COMMODITY FUTURES TRADING COMMISSION

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SECURITIES AND EXCHANGE COMMISSION

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Cash Settlement and Regulatory Halt Requirements for Security Futures Products

AGENCIES: Commodity Futures Trading Commission and Securities and Exchange Commission.

ACTION: Joint Proposed Rule.

SUMMARY: The Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively "Commissions") are proposing new rules under the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") generally to provide that the listing standards of national securities exchanges and national securities associations trading security futures products establish a final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and a halt in trading in any security futures product 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 rules proposed today would set forth more specifically how the exchange’s or association’s rules can satisfy the statutory provisions of the Commodity Futures Modernization Act of 2000 ("CFMA”).

DATES: Comments must be received on or before October 1, 2001.

ADDRESSES: Comments should be sent to both agencies at the addresses listed below.

CFTC: Comments should be sent to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. Attention: Office of the Secretary. Comments may be sent by facsimile transmission to (202) 418–5521, or by e-mail to secretary@cftc.gov. Reference should be made to "Cash Settlement and Regulatory Halt Requirements for Security Futures Products.”

SEC: All comments concerning the rule proposal should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–15–01; this file number should be included on the subject line if e-mail is used. Comment letters will be available for public inspection and copying in the SEC’s public reference room at the same address. Electronically submitted comment letters will be posted on the SEC’s Internet web site (http://www.sec.gov). The SEC does not edit personal identifying information, such as names or e-mail addresses, from electronic submissions. Submit only the information you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: CFTC: Richard A. Shiits, Acting Director, at (202) 418–5275; and Thomas M. Leahy, Jr., Financial Instruments Unit Chief, at (202) 418–5278, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. E-mail: (RShills@cftc.gov) or (TLeahy@cftc.gov).


SUPPLEMENTARY INFORMATION: The Commissions today are requesting public comment on proposed Rule 41.1, 4 41.25(a)(2),2 and 41.25(b)3 under the CEA and proposed Rule 6h–1 under the Exchange Act,4 that generally provide that the listing standards of national securities exchanges and national securities associations trading security futures products establish (i) a final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and (ii) a halt in trading in any security futures product 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.

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I. Executive Summary

The CFMA5 authorizes the trading of futures on individual stocks and narrow-based security indexes, and puts, calls, straddles, options, or privileges thereon (collectively, “security futures products”).6 The
CFMA defines security futures products as “securities” under the Exchange Act, 7 the Securities Act of 1933, 8 the Investment Company Act of 1940, 9 and the Investment Advisers Act of 1940, 10 and as contracts of sale for future delivery of a single security or of a narrow-based security index or options thereon under the CEA. 11 Accordingly, the regulatory framework established by the CFMA for the markets and intermediaries trading security futures products provides the SEC and the CFTC with joint jurisdiction. Under the Exchange Act, it is unlawful for any person to effect transactions in security futures products that are not listed on a national securities exchange 12 or on a national securities association registered pursuant to Section 15A(a) of the Exchange Act. 13 In addition, Section 6(b)(2) of the Exchange Act 14 provides that such an exchange or association may trade only those security futures products that conform with listing standards filed by the exchange or association with the SEC under Section 19(b) of the Exchange Act 15 and that meet certain criteria specified in Section 2(a)(1)(D)(i) of the CEA 16 and the standards and conditions enumerated in Section 6(h)(3) of the Exchange Act. 17 In particular, the CEA and the Exchange Act stipulate that the listing standards of an exchange or association trading security futures products shall, among other things, require that trading in the security futures product not be readily susceptible to manipulation of the price of such security futures product, nor to causing or being used in the manipulation of the price of any underlying security or option thereon. 18

In addition, listing standards must require that the market on which the security futures product trades has in place procedures to coordinate trading halts between such market and any market on which any security underlying the security futures product is traded and other markets on which any related security is traded. 19 The rule proposed today would set forth more specifically how the exchange’s or association’s rules can satisfy these statutory provisions. 20

surveillance and trading halt protections in Section 6(b)(5), they need not be cleared by OCC or any other specific clearing organization. 21

Accordingly, proposed SEC Rule 6h–1(b) and CFTC Rule 41.25(b)(1) would require that the final settlement price of a cash-settled security futures product based on a single security fairly reflect the opening price of the underlying security. Similarly, proposed SEC Rule 6h–1(c) and CFTC Rule 41.25(b)(2) would require that the final settlement price of a cash-settled security futures product based on a narrow-based security index fairly reflect the opening prices in the index’s underlying designed to prevent manipulation of price levels of the equity securities market or a substantial segment thereof.” The SEC believes that the proposed rule is necessary in the public interest, for the protection of investors, and the maintenance of fair and orderly markets.

21 Index products are cash-settled, not physically settled.


24 See CFTC Rule 41.25(b)(1)(II).
securities. The Commissions also are proposing that they may grant exemptions to national securities exchanges or national securities associations from such requirements.

B. Regulatory Halts

The securities markets have long-established procedures that require cross-market trading halts in an equity security, related equity securities, and related options whenever the market trading and listing the equity security (“listing market”) imposes a regulatory halt in that security.27 The most common type of regulatory halt is one that prevents trading in an equity security for a short time (usually less than an hour) while material news about the security’s issuer is disseminated to investors. The markets coordinate cross-market “news pending” regulatory halts to promote investor protection and fair security for a short time (usually less than an hour).28

The Commissions believe, therefore, that it would be appropriate for news pending cross-market halt procedures to apply to security futures products. The Commissions also believe that the application of these procedures to security futures products is necessary to satisfy the provisions of Section 2(a)(1)(D)(i)(X) of the CEA28 and Section 6(h)(3)(K) of the Exchange Act,29 which permit a national securities exchange or a national securities association registered pursuant to Section 15A(a) of the Exchange Act30 to trade only security futures products that conform to listing standards that, among other things, require procedures to “coordinate” trading halts between the listing market for the underlying security and other markets that trade the underlying security or any related security. The definition of “regulatory halt” set forth in proposed SEC Rule 6h–1(a)(3) and CFTC Rule 41.1(l) would include a delay, halt, or suspension of trading of a security by the listing market as a result of pending news.31

Proposed SEC Rule 6h–1(a)(3) and CFTC Rule 41.25(a)(2)(i) would require that trading on a security futures product based on a single security be halted at all times that such a news pending regulatory halt has been instituted by the listing market for the underlying security. The other type of regulatory halt currently used by the securities markets involves “circuit breaker” procedures.32 Since October 1988, the stock, options, and index futures markets have had in place circuit breaker procedures that would impose brief cross-market trading halts at pre-determined thresholds during a severe market decline. The coordinated cross-market trading halts provided by circuit breaker procedures are designed to operate only during significant market declines and to substitute orderly, pre-planned halts for the ad hoc and destabilizing halts that can occur when market liquidity is exhausted. The circuit breakers also protect investors and the markets by providing opportunities for markets and market participants to assess market conditions and potential systemic stress during a historic market decline.33

In approving the original circuit breakers proposed by the securities markets, the SEC noted that the circuit breakers were not an attempt to prevent markets from reaching new price levels, but an effort by the securities and futures markets to arrive at a coordinated means to address potentially destabilizing market volatility of the severity of the October 1987 market break.34 For these same reasons, the Commissions believe that it is important to require the application of cross-market circuit breaker regulatory halt procedures to security futures products. Moreover, the Commissions believe that such a requirement is necessary to satisfy the requirements of Section 2(a)(1)(D)(i)(X) of the CEA35 and Section 6(h)(3)(K) of the Exchange Act.36 If cross-market circuit breaker regulatory halt procedures were not applied to the security futures products, such a failure would undermine the use of a trading halt in the underlying securities. The definition of “regulatory halt” set forth in proposed SEC Rule 6h–1(a)(3) and CFTC Rule 41.1(l), therefore, would include a delay, halt, or suspension of trading of a security by the listing market as a result of the operation of circuit breaker procedures to halt or suspend trading in all security futures products trading on the listing market. Proposed SEC Rule 6h–1(d) and CFTC Rule 41.25(a)(2)(i) would require that trading on a security futures product based on a single security be halted at all times that such a circuit breaker regulatory halt has been instituted by the listing market for the underlying security.

