*The McGraw-Hill Companies*

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BY E-MAIL

August 10, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

**Re: <u>Comments to File No. SR-ISE-2012-22</u>**

Dear Ms. Murphy:

The McGraw-Hill Companies, Inc. ("McGraw-Hill"), on behalf of itself and its subsidiaries, Standard & Poor's Financial Services LLC and S&P Dow Jones Indices LLC (together, "S&P"), respectfully submits this comment letter in response to the Commission's request for written comments in its June 20, 2012 Order Instituting Proceedings ("OIP"). As discussed below and in prior comments submitted on behalf of McGraw-Hill and S&P[1] in connection with the proposed rule change filed by International Securities Exchange, LLC ("ISE"): (i) ISE's proposed "ISE Max SPY Index" options will cause investor confusion that will not be adequately mitigated by ISE's proposed disclosures; and (ii) there is a substantial likelihood of market disruption and harm to investors if the Commission were to approve the proposed rule change, and ISE were to commence trading, before McGraw-Hill's state-court litigation in Illinois against ISE to enjoin such trading were fully resolved. Accordingly, we respectfully submit that the Commission should disapprove ISE's proposed rule change.

## I. ISE's Proposed "ISE Max SPY Index" Options Will Cause Investor Confusion That ISE's Proposed Disclosures Will Not Adequately Mitigate

As discussed in the OIP, ISE proposes to list and trade options on a purported new index, the ISE Max SPY Index, "which is 'designed to represent 10 times the value of the published share prices in the SPDR S&P 500 ETF [("SPY")] Trust.'" OIP at 3 (quoting Securities Exchange Act Release No. 66614 (Mar. 16, 2012), 77 FR 16883). In reality, however, the index underlying the proposed options will be the S&P 500 Index. ISE does not intend to use the ISE Max SPY Index to calculate the settlement value of its proposed options product. Instead, ISE asserts that it will calculate its own estimate of the net asset value of the SPDR® S&P 500® ETF Trust, multiply that value by ten, and use that calculation to settle the contracts. *See* OIP at 3. As discussed in our prior comment letters, this effort is a thinly

[1] *See* Letters to Elizabeth M. Murphy, Secretary, Commission, from Kenneth M. Vittor, Executive Vice President and General Counsel, McGraw-Hill Companies, Inc., dated Apr. 11, 2012 ("McGraw-Hill Letter I") and June 18, 2012 ("McGraw-Hill Letter II").

disguised ruse by ISE to calculate its own version of the S&P 500 Index, using S&P's proprietary stock selection and weighting methodology. The SPDR® S&P 500® ETF Trust, as its name suggests, is designed to track the performance of the S&P 500 Index, and its portfolio weighting reflects the composition of the S&P 500 Index within hundredths of a percentage point. *See* Prospectus for SPDR S&P 500 ETF Trust, dated Jan. 25, 2012 ("SPDR Prospectus"), at 45-46.[2]

ISE's proposed "ISE Max SPY Index" options will cause investor confusion in at least five ways:

- First, the "ISE Max SPY Index" is not an actually an "index" in any sense of the word that ordinary investors would recognize. It is instead a rudimentary multiplication of the share price of a single equity security, the SPDR® S&P 500® ETF Trust, by ten. While the "Glossary" on ISE's own website defines an index as a "compilation of several stock prices into a single number,"[3] there is only one stock price in the calculation that ISE labels the "ISE Max SPY Index." Investors will likely be confused by ISE's offering of an index that fails to meet its own definition of what an index is.

- Second, even accepting the dubious proposition that ISE's multiplication of the share price of the SPDR® S&P 500® ETF Trust by ten could properly be understood to be an index, the name of ISE's new options product is misleading, as the options will not be settled on the basis of the ISE Max SPY Index. Ordinarily, as ISE acknowledges, the settlement value for a p.m.-settled index option would be determined "by reference to the reported level of the index as derived from the closing prices of the component securities." SR-ISE-2012-22 at 7 n.6. But here, neither the ISE Max SPY Index nor the published share prices of its sole component security (the SPDR® S&P 500® ETF Trust) will play any role in ISE's calculation of the settlement value of its proposed options. The disconnect between the ISE Max SPY Index that ISE misleadingly presents as the underlying instrument of the options and the manner in which those options actually will settle will cause investor confusion. While ISE proposes to disclose to investors the manner in which the contracts will settle, we respectfully submit that the Commission should be concerned that such a disclosure will be inadequate to dispel investor confusion given how unusual it is for an index option to settle on the basis of a value that is divorced entirely from the calculation of the index that is being presented as its underlying interest.

