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October 19, 2001

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth St., NW
Washington, DC 20549

Ms. Jean Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St., NW
Washington, DC 20581

Re: Cash Settlement and Regulatory Halt Requirements for Security Futures Products; Release No. 34-44743; File No. S7-15-01

Dear Mr. Katz and Ms. Webb:

The New York Stock Exchange ("NYSE") is pleased to take this opportunity to comment on the jointly proposed rule by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") regarding cash settlement and regulatory halts for security futures products (the "Release"). The proposed rule requires a final settlement price for a security futures product that fairly reflects the *opening price* of the underlying security or securities. The NYSE strongly supports the rule as proposed.

Cash Settlement

The Commodity Futures Modernization Act of 2000 (the "CFMA") established certain criteria that must be met in order to trade security futures products. Section 2(a)(1)(D)(i)(VII) of the Commodity Exchange Act ("CEA") and Section 6(h)(3)(H) of the Securities Exchange Act of 1934 ("Exchange Act") only permit trading of security futures products subject to listing standards that ensure trading in a security futures product will not be readily susceptible to manipulation. Cash settlement based on the opening price for security futures products would help to insure that there is adequate liquidity in the securities markets at the time the settlement price is established. This would limit subsequent opportunities for manipulative or abusive trading practices.

When stock index futures and options began trading in the mid-1980's, most if not all these products used closing-price settlement procedures that often strained the liquidity of the securities markets and raised concerns about opportunities for manipulative or abusive trading practices. Additionally, the time constraints faced by specialists in the last few minutes of the trading day to establish closing prices that would reflect equilibrium often caused sharp price movements in the indexes underlying the futures or options.

The NYSE sought to address these concerns even as it urged that the settlement of the derivative products be moved to the opening. In a series of proposed rule changes filed and approved during a three year period, the NYSE implemented special closing procedures that included a prohibition on the entry after 3:30 p.m. of market-on-close orders related to index arbitrage, and undertook a number of other steps designed to facilitate the identification of matching volumes of orders and securities before the close.[1] The NYSE repeatedly stated that the use of opening prices would obviate the need for such special closing procedures. "The Exchange believes that the appropriate response to market volatility relating to the expiration of derivative products is for futures and options markets to base the settlement prices of derivative products on opening, rather than closing prices."[2]

In spite of the new market-on-close order procedures, abusive trading schemes were conducted at the close. In a disciplinary case brought jointly by the Exchange and the Chicago Board Options Exchange, a manager of an equity program trading desk of a broker-dealer consented to a finding that he entered program trading market-on-close orders to purchase more than 34 million shares (valued at approximately $1.5 billion) in listed securities that were in the S&P 500 stock index when he had no reasonable basis to enter such orders and no reasonable expectation he could execute them.[3]

Even mistakes that occur at the close can leave markets with no time to recover. A recent example was a mistaken trade last May in London. A trader entered an order for £300 million (instead of £3 million) near the close, causing the stocks to plummet and the FTSE 100 index to suddenly lose 3.5%. The error and the stock prices could not be corrected until the following day.[4]

A few years earlier, also in London, two equity traders, in the final minutes of trading, manipulated the market for two stocks to drive down the FTSE 100 by 40 points. The

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[1] The Exchange has subsequently revised it market-on-close order procedures to provide that all market-on-close orders, regardless of strategy, must be entered by 3:40 p.m. on every trading day.

[2] Securities Exchange Act Release No. 26293, (November 17, 1988), 53 FR 47599 (November 23, 1988).

[3] Exchange Hearing Panel Decision 95-98, July 18, 1995

[4] The Independent (London), August 15, 2001, Business, p. 13, "LSE Fines Lehman Over Pounds 300m Mistake."

news report observed that "attempts to rig the market ahead of the expiry of Footsie derivatives contracts are not unusual. . . ."[5]

Experience teaches that it is the close, rather than the opening, of trading that is the target of those who would manipulate prices to their own advantage. In cases that were brought by the Exchange, the American, Pacific, and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, and the SEC, traders inflated the value of their department's proprietary portfolio by selling large quantities of 15 stocks, and buying and selling stock options—all at or near the close on the same day.[6]

Many market participants began moving to opening-price settlement procedures for stock index options contracts in an effort to better handle expiration-related unwinding programs. In doing so, specialists could then utilize long-standing opening procedures to disseminate price indications in an orderly manner and facilitate the unwinding process. Furthermore, more orderly markets were maintained because specialists understood that they would have the remainder of the trading session to trade out of any long or short positions acquired at the opening.

The option on the S&P 100 index the ("OEX"), however, did not move at that time, and has not since moved, to opening valuation for its expiration. With the new security futures products about to begin trading with an opening valuation, joining most other derivative security products in that regard, now would be an opportune time for the SEC to include the OEX in the universe of security derivative products that settle on the opening price.

The interests of investor protection in opening settlements for security derivative products is as strong today as it was a decade and more ago. The NYSE strongly supports the proposed regulation on cash settlement of security futures products. Requiring cash settlement on the opening price would significantly reduce price volatility and liquidity concerns and the potential for manipulative and abusive trading practices in security futures products. As proposed, the regulation is consistent with the criteria and intention of the CFMA that the underlying security not be readily susceptible to manipulation.

Regulatory Halts

The Commissions propose that trading in single-stock futures must halt for the duration of a regulatory trading halt (for news pending and cross-market circuit breakers) declared on the listing market for the security, and similarly for a narrow-based security index

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[5] The Guardian (London), December 19, 1997, p. 19, "JP Morgan Fined Pounds 350,000 for Market-rigging."

[6] Exchange Hearing Panel Decisions 83-62 and 83-63, June 2, 1983.

future when securities representing 30 percent or more of the market capitalization of the index are the subject of a regulatory halt.

The Exchange supports the trading halt requirements as proposed, and believes that they satisfy Section 2(a)(1)(D)(I)(X) of the CEA and Section 6(h)(3)(K) of the Exchange Act that require procedures to coordinate trading halts between the markets that trade the security and those that trade the security futures products on the security.

In footnotes 86, 88 and 123 of the Release, the Commissions observe that in addition to the proposed mandatory trading halt rules, a market is free to decide to halt trading in a security future for other reasons. The examples given in the footnotes describe "operational difficulties." There are occasions, however, when the primary market for a security will temporarily halt trading in the security because of a substantial imbalance of buy or sell orders. Traditionally, an order imbalance situation is not considered an "operational difficulty" in the nature of the examples given in the footnotes. We suggest, therefore, that the adopting release contain a somewhat broader statement of trading halts that markets may elect to impose.

The New York Stock Exchange appreciates the opportunity to comment on the proposed rules for security futures products. The NYSE looks forward to continuing to work with both the SEC and the CFTC in the implementation of the CFMA.

Sincerely,