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4-469

December 10,2003

VIA FEDERAL EXPRESS
Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, **N.W.**
Washington, D.C. **20549-0609**

Re: Petition Submitted by the International Securities Exchange, Inc. Concerning Index Options (Commission File No. 4-469).

Dear Mr. Katz:

Standard & Poor's, a division of The McGraw-Hill Companies, Inc., appreciates this opportunity to comment on the rule-making petition by the International Securities Exchange, Inc. ("ISE") relating to the licensing of index options ("Petition")." Standard & Poor's is a developer, licensor, and provider of securities indexes, including the S&P 500 Composite Stock Price Index. Standard & Poor's owns trademark, copyright and other intellectual property rights in these indexes; these rights have been recognized in a number of U.S. court decisions[2/] and are supported by the fact that Standard & Poor's is currently party to over 400 licensing agreements with issuers and sponsors of a wide variety of financial products that are based on its securities indexes. **As** a developer of securities indexes and an owner of property rights in those indexes, Standard & Poor's would be adversely affected by the amendments ("Amendments") that are proposed in the Petition.[3/]

In general, the Petition requests that the Securities and Exchange Commission ("Commission" or "SEC") adopt amendments to Rule 19c-5 under the Securities Exchange Act

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1/ Request for Rulemaking to Amend Rule 19c-5 Regarding Certain Options Exchange Licensing Arrangements (Nov. 1, 2002), ***available at*** http://www.sec.gov/rules/petitions/petn4-469.htm ("Petition").

2/ ***See, e.g.***, Standard & Poor's Corp. **v.** Commodity Exchange, Inc., 683 F.2d 704 (2d Cir. 1982) (enjoining the defendant from using the S&P 500 as the basis for its stock index futures contract and noting, among other things, that S&P devotes resources to creating its index and the index is a marketable product); Dow Jones & Co. v. Chicago Board of Trade, 546 F. Supp. 113 (S.D.N.Y. 1982) (finding that the DJIA is subject to copyright protection); McGraw-Hill Companies v. Vanguard Index Trust, No. 00-CIV 4247 (S.D.N.Y., Apr 25. 2001) (granting request for an injunction barring Vanguard from using S&P indexes and trademarks in connection with VIPERs because the issuance of VIPERs enlarged its contract with McGraw-Hill beyond the scope of the intended license, resulting in a breach of contract and infringement of McGraw-Hill's trademark rights); Board of Trade v. Dow Jones & Co., 456 N.E.2d 84 (Ill. 1983) (holding that Board's unauthorized use of DJIA as the basis for stock index futures constituted misappropriation).

3/ In this regard, Standard & Poor's would suffer direct economic harm and, therefore, would be an "adversely affected" or "aggrieved" party within the meaning of the Administrative Procedures Act ("APA"). As an adversely affected or aggrieved party, Standard & Poor's would have standing to seek judicial review of the Amendments under the APA. ***See*** 5 U.S.C. § 704. ***See also*** Data Processing v. Camp, 397 U.S. 150 (1970).

of 1934, as amended ("Exchange Act") that would prohibit an options exchange from being a party to exclusive or preferential licensing arrangements for index option products and options overlying other instruments, including options on securities whose value is based on an index. The ISE submits that "prohibiting such license arrangements will enhance competition in the market and will result in significant benefits for the investing public."[4] While Standard & Poor's fully supports the goals of reducing fees for investors and enhancing legitimate competition in the marketplace, we believe that the Amendments raise serious legal and policy issues and that the SEC should not publish them as a rule proposal.

First, it would be inappropriate for the SEC to publish the Amendments as a rule proposal because such publication would signify a marked departure from the SEC's historical position that matters regarding intellectual property -- and, specifically, the right to use that property -- are not within the scope of its authority. The ISE has failed to offer any novel or compelling reason why the SEC should disrupt this precedent, or the well-settled expectations of the public regarding the protection of intellectual property rights. Second, the SEC should not publish the Amendments because they are directly contrary to the well-established legitimacy of exclusive licensing arrangements under both U.S. intellectual property and antitrust laws, and the SEC's publication of them would exceed its statutory authority. Finally, the SEC should not publish the Amendments because they fail to provide for just compensation to private, unregulated property owners and, therefore, would cause an unconstitutional regulatory taking. For these reasons, which we discuss more fully below, Standard & Poor's urges the Commission not to publish the Amendments as a rule proposal.