Index futures and options also have been subject to the markets’ circuit breaker procedures since their adoption in 1988.37 In view of the broad-based index futures and options, current futures and options, however, these products generally have not been subject to news pending regulatory halts in the underlying securities. Nevertheless, the Commissions believe that, under some circumstances, trading should be halted in a security futures product based on a narrow-based security index when a substantial portion of the underlying securities is halted due to circuit breaker or news pending regulatory halts. Proposed SEC Rule 6h–1(e) and CFTC Rule 41.25(a)(2)(i) therefore 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.38

II. Discussion of Proposed Rulemaking

Before a national securities exchange or national securities association lists or trades security futures products, it is required to file, pursuant to Section 19(b) of the Exchange Act,39 a proposed rule change with the SEC establishing listing standards that comply with Section 6(h)(3) of the Exchange Act.40 Generally, a national securities exchange registered under Section 6(a) of the Exchange Act41 or a national securities association registered under Section 15A(a) of the Exchange Act42 must file proposed rule changes with the SEC pursuant to Section 19(b)(1) of the Exchange Act43 for notice, comment, and SEC approval, prior to implementation, unless the rule is otherwise permitted to become effective pursuant to Section 19(b)(3) of the

26Cross-market halt procedures are not required for non-regulatory halts, such as when one market halts trading because of an imbalance of buy and sell orders in a particular security or when trading is disrupted on one market due to a problem in its systems or on its trading floor.
27See, e.g., infra note and accompanying text.
3015 U.S.C. 78g(a)(5).
31Under the proposed rule, a pending news regulatory halt includes halts that are the result of a determination that there are matters relating to the security or issuer that have not been adequately disclosed to the public, or that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue. See proposed SEC Rule 6h–1(a)(3) and proposed CFTC Rule 41.1(l).
32See infra notes 77 and 78 and accompanying text.
37See Circuit Breaker Report, supra note.
38For a further discussion of the 30 percent threshold, see infra discussion at Section II.C.2(b).
4315 U.S.C. 78q(b)(1).
Exchange Act. A Security Futures Product Exchange or a national securities association registered under Section 15A(k) of the Exchange Act must generally submit, pursuant to Section 19(b)(7) of the Exchange Act, proposed rule changes relating to certain enumerated matters, including listing standards.

A. Staff Interpretive Guidance

Section 2(a)(1)(D)(i) of the CEA and Section 6(h)(3) of the Exchange Act enumerate the standards and conditions that these listing standards must meet. The rule being proposed today would identify certain requirements that the Commissions believe are necessary to satisfy these provisions. Because national securities exchanges and national securities associations may desire to begin trading security futures products prior to the Commissions taking final action on the proposed rule, the SEC staff believes that a proposed rule change filed by a national securities exchange registered under Section 6(a) of the Exchange Act or a national securities association registered pursuant to Section 15A(a) of the Exchange Act regarding listing standards for security futures products would satisfy, in part, the criteria enumerated in Section 6(h)(3)(H) and (K) of the Exchange Act if such listing standards conformed to the proposed rule. Therefore, until such time as the SEC acts on proposed SEC Rule 6h–1, if those proposed listing standards are consistent with proposed SEC Rule 6h–1, the SEC staff would recommend to the SEC that it approve proposed rules to establish listing standards filed by national securities exchanges and national securities associations and would not recommend to the SEC that it abrogate proposed rules to establish listing standards filed by Security Futures Product Exchanges. If, after receiving comment on their proposal, the Commissions determine to adopt a rule that is different from that proposed today, or to not adopt a rule, exchanges and associations would be free, or may be required, to propose changes to their listing standards.

B. Settlement Prices for Cash-Settled Security Futures Products

1. Prior Problems With Closing-Price Settlement Procedures

All currently traded index futures and options are cash-settled. When stock index futures and options began trading in the mid-1980s, virtually all of these products used closing-price settlement procedures. Closing-price settlement procedures in index futures and options generally base the index settlement price on the execution prices from the last regular session trades in the underlying securities. The cash settlement provisions of stock index futures and options contracts facilitated the growth of sizeable index arbitrage activities by firms and professional traders and made it relatively easy for arbitrageurs to buy or sell the underlying stocks at or near the market close on expiration Fridays in order to “unwind” arbitrage-related positions. Because of cash settlement, the amount of cash received by an arbitrageur by selling long positions (or the amount of cash paid out to buy or cover short positions) in underlying stocks at the close of an expiration Friday would exactly match the amount of cash that would have to be paid out to cover short positions (or received from the sale of long positions) in the expiring index futures or options.

These types of unwinding programs at the close on expiration Fridays often severely strained the liquidity of the securities markets. Because unwinding programs sometimes consisted of large sell (or buy) orders in individual securities, the securities markets often found it extremely difficult to solicit sufficient buy or sell interest to absorb the expiration-related programs within the limited time permitted to establish closing prices shortly after 4:00 p.m. (Eastern). It was not uncommon, therefore, for stock specialists to have to drop share prices sharply at the close to establish sufficient buy-side interest to draw in matching buy orders or to raise prices sharply at the close to establish sufficient sell-side interest to draw in matching sell orders. The time constraints faced by specialists to establish closing prices that would reflect an equilibrium between buy and sell interest resulted in sharp price movements in the indexes underlying the futures or options. In addition, regulators and self-regulators were concerned that the liquidity constraints faced by the securities markets to accommodate expiration-related buy or sell programs at the market close on expiration Fridays could exacerbate ongoing market swings during an expiration and could provide opportunities for entities to anticipate these pressures and enter orders as part of manipulative or abusive trading practices designed to artificially drive up or down share prices.

To reduce such expiration-related strains on market liquidity, the Chicago Mercantile Exchange (“CME”) in 1987 switched from closing-price settlement procedures to opening-price settlement procedures for certain stock index futures. The CME’s products include weekend—during which time, they were subject to considerable market risk.

The liquidity constraints faced by the securities markets due to unwinding programs used in closing-price settlement procedures were discussed by the SEC staff in its report on the market decline on November 15, 1991. See SEC Division of Market Regulation, Trading Analysis of November 15, 1991 (October 1992) (“Trading Analysis of November 15, 1991”). With respect to concerns regarding manipulation, the Commissions note that the Intermarket Surveillance Group ("ISG") was created under the auspices of the SEC in 1981 as a forum to ensure that national securities exchanges and national securities associations adequately share surveillance information and coordinate investigations designed to address potential intermarket manipulations and trading abuses. All national securities exchanges and national securities associations are full members of the ISG. Full members routinely share intermarket surveillance information and investigatory information, and the SEC believes that this framework has proven to be an essential mechanism to ensure that there is adequate information sharing and investigatory coordination for potential intermarket manipulations and trading abuses.

Since 1987, several futures exchanges and non-U.S. exchanges and associations have been affiliate members of the ISG. Affiliate members are required to share information on a more limited basis with the ISG. To fulfill the requirement of the CEA and Exchange Act that listing standards of exchanges and associations trading security futures products require procedures be in place for coordinated surveillance among the markets on which the security futures product is traded, any market on which the underlying security futures product is traded, and any other markets on which any related security is traded to detect manipulation and insider trading, the Commissions believe that it is essential that all such exchanges and associations be full members of the ISG. In view of the essential role that the ISG plays, the Commissions also believe that the ISG should grant full memberships to all national securities exchanges and national securities associations registered pursuant to Section 15A(a) of the Exchange Act trading securities futures products, including Security Futures Product Exchanges, upon a good-faith showing that the entities meet the criteria for full membership.


52 See supra note 12.

53 "Security Futures Product Exchanges" refers to the third Friday of each month that marks the expiration date for that month’s individual stock options, stock index options, and stock index futures contracts. On the expiration date, options and futures contracts cease to exist. Some stock index futures and options expire on a quarterly basis, with their expiration Friday occurring on the third Friday of the last month of the quarter (March, June, September, and December). 54 Steep discounts (premiums) were necessary in part because traders who bought (sold) stocks to offset unwinding programs had to maintain their newly acquired long (short) positions over the weekend—during which time, they were subject to considerable market risk.

