



COMMENT

01-17
①

RECEIVED
C.F.T.C.

2001 OCT -2 PM 1:25
OFC. OF THE SECRETARIAT

'01 OCT 2 PM 4 19

RECEIVED C.F.T.C.
RECORDS SECTION
Mr. Jonathan Katz

October 1, 2001

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
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: File No. S7-15-01, Cash Settlement and Regulatory Halt Requirements for Security Futures Products

Dear Mr. Katz and Ms. Webb:

The Chicago Board Options Exchange, Incorporated ("CBOE") is pleased to take this opportunity to comment on proposed rules ("Proposal") issued by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") regarding cash settlement and regulatory halt requirements for security futures products. The proposed rules would require cash-settled security futures products to use opening-price settlement procedures and would apply uniform regulatory trading halt requirements to security futures products. CBOE generally supports the application of opening-price settlement procedures on security futures products and the policy goal underlying uniform trading halt requirements. Nevertheless, CBOE has several comments relating to the application of the proposed rules, especially the lack of discretion that security futures exchanges would have in initiating and terminating "news-pending" regulatory halts. Our comments are discussed below.

Cash-Settlement Procedures

The CFTC and SEC propose that cash-settled security futures products be required to use opening-price settlement procedures. The Commissions make this Proposal because they believe that opening settlement procedures reduce the strains on liquidity strains from the unwinding of index arbitrage positions on Expiration Fridays. Most stock index option contracts and stock index future contracts were switched in the late 1980s from closing-price settlement procedures to opening-price settlement procedures for this reason and all subsequently introduced stock index options and futures have used opening-price settlement procedures. CBOE supports the requirement of opening-price settlement for cash-settled security futures products. As we noted in a prior comment letter on proposed listing standards and conditions for security futures, if cash-settled index options are required to be settled at the opening price, then cash-settled security futures should be settled in the same manner.¹ Any concerns about a closing

¹ Letter dated August 20, 2001, from Joanne Moffic-Silver, General Counsel, CBOE, to Ms. Jean Webb, Secretary, CFTC, regarding listing standards and conditions for security futures.

settlement of index options would be accentuated in the cash settlement of futures on a single stock or narrow-based index. Hence, we support the CFTC and SEC proposed opening-price settlement requirement for security futures products.

However, CBOE recommends changes to the provisions of the Proposal concerning situations in which the opening price for a security underlying a cash-settled securities futures product is not readily available to make those provisions consistent with existing provisions for cash-settled stock index options and stock index futures. The Proposal would require that, if an opening price for a security underlying a security futures product is not readily available, then the final settlement price would reflect the price of the underlying security during its most recent regular trading session. Thus, if the New York Stock Exchange ("NYSE") were closed for the entire day on an Expiration Friday, a cash-settled security future would be settled using prices from the close on the previous trading day. This requirement is contrary to the existing cash settlement procedures on CBOE for stock index options and on the futures exchanges for stock index futures. Stock index options and stock index futures use the next available opening prices for the halted securities.² Until May 2000 CBOE had used the prior closing price in these situations but changed its rules to be consistent with the procedures for stock index futures after Hurricane Floyd threatened to close the NYSE on the Expiration Friday of September 17, 1999.³ It is imperative that cash-settled security futures products use the same "look forward" procedures as do stock index options and stock index futures.⁴ Otherwise, there could be significant dislocations for persons holding positions in cash-settled security futures products and either stock index options or broad-based stock index futures on an Expiration Friday where a primary market for underlying securities did not open.⁵

Trading Halt Requirements

The Proposal would require national securities exchanges and national securities associations to halt trading in a single-stock future when a regulatory halt has been implemented by the market for the underlying security and for a narrow-based security index future when securities representing 30 percent or more of the market capitalization of the narrow-based index are subject to a regulatory halt. The Proposal defines a regulatory halt to include a "news-pending" halt and a circuit breaker halt. CBOE supports the extension of market-wide circuit breaker procedures to security futures products in order to ensure consistent circuit breaker procedures across equity products.

² See, e.g., CBOE Rule 24.7(e).

³ Securities Exchange Act Release No. 42857 (May 30, 2000).

⁴ CBOE rules use the next available opening prices, except if the current index value at expiration is fixed in accordance with the rules and by-laws of The Options Clearing Corporation. CBOE recommends that security futures products likewise have the proviso that the clearing corporation rules have precedence for determining the index value at expiration during a trading halt in the underlying securities.

