup>27</sup>

The Commissions believe, therefore, that it would be appropriate for news pending cross-market halt procedures to apply to security futures products. The Commissions also believe that the application of these procedures to security futures products is necessary to satisfy the provisions of Section 2(a)(1)(D)(i)(X) of the CEA<sup>28</sup> and Section 6(h)(3)(K) of the Exchange Act,<sup>29</sup> which permit a national securities exchange or a national securities association registered pursuant to Section 15A(a) of the Exchange Act<sup>30</sup> to trade only security futures products that conform to listing standards

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<sup>26</sup> Cross-market halts are not required for non-regulatory halts, such as when one market halts trading because of an imbalance of buy and sell orders in a particular security or when trading is disrupted on one market due to a problem in its systems or on its trading floor.

<sup>27</sup> See, e.g., *infra* note 72 and accompanying text.

<sup>28</sup> 7 U.S.C. 2(a)(1)(D)(i)(X).

<sup>29</sup> 15 U.S.C. 78f(h)(3)(K).

<sup>30</sup> 15 U.S.C. 78o-3(a).

that, among other things, require procedures to "coordinate" trading halts between the listing market for the underlying security and other markets that trade the underlying security or any related security. The definition of "regulatory halt" set forth in proposed SEC Rule 6h-1(a)(3) and CFTC Rule 41.1(l) would include a delay, halt, or suspension of trading of a security by the listing market as a result of pending news.<sup>31</sup> Proposed SEC Rule 6h-1(d) and CFTC Rule 41.25(a)(2)(i) would require that trading on a security futures product based on a single security be halted at all times that such a news pending regulatory halt has been instituted by the listing market for the underlying security.

The other type of regulatory halt currently used by the securities markets involves "circuit breaker" procedures.<sup>32</sup> Since October 1988, the stock, options, and index futures markets have had in place circuit breaker procedures that would impose brief cross-market trading halts at predetermined thresholds during a severe market decline. The coordinated cross-market trading halts provided by circuit breaker procedures are designed to operate only during significant market declines and to substitute orderly, pre-planned halts for the ad hoc and destabilizing halts that can occur when market liquidity is exhausted. The circuit breakers also protect investors and the markets by providing opportunities for markets and market participants to assess market conditions and potential systemic stress during a historic market decline.<sup>33</sup> In approving the original

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<sup>31</sup> Under the proposed rule, a pending news regulatory halt includes halts that are the result of a determination that there are matters relating to the security or issuer that have not been adequately disclosed to the public, or that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue. See proposed SEC Rule 6h-1(a)(3) and proposed CFTC Rule 41.1(l).

<sup>32</sup> See infra notes 77 and 78 and accompanying text.

<sup>33</sup> See Circuit Breaker Report by the Staff of the President's Working Group on Financial Markets dated August 18, 1998 ("Circuit Breaker Report").

circuit breakers proposed by the securities markets, the SEC noted that the circuit breakers were not an attempt to prevent markets from reaching new price levels, but an effort by the securities and futures markets to arrive at a coordinated means to address potentially destabilizing market volatility of the severity of the October 1987 market break.<sup>34</sup>

For these same reasons, the Commissions believe that it is important to require the application of cross-market circuit breaker regulatory halt procedures to security futures products. Moreover, the Commissions believe that such a requirement is necessary to satisfy the requirements of Section 2(a)(1)(D)(i)(X) of the CEA<sup>35</sup> and Section 6(h)(3)(K) of the Exchange Act.<sup>36</sup> If cross-market circuit breaker regulatory halt procedures were not applied to the security futures products, such a failure would undermine the use of a trading halt in the underlying securities. The definition of "regulatory halt" set forth in proposed SEC Rule 6h-1(a)(3) and CFTC Rule 41.1(l), therefore, would include a delay, halt, or suspension of trading of a security by the listing market as a result of the operation of circuit breaker procedures to halt or suspend trading in all equity securities trading on the listing market. Proposed SEC Rule 6h-1(d) and CFTC Rule 41.25(a)(2)(i) would require that trading on a security futures product based on a single security be halted at all times that such a circuit breaker regulatory halt has been instituted by the listing market for the underlying security.

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<sup>34</sup> See Securities Exchange Act Release No. 26198 (October 19, 1988), 53 FR 41637 (October 24, 1988).

<sup>35</sup> 7 U.S.C. 2(a)(1)(D)(i)(X).

<sup>36</sup> 15 U.S.C. 78f(h)(3)(K).

Index futures and options also have been subject to the markets' circuit breaker procedures since their adoption in 1988.<sup>37</sup> In view of the broad-based indexes underlying current futures and options, however, these products generally have not been subject to news pending regulatory halts in the underlying securities. Nevertheless, the Commissions believe that, under some circumstances, trading should be halted in a security futures product based on a narrow-based security index when a substantial portion of the underlying securities is halted due to circuit breaker or news pending regulatory halts. Proposed SEC Rule 6h-1(e) and CFTC Rule 41.25(a)(2)(ii), therefore, would require that trading on a security futures product based on a narrow-based security index be halted at all times that news pending or circuit breaker regulatory halts have been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index.<sup>38</sup>

## **II. Discussion of Proposed Rulemaking**

Before a national securities exchange or national securities association lists or trades security futures products, it is required to file, pursuant to Section 19(b) of the Exchange Act,<sup>39</sup> a proposed rule change with the SEC establishing listing standards that comply with Section 6(h)(3) of the Exchange Act.<sup>40</sup> Generally, a national securities exchange registered under Section 6(a) of the Exchange Act<sup>41</sup> or a national securities

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<sup>37</sup> See Circuit Breaker Report, supra note 33.

<sup>38</sup> For a further discussion of the 30 percent threshold, see infra discussion at Section II.C.2(b), Trading Halt Coordination in Narrow-Based Security Index Futures.

<sup>39</sup> 15 U.S.C. 78s(b).

<sup>40</sup> 15 U.S.C. 78f(h)(3).

<sup>41</sup> 15 U.S.C. 78f(a).

association registered under Section 15A(a) of the Exchange Act<sup>42</sup> must file proposed rule changes with the SEC pursuant to Section 19(b)(1) of the Exchange Act<sup>43</sup> for notice, comment, and SEC approval, prior to implementation, unless the rule is otherwise permitted to become effective pursuant to Section 19(b)(3) of the Exchange Act.<sup>44</sup> A Security Futures Product Exchange<sup>45</sup> or a national securities association registered under Section 15A(k) of the Exchange Act<sup>46</sup> must generally submit, pursuant to Section 19(b)(7) of the Exchange Act,<sup>47</sup> proposed rule changes relating to certain enumerated matters, including listing standards.

**A. Staff Interpretive Guidance**

Section 2(a)(1)(D)(i) of the CEA and Section 6(h)(3) of the Exchange Act enumerate the standards and conditions that these listing standards must meet.<sup>48</sup> The rule being proposed today would identify certain requirements that the Commissions believe are necessary to satisfy these provisions. Because national securities exchanges and national securities associations may desire to begin trading security futures products prior to the Commissions taking final action on the proposed rule, the SEC staff believes that a proposed rule change filed by a national securities exchange registered under Section 6(a)

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<sup>42</sup> 15 U.S.C. 78o-3(a).

<sup>43</sup> 15 U.S.C. 78s(b)(1).

<sup>44</sup> 15 U.S.C. 78s(b)(3).

<sup>45</sup> See supra note 12.

<sup>46</sup> 15 U.S.C. 78o-3(k)

<sup>47</sup> 15 U.S.C. 78s(b)(7).

<sup>48</sup> Section 2(a)(1)(D)(i) of the CEA, 7 U.S.C. 2(a)(1)(D)(i); Section 6(h)(3) of the Exchange Act, 15 U.S.C. 78f(h)(3).

of the Exchange Act<sup>49</sup> or a national securities association registered pursuant to Section 15A(a) of the Exchange Act<sup>50</sup> regarding listing standards for security futures products would satisfy, in part, the criteria enumerated in Section 6(h)(3)(H) and (K) of the Exchange Act<sup>51</sup> if such listing standards conformed to the proposed rule. Therefore, until such time as the SEC acts on proposed SEC Rule 6h-1, if those proposed listing standards are consistent with proposed SEC Rule 6h-1, the SEC staff would recommend to the SEC that it approve proposed rules to establish listing standards filed by national securities exchanges and national securities associations and would not recommend to the SEC that it abrogate proposed rules to establish listing standards filed by Security Futures Product Exchanges.<sup>52</sup> If, after receiving comment on their proposal, the Commissions determine to adopt a rule that is different from that proposed today, or to not adopt a rule, exchanges and associations would be free, or may be required, to propose changes to their listing standards.

**B. Settlement Prices for Cash-Settled Security Futures Products**

**1. Prior Problems with Closing-Price Settlement Procedures**

All currently traded index futures and options are cash-settled. When stock index futures and options began trading in the mid-1980s, virtually all of these products used closing-price settlement procedures. Closing-price settlement procedures in index futures and options generally base the index settlement price on the execution prices from the last regular session trades in the underlying securities. The cash settlement provisions of

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<sup>49</sup> 15 U.S.C. 78f(a).

<sup>50</sup> 15 U.S.C. 78o-3(a).

<sup>51</sup> 15 U.S.C. 78f(h)(3)(H) and (K).

<sup>52</sup> See supra note 12.

stock index futures and options contracts facilitated the growth of sizeable index arbitrage activities by firms and professional traders and made it relatively easy for arbitrageurs to buy or sell the underlying stocks at or near the market close on expiration Fridays<sup>53</sup> in order to "unwind" arbitrage-related positions. Because of cash settlement, the amount of cash received by an arbitrageur by selling long positions (or the amount of cash paid out to buy or cover short positions) in underlying stocks at the close on expiration Friday would exactly match the amount of cash that would have to be paid out to cover short positions (or received from the sale of long positions) in the expiring index futures or options.

These types of unwinding programs at the close on expiration Fridays often severely strained the liquidity of the securities markets. Because unwinding programs sometimes consisted of large sell (or buy) orders in individual securities, the securities markets often found it extremely difficult to solicit sufficient buy or sell interest to absorb the expiration-related programs within the limited time permitted to establish closing prices shortly after 4:00 p.m. (Eastern). It was not uncommon, therefore, for stock specialists to have to drop share prices sharply at the close to establish sufficient buy-side interest to draw in matching buy orders or to raise prices sharply at the close to establish sufficient sell-side interest to draw in matching sell orders.<sup>54</sup> The time constraints faced

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<sup>53</sup> The term "expiration Fridays" refers to the third Friday of each month that marks the expiration date for that month's individual stock options, stock index options, and stock index futures contracts. On the expiration date, options and futures contracts cease to exist. Some stock index futures and options expire on a quarterly basis, with their expiration Friday occurring on the third Friday of the last month of the quarter (March, June, September, and December).