55 The liquidity constraints faced by the securities markets due to unwinding programs used in closing-price settlement procedures were discussed by the SEC staff in its report on the market decline on November 15, 1991. See SEC Division of Market Regulation, Trading Analysis of November 15, 1991 (October 1992) (“Trading Analysis of November 15, 1991”). With respect to concerns regarding manipulation, the Commissions note that the Intermarket Surveillance Group ("ISG") was created under the auspices of the SEC in 1981 as a forum to ensure that national securities exchanges and national securities associations adequately share surveillance information and coordinate investigations designed to address potential intermarket manipulations and trading abuses. All national securities exchanges and national securities associations are full members of the ISG. Full members routinely share intermarket surveillance information and investigatory information, and the SEC believes that this framework has proven to be an essential mechanism to ensure that there is adequate information sharing and investigatory coordination for potential intermarket manipulations and trading abuses.

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the industry’s most actively traded index futures contract, which was based on the Standard & Poor’s 500 Stock Index ("SPX Futures"). Because SPX Futures were employed in the vast majority of index arbitrage trading programs at that time, the adoption of opening-price settlement procedures for these contracts had a significant effect on unwinding programs in the securities markets on SPX Futures’ quarterly expirations.

Most other market participants began moving to opening-price settlement procedures for stock index options contracts. For example, the New York Stock Exchange ("NYSE") and the Chicago Board Options Exchange ("CBOE") implemented opening-price settlement procedures for certain index options in 1987. Other exchanges adopted similar procedure for some of their index options. Exchanges also incorporated opening-price settlement requirements as part of their listing criteria for index options.

Opening-price settlement procedures offered several features that facilitated the ability of the securities markets to handle expiration-related unwinding programs. For example, the NYSE was able to use its existing electronic order-routing systems and electronic specialist books to process and match incoming unwinding stock orders before the opening of the regular trading session at 9:30 a.m. (Eastern). Specialists could then utilize long-standing procedures to disseminate price indications in an orderly manner before index component stocks opened for trading. Moreover, smaller price discounts or premiums were needed to draw in orders to offset unwinding programs because traders who entered the offsetting orders understood that they would have the remainder of the trading session to trade out of any index options acquired at the opening. As a result, it appears that the widespread adoption of opening-price settlement procedures in index futures and options has served to mitigate the liquidity strains that had previously been experienced in the securities markets on expirations.

2. Requirements for Security Futures Products Using Cash Settlement

In view of the experience gained with settlements in cash-settled stock index futures and options in the 1980s and in light of the potential for manipulation of the underlying securities markets, the Commissions preliminarily believe that it would be prudent, at the outset of trading in these products, to require exchanges specifying cash settlement in lieu of physical delivery for security futures products to use a final settlement price that fairly reflects the opening price of the underlying security or securities as the basis for cash settling positions at contract expiration.

60 See Amex Rule 901C, Commentary .02(c) (listing requirements for stock industry index groups pursuant to SEC Rule 19b-4(e)); CBOE Rule 24.20(b)(1) (listing criteria for narrow-based security index options under SEC Rule 19b-4(e)); PCX Rule 7.3(b)(1) (listing criteria for narrow-based security index options); Phlx Rule 1000A(b)(1) (listing criteria for narrow-based security index options pursuant to SEC Rule 19b-4(e)); see also Commentary to Phlx Rule 1000A(b)(8) ("For any series of index options first opened after March 30, 1987, the Exchange may, in its discretion, provide that the calculation of the final index settlement value of any index on which options are traded at the Exchange will be determined by reference to the closing price of the constituent stocks at a time other than the close of trading on the last trading day before expiration").

61 See proposed SEC Rule 6h-1(b) and (c) and proposed CFTC Rule 41.25(b).

a. Single-Stock Futures

Proposed SEC Rule 6h-1(b) and CFTC Rule 41.25(b) would require that the final settlement price of a cash-settled security futures product be based on a single security fairly reflecting the opening price of the underlying security. While the emphasis in the proposed rule is on cash settlements based on the opening price(s), the Commissions’ proposal would leave national securities exchanges and national securities associations trading security futures products with some flexibility in adopting rules that determine how the opening price is defined for this purpose. For example, under the proposed rule, a national securities exchange or national securities association could define the opening price for a single-stock future as the trade-weighted average price of the underlying security during the few minutes of trading of their first trading session. Alternatively, the opening price for a security futures product could be defined as the price reported for the first trade in that security at the beginning of the regular trading session.

Proposed SEC Rule 6h-1(b) and CFTC Rule 41.25(b) also would require that, if an opening price for an underlying security is not readily available, the final settlement price of the underlying security during its most recent regular trading session. The Commissions believe that, if

62 Proposed SEC Rule 6h-1(a)(1) and CFTC Rule 41.1(j) would define “opening price” as the price at which a security opened for trading, or a price that fairly reflects the price at which a security opened for trading, during the regular trading session of the national securities exchange or national securities association that lists the security. Proposed SEC Rule 6h-1(a)(2) and CFTC Rule 41.1(k) would define the “regular trading session” of a security as the normal hours for business of a national securities exchange or national securities association that lists the security.

63 Although proposed SEC Rule 6h-1(b) and (c) and CFTC Rule 41.25(b) and (b)(2) would not define when an opening price would not be “readily available,” national securities exchanges and national securities associations would have to establish, as part of their listing requirements, rules that interpret this term. The Commissions’ overriding concern is that settlement prices for cash-settled security futures products be established in a fair and predictable manner.
settlement price for a security futures product is derived. For example, while one national securities exchange or national securities association may decide to establish rules that would use the closing price from the most recent regular trading session if an opening price for a security underlying a security futures product is not readily available, another exchange or association could establish rules that would use a trade-weighted average over some portion of that session in such circumstances.

The Commissions do not believe at present that national securities exchanges and national securities associations should trade security futures products that settle at prices established by other than the most recent regular trading session. The Commissions believe that the final settlement price for a cash-settled single-stock future should reasonably reflect the opening price of the underlying security or, if that is not readily available, a price fairly reflective of the price in a liquid market for the underlying security. The Commissions believe that a price derived from the regular trading session of the national securities exchange or national securities association that lists the underlying security would have the greatest likelihood of reflecting the most reasonable price for that security, unlike a price generated from an extended trading hours session.

b. Narrow-Based Security Index Futures

Proposed SEC Rule 6h-1(c) and CFTC Rule 41.25(b)(2) would require, absent an exemption, national securities exchanges and national securities associations to establish that the final settlement price of a cash-settled narrow-based security index future reflect the opening prices of the underlying securities. As with single-stock futures, the Commissions are proposing that, if prices for one or more underlying securities were not readily available, the settlement prices for those securities would be derived from their most recent regular trading session. For the securities that did open normally, the settlement prices would be their respective opening prices.

c. Exemption

Proposed paragraph (f) of SEC Rule 6h-1 and paragraph (b)(3) of CFTC Rule 41.25 would permit the Commissions to grant a national securities exchange or national securities association an exemption from the above requirements. The SEC would grant such an exception, either conditionally or unconditionally, if it were necessary or appropriate in the public interest, and consistent with the protection of investors. The CFTC would grant such an exemption if the CFTC determines that it would be consistent with the public interest, the protection of investors, and otherwise furthers the provisions of the CEA.

d. Request for Comments Relating to Final Settlement Prices

The Commissions welcome comment on all aspects of the proposed rule as they relate to final settlement prices for cash-settled security futures products, including the following matters:

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.

Q2. If commenters believe that cash-settled 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?

Q3. Are there any additional safeguards that would be appropriate for security futures products cash settlement procedures to ensure that the anti-manipulation mandates in Section 2(a)(1)(D)(i) of the CEA and Section 6(h)(3)(H) of the Exchange Act are satisfied?

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?

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?

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?

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?

