



RECEIVED
C.F.T.C.

COMMENT

01-15
①

2001 AUG 21 AM 11: 01

OFFICE OF THE SECRETARIAT

Joanne Moffic-Silver
General Counsel and
Corporate Secretary
Legal Department

Phone: 312 786-7462
Fax: 312 786-7919
mofficj@cboe.com

RECEIVED
RECORDS SECTION
AUG 21 PM 2 37

RECEIVED
C.F.T.C.

August 20, 2001

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

Re: Listing Standards and Conditions for Security Futures

Dear Ms. Webb:

The Chicago Board Options Exchange, Incorporated ("CBOE") is pleased to take this opportunity to comment on proposed rules issued by the Commodity Futures Trading Commission ("CFTC") regarding listing standards and conditions for security futures products.¹ The Commodity Futures Modernization Act of 2000 ("CFMA") amended the Commodity Exchange Act to provide that in order for a board of trade to list security futures products, the products must meet a number of standards and conditions termed "listing standards." The proposed rulemaking would implement these standards and enumerate certain requirements and conditions for listing and trading security futures products.

CBOE generally supports the proposed rules. Nevertheless, CBOE has several comments relating to the scope and coverage of the proposed rules. Our comments are discussed below.

Position Limits

In the Proposing Release, the CFTC states that the proposed rules would establish position limits for security futures products that are set at levels comparable to the limits that apply to options on individual equities. Actually, the levels proposed by the CFTC are very different than the position limit levels imposed on stock options. CBOE Rule 4.11 includes five different tiers of position limits for stock options. The CFTC's proposal only includes one level for futures overlying less active securities, and then converts to a position accountability rule for futures on more active securities.

¹ 66 FR 37936 (July 20, 2001) ("Proposing Release").

The CFTC's proposed position limits also would differ significantly from the limits applicable to stock options in several other important areas. First, the limits would only apply to an expiring securities futures product during its last five trading days. Stock option position limits apply continuously. Second, a position accountability rule rather than a position limit would apply to security futures products based on a security that has an average daily trading volume greater than 20 million shares. Options on such securities are subject to position limits. Third, the proposed limits only apply to speculative positions; exchanges could exempt hedge positions pursuant to the provisions of the Commodity Exchange Act ("CEA"). The futures hedge exemptions under the CEA are much broader than the hedge exemptions for stock options both in what constitutes an allowable hedge as well as the size of the exempt position.

We would support the position limit approach proposed by the CFTC, provided that such approach is available for security options. Our concern with the proposal is not its substance, but the fact that it could lead to disparate position limit treatment between security futures and security options. The CFMA was intended to create regulatory parity between security futures products and comparable stock options. The CFTC's proposed rules depart from this standard by permitting significantly less restrictive position limits for security futures products than is available for security options.

We do not make this comment to criticize the CFTC's proposal. Indeed, we believe the position limits proposed by the CFTC are appropriate for security futures products and for stock options. For the reasons discussed in the CFTC's proposal, the reduced number of tiers, position accountability standard, futures-style hedge exemption, and application of limits only to the last five trading days of an expiring contract make equal sense for security options. Indeed, CBOE has long supported the use of a position accountability approach for options rather than a restrictive limits approach. The Securities and Exchange Commission ("SEC") has approved a position accountability approach for our three largest index options and for FLEX equity options. Consequently, we plan to submit proposed rule changes to the SEC for approval that would adopt for stock options the same standards proposed by the CFTC for security futures products. It is critical that CBOE be allowed to adopt these position limit rules for security options, otherwise equivalent regulatory treatment of security futures and security options would be undermined. Thus, we urge the CFTC to consult with the SEC before it takes final action on the proposal to determine if the SEC will permit CBOE to adopt these standards for security options. If the CFTC finds that the SEC is unwilling to do so, then the CFTC and SEC should not apply the proposed standards to security futures products but instead use the existing stock option position limit standards.

Cash-Settled Products

Other than a provision in proposed §41.25(b) that the cash-settlement price for security futures products must be reliable and acceptable, reflective of prices in the underlying securities market, and not readily susceptible to manipulation, the proposal does not establish special requirements for cash-settled security futures products. The

proposing release does note that additional conditions related to acceptable procedures for cash settlement will be addressed in a future joint rulemaking by the CFTC and SEC, but does not amplify as to what those conditions may cover. This silence is somewhat at odds with the SEC's position towards cash-settlement of stock index options and stock index futures. In the past the SEC has expressed strong concern that the unwinding of index arbitrage positions involving stock index options or stock index futures at the close on Expiration Friday could overwhelm the available liquidity in the market for the stocks in the affected indexes. Over a decade ago, the SEC began to urge the options and futures exchanges to switch their index derivative products to a settlement based on opening prices of the component stocks on Expiration Friday, because it believed that use of pre-opening procedures could facilitate a smoother unwinding of arbitrage positions.²

Due to the urging of the SEC on this matter, the options and futures exchanges switched settlement of most of their index derivative products to the opening on Expiration Friday. As a result, CBOE switched settlement of its S&P 500 index option to the open. In addition, CBOE has based every new index option on opening settlement since that time.³ If cash settled index options are required to be settled at the opening price, then cash settled futures on single stock should be settled in the same manner. Any concerns about closing settlement of index options would be accentuated in the cash settlement of futures on a single stock.⁴ Permitting cash settlement of security futures products at the closing price could lead to a re-evaluation of the current settlement practice in both the stock index options markets and the stock index futures markets. CBOE urges the CFTC and SEC to consider the implications of such a settlement choice.