⁵ For example, a firm that is hedging a stock index option with a cash-settled security future overlying the same index would have the option settle based on the opening prices on the next trading day and the future settle based on the closing prices from the previous trading day.

CBOE has a concern, however, with the absolute requirement that a security future halt during a "news-pending" halt in the underlying security. CBOE believes that the trading halt provisions for security futures should be comparable to those for stock options.

Currently, CBOE rules provide the Exchange with the discretion to declare a trading halt in a stock or index option in the interest of a fair and orderly market.⁶ Among the factors to be considered in determining whether to call a halt is whether trading in the underlying security or securities has been halted or suspended in the primary market. While the Exchange has advised its membership that it will generally halt trading in a stock option when trading in the underlying stock has been halted for regulatory reasons,⁷ it still possesses the discretion as to whether to impose a halt in these conditions. This discretion is important because there may be circumstances when it is necessary to allow trading in a stock option when the underlying stock is halted for regulatory reasons. For example, the Exchange might determine to allow closing-only transactions or a closing rotation for an option on Expiration Friday even though the underlying stock is halted so that option holders are not locked into their positions through expiration.

The Proposal does not grant security futures exchanges the same discretion as to whether to declare a trading halt for security futures products when there is a "news-pending" trading halt in the underlying security. CBOE believes that the rationale underlying the discretion for stock options extends equally to security futures. While generally CBOE would halt a future on a single stock when the underlying security is subject to a "news-pending" halt, there might be circumstances, such as the need to adjust positions before an expiration, where the Exchange would determine to permit some trading in the security future. Thus, CBOE recommends that the agencies amend the Proposal to require a trading halt in security futures products only when there is a market-wide circuit breaker trading halt and otherwise require security futures exchanges to have trading halt rules relating to "news-pending" halts that are comparable to the rules for stock options and stock index options.

CBOE has two problems with the proposed requirement that a narrow-based security future halt when securities representing 30 percent of the market capitalization of the underlying index are subject to a "news-pending" halt. First, it is mandatory, not discretionary, and thus suffers from the same problem as the provision of the Proposal relating to "news-pending" trading halts for single stock futures.⁸ In order to ensure

⁶ CBOE Rule 6.3 and CBOE Rule 24.7.

⁷ See, e.g., Regulatory Circular RG97-58, which can be found at ¶5251 of the CCH version of the CBOE rulebook, and Securities Exchange Act Release No. 35789 (May 31, 1995), which most recently approved the Circular.

⁸ Several years ago, CBOE discarded a fixed index weighting standard for halting or resuming trading in a stock index option. Instead, CBOE officials can consider the extent to which trading is not occurring in stocks underlying an index option in determining whether to halt trading in the index option.

Mr. Jonathan Katz
Ms. Jean Webb
October 1, 2001
Page 4

regulatory consistency between stock index options and stock index futures, the Proposal should be amended in the manner described in the paragraph above. Second, the Exchange believes that the extent to which trading is not occurring due to a "news-pending" halt in stocks underlying a narrow-based security index future should be the appropriate factor that the Exchange considers in this regard when deciding whether to halt a narrow-based security index future. By specifying a specific percentage level, the proposed rules may imply that it would be improper for an exchange to consider trading interruptions in underlying stocks that collectively represent less than 30 percent of an index. Moreover, the proposed rules would create an operational burden because not all indexes underlying security futures products necessarily would be capitalization weighted; some could be price-weighted or equal dollar weighted. It would be extremely difficult for a security futures exchange to determine real-time when securities comprising 30 percent of the market capitalization of a price-weighted or equal dollar weighted index are halted.

Thus, CBOE recommends that the extent to which trading is not occurring due to a "news-pending" halt in stocks underlying a narrow-based security index future should simply be a factor that an exchange considers when deciding whether to impose and maintain a trading halt with respect to the security index future, consistent with CBOE's trading halt rules for stock index options.

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

Sincerely,



Joanne Moffic-Silver
General Counsel

Cc: Elizabeth King, SEC
Alton Harvey, SEC
Elizabeth Fox, CFTC
Richard Shilts, CFTC

CBOE made the change because it believed that the interests of a fair and orderly market are better served when the rules allow Exchange officials the discretion to evaluate market conditions and circumstances and exercise their judgment as to when to halt or suspend trading. See e.g. Securities Exchange Act Release No. 39480 (December 22, 1997).