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COMMENT

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October 1, 2001

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

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

VIA FACSIMILE AND E-MAIL

Re: File No. S7-15-01 (66 Fed. Reg. 45904, August 30, 2001)
Cash Settlement and Regulatory Halt Requirements for Security Futures Products.

Dear Ms. Webb and Mr. Katz:

Chicago Mercantile Exchange Inc. ("CME") is pleased to offer comments on a proposal recently published by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (together the "Commissions") regarding rules designed to implement requirements regarding cash settlement and regulatory halts for Security Futures Products ("SFPs") under the Commodity Futures Modernization Act of 2000 ("CFMA").

I. INTRODUCTION – The proposed rulemaking deals with two areas where SFPs will interact both with the underlying cash equity markets and with other equity-related derivatives. Most rational observers have concluded that the development of equity-related derivatives has been of great benefit to the overall marketplace, but the evolution of their relationship to each other and to the underlying cash markets has sometimes been difficult and contentious. A great deal has been learned along the way. It is crucial that national securities exchanges and national securities associations listing SFPs have the freedom to design contracts and trading procedures that do not interfere with the interrelationships and balances that have evolved over recent decades.

CME has nearly twenty years' experience with the subjects of these proposed rules, having launched the first cash-settled futures contract – on Three-Month Eurodollars – in December 1981 and the industry leading stock index futures contract – on the Standard and Poor's 500 Stock Price Index® ("S&P 500") – in April 1982. CME currently also trades futures and futures options on the S&P MidCap 400®, S&P 500/BARRA® Value and Growth®, Nasdaq-100 Index®, Russell 2000®, FORTUNE e50™, and Nikkei® 225 stock indexes. CME's products currently account for over 95% of trading volume in U.S. equity index futures products. In 1987 CME became the first futures exchange to convert equity index futures contracts to cash settlement based on opening prices for the underlying securities.

CME also is well aware of the need for inter-market coordination in U.S. equity-related markets. CME's equity index products have been part of coordinated inter-market circuit breakers since their implementation and CME has been an active participant in their continuing evolution. In order to reduce cash-flow mismatches, CME and the Options Clearing Corporation ("OCC") have created a cross-margining arrangement for professional participants in their major index products. In addition, CME has established procedures to deal with temporary trading halts in the cash markets underlying its equity index products.

With the benefit of its wealth of relevant experience, CME is pleased to offer comments on the proposed regulations.

II. CASH-SETTLED SFPS – The Commissions now have proposed two requirements for cash-settled SFPS: 1) that they be settled to opening transactions in the underlying securities (unless specific exemptions are granted) and 2) that if an underlying security – or any component security in a narrow-based index ("NBI") – does not open for trading then the previous day's closing price(s) shall be used for cash settlement.

1. Settling at the Opening Price – Cash settlement of futures contracts is workable when market participants are able to execute transactions in the underlying market(s) at – or very near – the price(s) used for the final mark to market of the futures contract. Anticipation of convergence in turn allows arbitrageurs and other market participant to perform the vital role of maintaining alignment between cash and futures prices. It is easy to guarantee such convergence of cash and futures at termination when the relevant cash markets operate single-price auctions. For example, the New York Stock Exchange ("NYSE") and other securities exchanges accept market-on-open and market-on-close orders, both of which would facilitate convergence.

The switch in 1987 from closing prices to opening prices to settle CME's S&P 500 and other futures contracts was largely a response to the fact that Friday-afternoon settlements – which corresponded to existing practices for listed options expirations – exposed NYSE specialists to large information-less market-on-close orders without an adequate mechanism to cope. This sometimes resulted in unacceptable levels of price volatility. The switch to the opening, where order imbalances can be disseminated and market openings delayed, appears to have enhanced the specialists' ability to accommodate such orders and to lower associated price volatility, but it was by no means a perfect solution. For example, because the openings of all securities do not occur simultaneously, a special index calculation must be constructed using non-synchronous transaction prices. That procedure is very difficult to explain to many market participants. Also, many listed securities increasingly trade in alternative venues where transactions may occur and be reported before the official openings on the NYSE and other exchanges, adding to the confusion.

