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Student Comments
Course: Derivatives & Risk Management 2001

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Student Commenters¹:

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October 1, 2001

Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street N.W.
Washington, D.C. 20581

Via email: secretary@cftc.gov

CC: Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street,
N.W., Washington, DC 20549-0609 rule-comments@sec.gov (ref: File No. S7-15-01)

**Re: Cash Settlement and Regulatory Halt Requirements for Security Futures
Products**

COMMODITY FUTURES TRADING COMMISSION, 17 CFR Part 41
SECURITIES AND EXCHANGE COMMISSION, 17 CFR Part 240

Dear Ms. Webb:

The Fordham University School of Law in the City of New York offers a course called "Derivatives & Risk Management." This course is available to JD and LLM students at the Law School. As part of this year's course of study, the class is studying the Commodity Futures Modernization Act of 2000, and its effects on derivatives regulation. In the course of our study, we note with particular interest the rules jointly proposed by the Securities And Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) with reference to the regulation of single stock futures.

¹ The Comments are not the position of the University or the Law School

Several “Derivatives & Risk Management” students expressed an interest in specifically responding to the Commodity Futures Trading Commission’s (the “commission’s”) request for public comment on proposed Rule 41.1, 41.25(a)(2), and 41.25(b) under the CEA and proposed Rule 6h-1 under the Exchange Act, that provide, in pertinent part, that the listing standards of national securities exchanges and national securities associations trading security futures products establish that a halt in trading in any security futures product be mandated when a regulatory halt is instituted by the national securities exchange or national securities association listing the security or securities underlying the security futures product.

The students, whose names are referenced above², respectfully submit the following comment.

Coordinated Trading Halts

Section 2(a)(1)(D)(i)(X) of the Commodity Exchange Act³ and Section 6(h)(3)(K) of the Exchange Act⁴ provide that listing standards for security futures products require procedures to "coordinate" trading halts between the market that trades the security futures product, the market that lists and trades the underlying security, and other markets on which any related security is traded. Proposed SEC Rule 6h-1 and CFTC Rule 41.25(a)(2) attempt to assure such coordination.

In our view, the requirement that all trading be halted in the single stock futures whenever trading in the underlying security is halted is an overly broad mean for complying with the requirement that procedures be put in place to “coordinate” trading halts. We further feel that such trading halts undermines a purpose of the repeal of the Shad-Johnson Accord - providing a retail tool of risk management similar to those available to eligible swap participants. We suggest that the designation “coordinated” trading halt does not necessarily require the cessation of all trading in single stock futures.

We recommend an alternative to eliminating trading entirely in the single stock futures when a halt is instituted in the underlying security. To that end, we respectfully propose the institution of “trading halt sessions” in single stock future when the underlying security has been halted.

Single Stock Futures: Tools of Retail Risk Management

Specifically, proposed SEC Rule 6h-1(d) and CFTC Rule 41.25(a)(2)(i) would require national securities exchanges and national securities associations to halt trading in a single-stock future while a regulatory halt has been implemented by the listing market

² The views and comments expressed herein do not represent the views of the Fordham University School of Law or the views of any other individual or institution not specifically referenced at the end of this comment.

³ 7 U.S.C. 2(a)(1)(D)(i)(X).

⁴ 15 U.S.C. 78f(h)(3)(K).

for the underlying security. As proposed, the halt in the security futures product market would have to occur during the same time as a regulatory halt instituted on the listing market. We believe that such action is overly broad and burdensome in its application to retail investors for whom single stock futures might serve as the only available means for managing risk.

With the repeal of the Shad-Johnson Accord, retail investors are now able to trade futures contracts on individual stocks. The repeal allows retail investors to enjoy new opportunities for managing risk which were, at one time, the exclusive purview of large institutions.

Large institutions can structure risk transfer devices for equities using various over the counter products. These structured products are not generally available to retail investors. Single Stock Futures then, represent a unique, and special opportunity for retail investors and for the Commission protecting their interests.

The appeal of single stock futures as a retail risk management technique was recognized by Arthur Levitt, the former Chairman of the SEC, when he testified before the Committee on Agriculture, Nutrition, and Forestry, and the Committee on Banking, Housing and Urban Affairs; United States Senate, on June 21, 2000. In his testimony, Mr. Levitt commented, "...that single stock futures will be retail products. While extremely complex derivative products might not attract retail customers, a simple future on a share of a blue chip stock is the type of product that is sure to do so. Accordingly, legislation must maintain the SEC's ability to protect investors and to maintain integrity of the markets on which they trade."⁵

Leveling the Playing Field

Proposed SEC rule 6h-1(d) and CFTC rule 41.25 (a)(2)(i) would require an exchange or association trading security futures products to halt trading a single stock future when the primary market imposes a "news pending" or "circuit breaker" regulatory halt. It is our position that such coordinated trading halts between both the futures and the listing markets frustrate the legislative intent of "protecting investors" and "maintaining market integrity" because such rules apply unfairly to retail investors. Currently there is no uniform requirement that trading among eligible swap participants cease in swaps or other over-the-counter structured products derived from a particular security or index whenever there is a trading halt in the underlying security or index component.