C. Regulatory Halts

1. Background

Generally, there are two types of regulatory halts used in the equity and options markets: news pending halts and circuit breaker halts. News pending halts are designed to protect the interests of current and potential shareholders by facilitating the orderly dissemination of potentially market moving information and the discovery of fair and reasonable prices for securities based on new information. A news pending halt benefits current and potential shareholders by halting all trading in the securities until there has been an opportunity for the information to be disseminated to the public. It also helps to ensure public confidence in the market and promotes the integrity of the marketplace by giving the public an opportunity to evaluate information in making investment decisions. Circuit breakers are brief, coordinated cross-market trading halts used by the major stock, options, and index futures markets to mitigate systemic stress when a severe one-day market drop of historic proportions prevents the financial markets from operating in an orderly manner.

a. News Pending Halts

Currently, national securities exchanges and national securities associations may impose brief trading halts in specific securities pending the release of material information that would reasonably be expected to affect the prices of those securities.
halts give investors an opportunity to learn of and react to material news. The NYSE and Amex, for example, follow procedures for regulatory halts contained in the Consolidated Tape Association Plan (“CTA Plan”). Under the CTA Plan, a regulatory halt occurs whenever the listing market (termed the “primary market”) for an eligible security, in the exercise of its regulatory functions, halts or suspends trading in the security because the primary market has determined (i) that there are matters relating to the security or issuer that have not been adequately disclosed to the public, or (ii) that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue. The Commission preliminarily believes that it may be appropriate to include this definition of a news pending regulatory halt under the proposed rule because the exchanges already have experience in applying the requirement. When a regulatory trading halt is initiated by the primary market for a security, the regional exchanges and Nasdaq Intermarket also halt trading in the security, and the options exchanges halt trading in related options. The options exchanges also halt trading in an equity option when the underlying security has ceased trading.

The options markets also have in place rules regarding trading halts on exchange options. Several of the options markets will halt trading when, for example, a certain fixed percentage of the index halts trading or when it is appropriate in the interests of a fair and orderly market and to protect investors. For example, trading on the PCX in any index option is halted when trading in underlying securities whose weighted value represents more than 20 percent of the value of a broad-based index or 10 percent of the value of other indices is halted.64

b. Circuit Breaker Halts

The Commissions approved various exchanges’ circuit breaker proposals in response to the October 1987 market break to permit these brief, coordinated cross-market halts to provide opportunities during a severe market decline to reestablish an equilibrium between buying and selling interests in an orderly fashion, and to help ensure that market participants have a reasonable opportunity to become aware of, and respond to, significant price movements.41 Market-wide cross-market trading halts provided by circuit breaker procedures are designed to operate only during significant market declines and to substitute orderly, pre-planned halts for the ad hoc and destabilizing halts which can occur when market liquidity is exhausted.65 Currently, all stock exchanges and the NASD have rules or policies to implement coordinated circuit breaker halts.66 The options markets also have rules applying circuit breakers.67 Finally, the index futures exchanges have adopted circuit breaker halt procedures in conjunction with their price limit rules for index products.68

The current circuit breaker procedures call for cross-market trading halts when the Dow Jones Industrial Average (“DJIA”) declines by 10 percent, 20 percent, and 30 percent from the previous day’s closing value. At the beginning of each quarter, the markets use the average closing value of the DJIA for the previous month to establish specific price-decline triggers for the quarter.69 Specifically, a one-hour cross-market halt will be implemented if the DJIA declines by 10 percent prior to 2 p.m., and a one-half hour halt will be implemented if the DJIA declines by 10 percent between 2 p.m. and 2:30 p.m.70 If the DJIA declines by 10 percent at or after 2:30 p.m., trading generally will not halt when the 10 percent level is reached. If the DJIA declines 20 percent prior to 1 p.m., trading will halt for two hours. The options markets will halt trading in exchange traded options if the DJIA declines by 20 percent and 30 percent.71

A price limit, in itself, does not halt trading in the index futures options, but prohibits trading below the pre-set limit during a price decline. Intraday price limits are removed at pre-set times during the trading session, such as ten minutes after the thresholds are reached or at 3:30 p.m., whichever is earlier. Daily price limits remain in effect for the entire trading session. Specific price limits are set for each stock index futures contract. There are no price limits for U.S. stock index options, equity options, or stocks.

41 See, e.g., CME Rule 4002.I. The CME will implement a circuit breaker trading halt in SPX Futures if the 10 percent pre-set limit has been imposed in the securities markets and the futures are “locked” at their 10 percent price limit. Trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50 percent of the index capitalization. The CME will implement another circuit breaker trading halt in SPX Futures if the 20 percent circuit breaker halt has been imposed in the securities markets and the futures are “locked” at their 20 percent price limit. Trading will not reopen in SPX Futures until the circuit breaker halt has been lifted in the securities markets and trading has resumed in stocks comprising at least 50 percent of the index capitalization.

42 See Circuit Breaker Report, supra note 33, p. 2.

43 See, e.g., NYSE Rule 80b.
hours; trading will halt for one hour if the DJIA declines 20 percent between 1 p.m. and 2 p.m.; and trading will halt for the remainder of the day if a 20 percent decline occurs at or after 2 p.m. If the DJIA declines 30 percent at any time, trading will halt for the remainder of the day.

2. Trading Halt Coordination in Security Futures Products

As discussed above, Section 2(a)(1)(D)(I)(X) of the CEA and Section 6(b)(3)(K) of the Exchange Act provide that listing standards for security futures products must 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)(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 for the underlying security. 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. Thus, if the listing market halted trading in a security for 30 minutes, the security futures product market could not institute a halt and then reopen trading in the security futures product after two minutes. The Commissions believe that the purpose of halting trading in the underlying security would be frustrated if market participants could circumvent this halt by trading during the halt in the related security futures product.

b. Trading Halt Coordination in Narrow-Based Security Index Futures

Proposed SEC Rule 6h–1(e) and CFTC Rule 41.25(a)(2)(ii) would also require national securities exchanges and national securities associations to halt trading in certain circumstances in a security futures product based on a narrow-based security index. Although broad-based security indices have large numbers of component securities, if it is extremely unlikely that news pending regulatory halts would be imposed simultaneously in securities representing a significant portion of any index, this may not be the case with all narrow-based security index futures.

Accordingly, the proposal would require trading to be halted in a narrow-based security index futures product when securities representing 30 percent or more of the market capitalization of the narrow-based security index are subject to a regulatory halt.

The Commissions do not believe that trading of a security futures product based on a narrow-based security index should necessarily be halted because a trading halt has been instituted for only one, low-weighted component security. However, regulatory halts of components could affect a sufficiently large portion of an index to make continued trading of the security futures product a means to improperly circumvent regulatory halts in the underlying securities. For example, if a security futures product is based on a narrow-based security index consisting of two stocks and regulatory halts have been imposed by the listing market in one of the component stocks for pending news, the halt would be undermined if trading continued in the security futures product, because the security represents a substantial portion of the index value. Under these circumstances, the Commissions do not believe that trading halt procedures

reasons, such as operational difficulties being experienced by the market or its automated systems or concerns over clearance and settlement operations.


As with proposed SEC Rule 6h–1(d), the proposed rule is not designed to preclude a market trading security futures products on halting trading for other appropriate reasons, such as operational difficulties being experienced by the market or its automated systems or concerns over clearance and settlement operations.
whether a trading halt is appropriate for a narrow-based security index?

III. Request for Comments

The Commissions solicit comments on all aspects of proposed CFTC Rule 41.25(a)(2) and 41.25(b) under the CEA and proposed SEC Rule 6h–1 under the Exchange Act. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed rule.

IV. Paperwork Reduction Act

CFTC: The Paperwork Reduction Act (“PRA”) of 1995 (44 U.S.C. 3501 et seq.) imposes certain requirements on federal agencies (including the CFTC) in connection with their conducting or sponsoring any collection of information as defined by the PRA. This proposed rulemaking contains information collection requirements within the meaning of the PRA. The CFTC has submitted a copy of this part to the Office of Management and Budget (“OMB”) for its review in accordance with 44 U.S.C. 3507(d).

Collection of Information: Part 41, Relating to Security Futures Products, OMB Control Number 3038–XXXX.

