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Chairman and
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September 15, 2004

Mr. David Van Wagner
Chief Counsel
Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Chicago Mercantile Exchange European-Style Options

Dear Mr. Van Wagner:

As you know, the Chicago Mercantile Exchange ("CME") recently announced that all of its equity index options will be converted from American to European-style expiration. We are attaching a paper that analyzes the CME's proposed conversion to European-style expiration. Our paper concludes that, upon this conversion, equity index options that expire in a month in the March-June-September-December quarterly cycle ("quarterly options") will be cash-settled and do not qualify as options on futures. These quarterly options are options on a group or index of securities and therefore fall outside the coverage of the Commodity Exchange Act ("CEA") and outside the jurisdiction of the CFTC.

Under our analysis, the CME has no legal authority to trade such European-style quarterly options as a designated contract market under the CEA. Moreover, because these options fall under SEC jurisdiction, the CME cannot lawfully trade such options as an exchange in the U.S. without being registered as a national securities exchange under Section 6(b) of the Securities Exchange Act of 1934.

The CME submitted its rule amendments to convert its equity index options to European-style expiration by letter to the CFTC dated August 19, 2004. The rule amendments purport to become effective after having been submitted to the CFTC with the requisite certification that the rule amendments neither violate nor are inconsistent with any portion of the CEA or the rules thereunder. The CME has announced that it will list the European-style equity index options for trading starting on October 18, 2004.

We are concurrently communicating our analysis and concerns to the SEC and CME, and we have asked the CME to terminate its plan to convert its quarterly equity index options to European-style expiration. (See attached letter to Craig Donohue, President and CEO of the CME.) If the CME does not voluntarily terminate its plan, or amend its rules so as to bring them into conformity with applicable law, we are asking the CFTC to take appropriate action to ensure that there is no trading in these contracts without full compliance with the law, thereby avoiding later rescission of these contracts.

If you have any questions regarding this matter, please contact the undersigned or Joanne Moffic-Silver, CBOE's General Counsel, at (312) 786-7462.

Sincerely,

Bill Brodsky

William J. Brodsky

Attachments

ANALYSIS OF CME'S PROPOSED CONVERSION OF ITS EQUITY INDEX OPTIONS TO EUROPEAN-STYLE EXPIRATION

The Chicago Mercantile Exchange ("CME") recently announced that all of its equity index options products will be converted from American to European-style expiration. It plans to list the European-style options for trading starting on October 18, 2004. Upon this conversion, options that expire in a month in the March quarterly cycle ("quarterly options") will be cash-settled and will not qualify as options on futures. These options therefore will fall outside the coverage of the Commodity Exchange Act ("CEA") and outside the jurisdiction of the CFTC. Instead, such options will be securities options and thus subject to the exclusive jurisdiction of the SEC.

Description of CME European-Style Options

By letter to the CFTC dated August 19, 2004, the CME submitted a certification of amendments to its equity index options rules.[1] Among other things, the CME rule amendments convert all of its equity index options from American-style options to European-style options. The European-style options can be exercised only on the expiration date of the option.

The CME's S&P 500 futures contract has delivery dates in the March quarterly cycle (i.e., March, June, September and December). The CME plans to list European-style options that expire every month. For quarterly options, the underlying futures contract is the futures contract for the month in which the option expires. For example, the underlying futures contract for an S&P 500 option that expires in March is the March S&P 500 futures contract. For options that expire in a month other than those in the March quarterly cycle ("serial options"), the underlying futures contract is the next futures contract in the March quarterly cycle. For example, the underlying futures contract for S&P 500 options that expire in January or February is the March S&P 500 futures contract. *See* CME Rule 351A01.D.

Under CME's rules, trading in its quarterly options "shall terminate at the same date and time as the underlying futures contract." *See* CME Rule 351A01.I. A quarterly option that is held after the termination of trading shall be exercised automatically if it is "in the money." A quarterly option is deemed to be in the money if the "Final Settlement Price" of the underlying futures contract lies above the exercise price in the case of a call, or lies below the exercise price in the case of a put. *See* CME Rule 351A02.A. The "Final Settlement Price" for CME's S&P 500 futures contract is defined in CME Rule 35103.A as a special quotation of the S&P 500 Stock Price Index based on the opening prices of the component stocks in the index, determined on the third Friday of the contract month. Delivery under the CME's S&P 500 futures contract is by cash settlement based on the Final Settlement Price.