Other securities marketplaces, such as Nasdaq, do not currently operate centralized markets or accept single-price orders, so settling futures contracts based on their securities is a bit more complicated. A volume-weighted average transaction price over a short time interval has evolved into an industry

standard in such situations; but there is less agreement about when that time interval should occur.¹ CME adopted a five-minute period at the open for Nasdaq-100 futures largely because that time best corresponded to the procedures already in place for pricing listed securities underlying its other futures contracts, not because of a belief that the “best” prices would thereby be obtained.

When CME switched its S&P 500 futures settlement from the Friday close to the Friday open in 1987, listed securities dominated the index and the market share of alternative trading venues for the underlying securities was insignificant. In both respects the marketplace is quite different today.² The market share of the NYSE and other listed exchanges has declined. Trading now occurs in many different venues, and is less confined to the official trading hours of the listed exchanges. It may soon become the case that the exchanges on which some securities are listed are not the primary trading venues and therefore not the primary sources of liquidity. The proposed regulations do not take account of this possibility.

Likewise, the proposed regulations do not appear to recognize that SFPs can be constructed using securities for which the primary markets are foreign.³ For such securities the proposed definition of the opening price is not meaningful and the opening price on the foreign market may not be a practical solution for optimal contract design.

The proposed regulations would apply to NBI futures as well as single-stock futures. To the extent that there are NBIs on which options currently trade and for which cash settlement is based on closing prices, it would be a disservice to the marketplace to force futures on those indexes to adopt inconsistent settlement procedures.

We conclude that the proposed regulations would lock listed SFPs into procedures that may not be optimal going forward. Additionally, exchange-listed SFPs will be subject to intense competition. The CFMA allows equivalent products to trade in the upstairs institutional markets without meaningful regulation. SFP lookalikes already trade in foreign markets that are unregulated by the Commissions. To the extent that the proposed rules lead to sub-optimal design of SFPs traded on U.S. organized markets they unfairly tilt the competitive landscape.

The Commissions propose to allow exemptions from the requirement to use opening prices for cash settlement of SFPs (and the backstop procedures discussed below), but that avenue would be a poor alternative to rules that are flexible and better attuned to current and future market realities. In the current fast-changing landscape the Commissions should not lock listed SPF trading into procedures that lead to poor product design and that might soon turn into anachronisms.

2. Backstop Procedures – The Commissions propose that if a security does not open for trading on the settlement day, then the previous closing price for that security should be used for settlement. This proposal generally corresponds to procedures once in place at CME for equity-index futures. The logic is that if a security does not open because of a corporate event, it may be a protracted time – if ever – before it reopens for trading. Thus it is impractical to delay settlement of the futures contract until a tradable

¹ LIFFE and other European exchanges use a mid-day calculation. That approach can be especially useful when the underlying index contains stocks listed on multiple exchanges with non-synchronous opening and closing times.

² Nasdaq securities now make up approximately 16% of the capitalization of the S&P 500.

³ Securities underlying SFPs must be common stock registered under Section 12 of the Securities Exchange Act of 1934. Not all such securities are listed or traded on domestic exchanges.

price for the security is obtained. The uncertainty of when an acceptable price can be determined is deemed to outweigh the disruption caused by the potential mismatched pricing of offsetting cash and futures positions caused by look-back pricing, at least when only a small percentage of the weight in an index is likely to be affected.

Corporate events are not the only possible reasons why securities might not open for trading on settlement days. The threat that hurricane Floyd might prevent the NYSE from opening on Friday, September, 17, 1999 led U.S. derivatives exchanges and market participants to reconsider settlement day procedures. CME, in consultation with market participants, concluded that it would be far less disruptive to the marketplace to delay the pricing of the affected NYSE-listed securities in its futures contracts until the NYSE was able to reopen, rather than use look-back prices based on the previous day's close. CME and other exchanges subsequently amended their rules accordingly. There appears to be wide industry agreement that these amendments were appropriate. Similar reasoning is likely to prevail when a securities exchange is able to open some, but not all, of its securities on a settlement day.