<sup>54</sup> Steep discounts (premiums) were necessary in part because traders who bought (sold) stocks to offset unwinding programs had to maintain their newly acquired

by specialists to establish closing prices that would reflect an equilibrium between buy and sell interest resulted in sharp price movements in the indexes underlying the futures or options. In addition, regulators and self-regulators were concerned that the liquidity constraints faced by the securities markets to accommodate expiration-related buy or sell programs at the market close on expiration Fridays could exacerbate ongoing market swings during an expiration and could provide opportunities for entities to anticipate these pressures and enter orders as part of manipulative or abusive trading practices designed to artificially drive up or down share prices.<sup>55</sup>

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long (short) positions over the weekend – during which time, they were subject to considerable market risk.

<sup>55</sup> The liquidity constraints faced by the securities markets due to unwinding programs used in closing-price settlement procedures were discussed by the SEC staff in its report on the market decline on November 15, 1991. See SEC Division of Market Regulation, Trading Analysis of November 15, 1991 (October 1992) (“Trading Analysis of November 15, 1991”). With respect to concerns regarding manipulation, the Commissions note that the Intermarket Surveillance Group (“ISG”) was created under the auspices of the SEC in 1981 as a forum to ensure that national securities exchanges and national securities associations adequately share surveillance information and coordinate inquiries and investigations designed to address potential intermarket manipulations and trading abuses. All national securities exchanges and national securities associations are full members of the ISG. Full members routinely share a great deal of surveillance and investigatory information, and the SEC believes that this framework has proven to be an essential mechanism to ensure that there is adequate information sharing and investigatory coordination for potential intermarket manipulations and trading abuses.

Since 1987, several futures exchanges and non-U.S. exchanges and associations have been affiliate members of the ISG. Affiliate members are required to share information on a more limited basis with the ISG. To fulfill the requirement of the CEA and Exchange Act that listing standards of exchanges and associations trading security futures products “require procedures be in place for coordinated surveillance among the markets on which the security futures product is traded, any market on which the security underlying the security futures product is traded, and any other markets on which any related security is traded to detect manipulation and insider trading,” the Commissions believe that it is essential that all such exchanges and associations be full members of the ISG. In view of the

To reduce such expiration-related strains on market liquidity, the Chicago Mercantile Exchange ("CME") in 1987 switched from closing-price settlement procedures to opening-price settlement procedures for certain stock index futures. The CME's products included the industry's most actively traded index futures contract, which was based on the Standard & Poor's 500 Stock Index ("SPX Futures").<sup>56</sup> Because SPX Futures were employed in the vast majority of index arbitrage trading programs at that time, the adoption of opening-price settlement procedures for these contracts had a significant effect on unwinding programs in the securities markets on SPX Futures' quarterly expirations.

Most other market participants began moving to opening-price settlement procedures for stock index options contracts. For example, the New York Stock Exchange ("NYSE") and the Chicago Board Options Exchange ("CBOE") implemented opening-price settlement procedures for certain index options in 1987.<sup>57</sup> Other exchanges

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essential role that the ISG plays, the Commissions also believe that the ISG should grant full memberships to all national securities exchanges and national securities associations registered pursuant to Section 15A(a) of the Exchange Act trading securities futures products, including Security Futures Product Exchanges, upon a good-faith showing that the entities meet the criteria for full membership.

<sup>56</sup> The New York Futures Exchange also shifted its stock index futures to opening-price settlement procedures in 1987.

<sup>57</sup> See Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992); see, e.g., Securities Exchange Act Release No. 24367 (April 17, 1987), 52 FR 13890 (April 27, 1987) (approving CBOE proposal to list an option on an index that settled based on the opening prices of component securities); Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992) (approving CBOE proposal to, among other things, phase out all index options on the Standard & Poor's 500 Stock Index using closing-price settlement procedures); Securities Exchange Act Release No. 24276 (March 27, 1987), 52 FR 10836 (April 3, 1987) (permitting NYSE to base settlement on opening prices for options on two indices); Securities Exchange Act Release No. 25804 (June 15, 1988), 53 FR 23474 (June 22, 1988) (approving NYSE proposal

adopted similar procedures<sup>58</sup> for some of their index options.<sup>59</sup> Exchanges also incorporated opening-price settlement requirements as part of their listing criteria for index options.<sup>60</sup>

Opening-price settlement procedures offered several features that facilitated the ability of the securities markets to handle expiration-related unwinding programs. For example, the NYSE was able to use its existing electronic order-routing systems and

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to, among other things, provide for opening-price settlement of stock index options).

<sup>58</sup> See, e.g., Securities Exchange Act Release No. 26653 (March 21, 1989), 54 FR 12705 (March 28, 1989) (approving the American Stock Exchange's ("Amex") proposal for options on an index using settlement based on opening prices); Securities Exchange Release No. 31330 (October 16, 1992), 57 FR 48408 (October 23, 1992) (approving Amex's proposal to, among other things, phase out certain options where the settlement value upon expiration is based on the closing prices of component securities); Securities Exchange Act Release No. 36236 (September 14, 1995), 60 FR 49031 (September 21, 1995) (approving Pacific Stock Exchange ("PCX") proposal to revise the terms of certain options contracts from closing-price settlement to opening-price settlement); Securities Exchange Act Release No. 35131 (December 20, 1994), 59 FR 66990 (December 28, 1994) (giving immediate effectiveness to a Philadelphia Stock Exchange's ("Phlx") proposal regarding options on an index using settlements based on opening prices and satisfying generic listing criteria).

<sup>59</sup> Some index options, such as CBOE's options contracts based on the Standard & Poor's 100 Stock Index ("OEX options") retained closing-price settlement procedures. CBOE believed that these settlement procedures were appropriate for OEX options because these contracts were used primarily by retail investors and were not actively used in the types of index arbitrage unwinding programs that had strained the liquidity of the securities market at the close on expirations.

<sup>60</sup> See Amex Rule 901C, Commentary .02(c) (listing requirements for stock industry index groups pursuant to SEC Rule 19b-4(e)); CBOE Rule 24.2(b)(1) (listing criteria for narrow-based security index options under SEC Rule 19b-4(e)); PCX Rule 7.3(b)(1) (listing criteria for narrow-based security index options); Phlx Rule 1009A(b)(1) (listing criteria for narrow-based security index options pursuant to SEC Rule 19b-4(e)); see also Commentary to Phlx Rule 1000A(b)(8) ("For any series of index options first opened after March 30, 1987, the Exchange may, in its discretion, provide that the calculation of the final index settlement value of any index on which options are traded at the Exchange will be determined by reference to the prices of the constituent stocks at a time other than the close of trading on the last trading day before expiration").

electronic specialist books to process and match incoming unwinding stock orders before the opening of the regular trading session at 9:30 a.m. (Eastern). Specialists could then utilize long-standing procedures to disseminate price indications in an orderly manner before index component stocks opened for trading. Moreover, smaller price discounts or premiums were needed to draw in orders to offset unwinding programs because traders who entered the offsetting orders understood that they would have the remainder of the trading session to trade out of any long or short positions acquired at the opening. As a result, it appears that the widespread adoption of opening-price settlement procedures in index futures and options has served to mitigate the liquidity strains that had previously been experienced in the securities markets on expirations.

## **2. Requirements for Security Futures Products Using Cash Settlement**

In view of the experience gained with settlements in cash-settled stock index futures and options in the 1980s and in light of the potential for manipulation of the underlying securities markets, the Commissions preliminarily believe that it would be prudent, at the outset of trading in these products, to require exchanges specifying cash settlement in lieu of physical delivery for security futures products to use a final settlement price that fairly reflects the opening price of the underlying security or securities as the basis for cash settling positions at contract expiration.<sup>61</sup>

### **a. Single-Stock Futures**

Proposed SEC Rule 6h-1(b) and CFTC Rule 41.25(b)(1) would require that the final settlement price of a cash-settled security futures product based on a single security

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<sup>61</sup> See proposed SEC Rule 6h-1(b) and (c) and proposed CFTC Rule 41.25(b).

fairly reflect the opening price of the underlying security.<sup>62</sup> While the emphasis in the proposed rule is on cash settlements based on the opening price(s), the Commissions' proposal would leave national securities exchanges and national securities associations trading security futures products with some flexibility in adopting rules that determine how the opening price is defined for this purpose. For example, under the proposed rule, a national securities exchange or national securities association could define the opening price for a single-stock future as the trade-weighted average price of the underlying security during the first few minutes of trading of a regular trading session. Alternatively, the opening price for a security futures product could be defined as the price reported for the first trade in that security at the beginning of the regular trading session.

Proposed SEC Rule 6h-1(b) and CFTC Rule 41.25(b)(1) also would require that, if an opening price for an underlying security is not readily available, the final settlement price of the overlying cash-settled security futures product must fairly reflect the price of the underlying security during its most recent regular trading session. The Commissions believe 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

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<sup>62</sup> Proposed SEC Rule 6h-1(a)(1) and CFTC Rule 41.1(j) would define "opening price" as the price at which a security opened for trading, or a price that fairly reflects the price at which a security opened for trading, during the regular trading session of the national securities exchange or national securities association that lists the security. Proposed SEC Rule 6h-1(a)(2) and CFTC Rule 41.1(k) would define the "regular trading session" of a security as the normal hours for business of a national securities exchange or national securities association that lists the security.

appropriate substitute.<sup>63</sup> Again, the Commissions' proposal would provide national securities exchanges and national securities associations with some discretion to implement this general rule without dictating how the settlement price for a security futures product is derived. For example, while one national securities exchange or national securities association may decide to establish rules that would use the closing price from the most recent regular trading session if an opening price for a security underlying a security futures product is not readily available, another exchange or association could establish rules that would use a trade-weighted average over some portion of that session in such circumstances.

The Commissions do not believe at present that national securities exchanges and national securities associations should trade security futures products that settle at prices established by other than the most recent regular trading session. The Commissions believe that the final settlement price for a cash-settled single-stock future should reasonably reflect the opening price of the underlying security or, if that is not readily available, a price fairly reflective of the price in a liquid market for the underlying security. The Commissions believe that a price derived from the regular trading session of the national securities exchange or national securities association that lists the underlying security would have the greatest likelihood of reflecting the most reasonable price for that security, unlike a price generated from an extended trading hours session.