The SEC has established two methods of "coordinated" trading halts in order to preserve a fair and orderly market and to protect investors. The "News Pending" halt has been instituted to benefit shareholders by halting all trading in certain securities until there has been an opportunity to disseminate information to the public, allowing for a reasonable price to be reached based on the new information. "Circuit Breaker" halts exist to "mitigate systemic stress" when radical drops can prevent the

⁵ http://agriculture.senate.gov/Hearings/Hearings_2000/June_21_2000/00621lev.htm

orderly functioning of the financial markets. Eligible swap participants are only restricted by their ability to find a willing counterparty when the underlying security or index is halted. Retail and less sophisticated investors should have the same opportunity to contract to mitigate risk within the regulated world of single stock futures even when a trading halt in the underlying security is in effect.

The “loophole” for Sophisticated Traders

Evidence of the inconsistent applicability of trading halt rules can be gleaned from an analysis of the proposed rules regarding halting trading in narrow based security indexes. Proposed SEC Rule 6h-1(e) and CFTC Rule 41.25(a)(2)(ii), would require that trading on a security futures product based on a narrow-based security index be halted at all times that news pending or circuit breaker regulatory halts have been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index. Under this regulatory structure, sophisticated traders could create a synthetic future in a halted stock through a combination of trades in a narrow-based index and individual securities (or their derivatives). For example, a theoretical index could include two stocks one of which (Stock "A") comprises 75% of the index, and the other (Stock "B") comprises 25% of the index. Even if Stock B stops trading, the index will not stop trading because Stock B comprises less than 30% of the index. Therefore, a sophisticated trader could short the index and go long Stock "A" (or in its derivative single stock future) during a trading halt, creating a synthetic short futures position in Stock "B". Since the proposed regulations, under the aforementioned circumstance, effectively allows trading in single-stock future whose underlying security may be halted, the concept of “coordinated” trading halts should be revisited and the rules governing halting trading in narrow based indexes should be reconsidered.

Proposed Alternative to Halting Trading

To make the opportunities for retail investors more consistent with those afforded to eligible swap participants, to comply with Section 2(a)(1)(D)(i)(X) of the CEA and Section 6(h)(3)(K) of the Exchange Act providing for "coordinated" trading halts, and to close the “loophole” opened by Proposed SEC Rule 6h-1(e) and CFTC Rule 41.25(a)(2)(ii), We propose that the rules governing the trading of single-stock futures be amended to allow for special “trading halt sessions” during which investors with risk exposure to an underlying equity which has been halted might have the opportunity to enter into single stock futures transactions with “dealers”⁶ who are better able or more willing to take the investor’s unwanted risk.

⁶ Section 1256(g)(9) of the Community Renewal Relief Act of 2000⁶ defines “dealer securities futures contracts” as securities futures contracts that are traded on a qualified board or exchange and are entered into in the normal course of the dealers business in such contracts. For this purpose, a person is a dealer in securities futures contracts if the Secretary of the Treasury determines that the person performs functions with respect to such contracts similar to the functions performed with respect to stock options by persons registered with a national securities exchange as a market maker or specialist in listed options.

Trading Halt Sessions

This approach requires treating those who have Value at Risk in an underlying security (i.e. investors, long or short, who have a current interest in security or basket of securities, when a trading halt is announced) differently from investors with only a potential or prospective interest in securities or their derivatives when the halt is announced. While the former group would be entitled to hedge their positions by entering into single stock futures contract with willing "dealers," prospective investors would not be permitted to "speculate" during a "trading halt session." The innovation of a "trading halt session" preserves the "cooling off" function of a regulatory halt while leveling the playing field between retail investors and eligible swap participant by affording retail investors with the opportunity to manage risk in times of market crisis.

We propose that "dealers" in single stock futures remain available to retail investors (as counterparties to single stock futures transactions) even where the underlying security has been halted. We recognize that the market in single stock futures may be thin under such circumstances, but suggest that maintaining this avenue of risk management is necessary to buttress market integrity.

Conclusion:

We are of the opinion that by allowing trading to continue in single stock futures during a period of a halt in the underlying security, the Commission will offer greater protection to individual investors by allowing them to use these important tools of risk management when they may be of greatest necessity. We suggest that the Commission might redefine the concept of "coordinated" market halts as the term is applied to the market for single stock futures. We appreciate the opportunity to comment on the Proposed Rules and stand ready to assist the Commission and its staff if further clarification is required on any of the points raised in this letter.

Sincerely yours,

Larry Coury
Silvia Madrid
Laura Murias
Mike Periera
Vivek Sahota
Benjamin Sparks
Adrian Spirollari
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