- Third, investors are likely to be confused by an unwarranted association between ISE's proposed product and S&P. ISE concedes that it will be using S&P's proprietary stock selection and weighting methodology for the S&P 500 Index to calculate the settlement value for the proposed product. SR-ISE-2012-22 at 13 (admitting that the "securities that comprise the S&P 500® . . .

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[2] A copy of the current SPDR Prospectus is available at: https://www.spdrs.com/library-content/public/SPY%20Prospectus.pdf

[3] http://www.ise.com/WebForm/viewPage.aspx?categoryId=441#i (last visited Aug. 8, 2012)

are the same portfolio securities whose published prices are used to calculate the settlement value of the ISE Max SPY"); *see also id.* at 12. ISE's intention to multiply its estimate of the net asset value of SPDR® S&P 500® ETF Trust by ten reflects only its desire to have a settlement value that more closely matches the S&P 500 Index, as the net asset value of the Trust, by design, closely approximates one-tenth the level of the S&P 500 Index. Moreover, ISE will deviate from the manner in which the Trustee itself calculates the net asset value of the SPDR® S&P 500® ETF Trust in at least two respects to mirror more closely the way in which S&P calculates the S&P 500 Index. ISE concedes that it may use different prices of S&P 500 component securities for its calculation of the net asset value of the Trust than the Trustee itself would use. *See* SR-ISE-2012-22 at 40; *see also id.* at 6 n.3. ISE also admits that, in calculating its estimate of the net asset value of the Trust, it will not treat special dividends or special distributions paid by constituents of the S&P 500 Index in the same manner as the Trust. OIP at 19-20. These deviations will further cause confusion about whether ISE is trying to calculate the net asset value of the Trust or its own version of the S&P 500 Index. If ISE were trying to calculate the net asset value of the Trust, rather than approximate the S&P 500 Index even more closely, it presumably would use the closing stock prices used by the Trustee itself and would account for dividends and distributions that the Trust receives as a result of holding the securities that comprise the S&P 500 Index. One need look no further than ISE's own original rule filing for evidence of the likelihood of confusion between ISE's proposed product and S&P 500 options. In that filing, ISE proclaimed that its new product would provide its members and investors "with additional opportunities to trade S&P 500® options . . . in an exchange environment." SR-ISE-2012-22 at 15.[4] While ISE has attempted to explain away the description of its copycat product as another form of S&P 500 options, *see* OIP at 2 n.7, we respectfully submit that if ISE itself can confuse the two products and the source of the underlying indexes in an important regulatory filing, the Commission should expect that investors will also be confused. In sum, ISE's proposed disclosures are unlikely to dispel investor confusion over the identity and source of the index underlying the options.

- Fourth, investors are likely to be confused by ISE's reference to "ISE Max SPY Index" options as broad-based index options. As noted above, there is only one security that is the basis for the calculation of the ISE Max SPY Index, and according to ISE's own Rules, if the ISE Max SPY calculation were truly the underlying index, there would be only one "underlying security" for ISE Max SPY Index options. *See* ISE Rule 2001(o). ISE cannot have it all ways: if its options are based on the ISE Max SPY Index, they are based on a single security and are not broad-based; if its options are broad-based, it is only because they are, in fact, based on the S&P 500

[4] *See* Letter to Elizabeth M. Murphy, Secretary, Commission, from Janet McGinness, EVP & Corporate Secretary, NYSE Euronext, dated Apr. 2, 2012, at 2 (noting "there is a very large degree of economic equivalence" between ISE's proposed product and the S&P 500 options offered by the C2 exchange under license from S&P).

Index rather than any ISE Max SPY Index. ISE's proposed disclosures do not meaningfully address this source of potential confusion.