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<sup>63</sup> Although proposed SEC Rule 6h-1(b) and (c) and CFTC Rule 41.25(b)(1) and (b)(2) would not define when an opening price would not be "readily available," national securities exchanges and national securities associations would have to establish, as part of their listing standards, rules that interpret this term. The Commissions' overriding concern is that settlement prices for cash-settled security futures products be established in a fair and predictable manner.

b. Narrow-Based Security Index Futures

Proposed SEC Rule 6h-1(c) and CFTC Rule 41.25(b)(2) would require, absent an exemption, national securities exchanges and national securities associations to establish that the final settlement price of a cash-settled narrow-based security index future reflect the opening prices of the underlying securities. As with single-stock futures, the Commissions are proposing that, if prices for one or more underlying securities were not readily available, the settlement prices for those securities would be derived from their most recent regular trading session. For the securities that did open normally, the settlement prices would be their respective opening prices.

c. Exemption

Proposed paragraph (f) of SEC Rule 6h-1 and paragraph (b)(3) of CFTC Rule 41.25 would permit the Commissions to grant a national securities exchange or national securities association an exemption from the above requirements.<sup>64</sup> The SEC would grant such an exception, either conditionally or unconditionally, if it were necessary or appropriate in the public interest, and consistent with the protection of investors.<sup>65</sup> The CFTC would grant such an exemption if the CFTC determines that it would be consistent with the public interest, the protection of investors, and otherwise furthers the provisions of the CEA.<sup>66</sup>

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<sup>64</sup> See proposed SEC Rule 6h-1(f), and proposed CFTC Rule 41.25(b)(3).

<sup>65</sup> See Section 36 of the Exchange Act, 15 U.S.C. 78mm. In granting the SEC broad exemptive authority in Section 36, Congress intended to incorporate flexibility into the Exchange Act regulatory scheme to reflect a rapidly changing marketplace. See H.R. Rep. No. 104-622 (1996).

<sup>66</sup> Section 8a(5) of the CEA allows the CFTC to make and promulgate such rules and regulations as, in the judgment of the CFTC, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of the CEA. 7 U.S.C. 12a(5). The CFTC believes that granting an exemption to the use of

d. Request for Comments Relating to Final Settlement Prices

The Commissions welcome comment on all aspects of the proposed rule as they relate to final settlement prices for cash-settled security futures products, including the following matters:

- Q1. Commenters are requested to submit their views on whether cash-settled security futures products should be permitted to trade with closing-price settlement procedures. If so, commenters are asked to provide policy arguments in support of their views.
- Q2. If commenters believe that cash-settled security futures products should be permitted to settle at the closing price, what characteristics of security futures products would justify a determination that the liquidity pressures on the underlying securities market, associated with closing-price settlement procedures in index futures, would not present opportunities for manipulative activities in security futures products and their underlying securities?
- Q3. Are there any additional safeguards that would be appropriate for security futures product cash settlement procedures to ensure that the anti-manipulation mandates in Section 2(a)(1)(D)(i)(VII) of the CEA and Section 6(h)(3)(H) of the Exchange Act are satisfied?
- Q4. Would any additional safeguards for cash settlement procedures for security futures products be appropriate to promote the maintenance of fair and orderly markets under the Exchange Act?

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opening prices for cash settlement is consistent with Section 8a(5) of the CEA, so long as the exemption is consistent with the public interest, the protection of investors, and otherwise furthers the provisions of the CEA.

- Q5. In view of the use of opening-price settlement procedures in most actively traded index futures, what characteristics of security futures products and the manner in which they trade would indicate that opening-price settlement procedures would be inappropriate or unworkable for security futures products?
- Q6. Should the proposed rule provide national securities exchanges or national securities associations any additional flexibility to determine settlement prices when the regular session opening prices are not readily available in one or more of the underlying securities?
- Q7. Should the proposed rule require the use of only closing prices from the most recent trading session when regular session opening prices are not readily available in one or more of the underlying securities?

**C. Regulatory Halts**

**1. Background**

Generally, there are two types of regulatory halts used in the equity and options markets: news pending halts and circuit breaker halts. News pending halts are designed to protect the interests of current and potential shareholders by facilitating the orderly dissemination of potentially market moving information and the discovery of fair and reasonable prices for securities based on new information. A news pending halt benefits current and potential shareholders by halting all trading in the securities until there has been an opportunity for the information to be disseminated to the public. It also helps to ensure public confidence in the market and promotes the integrity of the marketplace by giving the public an opportunity to evaluate information in making investment decisions.

Circuit breakers are brief, coordinated cross-market trading halts used by the major stock, options, and index futures markets to mitigate systemic stress when a severe one-day market drop of historic proportions prevents the financial markets from operating in an orderly manner.<sup>67</sup>

a. News Pending Halts

Currently, national securities exchanges and national securities associations may impose brief trading halts in specific securities pending the release of material information that would reasonably be expected to affect the prices of those securities.<sup>68</sup> Trading halts give investors an opportunity to learn of and react to material news. The NYSE and Amex, for example, follow procedures for regulatory halts contained in the Consolidated Tape Association Plan ("CTA Plan").<sup>69</sup> Under the CTA Plan, a regulatory halt occurs whenever the listing market (termed the "primary market") for any eligible security, in the exercise of its regulatory functions, halts or suspends trading in the security because the primary market has determined (i) that there are matters relating to

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<sup>67</sup> See Circuit Breaker Report, *supra* note 33.

<sup>68</sup> See, e.g., Amex, Listing Standards, Policies and Requirements, Section 402(b); Boston Stock Exchange ("BSE") Rules of the Board of Governors, Supplement to Chapter XXVII, Section 4; National Association of Securities Dealers ("NASD") Rule 4120; and NYSE Listed Company Manual, Sections 202.06 and 202.07.

<sup>69</sup> See Securities Exchange Act Release No. 41315 (April 20, 1999), 64 FR 23142 (April 29, 1999) (noting that the NYSE follows the CTA Plan when instituting a regulatory halt); and Securities Exchange Act Release No. 41877 (September 14, 1999), 64 FR 51566 (September 23, 1999) (noting that Amex follows the CTA Plan when instituting a regulatory halt); see also CTA Plan (Second Restatement), Section XI (a). The CTA Plan is a joint industry plan that governs the consolidated transaction reporting system, and each of the participants agrees to comply with the provisions of the plan. Recognizing the importance of disseminating information with respect to trading halts in certain securities, the CTA Plan imposes notification obligations upon the primary market whenever a regulatory halt occurs.

the security or issuer that have not been adequately disclosed to the public, or (ii) that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue.<sup>70</sup> The Commissions preliminarily believe that it may be appropriate to include this definition of a news pending regulatory halt under the proposed rule<sup>71</sup> because the exchanges already have experience in applying the requirement. When a regulatory trading halt is initiated by the primary market for a security, the regional exchanges and Nasdaq Intermarket also halt trading in the security, and the options exchanges halt trading in related options. The options exchanges also halt trading in an equity option when the underlying security has ceased trading.<sup>72</sup>

The options markets also have in place rules regarding trading halts on index options.<sup>73</sup> Several of the options markets will halt trading when, for example, a certain fixed percentage of the index halts trading or when it is appropriate in the interests of a fair and orderly market and to protect investors. For example, trading on the PCX in any index option is halted whenever trading in underlying securities whose weighted value

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<sup>70</sup> See CTA Plan (Second Restatement), Section XI (a). For example, an event that may qualify under this standard and call for a regulatory halt is when it is unclear whether a security continues to meet the listing standards of the market on which the security is listed.

<sup>71</sup> See proposed SEC Rule 6h-1(a)(3) and proposed CFTC Rule 41.1(l).

<sup>72</sup> The rules of the options exchanges generally provide for halts in options whenever it is appropriate in the interests of a fair and orderly market and to protect investors. See Amex Rule 918(b); CBOE Rule 6.3(a) and .04 of the Interpretations and Policies of CBOE Rule 6.3; International Securities Exchange ("ISE") Rule 702; PCX Rule 6.65(a); and Phlx Rule 1047(b).

<sup>73</sup> See Amex Rule 918C(b)(3); CBOE Rule 24.7; PCX Rule 7.11; and Phlx Rule 1047A(c).

represents more than 20 percent of the value of a broad-based index or 10 percent of the value of other indices is halted.<sup>74</sup>

b. Circuit Breaker Halts

The Commissions approved various exchanges' circuit breaker proposals in response to the October 1987 market break to permit these brief, coordinated cross-market halts to provide opportunities during a severe market decline to reestablish an equilibrium between buying and selling interests in an orderly fashion, and help to ensure that market participants have a reasonable opportunity to become aware of, and respond to, significant price movements.<sup>75</sup> The coordinated cross-market trading halts provided by circuit breaker procedures are designed to operate only during significant market declines and to substitute orderly, pre-planned halts for the ad hoc and destabilizing halts which can occur when market liquidity is exhausted.<sup>76</sup> Currently, all stock exchanges and the NASD have rules or policies to implement coordinated circuit breaker halts.<sup>77</sup>

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<sup>74</sup> See PCX Rule 7.11. Similarly, under Phlx Rule 1047A(c), trading in any index option may be halted whenever trading on the primary market in underlying securities representing more than 10 percent of the current index value is halted or suspended, and there is approval from two floor officials and the concurrence of a market regulation officer. See Phlx Rule 1047A(c).

<sup>75</sup> See Securities Exchange Act Release No. 26198 (October 19, 1988), 53 FR 41637 (October 24, 1988) (Amex, CBOE, NASD, NYSE).

<sup>76</sup> See Circuit Breaker Report, supra note 33.

<sup>77</sup> See Securities Exchange Act Release No. 39846 (April 9, 1998), 63 FR 18477 (April 15, 1998) (order approving proposals by Amex, BSE, Chicago Stock Exchange ("CHX"), NASD, NYSE, and Phlx). See also Amex Rule 117; BSE, Rules of the Board of Governors, Section 34A; CHX Rule 10A; Cincinnati Stock Exchange ("CSE") Rule 12.11; NYSE Rule 80B; PCX Rule 4.22 (a), (b), and (c); and Phlx Rule 133. CSE Rule 12.11 gives the chairman or the president of the CSE the power to suspend trading whenever he or she believes that such suspension would be in the public interest, which has been interpreted as requiring the CSE, as a matter of policy, to halt trading in all equities traded on the CSE in conjunction with halted trading at all other U.S. equity and equity-

The options markets also have rules applying circuit breakers.<sup>78</sup> Finally, the index futures exchanges have adopted circuit breaker halt procedures in conjunction with their price limit rules<sup>79</sup> for index products.<sup>80</sup>

The current circuit breaker procedures call for cross-market trading halts when the Dow Jones Industrial Average ("DJIA") declines by 10 percent, 20 percent, and 30

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related markets. See Securities Exchange Act Release No. 26440 (January 10, 1989), 54 FR 1830 (January 17, 1989). The NASD also recognizes the risks imposed on any single market that remains open while all other U.S. markets have halted trading in response to extraordinary price movements, and maintains a market closing policy to halt, upon SEC request, all domestic trading in both securities listed on the Nasdaq Stock Market and all equity and equity-related securities trading in the over-the-counter market should other major securities markets initiate market-wide trading halts in response to extraordinary market conditions. See NASD Rule 4120; NASD IM-4120-4. The SEC notes that it has a standing request with the NASD to halt trading as quickly as practicable whenever the NYSE and other equity markets have suspended trading. See Securities Exchange Act Release No. 39582 (January 26, 1998), 63 FR 5408 (February 2, 1998).

