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October 3, 2001

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

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

Re: S7-15-01, Cash Settlement and Regulatory Halt Requirements for Security Futures Products

Dear Mr. Katz and Ms. Webb:

The Options Clearing Corportion ("OCC") is pleased to comment on File No. S7-15-01, "Cash Settlement and Regulatory Halt Requirements for Security Futures." The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC")(collectively, "Commissions") have proposed rules to provide, among other things, that the listing standards of national securities exchanges and national securities associations trading security futures products must provide for a final settlement price for each cash-settled security futures product based on the opening price of the underlying security or securities. The proposed listing standards would also require exchanges to adopt rules providing that, if an opening price is not readily available for an underlying security or constituent security of an underlying index, the final settlement price of the security futures product must fairly reflect the price of the security or securities during the most recent regular trading session.

The requirement relating to unavailability of an opening price is inconsistent with OCC security futures rules that were only recently approved by the SEC. It is also inconsistent with OCC's rules on broad-based index options and the rules of certain futures clearing organizations that clear futures and options on broad-based stock indices. Moreover, it would disconnect final settlement prices for security futures from the markets for the underlying stocks, thus frustrating the basic economic purpose of security futures as hedging instruments. In our view, this aspect of the Commissions' proposal also dictates an inappropriate division of responsibility between the rules of clearing organizations and the markets for which they clear.

General

OCC is a registered securities clearing agency that anticipates clearing security futures. OCC has executed a clearing agreement with Nasdaq LIFFE, LLC to clear security futures traded on that market, and is presently negotiating to clear security futures for a proposed joint venture among the Chicago Board Options Exchange, Chicago Mercantile Exchange, and Chicago Board of Trade. OCC has been approached to clear security futures for other markets as well.

Under OCC's rules, final settlement prices for security futures are normally determined as specified in the rules of the exchanges that clear such futures through OCC (although OCC's rules control in the case of a conflict).[1] However, OCC has the authority to fix final settlement prices when trading halts or other circumstances make it impossible to determine final settlement prices in the normal manner.[2] Given the role of a central clearinghouse as obligor under the security futures contracts that it clears, the rules of the clearinghouse, and not those of the exchanges, should define the clearinghouse's contractual obligations. We believe that the rules of security futures markets should defer to or at least be consistent with rules of its clearinghouse defining the latter's contractual obligations. This includes rules governing the fixing of final settlement prices.

Furthermore, when a final settlement price calculated in the usual way is unavailable, it is important that settlement prices be set in a way that will coordinate, to the fullest extent possible, the fixing of settlement prices for related products traded in

[1] OCC By-Laws, Article XII, Section 6
[2] OCC By-Laws, Article XII, Section 5.

different markets. In our view, this is best achieved by permitting the clearinghouse (which, as in OCC's case, may itself clear related products for competing markets) to have ultimate authority for fixing final settlement prices in such circumstances and by giving the clearing organization the flexibility to use, for example, closing prices from the most recent trading session or opening prices from the next opening session, depending upon the circumstances.

The Commissions' Proposal

The Commodity Futures Modernization Act of 2000 ("CFMA") provides that national securities exchanges and national securities associations can trade only those security futures products that conform to listing standards filed by the exchange or association with the SEC under Section 19(b) of the Exchange Act. Such listing standards must meet certain criteria specified in Section 2(a)(1)(D)(I) of the CEA and the standards and conditions set forth in Section 6(h)(3) of the Exchange Act. The proposed rulemaking "sets forth more explicitly how the exchange's or association's rules can satisfy" such statutory provisions, particularly with respect to final settlement price determination and trading halt procedures.

Our comment on the proposed rulemaking is limited to addressing that part of the proposal that dictates how final settlement prices must be determined. In the event the opening price of the underlying security(ies) is not available, the proposal specifies that the price of the underlying security(ies) during the most recent regular trading session must be used to calculate final settlement value.[3] We believe that this aspect of the proposal should be withdrawn, or, at a minimum, modified to permit the final settlement value to be based on the next opening of the security(ies), even if that occurs on a day after the regularly scheduled expiration date ("next opening").[4]

Rationale of the Proposal

The Commissions state that the final settlement price for a security future should be fairly reflective of the price in a liquid market for the underlying security – a