I. The SEC Should Not Publish the Amendments Because They Fundamentally Involve Matters of Intellectual Property, and Publication Would Upset Well-Settled SEC Policy and the Public's Expectations Regarding Intellectual Property Rights.

First and foremost, the Amendments involve matters of intellectual property. They squarely address the validity of existing, private contracts between intellectual property owners and their licensees, as well as the prospective rights of intellectual property owners to use and dispose of their property by entering into private contracts that enhance the value of that property (such as exclusive licensing arrangements). As the ISE states in its Petition: "our intent is first to restrict, and then to prohibit, any type of contractual relationship that prevents multiple exchanges from licensing index and similar products on the same terms and conditions as are available to another exchange.""

Repeatedly, the SEC has taken the position that it is not appropriate for the Commission to attempt to resolve intellectual property matters among competing parties, and that it lacks the authority to do so. For example, in an order approving rule changes relating to the listing and trading of warrants on the Deutsher Aktienindex, the SEC refused to address the legitimacy of a property owner's intellectual property rights, stating: "[T]he plain language of the U.S. securities

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4/ Petition, *supra* note 1, at 1.

5/ *Id.* at 4.

laws does not suggest that Congress intended that the Commission attempt, in the context of an approval proceeding for a securities product, to resolve intellectual property right claims that can be pursued elsewhere."[6/] Similarly, in an order approving proposed rule changes relating to the listing and trading of certain index participation units, the SEC refused to address matters involving intellectual property rights of index providers, stating that there is an existing, Congressionally-mandated framework to address such matters: "Congress enacted an elaborate statutory framework for the establishment, preservation and protection of intellectual property rights and has established specific federal agencies (e.g., the U.S. Patent and Trademark Office and the U.S. Copyright Office), to administer these laws."[7/] Further, in an order approving proposed rule changes relating to the listing and exchange trading of an option contract based on the Japan Index, the SEC refused to address matters involving intellectual property rights in securities indexes among competitors, stating that:

> Congress has enacted an elaborate statutory framework for the establishment, preservation and protection of intellectual property rights and established specific federal agencies to administer these laws. . . . The plain language of the U.S. securities laws does not suggest that Congress intended that the Commission attempt, in the context of an approval proceeding for a securities product, to resolve intellectual property right claims that can be pursued elsewhere."

The SEC's publication of the Amendments as a rule proposal would signify a marked departure from this historical policy position. By publishing the Amendments, the SEC would pass judgment on matters involving intellectual property rights because it would call into question both the validity of existing, private contracts for intellectual property and the ability of property owners to use and dispose of their property on a prospective basis. In support of the Amendments, the ISE asserts that multiple trading of equity options has benefited investors and that similar benefits will result if the SEC prevents index providers from entering into exclusive licensing arrangements with options exchanges. However, the ISE offers no novel or compelling reason for disturbing well-settled SEC policy and the legitimate rights of property owners. Moreover, there is a fundamental difference between equity options and index options that the Amendments disregard: courts and regulators consistently have recognized an intellectual property interest in index options, but have *not* recognized a similar property interest in equity .

6/ Order Approving Proposed Rule Changes Relating to the Listing and Trading of Warrants on the **DAX** Index, Exchange Act Release No. 36070 (Aug. 9,1995). ***See*** *also* Order Approving Proposed Rule Changes Relating to the Listing and Trading of a Broad Based Index Option Contract Based on the Japan Index, Exchange Act Release No. 28475 (Sept. 27. 1990); Order Approving Proposed Rule Changes Relating to the Listing and Trading of Index Participations, Exchange Act Release No. 26709 (Apr. 11, 1989).

7/ Order Approving Proposed Rule Changes Relating to the Listing and Trading of Index Participations. Exchange Act Release No. 26709 (Apr. 11, 1989).

8/ Order Approving Proposed Rule Changes Relating to the Listing and Trading of a Broad Based Index Option Contract Based on the Japan Index, Securities Exchange Act Rel. No. 28475 (Sept. 27, 1990).

options." Thus, although it may be appropriate for the SEC to prohibit options exchanges from establishing rules or practices limiting multiple trading of equity options, index options represent private interests in intellectual property and therefore can and should be treated differently.