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[1] For the sake of simplicity, this analysis refers only to CME's options on S&P 500 futures. However, the analysis herein is equally applicable to all of CME's proposed European-style equity index options.

Accordingly, the holder of a European-style S&P 500 quarterly option never receives a futures contract when the option is exercised, and the seller of such option is never required to deliver a futures contract. Under CME's rules, the option cannot be exercised until after the last day of trading for the option, which is also the last day of trading for the futures contract. Thus, the party who exercises a European-style quarterly option has no opportunity to trade or hold the underlying futures contract. When the European-style quarterly option is exercised, it is cash-settled based on the opening prices of the component stocks in the index. The price at which the underlying futures contract had traded at the CME plays no part in the determination of the Final Settlement Price.

In contrast, the serial month European-style S&P 500 options are bona fide options on futures. When the holder of a serial option exercises the option, he receives a position in the underlying futures contract rather than cash.

Analysis Under Commodity Exchange Act

Under the Commodity Exchange Act, the CFTC has exclusive jurisdiction over futures contracts on broad-based stock indexes and over options on such futures contracts. However, the CFTC has no jurisdiction over options that are directly on securities or a group or index of securities. This provision is codified in Section 2(a)(1)(C)(i) of the CEA, which states that the CFTC shall have no jurisdiction over, and the CEA shall not apply to:

> "any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities . . . , including any group or index of securities, or any interest therein or based on the value thereof."

A traditional option on futures contract can be easily distinguished from an option directly on securities or a group or index of securities. When the holder of a traditional futures option exercises that option, he receives a futures contract and has the ability to hold or trade that futures contract as he sees fit. In contrast, when the holder of a securities option exercises that option, he receives either the underlying securities (in the case of physical delivery) or a cash amount (in the case of cash settlement). In this critical respect, the CME's quarterly European-style S&P 500 options are securities options rather than futures options. Therefore, under the plain language of the CEA quoted above, the CME's quarterly European-style S&P 500 options are securities options that are outside of the coverage of the CEA and outside of the jurisdiction of the CFTC.

Moreover, because these options are not protected from SEC jurisdiction by virtue of the CFTC exclusive jurisdiction clause in the CEA, it follows that the CME cannot lawfully trade such options as an exchange in the U.S. without being registered as a national securities exchange under Section 6(b) of the Securities Exchange Act of 1934 ("1934 Act").

Conclusion

For purposes of regulatory jurisdiction under the CEA and the 1934 Act, the critical question is whether CME's quarterly European-style options are options on futures, as CME characterizes them, or options on a group or index of securities. Notwithstanding the CME's characterization of the quarterly European-style options, the economic reality is that they are not bona fide options on futures because (1) the party who exercises the option has no opportunity to trade or hold the underlying futures contract and (2) when the option is exercised, it is cash-settled based on the value of the S&P 500 Stock Price Index, rather than by prices determined in the futures market. Therefore, the CME has no authority to trade such options as a designated contract market under the CEA, and the CME cannot lawfully trade such options unless it registers as a national securities exchange under Section 6(b) of the 1934 Act.

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September 15, 2004

Mr. Craig S. Donohue
President and CEO
Chicago Mercantile Exchange
20 S. Wacker Drive
Chicago, Illinois 60606

Re: CME European-style options

Dear Craig:

I am writing to express the concern of Chicago Board Options Exchange ("CBOE") about the recent announcement that the Chicago Mercantile Exchange ("CME") intends to convert all of its equity index options products from American to European-style expiration. Upon such a conversion, options that expire in the March quarterly cycle ("quarterly options") no longer would qualify as options on futures and therefore would fall outside the coverage of the Commodity Exchange Act ("CEA") and outside the jurisdiction of the CFTC. Instead, such options would be securities options and therefore subject to the exclusive jurisdiction of the SEC. CME would have no legal authority to trade such securities options because CME is not registered as a national securities exchange under Section 6(b) of the Securities Exchange Act of 1934 (the "1934 Act"). Moreover, quarterly European-style S&P 500 options would be outside the scope of CME's license agreement with Standard & Poor's ("S&P") and instead would infringe upon CBOE's exclusive license with S&P. Accordingly, CBOE respectfully insists that CME terminate its plan to convert its quarterly options to European-style expiration.