An agency may not conduct or sponsor, and a person is not required to respond to, an information collection unless it displays a currently valid OMB control number. The CFTC is currently requesting a control number for this information collection from OMB.

As noted above, the CFMA lifted the ban on trading single stock and narrow-based stock index futures and established a framework for the joint regulation of these products by the CFTC and the SEC. In addition, the CFMA amended the CEA and the Exchange Act by adding a definition of “narrow-based security index,” which establishes an objective test of whether a security index is narrow-based.

Futures contracts on security indexes that meet the statutory definition are jointly regulated by the CFTC and the SEC. Futures contracts on indexes that do not meet the statutory definition remain under the sole jurisdiction of the CFTC.

The effect of proposed CFTC Rule 41.25(a)(2) and 41.25(b) will be to increase the burden previously submitted to OMB by 68 hours resulting from the preparation of materials to be filed with the CFTC in connection with the listing of security futures products by designated contract markets and registered derivatives transaction execution facilities.

The estimated burden of proposed CFTC Rule 41.25(a)(2) and 41.25(b) was calculated as follows:

Estimated number of respondents: 17.
Total annual responses: 850.
Estimated average number of hours per response: 0.8.
Estimated total number of hours of annual burden: 68.

This annual reporting burden represents an increase of 68 hours as a result of the proposed new rule.

It should be noted that proposed CFTC Rule 41.25(a)(2) and 41.25(b) is part of a larger proposed rulemaking that will require designated contract markets and registered derivatives transaction execution facilities to certify that they meet the listing standards criteria of part 41. Specifically, proposed CFTC Rule 41.23 will require that before these boards of trade list a new security futures product for trading, they certify that they comply with a number of listing standards set forth in proposed CFTC Rule 41.22, as well as the additional conditions for trading set forth in proposed CFTC Rule 41.25. In a previous notice of proposed rules, the CFTC estimated that the burden of each submission under proposed CFTC Rule 41.23 would be approximately one (1) hour. The extra burden imposed on designated contract markets and registered derivatives transaction execution facilities in certifying that they meet the criteria of proposed CFTC Rule 41.25(a)(2) and 41.25(b) should be minimal, since this certification will be a part of a larger certification. Nevertheless, the CFTC estimates that the additional burden imposed by this rule will create a burden of no more than .08 hours (approximately five (5) minutes) per response.

Organizations and individuals desiring to submit comments on the information collection requirements should direct them to the Office of Information and Regulatory Affairs, OMB, Room 10235 New Executive Building, Washington, DC 20503, Attention: Desk Officer for the Commodity Futures Trading Commission.

The CFTC considers comments by the public on this proposed collection of information in:

• Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the CFTC, including whether the information will have a practical use;

• Evaluating the accuracy of the CFTC’s estimate of the burden of the
proposed collection of information, including the validity of the methodology and assumptions used;  
• Enhancing the quality, usefulness, and clarity of the information to be collected; and  
• Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology (e.g., permitting electronic submission of responses).  

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the Federal Register. A comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the CFTC on the proposed regulation. Copies of the information collection submission to OMB are available from the CFTC from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, (202) 418-5160.

SEC: Certain provisions of the proposed rule contain “collection of information requirements” within the meaning of the PRA. Accordingly, the SEC submitted the collection of information requirements to OMB for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The SEC is revising the collection of information titled “Rule 19b–4 and Form 19b–4,” OMB Control No. 3235–0045. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The Exchange Act, as amended by the CFMA, provides that a national securities exchange or national securities association may trade security futures products only if the listing standards for such products conform with the requirements set forth in Section 6(h)(3) of the Exchange Act. These listing standards must, among other things, require that: (1) trading in security futures products not be readily susceptible to price manipulation, and (2) the exchange or association on which the security futures product is traded has in place procedures to coordinate trading halts with the market listing the security or securities underlying the security futures products.¹⁰¹ To further these statutory mandates, the SEC is proposing SEC Rule 6h–1, which would provide that the listing standards of national securities exchanges and national securities associations trading security futures products establish: (1) A final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities rather than the closing price, on the grounds that settlement based on the closing price creates greater volatility and more opportunity for price manipulation; and (2) a halt in trading in any security futures product 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 SEC anticipates that national securities exchanges and national securities associations that wish to trade security futures products would file with the SEC proposed rule changes, pursuant to Section 19(b) of the Exchange Act, to establish listing standards that are consistent with the requirements set forth in Section 6(h)(3) of the Exchange Act.¹⁰³ The SEC would review the proposed rule changes submitted by national securities exchanges and national securities associations in the manner prescribed by Section 19(b) of the Exchange Act.¹⁰⁴ In addition, the SEC would publish these proposed rule changes to afford the public an opportunity to comment on the listing standards adopted by exchanges and associations with respect to security futures products. The SEC estimates that there would be 17 respondents to the proposed rule: 9 currently registered national securities exchanges, 1 national securities association (the NASD) that operates a securities market (Nasdaq), and an estimated 7 futures markets that are expected to register as Security Futures Product Exchanges. The information collected pursuant to proposed SEC Rule 6h–1 would not be kept confidential and would be publicly available.

The SEC estimates the paperwork burden for each respondent, to comply with proposed SEC Rule 6h–1 would be 10 hours of legal work at $128/hour,¹⁰⁵ for a total cost of $1280 per respondent. The SEC estimates that the total burden on all respondents would be 170 hours (10 hours/response × 17 respondents × 1 response/respondent), for a total cost of $21,760 ($1280/response × 17 respondents × 1 response/respondent). These burdens would be incurred on a one-time basis and would not recur. As set forth in SEC Rule 17a–1,¹⁰⁶ a national securities exchange or national securities association is required to retain records of the collection of information for at least five years, the first two years in an easily accessible place. However, Rule 17a–1 requires a Security Futures Product Exchange to retain only those records relating to persons, accounts, agreements, contracts, and transactions involving security futures products.¹⁰⁷ Pursuant to 44 U.S.C. 3506(c)(2)(B), the SEC solicits comments to:

1. Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information would have practical utility;
2. Evaluate the accuracy of the SEC’s estimate of the burden of the proposed collections of information;
3. Enhance the quality, utility, and clarity of the information to be collected; and
4. Minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements proposed above should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10102, New Executive Office Building, Washington, DC 20503; and (2) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549–0609, with reference to File No. S7–15–01.

OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The SEC has submitted the proposed collections of information to OMB for approval. Requests for the materials submitted to OMB by the SEC

¹⁰⁵ The estimated rate of $128 per hour is derived from the SIA Management and Professional Earnings, Table 107 (Attorney, New York), and includes a 35 percent differential for bonus, overhead, and other expenses.
¹⁰⁶ 17 CFR 240.17a–1.
with regard to these collections of information should be in writing, refer to File No. S7–15–01, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 5th Street, NW, Washington, DC 20549.

V. Costs and Benefits of the Proposed Rulemaking

CFTC. Section 15 of the CEA requires the CFTC to consider the costs and benefits of its action before issuing a new regulation. The CFTC understands that, by its terms, section 15 does not require the CFTC to quantify the costs and benefits of a new regulation or to determine whether the benefits of the proposed regulation outweigh its costs. Nor does it require that each proposed rule be analyzed in isolation when that rule is a component of a larger package of rules or rule revisions. Rather, section 15 simply requires the CFTC to “consider the costs and benefits” of its action.

Section 15 further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the CFTC could in its discretion give greater weight to any one of the five enumerated areas of concern and could in its discretion determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The proposed rule constitutes one part of a package of related rule provisions. The rule provides guidance and establishes procedures for trading facilities in order to facilitate compliance with governing laws related to security futures products. The CFTC has considered the costs and benefits of the proposed rule as a totality, in light of the specific areas of concern identified in section 15. The proposed rule should have no effect, from the standpoint of imposing costs or creating benefits, on the financial integrity or price discovery function of the futures and options markets or on the risk management practices of trading facilities or others. The proposed rule should also have no material effect on the protection of market participants and the public and should not impact the efficiency and competition of the markets.