- Last, but by no means least, investors are likely to be confused by ISE's litigation risk disclosure. As the Commission is aware, ISE is a defendant in a litigation initiated by McGraw-Hill and the Chicago Board Options Exchange ("CBOE") in Illinois state court to enjoin ISE from listing and trading its proposed options. In an effort to address concerns about potential harm to investors, ISE proposes to insert a litigation risk discussion into the Options Disclosure Document ("ODD") which will be substantially similar to the litigation risk language included in prior versions of the ODD with respect to index participation products. OIP at 10. While such a disclosure would alert to investors to the existence of risk, it would not give them any meaningful way to evaluate the magnitude of the risk, the likely outcome on the merits of the dispute, the likelihood of any specific form of relief that a court would order, and what type of wind-down procedures, if any, might be available. *See* April 19, 1989 Supplement to Index Participation Disclosure Document (attached as Exhibit 1).

## II. There Is a Substantial Likelihood of Market Disruption and Harm to Investors if the Commission Were to Approve ISE's Proposed Rule Change and Allow ISE to Commence Trading Prior to Resolution of Judicial Challenges to the Lawfulness of the Proposed Options Under State Law

As noted above, McGraw-Hill and CBOE have commenced proceedings in Illinois state court to enjoin ISE from listing and trading its proposed "ISE Max SPY Index" options as a violation of a standing injunction that bars ISE from using the S&P 500 as the basis of index options and bars the Options Clearing Corporation ("OCC") from issuing, clearing, or settling such options. *See* OIP at 6-7 & n.24; McGraw-Hill Letter I at 1-2; McGraw-Hill Letter II at 1-2. If ISE, with the Commission's approval, were to commence trading in its infringing product before litigation seeking to enjoin such trading is resolved, the harm to investors would be severe. *See, e.g., Standard & Poor's Corp. v. Commodity Exch., Inc.*, 683 F.2d 704, 711-12 (2d Cir. 1982) ("*Comex*") (affirming a preliminary injunction against futures trading that allegedly infringed S&P's intellectual property, because "[i]f S&P ultimately prevails on the merits . . . the orderly conduct of the Comex 500 futures market and the financial positions of thousands of traders . . . would be drastically affected").

ISE's proposal for preventing market disruption and harm to investors in the event that the state court rules adversely to it after trading has commenced is inadequate. ISE represents that, if enjoined from offering the proposed options after it has commenced trading, it would seek to have the state court permit it to offer a market for closing-only transactions for as long as it takes all open interests to wind down in an orderly manner. OIP at 9. ISE provides no support for its presumptuous contention that it is "inconceivable that the Court would refuse to permit such a closing-only market." Letter to Elizabeth M. Murphy, Secretary, Commission, from Michael J. Simon, Secretary and General Counsel, ISE, dated June 15, 2012 ("ISE Response Letter II") at 4. To the contrary, there is no reason to believe that the Court would allow ISE to continue to willfully violate McGraw-Hill's rights for the benefit of investors

who ISE contends will have been informed of the risks of investing in a product that is the subject of pending litigation. Indeed, the litigation risk disclosure that ISE assertedly will use as a model for its proposed risk disclosure here expressly contemplates that a court might order trading "to be promptly terminated in whole or in part" and enforcement of contract performance "might be restricted or even prohibited." Exhibit 1. That disclosure observed—contrary to ISE's assurances that a court would allow a closing-only, wind-down market—that "[t]he actions that a court might take and the legal and market consequences of such actions cannot be predicted with certainty, and there may be additional risks to purchasers and writers . . . resulting from such actions." *Id.*

If a court determined to enjoin the trading of ISE Max SPY Index options, investors would be subject to uncertain means of a wind-down of any open interest,[5] and even if the courts were to allow a wind-down market for ISE's proposed options, ISE offers no details on how that market would function or whether it could adequately protect investors. We respectfully submit that it would not. A closing-only, wind-down market would be highly illiquid and would still come with a deadline for transactions. Such a market would disrupt investors' hedging strategies, compromise their ability to choose when to trade or exercise their options, and expose them to additional unexpected market risk.