<sup>78</sup> See Amex Rule 950 (applying Amex Rule 117, Trading Halts Due to Extraordinary Market Volatility, to options transactions); CBOE Rule 6.3B; ISE Rule 703; PCX Rule 4.22 (which applies to options contracts through Rules 6.1(a) and (e)); and Phlx Rule 133.

<sup>79</sup> A price limit, in itself, does not halt trading in the futures, but prohibits trading at prices below the pre-set limit during a price decline. Intraday price limits are removed at pre-set times during the trading session, such as ten minutes after the thresholds are reached or at 3:30 p.m., whichever is earlier. Daily price limits remain in effect for the entire trading session. Specific price limits are set for each stock index futures contract. There are no price limits for U.S. stock index options, equity options, or stocks.

<sup>80</sup> See, e.g., CME Rule 4002.I. The CME will implement a circuit breaker trading halt in SPX Futures if the 10 percent circuit breaker halt has been imposed in the securities markets and the futures are "locked" at their 10 percent price limit. Trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50 percent of the index capitalization. The CME will implement another circuit breaker trading halt in SPX Futures if the 20 percent circuit breaker halt has been imposed in the securities markets and the futures are locked at their 20 percent price limit. Once again, trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50 percent of the index capitalization.

percent from the previous day's closing value. At the beginning of each quarter, the markets use the average closing value of the DJIA for the previous month to establish specific point-decline triggers for the quarter.<sup>81</sup> Specifically, a one-hour cross-market halt will be implemented if the DJIA declines by 10 percent prior to 2:00 p.m., and a one-half hour halt will be implemented if the DJIA declines by 10 percent between 2:00 p.m. and 2:30 p.m.<sup>82</sup> If the DJIA declines by 10 percent at or after 2:30 p.m., trading generally will not halt when the 10 percent level is reached. If the DJIA declines 20 percent prior to 1:00 p.m., trading will halt for two hours; trading will halt for one hour if the DJIA declines 20 percent between 1:00 p.m. and 2:00 p.m.; and trading will halt for the remainder of the day if a 20 percent decline occurs at or after 2:00 p.m. If the DJIA declines 30 percent at any time, trading will halt for the remainder of the day.

## **2. Trading Halt Coordination in Security Futures Products**

As discussed above, Section 2(a)(1)(D)(i)(X) of the CEA<sup>83</sup> and Section 6(h)(3)(K) of the Exchange Act<sup>84</sup> provide that listing standards for security futures products must require procedures to "coordinate" trading halts between the market that trades the security futures product, the market that lists and trades the underlying security, and other markets on which any related security is traded. Proposed SEC Rule 6h-1 and CFTC Rule 41.25(a)(2) would help assure such coordination, as well as preserve the investor protection and market integrity provisions of regulatory halt procedures in the securities markets.

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<sup>81</sup> See Circuit Breaker Report, supra note 33, p. 2.

<sup>82</sup> See, e.g., NYSE Rule 80b.

<sup>83</sup> 7 U.S.C. 2(a)(1)(D)(i)(X).

<sup>84</sup> 15 U.S.C. 78f(h)(3)(K).

a. Trading Halt Coordination in Single-Stock Futures

Specifically, proposed SEC Rule 6h-1(d) and CFTC Rule 41.25(a)(2)(i) would require national securities exchanges and national securities associations to halt trading in a single-stock future while a regulatory halt has been implemented by the listing market for the underlying security.<sup>85</sup> The halt in the security futures product market would have to occur during the same time as a regulatory halt instituted on the listing market. Thus, if the listing market halted trading in a security for 30 minutes, the security futures product market could not institute a halt and then reopen trading in the security futures product after two minutes. The Commissions believe that the purpose of halting trading in the underlying security would be frustrated if market participants could circumvent this halt by trading during the halt in the related security futures product.<sup>86</sup>

b. Trading Halt Coordination in Narrow-Based Security Index Futures

Proposed SEC Rule 6h-1(e) and CFTC Rule 41.25(a)(2)(ii) would also require national securities exchanges and national securities associations to halt trading under certain circumstances in a security futures product based on a narrow-based security index. Although broad-based security indices have large numbers of component

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<sup>85</sup> Proposed SEC Rule 6h-1(a)(3) and CFTC Rule 41.1(l) would define "regulatory halt" as a delay, halt, or suspension in the trading of a security that is instituted by the national securities exchange or national securities association that lists the security, as a result of: (i) pending news, or (ii) the operation of circuit breaker procedures to halt or suspend trading in all equity securities trading on that national securities exchange or national securities association.

<sup>86</sup> The trading halt provisions of proposed SEC Rule 6h-1(d) and CFTC Rule 41.25(a)(2)(i) would not be exclusive. The proposed rule is not designed to preclude a market trading security futures products from halting trading for other appropriate reasons, such as operational difficulties being experienced by the market or its automated systems or concerns over clearance and settlement operations.

securities, so that it is extremely unlikely that news pending regulatory halts would be imposed simultaneously in securities representing a significant portion of any index, this may not be the case with all narrow-based security indexes. Accordingly, the proposal would require trading to be halted in a narrow-based security index futures product when securities representing 30 percent or more of the market capitalization of the narrow-based security index<sup>87</sup> are subject to a regulatory halt.<sup>88</sup>

The Commissions do not believe that trading of a security futures product based on a narrow-based security index should necessarily be halted because a trading halt has been instituted for only one, low-weighted component security. However, regulatory halts of components could affect a sufficiently large portion of an index to make continued trading of the security futures product a means to improperly circumvent regulatory halts in the underlying securities. For example, if a security futures product is based on a narrow-based security index consisting of two stocks and regulatory halts have been imposed by the listing market in one of the component stocks for pending news, the halt would be undermined if trading continued in the security futures product, because the security represents a substantial portion of the index value. Under these circumstances, the Commissions do not believe that trading halt procedures would be

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<sup>87</sup> The Commissions jointly proposed rules to establish the method of determining the market capitalization of a narrow-based security index. See Securities Exchange Act Release No. 44288 (May 10, 2001), 66 FR 27560 (May 17, 2001).

<sup>88</sup> As with proposed SEC Rule 6h-1(d) and CFTC Rule 41.25(a)(2)(i), the trading halt provisions of proposed SEC Rule 6h-1(e) and CFTC Rule 41.25(a)(2)(ii) would not be exclusive. The proposed rule is not designed to preclude a market trading security futures products based on narrow-based security indexes from halting trading at a threshold of less than 30% of the market capitalization of the index or for other appropriate reasons, such as operational difficulties being experienced by the market or its automated systems or concerns over clearance and settlement operations.

coordinated, as contemplated by Section 2(a)(1)(D)(i)(X) of the CEA<sup>89</sup> and Section 6(h)(3)(K) of the Exchange Act,<sup>90</sup> if the security futures product continued to trade while investors were precluded from trading the underlying securities. Moreover, the SEC believes that continued trading in the security futures product under these circumstances could undercut key provisions in the securities laws designed to protect investors and promote the fair and orderly operation of the markets.

The Commissions preliminarily believe that the 30 percent threshold is appropriate because it appears to be sufficiently large to avoid imposing trading halts in security futures products unnecessarily when halts have been implemented in a few isolated underlying securities. In addition, the Commissions believe that the proposed 30 percent threshold is consistent with the definition of "narrow-based security index" under the CEA and the Exchange Act.<sup>91</sup> In general, indexes in which a component security is more than 30 percent of an index's weighting are considered narrow-based and, therefore, futures on such indexes are "securities." This 30 percent threshold represents, in part, a determination by Congress as to when an index becomes so highly concentrated in one security that trading in a future on that index becomes a surrogate for trading in the underlying security. For this reason, the Commissions preliminarily believe that when trading is halted in a component security or securities of an index that represent 30

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<sup>89</sup> 7 U.S.C. 2(a)(1)(D)(i)(X).

<sup>90</sup> 15 U.S.C. 78f(h)(3)(K).

<sup>91</sup> See Section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55), and Section 1a(25) of the CEA, 7 U.S.C. 1a(25). The Commissions jointly proposed rules to establish the method of determining the market capitalization of a narrow-based security index. See supra note 87.

percent or more of that index's weighting, trading should also be halted in the futures overlying that index.

c. Request for Comments Relating to Trading Halts

The Commissions welcome comment on all aspects of the proposed rule as it relates to trading halts for security futures products, including the following matters:

- Q8. Do commenters believe that there are circumstances in which permitting a single stock futures product to trade while the underlying security is subject to a regulatory halt in the listing market would be consistent with the mandate in Section 2(a)(1)(D)(i)(X) of the CEA<sup>92</sup> and Section 6(h)(3)(K) of the Exchange Act,<sup>93</sup> requiring a national securities exchange or national securities association on which security futures products trade to have procedures to coordinate trading halts with the listing market of the underlying security?
- Q9. If a regulatory halt is in place for securities representing 30 percent or more of a narrow-based security index's capitalization, do commenters believe that there are circumstances in which permitting a security futures product based on such an index to trade would be consistent with the mandate in Section 2(a)(1)(D)(i)(X) of the CEA<sup>94</sup> and Section 6(h)(3)(K) of the Exchange Act,<sup>95</sup> requiring a national securities exchange or national securities association on which security futures products trade to have procedures to coordinate trading halts with the listing market of the underlying security? Do commenters

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<sup>92</sup> 7 U.S.C. 2(a)(1)(D)(i)(X).

<sup>93</sup> 15 U.S.C. 78f(h)(3)(K).

<sup>94</sup> 7 U.S.C. 2(a)(1)(D)(i)(X).

<sup>95</sup> 15 U.S.C. 78f(h)(3)(K).

recommend using a higher or lower threshold percentage of an index's capitalization before an index future must halt trading?