We believe that the SEC should not depart from its historical policy position, but rather should leave decisions regarding intellectual property owners' rights (which include the right to use that property and exclude others from using it) up to the federal agencies that Congress specifically authorized to handle such matters. These agencies traditionally have handled what the ISE seeks in its Petition (*i.e.*, restrictions on the use and availability of intellectual property), and the ISE has failed to offer any compelling reason why the SEC should ignore the traditional authority of other federal agencies by publishing the Amendments as a rule proposal.

II. The Amendments Are Directly Contrary to the Well-Established Legitimacy of Exclusive Licensing Arrangements Under Intellectual Property and Antitrust Laws, and the SEC's Publication of Them Would Exceed Its Statutory Authority.

The SEC should not publish the Amendments because such publication would exceed the scope of the SEC's authority under the Exchange Act. In that regard: (1) there are more appropriate forums for addressing matters involving the intellectual property rights of private, unregulated persons as the SEC has acknowledged on numerous occasions; and (2) those more appropriate forums specifically have recognized the legitimacy of the exclusive licensing rights that the Amendments would abrogate. It is difficult to see how Congress could have intended -- under Section 19(c) or *any* other section of the Exchange Act -- to provide the SEC with the broad authority to abrogate the intellectual property rights of private, unregulated persons, which have been recognized as legitimate under other regulatory schemes." To be sure, publication of the Amendments would overturn, or at least impinge severely on, traditional regulation of intellectual property rights by courts and other federal agencies that Congress specifically established to adjudicate such matters. To the extent the Amendments preempt or are inconsistent with the positions of those courts and agencies, we believe they go beyond the Commission's general rule making power under the Exchange Act.

In direct contrast to the ban on exclusive licensing proposed by the Amendments, the patent, trademark, and copyright laws convey a right to exclude others from engaging in certain business activities.[11] These laws recognize that the commercial licensee must devote substantial time and money to attempt to develop a product, with no guarantee that it will be successful.

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[9] *See* sources cited, ***supra*** note 2. *See also* Golden Nugget, Inc. v. American Stock Exchange, Inc., 828 F.2d 586 (1987) (concluding that plaintiff Golden Nugget did not have a property or other protectable interest in its common stock that could be "appropriated").

[10] *See* The Business Roundtable v. Securities and Exchange Commission, 905 F.2d 406,413-14 (D.C. Cir. 1990) (holding that SEC exceeded its authority granted in Section 19(c) in promulgating a rule that would "directly invade the 'firmly established' state jurisdiction" over corporate governance and voting rights).

[11] The Constitution grants Congress the "Power . . . [t]o promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries." U.S. CONSTITUTION. art. I, § 8, cl. 8.

Exclusive licenses are, thus, an inducement and reward for a company willing to step forward and take such a risk -- knowing that if it succeeds in the development, the exclusive license will protect it from more risk-averse competitors. The Supreme Court has noted that the protections against unauthorized use that are conveyed by intellectual property laws is "intended to motivate the creative activity of authors and inventors by the provision of a special reward."[12/]

Like the intellectual property laws, the antitrust laws are "aimed at encouraging innovation, industry, and competition."[13/] Significantly, the antitrust agencies take the position that intellectual property licensing creates pro-competitive benefits *and that exclusive licensing arrangements are beneficial.* According to the U.S. Department of Justice and Federal Trade Commission Guidelines for the Licensing of Intellectual Property:

> [L]imitations on intellectual property licenses may serve procompetitive ends by allowing the licensor to exploit its property as efficiently and effectively as possible. These various forms of exclusivity can be used to give a licensee an incentive to invest in the commercialization and distribution of products embodying the licensed intellectual property and to develop additional applications for the intellectual property. . . . These benefits of licensing restrictions apply to patent, copyright, and trade secret licenses, and to know-how agreements.[14/]

Indeed, "compulsory licensing" -- as proposed by the Amendments -- directly conflicts with the rights granted to the intellectual property owner by the intellectual property laws. It is for this reason that *neither* the intellectual property laws *nor* the antitrust laws contain any general provision for: (1) compulsory licensing of intellectual property rights; or **(2)** requiring a licensor to license to additional parties on the same terms.[15/] Moreover, in the antitrust realm, compulsory licensing is a remedy that is *rarely* ordered by courts; even then, it is only ordered as a remedy for antitrust violations.[16/] In the present case, there have been no allegations of antitrust violations by any index owner or licensee. Existing indexes, such as the S&P 500, that are subject to exclusive licensing arrangements are not the only indexes of companies in the United States. Other indexes can be developed and used for trading index options, as evidenced

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12/ Sony Corp. of America v. Universal City Studios, Inc., 464 U.S. 417,429 (1984).