Clarification of Specific Proposed Rules

CBOE would like confirmation as to its understanding of the proposed rules in several areas. First, proposed §41.22(i) would require a board of trade for a security futures product to have procedures in place to coordinate regulatory trading halts between the board of trade and the markets on which any underlying security is traded or on which any related security is traded. We read this section as relating only to the obligation to adopt the same type of intermarket circuit breakers for security futures products that currently apply to stock index options or stock index futures.⁵ If the proposed rule is also

² See e.g., Securities Exchange Act Release No. 30944 (July 21, 1992).

³ We kept settlement of our Standard & Poor's 100 index option at the close due to the heavy retail involvement in the product.

⁴ Theoretically, cash settlement of security futures products should offer the same potential for price pressure at expiration due to the unwinding of arbitrage positions as does cash settlement of stock index options and stock index futures. Indeed, futures on individual stocks may create more expiration day pressure because the unwinding activity is concentrated in individual stocks.

⁵ See e.g., CBOE Rule 6.3B.

intended to cover trading halts other than circuit breakers, then it goes far beyond the trading halt coordination applicable to individual stock options.⁶ We do not believe that trading halt coordination for security futures products needs to be more extensive than for stock options.

Second, proposed §41.22(d) would limit persons who can solicit, accept any order for, or otherwise deal in any securities futures transaction to futures commission merchants ("FCM"), introducing brokers ("IB"), commodity trading advisors ("CTA"), commodity pool operators ("CPO") and associated persons ("AP") subject to suitability rules comparable to those of a national securities association (e.g., the NASD), "except to the extent otherwise permitted under the Securities Exchange Act of 1934 and the rules and regulations thereunder". The list of FCM, IB, CTA, CPO, and AP does not cover all floor members of CBOE. For example, it would not cover most designated primary market makers because they do not fall under any of the enumerated categories. We read the proposed rules as still covering these and all other CBOE members because, as broker-dealers or associated persons under the securities laws, they are otherwise permitted under the securities laws to accept, solicit, or deal in securities futures. If we are wrong in our understanding, then the rule needs to be corrected to ensure that it does not preclude CBOE members who do not come under the list of identified categories in the rule from engaging in security futures transactions. Moreover, there would be no policy reason for precluding any CBOE member from engaging in security futures transactions. All CBOE members will be subject to CBOE's suitability rule for securities futures products, which will be comparable to the NASD's suitability rule.⁷

Third, subsections (g), (h), and (i) of proposed §41.22 impose surveillance, audit trails, and trading halt requirements on boards of trade for security futures products, but exempt alternative trading systems ("ATSS"), national securities associations, and national securities exchanges of which the ATS is a member. The proposed exemptions do not appear to capture accurately the exemptions contained in the statute. The CFMA provides exemptions in these areas to an ATS if a national securities association or a national securities exchange of which the ATS is a member has the requisite rules and procedures.⁸ The statute does not provide exemptions to any national securities

⁶ CBOE's trading halt rule for stock options is Rule 6.3.

⁷ CBOE's suitability rule for options (Rule 9.9) is almost identical to the NASD options suitability rule. The security futures markets are working on uniform suitability rules for security futures products. The joint venture through which CBOE will trade security futures products and/or CBOE itself will adopt the uniform suitability rule for security futures products or a rule substantially similar to the NASD suitability rule.

⁸ Under the securities laws, an ATS must be a member of a self-regulatory organization such as a national securities association or national securities exchange. Thus, an ATS' self-regulatory organization would be subject to the surveillance, audit trail, and trading halt requirements.

Ms. Jean Webb
August 20, 2001
Page 5 of 5

association or exchange. If our reading of the statute is correct, then the CFTC should amend its proposal accordingly to track the statute.

Fourth, it is unclear from the proposal whether the proposed rules cover all boards of trade for security futures products or only those who are not notice-registrants with the CFTC. CBOE would be interested in whether the CFTC's proposed certification and listing standards cover national securities exchanges registered pursuant to Section 6(a) of the Securities Exchange Act of 1934 or whether these entities would be required to submit listing standard certifications only to the SEC.

Once again, CBOE appreciates the opportunity to comment on the proposed security futures rules of the CFTC. If you have any questions regarding the issues raised in this letter, please feel free to me at (312) 786-7462.

Sincerely,



Joanne Moffic Silver
General Counsel

cc: Elizabeth Fox, CFTC
Elizabeth King, SEC