Q10. If so, would trading halts in securities representing a larger percentage of the index capitalization warrant a halt in the overlying narrow-based security index future? For example, would halts in underlying securities representing 50 percent<sup>96</sup> of the index capitalization warrant a halt in trading the narrow-based security index future?

Q11. If continued trading in security futures products were permitted even if halts had been instituted for most or all of the underlying securities, would this put additional price pressure on the underlying security or securities when reopenings are attempted after the halts were lifted? How would this promote the maintenance of fair and orderly markets under the Exchange Act?

Q12. Is the proposed definition of "regulatory halt" sufficient to address all instances in which trading in security futures products should halt when trading is unavailable in the underlying security?

Q13. Do commenters believe that the Commissions should apply a standard, other than a percentage threshold of an index's capitalization, in determining whether a trading halt is appropriate for a narrow-based security index?

### **III. Request for Comments**

The Commissions solicit comments on all aspects of proposed CFTC Rule 41.25(a)(2) and 41.25(b) under the CEA and proposed SEC Rule 6h-1 under the

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<sup>96</sup> The Commissions note that, following a circuit breaker trading halt in SPX Futures on the CME, trading would not reopen until the circuit breaker halt has been lifted in the securities markets, and trading has resumed in stocks comprising at least 50 percent of the index capitalization. See supra note 80.

Exchange Act. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed rule.

#### **IV. Paperwork Reduction Act**

**CFTC:** The Paperwork Reduction Act ("PRA") of 1995 (44 U.S.C. 3501 et seq.) imposes certain requirements on federal agencies (including the CFTC) in connection with their conducting or sponsoring any collection of information as defined by the PRA. This proposed rulemaking contains information collection requirements within the meaning of the PRA. The CFTC has submitted a copy of this part to the Office of Management and Budget ("OMB") for its review in accordance with 44 U.S.C. 3507(d).

Collection of Information: Part 41, Relating to Security Futures Products, OMB Control Number 3038-XXXX.

An agency may not conduct or sponsor, and a person is not required to respond to, an information collection unless it displays a currently valid OMB control number. The CFTC is currently requesting a control number for this information collection from OMB.

As noted above, the CFMA lifted the ban on trading single stock and narrow-based stock index futures and established a framework for the joint regulation of these products by the CFTC and the SEC. In addition, the CFMA amended the CEA and the Exchange Act by adding a definition of "narrow-based security index," which establishes an objective test of whether a security index is narrow-based.<sup>97</sup> Futures contracts on security indexes that meet the statutory definition are jointly regulated by the CFTC and

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<sup>97</sup> See Section 1a(25)(A) of the CEA, 7 U.S.C. 1a(25)(A); Section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 77c(a)(55)(B).

the SEC. Futures contracts on indexes that do not meet the statutory definition remain under the sole jurisdiction of the CFTC.

The effect of proposed CFTC Rule 41.25(a)(2) and 41.25(b) will be to increase the burden previously submitted to OMB by 68 hours resulting from the preparation of materials to be filed with the CFTC in connection with the listing of security futures products by designated contract markets and registered derivatives transaction execution facilities.

The estimated burden of proposed CFTC Rule 41.25(a)(2) and 41.25(b) was calculated as follows:

Estimated number of respondents:	17
Total annual responses:	850
Estimated average number of hours per response:	.08
Estimated total number of hours of annual burden:	68

This annual reporting burden represents an increase of 68 hours as a result of the proposed new rule.

It should be noted that proposed CFTC Rule 41.25(a)(2) and 41.25(b) is part of a larger proposed rulemaking that will require designated contract markets and registered derivatives transaction execution facilities to certify that they meet the listing standards criteria of part 41. Specifically, proposed CFTC Rule 41.23 will require that before these boards of trade list a new security futures product for trading, they certify that they comply with a number of listing standards set forth in proposed CFTC Rule 41.22, as well as the additional conditions for trading set forth in proposed CFTC Rule 41.25. In a previous notice of proposed rules, the CFTC estimated that the burden of each submission under proposed CFTC Rule 41.23 would be approximately one (1) hour. The extra burden imposed on designated contract markets and registered derivatives

transaction execution facilities in certifying that they meet the criteria of proposed CFTC Rule 41.25(a)(2) and 41.25(b) should be minimal, since this certification will be a part of a larger certification. Nevertheless, the CFTC estimates that the additional burden imposed by this rule will create a burden of no more than .08 hours (approximately five (5) minutes) per response.

Organizations and individuals desiring to submit comments on the information collection requirements should direct them to the Office of Information and Regulatory Affairs, OMB, Room 10235 New Executive Building, Washington, DC 20503, Attention: Desk Officer for the Commodity Futures Trading Commission.

The CFTC considers comments by the public on this proposed collection of information in:

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the CFTC, including whether the information will have a practical use;
- Evaluating the accuracy of the CFTC's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhancing the quality, usefulness, and clarity of the information to be collected; and
- Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology (e.g., permitting electronic submission of responses).

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the Federal Register. A comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the CFTC on the proposed regulation. Copies of the information collection submission to OMB are available from the CFTC from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, (202) 418-5160.

**SEC:** Certain provisions of the proposed rule contain "collection of information requirements" within the meaning of the PRA.<sup>98</sup> Accordingly, the SEC submitted the collection of information requirements to the OMB for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The SEC is revising the collection of information titled "Rule 19b-4 and Form 19b-4," OMB Control No. 3235-0045. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The Exchange Act, as amended by the CFMA, provides that a national securities exchange or national securities association may trade security futures products only if the listing standards for such products conform with the requirements set forth in Section 6(h)(3) of the Exchange Act.<sup>99</sup> These listing standards must, among other things, require that: (1) trading in security futures products not be readily susceptible to price manipulation,<sup>100</sup> and (2) the exchange or association on which the security futures product is traded has in place procedures to coordinate trading halts with the market

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<sup>98</sup> 44 U.S.C. 3501 et seq.

<sup>99</sup> 15 U.S.C. 78f(h)(3).

<sup>100</sup> See 15 U.S.C. 78f(h)(3)(H).

listing the security or securities underlying the security futures product.<sup>101</sup> To further these statutory mandates, the SEC is proposing SEC Rule 6h-1, which would provide that the listing standards of national securities exchanges and national securities associations trading security futures products establish: (1) a final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities rather than the closing price, on the grounds that settlement based on the closing price creates greater volatility and more opportunity for price manipulation; and (2) a halt in trading in any security futures product when a regulatory halt is instituted by the national securities exchange or national securities association listing the security or securities underlying the security futures product.

The SEC anticipates that national securities exchanges and national securities associations that wish to trade security futures products would file with the SEC proposed rule changes, pursuant to Section 19(b) of the Exchange Act,<sup>102</sup> to establish listing standards that are consistent with the requirements set forth in Section 6(h)(3) of the Exchange Act.<sup>103</sup> The SEC would review the proposed rule changes submitted by national securities exchanges and national securities associations in the manner prescribed by Section 19(b) of the Exchange Act.<sup>104</sup> In addition, the SEC would publish these proposed rule changes to afford the public an opportunity to comment on the listing standards adopted by exchanges and associations with respect to security futures products. The SEC estimates that there would be 17 respondents to the proposed rule:

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<sup>101</sup> See 15 U.S.C. 78f(h)(3)(K).

<sup>102</sup> 15 U.S.C. 78s(b).

<sup>103</sup> 15 U.S.C. 78f(h)(3).

<sup>104</sup> 15 U.S.C. 78s(b).

9 currently registered national securities exchanges, 1 national securities association (the NASD) that operates a securities market (Nasdaq), and an estimated 7 futures markets that are expected to register as Security Futures Product Exchanges. The information collected pursuant to proposed SEC Rule 6h-1 would not be kept confidential and would be publicly available.

The SEC estimates the paperwork burden for each respondent, to comply with proposed SEC Rule 6h-1 would be 10 hours of legal work at \$128/hour,<sup>105</sup> for a total cost of \$1280 per respondent. The SEC estimates that the total burden on all respondents would be 170 hours (10 hours/response x 17 respondents x 1 response/respondent), for a total cost of \$21,760 (\$1280/response x 17 respondents x 1 response/respondent). These burdens would be incurred on a one-time basis and would not recur.

As set forth in SEC Rule 17a-1,<sup>106</sup> a national securities exchange or national securities association is required to retain records of the collection of information for at least five years, the first two years in an easily accessible place. However, Rule 17a-1 requires a Security Futures Product Exchange to retain only those records relating to persons, accounts, agreements, contracts, and transactions involving security futures products.<sup>107</sup>

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<sup>105</sup> The estimated rate of \$128 per hour is derived from the SIA Management and Professional Earnings, Table 107 (Attorney, New York), and includes a 35 percent differential for bonus, overhead, and other expenses.

<sup>106</sup> 17 CFR 240.17a-1.

<sup>107</sup> See 15 U.S.C. 78q(b)(4)(B).

Pursuant to 44 U.S.C. 3506(c)(2)(B), the SEC solicits comments to:

- (1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information would have practical utility;
- (2) Evaluate the accuracy of the SEC's estimate of the burden of the proposed collections of information;
- (3) Enhance the quality, utility, and clarity of the information to be collected; and
- (4) Minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements proposed above should direct them to the following persons:

- (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10102, New Executive Office Building, Washington, DC 20503; and
- (2) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549-0609, with reference to File No. S7-15-01.

OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The SEC has submitted the proposed collections of information to OMB for approval. Requests for the materials submitted to OMB by the SEC with regard to these collections of information should be in writing, refer to File No. S7-15-01, and be submitted to the Securities and

Exchange Commission, Records Management, Office of Filings and Information Services, 450 5th Street, NW, Washington, DC 20549.

## **V. Costs and Benefits of the Proposed Rulemaking**

**CFTC:** Section 15 of the CEA requires the CFTC to consider the costs and benefits of its action before issuing a new regulation.<sup>108</sup> The CFTC understands that, by its terms, section 15 does not require the CFTC to quantify the costs and benefits of a new regulation or to determine whether the benefits of the proposed regulation outweigh its costs. Nor does it require that each proposed rule be analyzed in isolation when that rule is a component of a larger package of rules or rule revisions. Rather, section 15 simply requires the CFTC to “consider the costs and benefits” of its action.

Section 15 further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the CFTC could in its discretion give greater weight to any one of the five enumerated areas of concern and could in its discretion determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The proposed rule constitutes one part of a package of related rule provisions. The rule provides guidance and establishes procedures for trading facilities in order to facilitate compliance with governing laws related to security futures products.

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<sup>108</sup> 7 U.S.C. 19.