13/ Atari Games Corp. **v.** Nintendo of America, Inc., 897 F.2d 1572, 1576 (Fed. Cir. 1990). *See also* U.S. Department of Justice & Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property § 1 (1995) ("Intellectual Property Guidelines")

14/ Intellectual Property Guidelines, ***supra*** note 13, at § 2.3 (emphasis added).

15/ ***See,*** *e.g.*, American Bar Association Section of Antitrust Law, ANTITRUST **LAW** DEVELOPMENTS, (5th ed. 2002), at 1076 ("It has long been held that a simple unilateral refusal to use or license a patent or copyright cannot form the basis for an antitrust claim."). ***See*** *also* Intellectual Property Guidelines, ***supra*** note 13, at § 4.1.2.

16/ A leading treatise directly addresses what the Amendments seek here, and rejects it out of hand: "If an intellectual property owner who once licenses a right is thereafter compelled to make licenses available to all comers on substantially equal terms, the likely effect will be to discourage licensing altogether. Certainly the effect would be to prohibit exclusive licensing, which is often the most efficient means of extracting value from an intellectual property right." Hovenkamp, Janis, & Lemley, INTELLECTUAL PROPERTY AND ANTITRUST, §13.2c, at 13-8 (emphasis added).

by the proliferation of index options products on U.S. exchanges in recent years. In addition, there are no barriers to entry or other regulatory barriers to competition; anyone can develop a competing index to rival the indexes that are subject to exclusive licensing arrangements. In fact, the exchanges themselves may develop their own index products.[17]

In sum, if the Commission publishes the Amendments as a rule proposal, it would not only vitiate the legitimate intellectual property rights of private, unregulated persons, but also would upset the well-established legitimacy of exclusive licensing arrangements under both intellectual property and antitrust laws. We do not believe that Congress could have intended to delegate such broad authority to the SEC under Section 19(c) or the Exchange Act generally.

III. The SEC Should Not Publish the Amendments Because They Do Not Provide for Just Compensation to Property Owners and, Therefore, Would Cause an Unconstitutional Regulatory Taking.

Finally, the SEC should not publish the Amendments as a rule proposal because they would constitute a regulatory taking of index providers' property for which just compensation would be due from the United States under the Fifth Amendment to the Constitution. As stated above, the Amendments would not only abrogate existing, valid private contracts between index providers and licensees, but they also would prevent intellectual property owners from fully using their property, thus severely diminishing the value of that property. Because the Amendments fail to provide for just compensation to property owners, they would cause a regulatory taking in violation of the Constitution.

The Fifth Amendment says, "[N]or shall private property be taken for public use, without just compensation.""[18] Justice Holmes, speaking for the Supreme Court, described the purpose of this clause ("Taking Clause") in terms directly applicable here: "[A] strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change."[19] There is no doubt that indexes *and the right to use and dispose of those* indexes are "property" covered by the Taking Clause.[20] There also is no doubt that the effect of the Amendments would be to "take" this property. Among the factors to be considered when determining whether a governmental action has gone beyond "regulation"

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[17] On this point, it is very curious that the Amendments do ***not*** appear to cover any such proprietary indexes created by exchanges. For example, as proposed by the ISE in the Petition, if the ISE or another exchange develops an index and obtains intellectual property rights in that index, the exchange would *not* be required to license that index product to other exchanges under the Amendments -- although a private, unregulated person that creates a similar such product would be compelled to do so.

[18] U.S. CONST. amend V.

[19] Pennsylvania Coal v. Mahon, 260 U.S. 393,416 (1922)

[20] *See* sources cited, *supra* note 2. ***See*** *also* Ruckelshaus v. Monsanto Company, 467 U.S. 986 (1984) (recognizing a property right in trade secrets for purposes of the Taking Clause); Lynch v. United States, 292 U.S. 571. 579 (stating that valid contracts are property that are protected by the Fifth Amendment). The Supreme Court repeatedly has emphasized that the term "property" includes not only the physical thing, but also the right to possess, use, and dispose of it. *Cf.* ***Ruckelshaus,*** 467 U.S. at 1003.

and effects a "taking" are the character of the governmental action, its economic impact, and its interference with reasonable investment-backed expectations.[21] Of these, any single factor may be sufficient to find a regulatory taking.[22]