Accordingly, the CFTC has determined to propose the rule discussed above. The CFTC invites public comment on the application of the cost-benefit provision of section 15 of the CEA in regard to the proposed rule. Commenters also are invited to submit any data that they may have quantifying the costs and benefits of the proposed rule.

SEC. The CFMA 109 authorizes the trading of futures on individual stocks and narrow-based security indexes, and puts, calls, straddles, options, or privileges thereon (collectively, “security futures products”). The CFMA requires, among other things, that trading in the security futures product not result in manipulation of the price of such security futures product, nor to causing or being used in the manipulation of the price of any underlying security or option thereon. In addition, listing standards must require that the market on which the security futures product trades has in place procedures to coordinate trading halts between such market and any market on which any security underlying the security futures product is traded and other markets on which any related security is traded.

Accordingly, the SEC is proposing new SEC Rule 6h–1 under the Exchange Act generally to provide that the listing standards of national securities associations trading security futures products establish (1) a final settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and (2) a halt in trading in any security futures product when a regulatory halt is instituted by the national securities exchange or national securities associations listing the security or securities underlying the security futures product.

Specifically, proposed SEC Rule 6h–1(a) would provide the definitions of the terms “opening price,” “regular trading session,” and “regulatory halt.” Proposed SEC Rule 6h–1(b) would require that the settlement price of a cash-settled security futures product based on a single security fairly reflect the opening price of the underlying security. Similarly, proposed SEC Rule 6h–1(c) would require that the settlement price of a cash-settled security futures product based on a narrow-based security index fairly reflect the opening prices in the index’s underlying securities. Furthermore, the SEC is proposing SEC Rule 6h–1(d) to require that trading on a security futures product based on a single security be halted at all times that a regulatory halt has been instituted by the listing market due to pending news or the operation of circuit breaker procedures for the underlying security. Likewise, proposed SEC Rule 6h–1(e) would require that trading of a security futures product based on a narrow-based security index be halted at all times that a regulatory halt has been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index.

The SEC is considering the costs and benefits of proposed SEC Rule 6h–1 and requests comment on all aspects of this cost-benefit analysis, including identification of additional costs or benefits of the proposed rule. The SEC encourages commenters to identify, discuss, analyze, and supply relevant data concerning the proposed rule.

A. Benefits of Proposed SEC Rule 6h–1 Under the Exchange Act

Proposed SEC Rule 6h–1(a) would define the terms “opening price,” “regular trading session,” and “regulatory halt,” and, therefore, the SEC preliminarily believes that there would be no costs imposed on the respondents arising from proposed SEC Rule 6h–1(a). However, in providing the definitions of the relevant terms, the SEC preliminarily believes that proposed SEC Rule 6h–1(a) should benefit respondents by providing legal certainty to respondents when complying with the rule.

The SEC also preliminarily believes that the provisions for cash-settled security futures products under proposed SEC Rule 6h–1(b) and (c) is necessary to minimize opportunities for intermarket manipulations and to promote the fair and orderly operation of

110 However, no person may offer to enter into, enter into, or confirm the execution of any option on a security future for at least three years after the enactment of the CFMA.
113 Proposed SEC Rule 6h–1.
of the securities markets. In particular, opening-price settlement procedures appear to be necessary to satisfy the provisions of Section 2(a)(1)(D)(i)(VII) of the CEA 119 and Section 6(h)(3)(H) of the Exchange Act 120 that listing standards for security futures products must require that trading in a security futures product not be readily susceptible to manipulation of the price of such product, nor to causing or being used in the manipulation of the price of any underlying security, option on such security, or option on a group or index including such securities.

Furthermore, the SEC preliminarily believes that using opening-price settlement procedures should avoid the problems caused by arbitrageurs unwinding large arbitrage-related positions at the market close on expiration Fridays that would severely strain the liquidity of the securities markets. Closing-price settlement procedures often made it extremely difficult for the securities markets to solicit sufficient buy or sell interest to match up with the expiration-related programs that often created buy or sell imbalances within the limited time permitted to establish closing prices shortly after 4:00 p.m. (Eastern).

Therefore, it was not uncommon for stock specialists to drop share prices sharply at the close in order to provide sufficient discounts to draw in matching buy orders or raise prices sharply at the close to provide sufficient premiums to draw in matching sell orders.

Furthermore, closing-price settlement procedures imposed time constraints on specialists to establish closing prices that would result in an equilibrium between buy and sell interest, which in turn produced sharp price movements in the indexes underlying the index futures or options contracts. In addition, the SEC preliminarily believes that the liquidity constraints associated with expiration-related buy or sell programs at the close on expiration Fridays would aggravate ongoing market swings during an expiration and provide opportunities for entities to anticipate these pressures and enter orders as part of manipulative or abusive trading practices designed to artificially drive up or down share prices. 121

The SEC preliminarily believes that proposed SEC Rule 6h–1(b) and (c), which require opening-price settlement procedures for cash-settled security futures products, should facilitate the ability of the securities markets to handle expiration-related unwinding programs and should mitigate the liquidity strains that had previously been experienced in the securities markets on expirations. It is likely that smaller price discounts or premiums will be needed to draw in orders to offset unwinding programs since traders who enter the offsetting orders will have the remainder of the trading session to trade out of any long or short positions acquired at the opening.

Furthermore, the SEC preliminarily believes that the language of the proposed rule will provide national securities exchanges and national securities associations with flexibility in establishing the procedures for determining the opening price at which to settle for a particular security futures product. For instance, a national securities exchange or a national securities association would be free to define the opening price as a trade-weighted average price of the underlying security during the first few minutes of trading of a regular trading session or the price reported for the first trade in the underlying security at the beginning of the regular trading session. In addition, proposed SEC Rule 6h–1(b) and (c) also would require that, if an opening price for an underlying security is not readily available, the settlement price of the opening-cash-settled security futures product or the cash-settled narrow-based security index future must fairly reflect the price of the underlying security or securities during its most recent regular trading session. Again, the proposal would provide national securities exchanges and national securities associations with some discretion to implement this general rule without dictating how the settlement price is derived for a security futures product.

Further, the SEC believes that the exemption provided for in proposed SEC Rule 6h–1(f), which allows the SEC to provide exemptions from this section, 122 would provide national securities exchanges and national securities associations with sufficient flexibility to use a price outside of the opening price for cash-settled security futures products. Accordingly, proposed SEC Rule 6h–1(f) would benefit national securities exchanges and national securities associations by providing them with flexibility in responding to changing market conditions, as well as provide the SEC with continued oversight over the respondents by granting an exemption when it is necessary or appropriate in the public interest and is consistent with the protection of investors.

Proposed SEC Rule 6h–1(d) and (e) would require trading to be halted on security futures products at all times that a regulatory halt has been instituted for the underlying security or for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index. The proposal would help preserve the investor protection and market integrity provisions of regulatory halt procedures in the securities markets. The SEC preliminarily believes that the close relationship between the underlying security or securities and the pricing of the overlying security futures product generally justifies a regulatory halt of the security futures product at all times that a regulatory halt has been instituted for the underlying security or securities.123

With respect to regulatory halts due to pending news, proposed SEC Rule 6h–1(d) and (e) would benefit current and potential shareholders by providing an opportunity for material information about the underlying security or securities to be disseminated to the public. Pending news development may have a significant effect on trading, and the SEC believes that all investors should have an opportunity to learn of and react to material information in order to make informed investment judgments.124

Accordingly, such news pending regulatory halts would foster public confidence in the market and promote the integrity of the market place. Furthermore, the SEC preliminarily believes that requiring an exchange or association to halt trading on a security futures product at all times that a regulatory halt has been instituted for the underlying security or securities would contribute to the maintenance of an efficient market.

123 The trading halt provisions of proposed SEC Rule 6h–1(d) and CFTC Rule 41.25(a)(2)(i) would not be exclusive. The proposed rule is not designed to preclude a market trading security futures products from halting trading for other appropriate reasons, such as operational difficulties being experienced by the market or its automated systems or concerns over clearance and settlement operations.