The CFTC has considered the costs and benefits of the proposed rule as a totality, in light of the specific areas of concern identified in section 15. The proposed rule should have no effect, from the standpoint of imposing costs or creating benefits, on the financial integrity or price discovery function of the futures and options markets or on the risk management practices of trading facilities or others. The proposed rule also should have no material effect on the protection of market participants and the public and should not impact the efficiency and competition of the markets.

Accordingly, the CFTC has determined to propose the rule discussed above. The CFTC invites public comment on the application of the cost-benefit provision of section 15 of the CEA in regard to the proposed rule. Commenters also are invited to submit any data that they may have quantifying the costs and benefits of the proposed rule.

**SEC:** The CFMA<sup>109</sup> authorizes the trading of futures on individual stocks and narrow-based security indexes, and puts, calls, straddles, options, or privileges thereon (collectively, “security futures products”).<sup>110</sup> The CFMA requires, among other things, that trading in the security futures product not be readily susceptible to manipulation of the price of such security futures product, nor to causing or being used in the manipulation of the price of any underlying security or option thereon.<sup>111</sup> In addition, listing standards must require that the market on which the security futures product trades has in place procedures to coordinate trading halts between such market and any market

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<sup>109</sup> Pub. L. No. 106-554, Appendix E, 114 Stat. 2763.

<sup>110</sup> However, no person may offer to enter into, enter into, or confirm the execution of any option on a security future for at least three years after the enactment of the CFMA. See Section 2(a)(1)(D)(iii) of the CEA, 7 U.S.C. 2(a)(1)(D)(iii); Section 6(h)(6) of the Exchange Act, 15 U.S.C. 78f(h)(6).

<sup>111</sup> See Section 2(a)(1)(D)(i)(VII) of the CEA, 7 U.S.C. 2(a)(1)(D)(i)(VII); Section 6(h)(3)(H) of the Exchange Act, 15 U.S.C. 78f(h)(3)(H).

on which any security underlying the security futures product is traded and other markets on which any related security is traded.<sup>112</sup>

Accordingly, the SEC is proposing new SEC Rule 6h-1 under the Exchange Act generally to provide that the listing standards of national securities exchanges and national securities associations trading security futures products establish (1) a final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and (2) a halt in trading in any security futures product when a regulatory halt is instituted by the national securities exchange or national securities association listing the security or securities underlying the security futures product.<sup>113</sup>

Specifically, proposed SEC Rule 6h-1(a) would provide the definitions of the terms “opening price,” “regular trading session,” and “regulatory halt.”<sup>114</sup> Proposed SEC Rule 6h-1(b) would require that the settlement price of a cash-settled security futures product based on a single security fairly reflect the opening price of the underlying security.<sup>115</sup> Similarly, proposed SEC Rule 6h-1(c) would require that the settlement price of a cash-settled security futures product based on a narrow-based security index fairly reflect the opening prices in the index's underlying securities.<sup>116</sup> Furthermore, the SEC is proposing SEC Rule 6h-1(d) to require that trading on a security futures product based on a single security be halted at all times that a regulatory halt has been instituted by the

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<sup>112</sup> See Section 2(a)(1)(D)(i)(X) of the CEA, 7 U.S.C. 2(a)(1)(D)(i)(X); Section 6(h)(3)(K) of the Exchange Act, 15 U.S.C. 78f(h)(3)(K).

<sup>113</sup> Proposed SEC Rule 6h-1.

<sup>114</sup> Proposed SEC Rule 6h-1(a).

<sup>115</sup> Proposed SEC Rule 6h-1(b).

<sup>116</sup> Proposed SEC Rule 6h-1(c).

listing market due to pending news or the operation of circuit breaker procedures for the underlying security.<sup>117</sup> Likewise, proposed SEC Rule 6h-1(e) would require that trading of a security futures product based on a narrow-based security index be halted at all times that a regulatory halt has been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index.<sup>118</sup>

The SEC is considering the costs and benefits of proposed SEC Rule 6h-1 and requests comment on all aspects of this cost-benefit analysis, including identification of additional costs or benefits of the proposed rule. The SEC encourages commenters to identify, discuss, analyze, and supply relevant data concerning the proposed rule.

**A. Benefits of Proposed SEC Rule 6h-1 under the Exchange Act**

Proposed SEC Rule 6h-1(a) would define the terms “opening price,” “regular trading session,” and “regulatory halt,” and, therefore, the SEC preliminarily believes that there would be no costs imposed on the respondents arising from proposed SEC Rule 6h-1(a). However, in providing the definitions of the relevant terms, the SEC preliminarily believes that proposed SEC Rule 6h-1(a) should benefit respondents by providing legal certainty to respondents when complying with the rule.

The SEC also preliminarily believes that the provisions for cash-settled security futures products under proposed SEC Rule 6h-1(b) and (c) is necessary to minimize opportunities for intermarket manipulations and to promote the fair and orderly operation of the securities markets. In particular, opening-price settlement procedures appear to be

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<sup>117</sup> Proposed SEC Rule 6h-1(d).

<sup>118</sup> Proposed SEC Rule 6h-1(e).

necessary to satisfy the provisions of Section 2(a)(1)(D)(i)(VII) of the CEA<sup>119</sup> and Section 6(h)(3)(H) of the Exchange Act<sup>120</sup> that listing standards for security futures products must require that trading in a security futures product not be readily susceptible to manipulation of the price of such product, nor to causing or being used in the manipulation of the price of any underlying security, option on such security, or option on a group or index including such securities.

Furthermore, the SEC preliminarily believes that using opening-price settlement procedures should avoid the problems caused by arbitrageurs unwinding large arbitrage-related positions at the market close on expiration Fridays that would severely strain the liquidity of the securities markets. Closing-price settlement procedures often made it extremely difficult for the securities markets to solicit sufficient buy or sell interest to match up with the expiration-related programs that often created buy or sell imbalances within the limited time permitted to establish closing prices shortly after 4:00 p.m. (Eastern). Therefore, it was not uncommon for stock specialists to drop share prices sharply at the close in order to provide sufficient discounts to draw in matching buy orders or raise prices sharply at the close to provide sufficient premiums to draw in matching sell orders. Furthermore, closing-price settlement procedures imposed time constraints on specialists to establish closing prices that would result in an equilibrium between buy and sell interest, which in turn produced sharp price movements in the indexes underlying the index futures or options contracts. In addition, the SEC preliminarily believes that the liquidity constraints associated with expiration-related buy or sell programs at the close on expiration Fridays would aggravate ongoing market

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<sup>119</sup> 7 U.S.C. 2(a)(1)(D)(i)(VII).

<sup>120</sup> 15 U.S.C. 78f(h)(3)(H).

swings during an expiration and provide opportunities for entities to anticipate these pressures and enter orders as part of manipulative or abusive trading practices designed to artificially drive up or down share prices.<sup>121</sup>

The SEC preliminarily believes that proposed SEC Rule 6h-1(b) and (c), which require opening-price settlement procedures for cash-settled security futures products, should facilitate the ability of the securities markets to handle expiration-related unwinding programs and should mitigate the liquidity strains that had previously been experienced in the securities markets on expirations. It is likely that smaller price discounts or premiums will be needed to draw in orders to offset unwinding programs since traders who enter the offsetting orders will have the remainder of the trading session to trade out of any long or short positions acquired at the opening.

Furthermore, the SEC preliminarily believes that the language of the proposed rule will provide national securities exchanges and national securities associations with flexibility in establishing the procedures for determining the opening price at which to settle for a particular security futures product. For instance, a national securities exchange or a national securities association would be free to define the opening price as a trade-weighted average price of the underlying security during the first few minutes of trading of a regular trading session or the price reported for the first trade in the underlying security at the beginning of the regular trading session. In addition, proposed SEC Rule 6h-1(b) and (c) also would require that, if an opening price for an underlying security is not readily available, the settlement price of the overlying cash-settled security

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<sup>121</sup> The liquidity constraints faced by the securities markets due to unwinding programs used in closing-price settlement procedures were discussed by the SEC staff in its report on the market decline on November 15, 1991. See Trading Analysis of November 15, 1991, *supra* note 55.

futures product or the cash-settled narrow-based security index future must fairly reflect the price of the underlying security or securities during its most recent regular trading session. Again, the proposal would provide national securities exchanges and national securities associations with some discretion to implement this general rule without dictating how the settlement price is derived for a security futures product.

Further, the SEC believes that the exemption provided for in proposed SEC Rule 6h-1(f), which allows the SEC to provide exemptions from this section,<sup>122</sup> would provide national securities exchanges and national securities associations with sufficient flexibility to use a price outside of the opening price for cash settled security futures products. Accordingly, proposed SEC Rule 6h-1(f) would benefit national securities exchanges and national securities associations by providing them with flexibility in responding to changing market conditions, as well as provide the SEC with continued oversight over the respondents by granting an exemption when it is necessary or appropriate in the public interest and is consistent with the protection of investors.

Proposed SEC Rule 6h-1(d) and (e) would require trading to be halted on security futures products at all times that a regulatory halt has been instituted for the underlying security or for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index. The proposal would help preserve the investor protection and market integrity provisions of regulatory halt procedures in the securities markets. The SEC preliminarily believes that the close

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<sup>122</sup> The SEC may grant an exemption, either unconditionally or on specified terms and conditions, from using an opening price settlement for cash settled security futures products if it finds that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors. See Section 36 of the Exchange Act, 15 U.S.C. 78mm.

relationship between the underlying security or securities and the pricing of the overlying security futures product generally justifies a regulatory halt of the security futures product at all times that a regulatory halt has been instituted for the underlying security or securities.<sup>123</sup>

With respect to regulatory halts due to pending news, proposed SEC Rule 6h-1(d) and (e) would benefit current and potential shareholders by providing an opportunity for material information about the underlying security or securities to be disseminated to the public. Pending news development may have a significant effect on trading, and the SEC believes that all investors should have an opportunity to learn of and react to material information in order to make informed investment judgments.<sup>124</sup> Accordingly, such news pending regulatory halts would foster public confidence in the market and promote the integrity of the market place. Furthermore, the SEC preliminarily believes that requiring an exchange or association to halt trading on a security futures product at all times that a regulatory halt has been instituted for the underlying security or securities should contribute to the maintenance of an efficient market.

In addition, the SEC preliminarily believes that instituting a regulatory halt in the trading of security futures product due to the operation of circuit breakers would further protect investors and the markets by mitigating potential systemic stress during a historic market decline and allow for the reestablishment of an equilibrium between buying and

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<sup>123</sup> The trading halt provisions of proposed SEC Rule 6h-1(d) and CFTC Rule 41.25(a)(2)(i) would not be exclusive. The proposed rule is not designed to preclude a market trading security futures products from halting trading for other appropriate reasons, such as operational difficulties being experienced by the market or its automated systems or concerns over clearance and settlement operations.