At best, ISE is asking the Commission to approve trading of a legally dubious product on the untested assumption that it can successfully mitigate the market disruption and harm to investors that would result from enforcement of the injunction after the trading commences. But there is no reason for the Commission to allow ISE to expose investors to the extraordinary risks of closing-only markets and replacement indexes that its wind-down plans entail. The Commission can avoid exposing investors to these risks simply by allowing the courts to fully resolve the litigation against ISE first.

For the foregoing reasons and those expressed in our April 11 and June 18 letters, the Commission should disapprove ISE's proposed rule change.

Respectfully submitted,

Kenneth M. Vittor
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The McGraw-Hill Companies, Inc.

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[5] As one possibility, ISE notes that the OCC has by-laws and rules that permit it to create and use a "replacement index" to close out the open interest. ISE Response Letter II at 4. But given that the purpose of the ISE's proposed product is to mimic options on the S&P 500 Index, it is difficult to conceive of a replacement index that would adequately protect investors' interests without violating McGraw-Hill's proprietary rights.

EXHIBIT 1

# April 19, 1989 Supplement to Index Participations Disclosure Document

*The following supplements material in the April 14, 1989 edition of* INDEX PARTICIPATIONS *under the caption "Special Risks of IPs—Other Risks":*

By orders dated April 11, 1989 (the "Approval Orders"), the Securities and Exchange Commission (the "SEC") approved the rules of the three exchanges named on the inside front cover of this booklet and the rules of OCC applicable to trading in, and the issuance, clearance and exercise of, IPs. In comment letters filed in connection with the SEC's approval procedures, the Board of Trade of the City of Chicago (the "CBT"), the Chicago Mercantile Exchange (the "CME") and the Commodity Futures Trading Commission (the "CFTC") each expressed its view that the SEC lacks jurisdiction to authorize trading in IPs on the grounds that an IP is not a "security" as defined in the Securities Exchange Act of 1934 (the "1934 Act"), but is instead a "futures contract" within the exclusive jurisdiction of the CFTC pursuant to the Commodity Exchange Act (the "CEA") and therefore can be traded lawfully only on a contract market designated by the CFTC pursuant to the CEA.

In issuing the Approval Orders, the SEC determined that an IP is a "security" within the meaning of the 1934 Act, and not a futures contract, and that exchange trading in IPs is therefore subject to the jurisdiction of the SEC. The CME and the CBT have filed petitions in the United States Court of Appeals for the Seventh Circuit for review of the Approval Orders. The petitions assert that the Approval Orders must be set aside on the grounds that (1) the SEC lacked jurisdiction to approve trading in, and the issuance, clearance and exercise of, IPs because IPs are not "securities" under the federal securities laws, (2) the CFTC has exclusive jurisdiction over IPs because IPs are futures contracts under the CEA, and (3) neither the CFTC nor the SEC has authority to allow IPs to be settled by actual delivery of the underlying stocks.

In comment letters filed with the SEC in the approval proceedings by the Investment Company Institute (the "ICI") and its counsel, the ICI expressed the view that the IPs rules of the exchanges and OCC involve the unlawful creation and operation of unregistered investment companies in violation of the Investment Company Act of 1940 (the "ICA"). The SEC determined in the Approval Orders that IPs are not subject to the ICA. The ICI has notified the SEC of its intention to seek judicial review of the Approval Orders.

Applications for a stay of the Approval Orders filed by the CME, the CBT and the ICI are pending at the date of this supplement. If a stay of either Approval Order pending judicial review is granted by the SEC or a court before trading of IPs has commenced, then such trading will not be commenced until the stay is terminated. If a stay is not granted or is terminated, some or all of the markets may commence trading in IPs, notwithstanding the pendency of the judicial review. If either Approval Order is set aside or temporary injunctive relief or a stay is granted after trading in IPs has commenced, trading in IPs might be ordered to be promptly terminated in whole or in part, or all further opening transactions in IPs might be enjoined, and the enforcement of performance of the terms of the IPs might be restricted or even prohibited. The actions that a court might take and the legal and market consequences of such actions cannot be predicted with certainty, and there may be additional risks to purchasers and writers of IPs resulting from such actions.