Therefore, CME strongly recommends that the proposed rules be amended to conform to current practice for broad-based index futures, where a distinction is drawn between corporate events and exchange-specific events in the design of settlement procedures. It would be unproductive and wasteful to require each exchange listing SFPs to apply for an exemption to do so.

3. Response to Specific Requests for Guidance –

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.

For the reasons listed above, it may be preferable to adopt closing-price settlement procedures for SFPs in some circumstances. Reasons could include consistency with related markets and lack of viable alternatives.

Q2: IF COMMENTERS BELIEVE THAT CASH-SETTLEMENT 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?

CME does not agree completely that the use of opening (or other) prices for cash settlement of equity-related derivatives instead of closing prices renders the marketplace materially less susceptible to manipulative practices. Moreover, improvements in audit trails, recordkeeping practices, and inter-exchange cooperation over the last fourteen years have greatly increased the ability to detect and punish attempted manipulative activities. CME therefore believes that the decision of whether to use opening prices rather than closing prices should rest on the ability of securities markets to accommodate order imbalances at the opening versus the close, not on any perceived threat of increased attempted manipulative activity.

Q3: *ARE THERE ANY ADDITIONAL SAFEGUARDS THAT WOULD BE APPROPRIATE FOR SECURITY FUTURES PRODUCT CASH SETTLEMENT PROCEDURES TO ENSURE THAT THE ANTI-MANIPULATIVE MANDATE IN SECTION 2(A)(1)(D)(I)(VII) OF THE CEA AND SECTION 6(H)(3)(H) OF THE EXCHANGE ACT ARE SATISFIED?*

No.

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?*

No. Additional safeguards would be more likely to restrict the ability to design SFPs that are relevant to varying market conditions.

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?*

As discussed above, facilities – such as the acceptance of market-on-close orders or a call market – that permit multiple securities-market participants to transact at a single price are best suited to permit convergence of cash markets and cash-settled derivatives markets, at whatever time of day they are available. This is true for SFPs as well as for broad-based index futures, equity swaps, etc.

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?*

Yes. As alluded to above, cash-settlement procedures for SFPs must be allowed to adapt to specific institutional features and to attempt to anticipate unusual events.

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?*

No. As discussed above, such a restriction would diminish the likelihood of cash/futures convergence and therefore would gravely harm the willingness of arbitrageurs to link SFP futures to the underlying cash markets.

III. REGULATORY HALTS – The Commissions have proposed that exchanges and associations halt SFP trading whenever trading in the underlying security – or 30% or more of the underlying securities in the case of an NBI – has been halted by the listing exchange because of a regulatory event; that is, because of 1) a corporate news event or 2) a coordinated circuit breaker event.

1. **Corporate News Events** – CME supports equity-market coordination in general and this proposal to require halts in single-stock futures trading when trading in the underlying security has been halted because of a corporate news event. With respect to NBI futures, CME is concerned that it may be operationally difficult to determine on a real-time basis whether a particular threshold of halted market capitalization has been crossed (or re-crossed), such as the 30% proposed by the Commissions. Special programming may be needed to perform the necessary calculations. CME hopes that the Commissions will recognize this potential difficulty and accept good-faith attempts to comply with the requirement at reasonable expense. For example, CME presumes that the use of market capitalization as of the previous day's close would be acceptable.

2. **Coordinated Circuit Breaker Events** – Again, CME supports the program of coordinated circuit breakers that has been endorsed by the President's Working Group and adopted by most U.S. equity-related marketplaces. CME also agrees that SFP trading should be subject to those coordinated circuit breakers. CME notes, however, that SFP lookalikes can trade in the unregulated upstairs market and do currently trade in foreign jurisdictions. To the extent that these other venues do not adhere to the coordinated circuit breakers, as is also the case in the underlying cash securities markets, there is a potential competitive issue. Therefore CME recommends that the Commissions allow exchanges latitude in the ways that they implement coordinated circuit breakers. CME also notes the need for flexibility in imposing this requirement on SFPs where the principal trading venues for the underlying securities – or for a subset in the case of a NBI – are in foreign markets.