[3] Proposed CEA Rule 41.25(b); Proposed Exchange Act Rule 240.6h1(b).
[4] Although it might be possible to interpret the current proposal to allow the use of price(s) from the next regular trading session, the proposed rules are at best ambiguous in that regard. Moreover, based on conversations with SEC staff, we understand that they would not necessarily concur in such an interpretation.

proposition with which OCC fully agrees. They further state that a price derived from the last regular trading session of the national securities exchange or national securities association that lists the underlying security would have a greater likelihood of reflecting the most reasonable price for that security than a price generated from an extended trading session. OCC agrees with that as well. However, the release does not address the possibility of utilizing a next opening price for purposes of determining a final settlement price, even though OCC's present rules for both broad-based index options and security futures allow for that possibility. OCC believes that a next opening price will often be a fairer measure of a security's market value at expiration of the overlying futures contract than a historical price drawn from the last regular trading session before expiration. And even where the issue of fairness is debatable, there will be still be a need to take into account the potential effects of disconnects between the pricing of security futures and related equity derivatives. These considerations argue for flexibility in the fixing of final settlement prices, and certainly for the ability to base them on next opening prices.

Current OCC Policy

The SEC recently approved a comprehensive set of changes to OCC's By-Laws and rules to provide for the clearing of security futures.[5] Among these provisions is a By-Law addressing the determination of final settlement prices for security futures when prices from primary market(s) for the underlying security(ies) are not available.[6] This By-Law provides OCC with significant flexibility in determining final settlement prices where the underlying markets are closed at expiration. The By-Law states that OCC "may fix the final settlement price for affected futures, based on its judgment as to what is appropriate for the protection of investors and the public interest, taking into account such factors as fairness to buyers and sellers of affected futures, the maintenance of a fair and orderly market in such futures, and consistency of interpretation and practice." Specific reference is made to the possibility that OCC might fix the final settlement price on the basis of the reported price of the underlying security or reported level of the underlying index at the close of regular trading hours on the last preceding trading day for which a closing stock price or index level was reported. However, the By-Law expressly states that OCC may instead fix the final settlement price for affected futures

[5] Exchange Act Release No. 44727 (August 20, 2001), 66 FR 45351 (August 28, 2001) (approving SR-OCC-2001-07).
[6] OCC By-Laws, Article XII, Section 5.

using the opening prices of the relevant security or securities when the primary market(s) reopen.[7]

This By-Law parallels an OCC By-Law applicable to index options.[8] The latter was amended in May 2000 to specifically authorize OCC to use next opening prices. This was done in part to allow OCC to coordinate the setting of exercise settlement values of index options with the final settlement values of corresponding index futures.[9] In approving these changes, the SEC stated that the practice of using different dates, and hence potentially different index values, for fixing the final settlement values for options and futures on the same index had the potential to create uncertainty and risks for many market participants.[10]

OCC Recommended Amendment

The Commissions should permit use of the next opening to determine security future final settlement values in the unusual situation where an underlying security does not open on the date that final settlement prices are scheduled to be determined. This can be achieved by deleting from proposed Exchange Act Rule 240.6h-1 and CEA Rule 41.25, respectively, the provision that requires that "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."[11] We believe that the Commissions' rules should not force the exchanges to adopt rules in this area at all, but rather should permit that function to be left to the rules of the clearing organization. Whether or not the exchanges have rules on this subject, it should remain clear that the rules of the clearing organization will control in the event of any inconsistency, thus assuring uniformity of treatment of fungible products that might be traded on more than one exchange.

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[7] Id.
[8] OCC By-Laws, Article XVII, Section 4 (as amended effective September 16, 2000).
[9] Exchange Act Release No. 42769 (May 9, 2000) 65 FR 31036 (May 15, 2000). See Chicago Mercantile Exchange Rule 4003; cf. Chicago Board of Trade Rule 4342.02.
[10] Id.
[11] This language is contained in proposed Exchange Act Rule 240.6h-1(b) and CEA Rule 41.25(b)(1). Similar language should also be deleted in proposed Exchange Act Rule 240.6h-1(c) and CEA Rule 41.25(b)(2) to support the same fix for narrow-based index futures.