<sup>124</sup> See Securities Exchange Act Release No. 32890 (September 14, 1993), 58 FR 48916 (September 20, 1993).

selling interests in an orderly fashion. The SEC generally believes that pre-determined, coordinated, cross-market operations of circuit breakers would effectively address market declines that threaten to result in ad hoc and potentially destabilizing market closings. The SEC preliminarily believes that the circuit breakers levels are sufficiently broad enough to be triggered only on rare occasions and represent a reasonable means to protect the nation's financial markets and participants from rapid market declines.<sup>125</sup> Circuit breaker procedures would also help to ensure that market participants had a reasonable opportunity to become aware of, and respond to, significant price movements.

With respect to narrow-based security indexes, the SEC believes that trading should necessarily be halted when a trading halt has been instituted for a sufficiently large portion of an index in order to prevent continued trading of the security futures product from becoming a means to improperly circumvent regulatory halts in the underlying securities. If trading in only one component security is halted, continued trading in a security index future in which such a security represents a substantial portion of the index value could also undermine the trading halt in the underlying security. The SEC preliminarily believes that trading halt procedures also would not be coordinated, as contemplated by Section 2(a)(1)(D)(i)(X) of the CEA<sup>126</sup> and Section 6(h)(3)(K) of the Exchange Act,<sup>127</sup> if the security futures product continued to trade while investors were precluded from trading some or all of the underlying securities. Moreover, the SEC preliminarily believes that continued trading in the security futures product under these

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<sup>125</sup> See Securities Exchange Act Release No. 27370 (October 23, 1989), 54 FR 43881 (October 27, 1989).

<sup>126</sup> 7 U.S.C. 2(a)(1)(D)(i)(X).

<sup>127</sup> 15 U.S.C. 78f(h)(3)(K).

circumstances would undercut key provisions in the securities laws designed to protect investors and promote the fair and orderly operation of the markets. Accordingly, the SEC believes that a general practice whereby trading is halted for the security futures product when investors lack access to current pricing information in the primary market for the underlying security should contribute to the maintenance of fair and orderly markets. Therefore, proposed SEC Rule 6h-1(e) would require a trading halt in the security futures product overlying the index when trading is halted in a component security or securities of an index that represents 30 percent or more of the index's weighting. Moreover, the SEC believes that this coordination of trading halts, as contemplated by proposed SEC Rule 6h-1(d) and (e), would generally benefit investors and the market by providing less opportunity for abuse and manipulation.

Proposed SEC Rule 6h-1(d) and (e) also would further increase investor confidence in the stability of the markets by assuring investors and the public that the national securities exchanges and national securities associations trading security futures product are reasonably equipped to handle market demand and pending material news.

Furthermore, in order to be effective, circuit breakers have to be coordinated across stock, stock index futures, and options markets in order to prevent intermarket problems of the kind experienced in October 1987.<sup>128</sup> Since the markets currently

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<sup>128</sup> In response to the events of October 19, 1987, when the Dow Jones Industrial Average ("DJIA") sustained a one-day decline of 508 points (22.6%), the nation's securities and futures markets in 1988 adopted rules that provide for coordinated, cross-market trading halts in all equity and equity-derivative markets following specified declines in the DJIA. See Circuit Breaker Report, supra note 33. See also Securities Exchange Act Release No. 38080 (December 23, 1996), 61 FR 69126 (December 31, 1996) (citing the SEC's desire to have coordinated mechanisms across these markets to deal with potential volatility that may develop during periods of extreme downward volatility).

coordinate regulatory halts between the listing market for the underlying security and other markets that trade the underlying security or any related security in order to promote investor protection and fair and orderly markets, proposed SEC Rule 6h-1(d) and (e) would help ensure such coordination and effectiveness through the use of regulatory halts in the markets trading security futures products.

The SEC also preliminarily believes that the proposed rule will provide all market participants a clear guideline of when regulatory halts are to be observed for trading in the security futures products.

**B. Costs of Proposed SEC Rule 6h-1 under the Exchange Act**

The SEC estimates that there would be 17 respondents to the proposed rule: 9 currently registered national securities exchanges, 1 national securities association (the NASD) that operates a securities market (Nasdaq), and an estimated 7 futures markets that are expected to register as Security Futures Product Exchanges.

National securities exchanges and national securities associations may file proposed rule changes pursuant to Section 19(b) of the Exchange Act<sup>129</sup> to implement proposed SEC Rule 6h-1.<sup>130</sup> However, the SEC notes that even in the absence of proposed SEC Rule 6h-1, pursuant to the CFMA, to trade security futures products, each of the respondents would have to file one or more proposed rule changes to adopt listing standards for security futures products.

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<sup>129</sup> 15 U.S.C. 78s(b).

<sup>130</sup> The SEC has adopted Rule 19b-7, which would direct Security Futures Product Exchanges to file proposed rule changes on Form 19b-7. See Securities Exchange Act Release No. 44692, supra note 12.

Under Rule 17a-1 of the Exchange Act,<sup>131</sup> a national securities exchange or national securities association is required to retain records of the collection of information for at least 5 years, with the first 2 years in an easily accessible place. However, Rule 17a-1 requires a Security Futures Product Exchange to retain only those records relating to persons, accounts, agreements, contracts, and transactions involving security futures products.<sup>132</sup> As discussed above, the SEC also does not believe that the collection of information required by proposed SEC Rule 6h-1 would result in any additional clerical work or miscellaneous clerical expenses since these clerical burdens would be incurred even in the absence of proposed SEC Rule 6h-1<sup>133</sup> and are actually due to the statutory requirement. The SEC preliminarily believes that respondents would not incur any additional capital or start-up costs, nor any additional operational or maintenance costs to comply with the collection of information requirements under proposed SEC Rule 6h-1.<sup>134</sup>

In addition, proposed SEC Rule 6h-1 would require respondents that chose to trade these products to develop a system for determining the settlement price of a cash-settled security futures product to fairly reflect the opening price of the underlying security. However, because respondents to the proposed rule currently have systems in place to determine opening prices, the SEC preliminarily believes that respondents complying with the settlement provisions of proposed SEC Rule 6h-1 would only incur

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<sup>131</sup> 17 CFR 240.17a-1.

<sup>132</sup> See 15 U.S.C. 78q(b)(4)(B).

<sup>133</sup> See Paperwork Reduction Act discussion at Section IV.

<sup>134</sup> Id.

minimal operational or maintenance costs to reconfigure their current settlement procedures to fairly reflect the opening price of the underlying security.

Finally, the SEC preliminarily believes that national securities exchanges and national securities associations would incur operational costs in developing a system to monitor when other markets have instituted a regulatory halt for an underlying security of the security futures product in order to comply with proposed SEC Rule 6h-1(b) and (c). However, the SEC notes that 9 of the estimated 17 respondents are already required to provide notification of regulatory halts since they are participants of the Consolidated Tape Association Plan (“CTA Plan”)<sup>135</sup> and thus, should already have systems in place to monitor each other of regulatory halts being instituted. The SEC also estimates that each of the remaining respondents will have to develop a similar system to monitor when regulatory halts have been instituted by the primary market of the underlying security. The SEC requests comments on the number of respondents who will actually have to develop a monitoring and notification system and the estimated costs in developing such a system.

### **C. Request for Comments**

The SEC requests data to quantify the costs and benefits above. The SEC seeks estimates of these costs and benefits, as well as any costs and benefits not already described, which may result from the adoption of this proposed rule.

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<sup>135</sup> The CTA Plan is a joint industry plan that governs the consolidated transaction reporting system. Parties to the CTA Plan are as follows: the American Stock Exchange, Inc., Boston Stock Exchange, Inc., Chicago Board Options Exchange, Inc., Chicago Stock Exchange, Inc., Cincinnati Stock Exchange, Inc., National Association of Securities Dealers, Inc., New York Stock Exchange, Inc., Pacific Stock Exchange, Inc., and Philadelphia Stock Exchange, Inc. See CTA Plan (Second Restatement), Section III (a).

The SEC requests comment on the estimate of the number of respondents that would be affected by proposed SEC Rule 6h-1 and the costs and benefits associated with complying with the proposed rule. The SEC specifically requests comments on the operational and maintenance costs associated with the proposal and whether these costs would be significant. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposal.

**VI. Consideration of the Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation**

**SEC:** Section 3(f) of the Exchange Act<sup>136</sup> requires the SEC, whenever it is engaged in rulemaking, and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act<sup>137</sup> requires the SEC, when promulgating rules under the Exchange Act, to consider the impact any such rules would have on competition. Section 23(a)(2) of the Exchange Act further provides that the SEC may not adopt a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The SEC has considered the proposed rule in light of the standards set forth in Sections 3(f) and 23(a)(2) of the Exchange Act.<sup>138</sup>

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<sup>136</sup> 15 U.S.C. 78c(f).

<sup>137</sup> 15 U.S.C. 78w(a)(2).

<sup>138</sup> 15 U.S.C. 78c(f) and 78w(a)(2). The CFTC is not required to evaluate proposed rules under these standards.

## **A. Settlement Prices for Cash-Settled Security Futures Products**

### **1. Effects on Competition**

Proposed SEC Rule 6h-1(b) and (c) would require national securities exchanges and national securities associations that trade security futures products to trade cash-settled security futures products only if the final settlement price for each cash-settled security futures products fairly reflects the opening price for the underlying security or securities. If adopted, the proposal may affect competition, as national securities exchanges and national securities associations would not be able to choose between using opening prices and closing prices for settlement of cash-settled security futures products. However, as discussed above, the SEC preliminarily believes that the benefits to be gained by such restriction justify any potential costs, and that any such restriction is appropriate in furtherance of the purposes of the Exchange Act, particularly the purpose of reducing market volatility and the opportunities for market manipulation. The SEC solicits comment on the impact on competition of the proposed rule regarding settlement prices for cash-settled security futures products.

### **2. Effects on Efficiency and Capital Formation**

The SEC preliminarily believes that, as addressed above, the proposal regarding settlement prices for cash-settled security futures products would reduce market volatility and opportunities for market manipulation of security futures products and would ultimately improve efficiency and capital formation by strengthening investors' confidence in the market for these products. Commenters are invited to submit comments on the effect of the proposed rule regarding settlement prices for cash-settled security futures products on efficiency and capital formation.