3. **Response to Specific Requests for Guidance** –

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 AND SECTION 6(H)(3)(K) OF THE EXCHANGE ACT, 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?

Yes. If the listing market is not the principal trading venue for the underlying security then the prices on that market may not be reflective of current market conditions. Exchanges should be granted the flexibility to make appropriate decisions in such circumstances.

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 AND SECTION 6(H)(3)(K) OF THE EXCHANGE ACT, 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 RECOMMEND USING A HIGHER OR LOWER THRESHOLD PERCENTAGE OF AN INDEX'S CAPITALIZATION BEFORE AN INDEX FUTURES MUST HALT TRADING?

Yes. The mandate in the cited sections of the CEA and Exchange Act does not appear to contemplate situations where the listing market is not the primary trading venue for the underlying security or where the listing market is in a foreign country, perhaps in a substantially different time zone. This situation could exist for all or a subset of the securities in an NBI. The Commissions should allow flexibility in such situations.

CME has no opinion on the "correct" market capitalization to trigger trading halts and re-starts. CME notes that the trigger points for coordinated circuit breakers are currently determined according to the level of the Dow Jones Industrial Average ("DJIA"), a price-weighted index of thirty large-capitalization U.S.-listed securities. Given that the market conditions affecting those thirty securities may be totally unrelated to the market conditions affecting the securities in a particular NBI, it appears to be impossible to divine an optimal capitalization threshold across all possible NBIs.

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 OF THE INDEX CAPITALIZATION WARRANT A HALT IN TRADING THE NARROW-BASED SECURITY INDEX FUTURE?

See CME response to Q9.

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?

As alluded to above, there are tradeoffs to be considered due to the narrow subset of securities that trigger a coordinated circuit breaker event. If SFPs that have not declined to the trigger level(s) are allowed to continue trading, continued SFP trading might actually alleviate pressure in the underlying securities.

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?

The proposed definition of a regulatory halt could be refined to address situations not contemplated by the CFMA, as mentioned above.

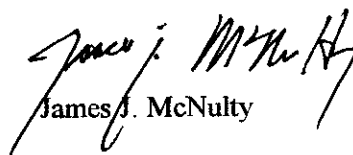
Q13: DO COMMENTERS BELIEVE THAT THE COMMISSIONS SHOULD APPLY A STANDARD, OTHER THAN A PERCENTAGE THRESHOLD OF AN INDEX'S CAPITALIZATION, IN DETERMINING WHETHER A TRADING HALT IS APPROPRIATE FOR A NARROW-BASED SECURITY INDEX?

Given the many complex issues involved, it may not be possible to determine a "correct" answer to this question. A possible solution that sidesteps them would be to allow NBI futures (based principally on U.S.-listed securities) to continue trading until they have become limit offered at a price limit corresponding to a particular coordinated circuit breaker level.

IV. CONCLUSION – Although the proposed regulations raise a number of issues that have been discussed above, CME is most concerned with the proposal to require cash-settled SFPs to adopt a look-back calculation procedure in all circumstances for securities that have not opened on the final settlement day. CME believes that this requirement would seriously impact the willingness of arbitrageurs to maintain alignment of such SFPs with the cash market, thus impairing their chance for success. CME hopes that the Commission will revise the proposed regulation to reflect the reality that corporate news events are not the only circumstances that force securities not to open for trading on the final settlement day. The proposed regulations must recognize the need to guarantee convergence of cash and futures markets to the extent possible.

CME appreciates the opportunity to comment on the proposed rules and hopes that its opinions and recommendations will be considered seriously by the Commissions.

Respectfully submitted,


James J. McNulty

cc: The Honorable James E. Newsome
The Honorable Harvey L. Pitt
The Honorable Thomas J. Erickson
The Honorable Barbara Pederson Holum
The Honorable Isaac C. Hunt, Jr.
The Honorable David D. Spears
The Honorable Laura S. Unger