The foregoing conclusions follow from the fact that European-style quarterly options can only settle in cash, and never in the purchase or sale of a futures contract. The underlying futures contract for quarterly options is the futures contract for the month in which the option expires. For example, the underlying futures contract for an S&P 500 option that expires in March is the March S&P 500 futures contract. Under CME's rules, trading in its quarterly options "shall terminate at the same date and time as the underlying futures contract." *See* CME Rule 351A01.I. A quarterly option that is held after the termination of trading shall be exercised automatically if it is "in the money." A quarterly call option is deemed to be in the money if the "Final Settlement Price" of the underlying futures contract lies above the exercise price of the option. *See* CME Rule 351A02.A. The "Final Settlement Price" for CME's S&P 500 futures contract is defined in CME Rule 35103.A as a special quotation of the S&P 500 Stock Price Index based on the opening prices of the component stocks in the index, determined on the third Friday of the contract month. Delivery under the CME's S&P 500 futures contract is by cash settlement based on the Final Settlement Price.

Thus, under CME's rules, the holder of a European-style quarterly option never receives a futures contract when the option is exercised. By definition, the option cannot be exercised until after the last day of trading for the option, which is also the last day of trading for the futures contract. Thus, the party who exercises the European-style quarterly option has no opportunity to trade or hold the underlying futures contract. When the European-style quarterly option is exercised, it is cash-settled based on a published value of the underlying index. The price at which the underlying futures contract had traded at the CME plays no part in the determination of the Final Settlement Price for European-style quarterly options. In contrast, options that expire in months other than those in the March quarterly cycle ("serial options") are bona fide options on futures. When the holder of a serial month option exercises the option, he receives a position in the underlying futures contract rather than cash.

As you know, the CFTC has exclusive jurisdiction over futures contracts on broad-based stock indexes and over options on such futures contracts. However, the CFTC has no jurisdiction over transactions in options that are directly on securities or a group or index of securities or that are based on the value of such securities or such group or index of securities. This provision is codified in Section 2(a)(1)(C)(i) of the CEA, which states that the CFTC shall have no jurisdiction over, and the CEA shall not apply to:

> "any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities . . . , including any group or index of securities, or any interest therein or based on the value thereof."

A traditional option on futures contract can be easily distinguished from an option directly on securities or a group or index of securities. When the holder of a traditional futures option exercises that option, he receives a futures contract and has the ability to hold or trade that futures contract as he sees fit. In contrast, when the holder of a securities option exercises that option, he receives either the underlying securities (in the case of physical delivery) or a cash amount (in the case of cash settlement). In this critical respect, the CME's quarterly European-style options are securities options rather than futures options. Therefore, under the plain language of the CEA quoted above, CME's proposed quarterly European-style options are securities options that are outside of the coverage of the CEA and outside of the jurisdiction of the CFTC. As securities options, they must be traded on a national securities exchange registered with the SEC under Section 6(b) of the 1934 Act.

CME's proposed quarterly European-style S&P 500 options also are outside of the scope of CME's license agreement with Standard & Poor's, based on those portions of the agreement that were made publicly available by the CME as an exhibit to the CME's Registration Statement on Form S-4. In that agreement, S&P grants to CME a license to use the S&P Stock Indices solely in connection with creating, marketing, trading, clearing and promoting Indexed Contracts. The term "Indexed Contracts" is defined to mean, as is applicable here, "Option Contracts" that are indexed to any of the S&P Stock Indices. The term "Option Contract" is defined to mean an "option to purchase or sell Futures Contracts." The CME's proposed quarterly European-style S&P 500 options are not options "to purchase or sell Futures Contracts" because the party who exercises the option has no opportunity to purchase or sell a futures contract.

Moreover, under the terms of the license agreement between S&P and CBOE, CBOE has an exclusive license in respect of the S&P 500 for "Standardized Option Contracts" as that term is defined in the CBOE license agreement. Because standardized European-style options are settled based on the published special quotation value of the S&P 500 Stock Price Index, they clearly fit within that definition. Thus, S&P cannot permit CME to trade such options under the exclusivity provision contained in the CBOE license agreement.

For all of these reasons, CME is not permitted to trade European-style quarterly options. We hope CME will acknowledge this fact and will terminate its plan to convert its quarterly equity index options products to European-style expiration. As noted above, we have no objection to CME's proposed trading of European-style serial options, as they are bona fide options on futures. We would welcome the opportunity to discuss this situation with you and to explain more fully the nature and depth of our concern. However, in light of the imminence of CME's planned conversion, we feel it is necessary simultaneously to bring our concerns to the attention of, and to request actions from, the CFTC, the SEC and S&P. We hope that CME's prompt action to reverse course will eliminate the need to pursue these other avenues.

Sincerely,

Bill

William J. Brodsky