In addition, the SEC preliminarily believes that instituting a regulatory halt in the trading of security futures products due to the operation of circuit breakers would further protect investors and the markets by mitigating potential systemic stress during a historic market decline and allow for the reestablishment of an equilibrium between buying and selling interests in an orderly fashion. The SEC generally believes that pre-determined, coordinated, cross-market operations of circuit breakers would effectively address market declines that threaten to result in ad hoc and potentially destabilizing market closings. The SEC preliminarily believes that the circuit breakers levels are sufficiently broad enough to be triggered only on rare occasions and represent a reasonable means to protect the nation’s financial markets and participants from rapid market declines. Circuit breaker procedures would also help to ensure that market participants had a reasonable opportunity to become aware of, and respond to, significant price movements.

With respect to narrow-based security indexes, the SEC believes that trading should necessarily be halted when a trading halt has been instituted for a sufficiently large portion of an index in order to prevent continued trading of the security futures product from becoming a means to improperly circumvent regulatory halts in the underlying securities. If trading in only one component security is halted, continued trading in a security index future in which such a security represents a substantial portion of the index value could also undermine the trading halt in the underlying security. The SEC preliminarily believes that trading halt procedures also would not be coordinated, as contemplated by Section 2(a)(1)(D)(i)(X) of the CEA and Section 6(h)(3)(K) of the Exchange Act, if the security futures product continued to trade while investors were precluded from trading some or all of the underlying securities. Moreover, the SEC preliminarily believes that continued trading in the security futures product under these circumstances would undercut key provisions in the securities laws designed to protect investors and promote the fair and orderly operation of the markets. Accordingly, the SEC believes that a general practice whereby trading is halted for the security futures product when investors lack access to current pricing information in the primary market for the underlying security should contribute to the maintenance of fair and orderly markets. Therefore, proposed SEC Rule 6h–1(e) would require a trading halt in the security futures product overlying the index when trading is halted in a component security or securities of an index that represents 30 percent or more of the index’s weighting. Moreover, the SEC believes that this coordination of trading halts, as contemplated by proposed SEC Rule 6h–1(d) and (e), would generally benefit investors and the market by providing less opportunity for abuse and manipulation.

Proposed SEC Rule 6h–1(d) and (e) also would further increase investor confidence in the stability of the markets by assuring investors and the public that the national securities exchanges and national securities associations trading security futures products are reasonably equipped to handle market demand and pending material news.

Furthermore, in order to be effective, circuit breakers have to be coordinated across stock, stock index futures, and options markets in order to prevent intermarket problems of the kind experienced in October 1987. Since the markets currently coordinate regulatory halts between the listing market for the underlying security and other markets that trade the underlying security or any related security in order to prevent material news, the SEC believes that coordination of trading halts, as contemplated by proposed SEC Rule 6h–1(d) and (e) would help ensure such coordination and effectiveness through the use of regulatory halts in the markets trading security futures products.

The SEC also preliminarily believes that the proposed rule would provide all market participants a clear guideline of when regulatory halts are to be observed for trading in the security futures products.[128]

B.Costs of Proposed SEC Rule 6h–1 under the Exchange Act

The SEC estimates that there would be 17 respondents to the proposed rule: 9 currently registered national securities exchanges, 1 national securities association (the NASD) that operates a securities market (Nasdaq), and an estimated 7 futures markets that are expected to register as Security Futures Product Exchanges.

National securities exchanges and national securities associations may file proposed rule changes pursuant to Section 19(b) of the Exchange Act to implement proposed SEC Rule 6h–1. However, the SEC notes that even in the absence of proposed SEC Rule 6h–1, pursuant to the CFMA, to trade security futures products, each of the respondents would have to file one or more proposed rule changes to adopt listing standards for security futures products.

Under Rule 17a–1 of the Exchange Act, a national securities exchange or national securities association is required to retain records of the collection of information for at least 5 years, with the first 2 years in an easily accessible place. However, Rule 17a–1 requires a Security Futures Product Exchange to retain only those records relating to persons, accounts, agreements, contracts, and transactions involving security futures products. As discussed above, the SEC also does not believe that the collection of information required by proposed SEC Rule 6h–1 would result in any additional clerical work or miscellaneous clerical expenses since these clerical burdens would be incurred even in the absence of proposed SEC Rule 6h–1 and are actually due to the statutory requirement. The SEC preliminarily believes that respondents would not incur any additional capital or start-up costs, nor any additional operational or maintenance costs to comply with the collection of information requirements under proposed SEC Rule 6h–1.

In addition, proposed SEC Rule 6h–1 would require respondents that chose to trade these products to develop a system for determining the settlement price of a cash-settled security futures product

[128] In response to the events of October 19, 1987, when the Dow Jones Industrial Average (“DJIA”) sustained a one-day decline of 508 points (22.6%), the nation’s securities and futures markets in 1988 adopted rules that provide for coordinated, cross-market trading halts in all equity and equity-derivative markets following specified declines in the DJIA. See Circuit Breaker Report, supra note 1.


[133] See Paperwork Reduction Act discussion at Section IV.

[134] Id.
to fairly reflect the opening price of the underlying security. However, because respondents to the proposed rule currently have systems in place to determine opening prices, the SEC preliminarily believes that respondents complying with the settlement provisions of proposed SEC Rule 6h–1 would only incur minimal operational or maintenance costs to reconfigure their current settlement procedures to fairly reflect the opening price of the underlying security.

Finally, the SEC preliminarily believes that national securities exchanges and national securities associations would incur operational costs in developing a system to monitor when other markets have instituted a regulatory halt for an underlying security of the security futures product in order to comply with proposed SEC Rule 6h–1(b) and (c). However, the SEC notes that 9 of the estimated 17 respondents are already required to provide notification of regulatory halts since they are participants of the Consolidated Tape Association Plan ("CTA Plan") and, thus, should already have systems in place to monitor each other of regulatory halts being instituted. The SEC also estimates that each of the remaining respondents will have to develop a similar system to monitor when regulatory halts have been instituted by the primary market of the underlying security. The SEC requests comments on the number of respondents who will actually have to develop a monitoring and notification system and the estimated costs in developing such a system.

C. Request for Comments

The SEC requests data to quantify the costs and benefits above. The SEC seeks estimates of these costs and benefits, as well as any costs and benefits not already described, which may result from the adoption of this proposed rule.

The SEC requests comments on the estimate of the number of respondents that would be affected by proposed SEC Rule 6h–1 and the costs and benefits associated with complying with the proposed rule. The SEC specifically requests comments on the operational and maintenance costs associated with the proposal and whether these costs would be significant. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposal.

VI. Consideration of the Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

SEC: Section 3(f) of the Exchange Act requires the SEC, whenever it is engaged in rulemaking, and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act requires the SEC, when promulgating rules under the Exchange Act, to consider the impact any such rules would have on competition. Section 23(a)(2) of the Exchange Act further provides that the SEC may not adopt a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The SEC has considered the proposed rule in light of the standards set forth in Sections 3(f) and 23(a)(2) of the Exchange Act.

A. Settlement Prices for Cash-Settled Security Futures Products

1. Effects on Competition

Proposed SEC Rule 6h–1(b) and (c) would require national securities exchanges and national securities associations to trade security futures products to trade cash-settled security futures products only if the final settlement price for each cash-settled security futures product fairly reflects the opening price for the underlying security or securities. If adopted, the proposal may affect competition, as national securities exchanges and national securities associations would not be able to choose between using opening prices and closing prices for settlement of cash-settled security futures products. However, as discussed above, the SEC preliminarily believes that the benefits to be gained by such restriction justify any potential costs, and that any such restriction is appropriate in furtherance of the purposes of the Exchange Act, particularly the purpose of reducing market volatility and the opportunities for market manipulation.

For purposes of the Small Business Regulatory Fairness Act of 1996, the SEC also is requesting information regarding the potential impact of the proposed rule on the economy on an annual basis. Commentators should provide empirical data to support their views.

VII. Regulatory Flexibility Act

CFTC: The Regulatory Flexibility Act (“RFA”) requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The rule adopted herein would affect designated contract markets and registered derivatives transaction execution facilities. The CFTC has previously established certain definitions of “small entities” to be used in evaluating the impact of its rules on small entities in accordance with the RFA. In its previous determinations, the CFTC has concluded that contract markets are not small entities for the purpose of the RFA. The CFTC has also recently proposed determining that the other trading facilities subject to its jurisdiction, for reasons similar to those applicable to contract markets, would not be small entities for purposes of the RFA.