In the present case, we believe that the force of the third factor, alone -- interference with reasonable investment-backed expectations -- is sufficiently overwhelming to establish that the Amendments would constitute a regulatory taking. Index providers such as Standard & Poor's invest significant time, personnel, capital, and other resources to develop and maintain products that they hope will meet a need within the investment community and become successful. They do so with the expectation that, if they produce a product of value, they will be able to recoup their investment by controlling the licensing of that product and pricing it at a level that reflects this value.[23] This expectation is not only reasonable -- it is *encouraged* by intellectual property laws, which protect those licensing and pricing rights in order to honor investment-backed expectations.[24] Standard & Poor's has, in fact, developed a substantial business line based on the licensing of its proprietary securities indices and currently intends to continue to invest and expand that business in the foreseeable future. In addition, as widely reported in the financial press, the index licensing business has become increasingly competitive, based largely on the expectation of index owners that their intellectual property rights will continue to be fully recognized and not impinged by the SEC or any other regulatory body.

As previously articulated by another commenter, if an index provider develops a new index, but is required to reach a licensing agreement with either all or none of the options exchanges, the provider's ability to extract value from its property would be severely diminished.[25] In that regard, the index provider would have virtually no bargaining power vis-a-vis the exchanges: The options exchanges, knowing that they all must receive the same license terms, would have no incentive to pay the provider any more than any other exchange. Instead, each exchange would seek to obtain the lowest possible license fee, thereby driving down the amount of the fee that the index provider could demand for its product. By dictating supply,

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[21] ***See, e.g.***, ***Ruckelshaus,*** 467 U.S. at 986; Penn Central Transportation Co. v. New York, 438 U.S. 104, 124 (1978).

[22] *Cf.* ***Ruckelshaus,*** 467 U.S. at 986 (finding that a regulatory taking occurred based on the "reasonable investment-backed expectation" factor).

[23] In the case of license arrangements involving option exchanges, index providers have sometimes determined that a reasonable return on their investment is jeopardized by market fragmentation. This has led to the practice, in certain cases, of granting one options exchange the exclusive right with respect to options based on the index.

Indeed, the Supreme Court has stated that the "right to exclude others is generally 'one of the most essential sticks in the bundle of rights that are commonly characterized as property." ***Ruckelshaus,*** 467 U.S. at 1011 (quoting Kaiser Aetna v. United States, 444 U.S. 164, 176(1979)0.

[25] ***See*** Letter by Todd Silverberg, General Counsel, SIG Indices, LLLP to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated June ***30,*** 2003, ***available at*** http://www.sec.gov/rules/petitions/4-469/sigindicies063003.htm.

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then, the Amendments would have the effect of dictating price, thus limiting the amount of investment return that private, unregulated persons may receive for their property.[26/]

In addition to interfering with reasonable investment-backed expectations, the Amendments would constitute a regulatory taking because they would have enormous economic impact. Specifically, they would abrogate existing, valid contracts and prevent intellectual property owners from fully using their property, thus depriving them of potentially millions of dollars in annual licensing revenues. Moreover, the Amendments would have a future "economic impact" of quite a different sort: They would eliminate the incentives for independent index providers to make the future investments necessary to develop a successful index product. If index providers are unwilling to develop new products, the ultimate beneficiaries of their new products -- the investing public -- also will sustain losses because they will be deprived of the benefits associated with those index products.

IV. Conclusion

For the reasons discussed above, we believe that the Amendments raise serious legal and policy issues and respectfully submit that the Commission should not publish them as a rule proposal. Although we have primarily focused our discussion on the significant legal issues for purposes of this comment letter, we are equally concerned by the troubling policy issues raised by the Amendments, including the fact that a change in exclusive licensing practice would not only vitiate index providers' legitimate rights in their intellectual property, but also undermine innovation in the marketplace and the development of new index products that are sought by and benefit investors. In the event that the Commission elects to publish the Amendments as a rule proposal, we will supplement our legal concerns and articulate our policy concerns more fully.

26/ Again, we do not believe that Congress intended to delegate to the SEC under the Exchange Act the authority to take property from private, unregulated persons for which just compensation would be due from the United States under the Fifth Amendment to the Constitution.

Thank you for providing us with the opportunity to comment on the Petition. If you have any questions, or if we can provide any further information, please contact the undersigned at (212) 512-3914 or Brandon Becker of the Wilmer Cutler & Pickering law firm, at (202) 663-6979.

Sincerely,

David B. Stafford

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
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