OCC believes that use of the next opening can, under a number of circumstances, provide the fairest and most reasonable settlement price. This can be shown by contrasting the effect of using a "look back" approach (as apparently required by the Commissions' proposal) with that of a look forward approach, such as using the next opening. This comparison appropriately involves analyzing the impact of both approaches on a market participant's hedge, since many security futures holders, particularly institutions and trading professionals, will be hedged with stock and other related instruments. These hedges are typically unwound at or around the time of final settlement price determination.

Our concern with the Commissions' proposed rule can be vividly illustrated by reference to the recent market shutdown resulting from the events of September 11th and lasting through September 14th, 2001. If Friday, September 14th, had been an expiration Friday, the Commissions' proposal would have required maturing security futures to be settled based on a price derived from the regular trading session on September 10th. Traders holding short security futures positions on September 10th who thought they were hedged by owning the underlying stock would have had no opportunity to liquidate their stock position in a U.S. market before September 17th, when the prices of most stocks were dramatically lower than the closing price on September 10th. Yet the final settlement price of their security futures contracts would have been based on the higher September 10th prices, resulting in a final variation settlement on the futures contracts that would fall far short of the amount needed to compensate the holder of the short futures position for the loss in the value of the stock hedge. Such an investor would have suffered potentially heavy losses on positions that were intended to be fully hedged.

In contrast, had the security futures been settled based on the opening prices on September 17th (the next opening), short security futures holders would have received a large final variation payment (a dollar amount equal to the number of shares covered by the futures position multiplied by the excess of the closing price on September 10th over the final settlement price), which would have served to offset their losses on the stock hedge. Conversely, holders of long security futures positions would not have been able to realize a windfall by closing out their short stock hedges at the September 17th price without having to make an offsetting final variation payment to short security futures holders. Even unhedged participants would likely view settlement based on the September 17th opening as the fairest outcome, because that price would be a much better proxy for the value of their positions at expiration than the closing price on September 10th. When the market for the underlying interest is closed at expiration, the reason for

the closure may be an event that has a major impact on the value of that interest. In that case, the true value of the interest at expiration will generally be best represented by the price when the market reopens, after market participants have had a chance to evaluate the significance of the event.

We also believe it is important to foster consistency in final settlement price determinations among related instruments. The proposed rulemaking would create a potential disconnect in final settlement price determinations between security futures and (i) broad based stock index futures , (ii) OCC-issued stock index options, (iii) physically-settled security futures and (iv) the stock market itself. As stated earlier, broad based stock index futures, as well as OCC-issued stock index options, can or must use next opening settlement. Many traders will likely use cash-settled security futures as part of a hedged portfolio that includes these and possibly other cash-settled instruments. Not permitting next opening settlement may dissuade use of cash-settled security futures if traders fear the potential disparity in settlement prices that can result from using cash-settled security futures.

We do not believe that use of next opening settlement raises any of the concerns set forth in the release. Unlike a market close, a market reopening, regardless of whether it takes place as a regularly scheduled market opening or as a mid-day opening, can and would likely occur in an organized manner that provides an opportunity for all market liquidity to be represented at the opening. As a result, a next opening price should be fairly reflective of the price in a liquid market for the underlying security. The presence of such liquidity should also mitigate manipulation concerns. The liquidity available at a next opening should far exceed the liquidity present in an extended trading hours session, an example noted by the Commissions as a "market" that would not have the greatest likelihood of reflecting a reasonable price for the security(ies). In summary, we believe a next opening settlement is equivalent in most respects to a regularly scheduled A.M. settlement and is not akin to P.M. settlement or basing settlement off prices taken from an illiquid market.

Conclusion

For the reasons given above, we believe that the fixing of final settlement prices when the underlying markets are closed at expiration should be governed by clearinghouse rules, not by exchange rules. Given the unpredictability of the circumstances that may cause underlying markets not to open, we believe that

clearinghouses should not be bound by inflexible rules in fixing final settlement prices for security futures. Use of next opening prices under such circumstances is a reasonable final settlement price procedure that is not at odds with concerns addressed by the proposed rulemaking and would promote consistency with the rules applicable to other securities-based derivatives regulated by the Commissions. We therefore urge the Commissions not to require exchanges and associations to adopt rules addressing the determination of security futures final settlement prices when opening prices are not readily available.

We would be pleased to discuss any of these issues with you further. Please feel free to contact me at (312) 322-1817 or Michael Walinskas at (312) 322-4451.

Sincerely,

William H. Navin

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