## **B. Trading Halts for Security Futures Products**

### **1. Effects on Competition**

The SEC acknowledges that the proposed rule establishing a criteria for trading halts for security futures products could impose a burden on competition, because national securities exchanges and national securities associations that trade a security futures product would not be permitted to act as a surrogate market for an underlying security or securities when such security or securities are subject to a regulatory halt on the listing market. However, as discussed more fully above, the SEC preliminarily believes that any burden on competition as a result of a trading halt is appropriate in furtherance of the purposes of the Exchange Act. The SEC solicits comment on the impact on competition of the proposed rule regarding trading halts for security futures products.

### **2. Effects on Efficiency and Capital Formation**

The SEC preliminarily believes that the proposal regarding trading halts for security futures products, which would require national securities exchanges and national securities associations to halt trading in security futures products when trading is halted in the underlying security or securities, will ultimately improve efficiency and capital formation by creating a fairer and more orderly marketplace. Commenters are invited to submit comments on the effect of the proposed rule regarding trading halts for security futures products on efficiency and capital formation.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the SEC also is requesting information regarding the potential impact of the

proposed rule on the economy on an annual basis. Commentators should provide empirical data to support their views.

## **VII. Regulatory Flexibility Act**

**CFTC:** The Regulatory Flexibility Act (“RFA”) requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities.<sup>139</sup> The rule adopted herein would affect designated contract markets and registered derivatives transaction execution facilities. The CFTC has previously established certain definitions of “small entities” to be used in evaluating the impact of its rules on small entities in accordance with the RFA.<sup>140</sup> In its previous determinations, the CFTC has concluded that contract markets are not small entities for the purpose of the RFA.<sup>141</sup> The CFTC has also recently proposed determining that the other trading facilities subject to its jurisdiction, for reasons similar to those applicable to contract markets, would not be small entities for purposes of the RFA.<sup>142</sup>

Accordingly, the CFTC does not expect the rule, as proposed herein, to have a significant economic impact on a substantial number of small entities. Therefore, the Acting Chairman, on behalf of the CFTC, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed amendments will not have a significant economic impact on a substantial number of small entities. The CFTC invites the public to comment on the finding that this proposed rule would not have a significant economic impact on a substantial number of small entities.

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<sup>139</sup> 5 U.S.C. 601 et seq.

<sup>140</sup> See 47 FR 18618-21 (April 30, 1982).

<sup>141</sup> See id. at 18619 (discussing contract markets).

<sup>142</sup> See 66 FR 14262, 14268 (March 9, 2001).

**SEC:** Section 3(a) of the RFA<sup>143</sup> requires the SEC to undertake an initial regulatory flexibility analysis of the proposed rules on small entities unless the SEC certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>144</sup> Proposed SEC Rule 6h-1 would require national security exchanges and national security associations trading security futures products to trade cash-settled security futures products only if the final settlement price for each cash-settled security futures product fairly reflects the opening price of the underlying security or securities, and to halt in trading in any security futures product when a regulatory halt is instituted for the underlying security or securities of the security futures product. There are nine currently registered national securities exchanges, one national securities association, and seven futures markets that are likely to register as Security Futures Product Exchanges, all of which would be subject to the proposed rule and none of which are small entities. The SEC has certified that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities. A copy of the certification is attached as Appendix A.

## **VIII. Statutory Basis and Text of Proposed Rule**

### **List of Subjects**

17 CFR Part 41

Security futures products, Trading halts and Settlement provisions.

17 CFR Part 240

Securities.

### **Commodity Futures Trading Commission**

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<sup>143</sup> 5 U.S.C. 603(a).

<sup>144</sup> 5 U.S.C. 605(b).

17 CFR Chapter I

The CFTC has authority to propose these rules pursuant to sections 2(a)(1)(D)(i)(VII), 2(a)(1)(D)(i)(X), and 8a(5) of the CEA, 7 U.S.C. 2(a)(1)(D)(i)(VII), 2(a)(1)(D)(i)(X), and 12a(5).

In accordance with the foregoing, Title 17, Chapter I of the Code of Federal Regulations is proposed to be amended by amending Part 41 as follows:

**Part 41—SECURITY FUTURES PRODUCTS**

1. The authority citation for Part 41 is revised to read as follows:

Authority: 7 U.S.C. 1a(25), 2(a), 6j, 7a-2(c) and 12a(5).

2. Section 41.1 is amended by adding paragraphs (j), (k) and (l) to read as follows:

**§41.1 Definitions.**

For purposes of this part:

\* \* \* \* \*

(j) Opening price means the price at which a security opened for trading, or a price that fairly reflects the price at which a security opened for trading, during the regular trading session of the national securities exchange or national securities association that lists the security.

(k) Regular trading session of a security means the normal hours for business of a national securities exchange or national securities association that lists the security.

(l) Regulatory halt means a delay, halt, or suspension in the trading of a security, that is instituted by the national securities exchange or national securities association that lists the security, as a result of:

(1) A determination that there are matters relating to the security or issuer that have not been adequately disclosed to the public, or that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue; or

(2) The operation of circuit breaker procedures to halt or suspend trading in all equity securities trading on that national securities exchange or national securities association.

3. Section 41.25, as proposed on July 20, 2001, 66 FR 37932, is further proposed to be amended by revising paragraphs (a)(2) and (b) to read as follows:

**§41.25 Additional conditions for trading for security futures products.**

**(a) Common provisions.**

\* \* \*

(2) Regulatory Trading Halts. The rules of a designated contract market or registered derivatives transaction execution facility that lists or trades one or more security futures products must include the following provisions:

(i) Trading of a security futures product based on a single security shall be halted at all times that a regulatory halt has been instituted for the underlying security; and

(ii) Trading of a security futures product based on a narrow-based security index shall be halted at all times that a regulatory halt has been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index.

\* \* \* \* \*

(b) **Special requirements for cash-settled contracts.** For cash-settled security futures products, the cash-settlement price must be reliable and acceptable, be reflective of prices in the underlying securities market and be not readily susceptible to manipulation.

(1) The final settlement price of a cash-settled security futures product based on a single security shall fairly reflect the opening price of the underlying security. If an opening price for the underlying security is not readily available, the final settlement price of the security futures product shall fairly reflect the price of the underlying security during its most recent regular trading session; and

(2) The final settlement price of a cash-settled security futures product based on a narrow-based security index shall fairly reflect the opening prices of the underlying securities. If an opening price for one or more underlying securities is not readily available, the final settlement price of the narrow-based security index future shall, for the underlying securities for which opening prices are not readily available, fairly reflect the prices of those underlying securities during their most recent regular trading session.

(3) The Commission may exempt from the provisions of paragraphs (b)(1) and (b)(2) of this section, either unconditionally or on specified terms and conditions, any designated contract market or registered derivatives transaction execution facility, when the Commission determines that an exemption is consistent with the public interest, the protection of investors, and otherwise furthers the purposes of the Act.

\* \* \* \* \*

Issued in Washington, DC on August 24, 2001 By the Commodity Futures  
Trading Commission.

Jean A. Webb  
Secretary

**Securities and Exchange Commission**

17 CFR Chapter II

The SEC is proposing the rules pursuant to its authority under Exchange Act Sections 6, 9, 15A, 19, 23(a), and 36, 15 U.S.C. 78f, 78i, 78o-3, 78s, 78w(a), and 78mm.

In accordance with the foregoing, Title 17, Chapter II, part 240 of the Code of Federal Regulations is proposed to be amended as follows:

**PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

1. The authority citation for part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78o-3, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 240.6h-1 is added to read as follows:

**§240.6h-1 Settlement and regulatory halt requirements for security futures products.**

- (a) For the purposes of this section:

(1) Opening price means the price at which a security opened for trading, or a price that fairly reflects the price at which a security opened for trading, during the regular trading session of the national securities exchange or national securities association that lists the security.

(2) Regular trading session of a security means the normal hours for business of a national securities exchange or national securities association that lists the security.

(3) Regulatory halt means a delay, halt, or suspension in the trading of a security, that is instituted by the national securities exchange or national securities association that lists the security, as a result of:

(i) A determination that there are matters relating to the security or issuer that have not been adequately disclosed to the public, or that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue; or

(ii) The operation of circuit breaker procedures to halt or suspend trading in all equity securities trading on that national securities exchange or national securities association.

(b) The final settlement price of a cash-settled security futures product based on a single security shall fairly reflect the opening price of the underlying security. If an opening price for the underlying security is not readily available, the final settlement price of the security futures product shall fairly reflect the price of the underlying security during its most recent regular trading session.

(c) The final settlement price of a cash-settled security futures product based on a narrow-based security index shall fairly reflect the opening prices of the underlying

securities. If an opening price for one or more underlying securities is not readily available, the final settlement price of the narrow-based security index future shall, for the underlying securities for which opening prices are not readily available, fairly reflect the prices of those underlying securities during their most recent regular trading session.

(d) Trading of a security futures product based on a single security shall be halted at all times that a regulatory halt has been instituted for the underlying security.

(e) Trading of a security futures product based on a narrow-based security index shall be halted at all times that a regulatory halt has been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index.

(f) The Commission may exempt from the provisions of paragraphs (b) and (c) of this section, either unconditionally or on specified terms and conditions, any national securities exchange or national securities association if the Commission determines that such exemption is necessary or appropriate in the public interest, and consistent with the protection of investors.

By the Securities and Exchange Commission.

Jonathan G. Katz<sup>145</sup>  
Secretary

August 24, 2001

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<sup>145</sup> Chairman Pitt did not participate in this matter.

## Appendix A

Note: Appendix A to the preamble will not appear in the Code of Federal Regulations.

### **REGULATORY FLEXIBILITY ACT CERTIFICATION**

The Securities and Exchange Commission (“Commission”) hereby certifies pursuant to 5 U.S.C. § 605(b) that proposed Rule 6h-1 under the Securities Exchange Act of 1934 (“Exchange Act”), which generally would provide that the listing standards of national security exchanges and national security associations trading security futures products establish (i) a settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and (ii) a halt in trading in any security futures product when a regulatory halt is instituted by the national securities exchange or national securities association listing the security or securities underlying the security futures product, would not, if adopted, have a significant economic impact on a substantial number of small entities. Proposed Rule 6h-1 under the Exchange Act likely would apply to nine currently registered national securities exchanges, one national securities association, and an estimated seven futures markets that are expected to register as Security Futures Product Exchanges, none of which is a small entity for the purpose of the Regulatory Flexibility Act. Accordingly, proposed Rule 6h-1, if adopted, would not have a significant economic impact on a substantial number of small entities.

By the Commission.

/s/ Jonathan G. Katz  
Jonathan G. Katz  
Secretary

Dated: August 24, 2001