Accordingly, the CFTC does not expect the rule, as proposed herein, to have a significant economic impact on a substantial number of small entities. Therefore, the Acting Chairman, on behalf of the CFTC, hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed amendments will not have a significant economic impact on a substantial number of small entities. The CFTC invites the public to comment on the finding that this proposed rule would not have a significant economic impact on a substantial number of small entities.

SEC: Section 3(a) of the RFA requires the SEC to undertake an initial regulatory flexibility analysis of the proposed rules on small entities unless the SEC certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities. Proposed SEC Rule 6b–1 would require national security exchanges and national security associations trading security futures products to trade cash-settled security futures products only if the final settlement price for each cash-settled security futures product fairly reflects the opening price of the underlying security or securities, and to halt in trading in any security futures product when a regulatory halt is instituted for the underlying security or securities of the security futures product. There are nine currently registered national securities exchanges, one national securities association, and seven futures markets that are likely to register as Security Futures Product Exchanges, all of which would be subject to the proposed rule and none of which are small entities. The SEC has certified that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities. A copy of the certification is attached as Appendix A.

VIII. Statutory Basis and Text of Proposed Rule

List of Subjects

17 CFR Part 41

Security futures products, Trading halts and Settlement provisions.

17 CFR Part 240

Securities.

Commodity Futures Trading Commission

17 CFR Chapter I

The CFTC has authority to propose these rules pursuant to sections 2(a)(1)(D)(i)(VII), 2(a)(1)(D)(ii)(X), and 8a(5) of the CEA, 7 U.S.C. 2(a)(1)(D)(i)(VII), 2(a)(1)(D)(ii)(X), and 12a(5). In accordance with the foregoing, Title 17, Chapter I of the Code of Federal Regulations is proposed to be amended by amending Part 41 as follows:

PART 41—SECURITY FUTURES PRODUCTS

1. The authority citation for Part 41 is revised to read as follows:

Authority: 7 U.S.C. 1a(25), 2(a), 6j, 7a–2(c) and 12a(5).

2. Section 41.1 is amended by adding paragraphs (j), (k) and (l) to read as follows:

§ 41.1 Definitions.

For purposes of this part:

(j) Opening price means the price at which a security opened for trading, or a price that fairly reflects the price at which a security opened for trading, during the regular trading session of the national securities exchange or national securities association that lists the security.

(k) Regular trading session of a security means the normal hours for business of a national securities exchange or national securities association that lists the security.

(l) Regulatory halt means a delay, halt, or suspension in the trading of a security, that is instituted by the national securities exchange or national securities association that lists the security, as a result of:

1. A determination that there are matters relating to the security or issuer that have not been adequately disclosed to the public, or that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue; or

2. The operation of circuit breaker procedures to halt or suspend trading in all equity securities trading on that national securities exchange or national securities association.

3. Section 41.25, as proposed on July 20, 2001, 66 FR 37932, is further proposed to be amended by revising paragraphs (a)(2) and (b) to read as follows:

§ 41.25 Additional conditions for trading for security futures products.

(a) Common provisions. * * * * * (2) Regulatory Trading Halts. The rules of a designated contract market or registered derivatives transaction execution facility that lists or trades one or more security futures products must include the following provisions:

(i) Trading of a security futures product based on a single security shall be halted at all times that a regulatory halt has been instituted for the underlying security; and

(ii) Trading of a security futures product based on a narrow-based security index shall be halted at all times that a regulatory halt has been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index.

* * * * * * * 

(b) Special requirements for cash-settled contracts. For cash-settled security futures products, the cash-settlement price must be reliable and acceptable, be reflective of prices in the underlying securities market and be not readily susceptible to manipulation.

1. The final settlement price of a cash-settled security futures product based on a single security shall fairly reflect the opening price of the underlying security. 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; and (1) The final settlement price of a cash-settled security futures product based on a narrow-based security index shall fairly reflect the opening prices of the underlying securities. If an opening price for one or more underlying securities is not readily available, the final settlement price of the narrow-based security index future shall, for the underlying securities for which opening prices are not readily available, fairly reflect the prices of those underlying securities during their most recent regular trading session. (2) The Commission may exempt from the provisions of paragraphs (b)(1) and (b)(2) of this section, either unconditionally or on specified terms and conditions, any designated contract market or registered derivatives transaction execution facility, when the Commission determines that an exemption is consistent with the public interest, the protection of investors, and otherwise furthers the purposes of the Act.

Issued in Washington, DC on August 24, 2001 by the Commodity Futures Trading Commission.

Jean A. Webb, Secretary.

Securities and Exchange Commission

17 CFR Chapter II

The SEC is proposing the rules pursuant to its authority under Exchange Act Sections 6, 9, 15A, 19, 23(a), and 36, 15 U.S.C. 78f, 78i, 78o–3, 78s, 78w(a), and 78mm.

In accordance with the foregoing, Title 17, Chapter II, part 240 of the Code of Federal Regulations is proposed to be amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77gff, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78o–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78o–3, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 79q, 79r, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

2. Section 240.6h–1 is added to read as follows:

§ 240.6h–1 Settlement and regulatory halt requirements for security futures products.

(a) For the purposes of this section:

(1) Opening price means the price at which a security opened for trading, or a price that fairly reflects the price at which a security opened for trading, during the regular trading session of the national securities exchange or national securities association that lists the security.

(2) Regular trading session of a security means the normal hours for business of a national securities exchange or national securities association that lists the security.

(3) Regulatory halt means a delay, halt, or suspension in the trading of a security, that is instituted by the national securities exchange or national securities association that lists the security, as a result of:

(i) A determination that there are matters relating to the security or issuer that have not been adequately disclosed to the public, or that there are regulatory problems relating to the security which should be clarified before trading is permitted to continue; or

(ii) The operation of circuit breaker procedures to halt or suspend trading in all equity securities trading on that national securities exchange or national securities association.

(b) The final settlement price of a cash-settled security futures product based on a single security shall fairly reflect the opening price of the underlying security. 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.

(c) The final settlement price of a cash-settled security futures product based on a narrow-based security index shall fairly reflect the opening prices of the underlying securities. If an opening price for one or more underlying securities is not readily available, the final settlement price of the narrow-based security index future shall, for the underlying securities for which opening prices are not readily available, fairly reflect the prices of those underlying securities during their most recent regular trading session.

(d) Trading of a security futures product based on a single security shall be halted at all times that a regulatory halt has been instituted for the underlying security.

(e) Trading of a security futures product based on a narrow-based security index shall be halted at all times that a regulatory halt has been instituted for one or more underlying securities that constitute 30 percent or more of the market capitalization of the narrow-based security index.

(f) The Commission may exempt from the provisions of paragraphs (b) and (c) of this section, either unconditionally or on specified terms and conditions, any national securities exchange or national securities association if the Commission determines that such exemption is necessary or appropriate in the public interest, and consistent with the protection of investors.

By the Securities and Exchange Commission.


Margaret H. McFarland,
Deputy Secretary.

Appendix A

Note: Appendix A to the preamble will not appear in the Code of Federal Regulations.

Regulatory Flexibility Act Certification

The Securities and Exchange Commission (“Commission”) hereby certifies pursuant to 5 U.S.C. 605(b) that proposed Rule 6h–1 under the Securities Exchange Act of 1934 (“Exchange Act”), which generally would provide that the listing standards of national security exchanges and national security associations trading security futures products establish (i) a settlement price for each cash-settled security futures product that fairly reflects the opening price of the underlying security or securities, and (ii) a halt in trading in any security futures product 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, would not, if adopted, have a significant economic impact on a substantial number of small entities. Proposed Rule 6h–1 under the Exchange Act likely would apply to nine currently registered national securities exchanges, one national securities association, and an estimated seven futures associations trading security futures products.

By the Commission.


Jonathan G. Katz,
Secretary.

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Chairman Pitt did not participate in this matter.