TRADING OPTIONS IN ETFS DOES NOT INFRINGE PROPRIETARY RIGHTS OF FUNDS' CREATORS

The Second Circuit has recently opened the field to the trading of options on shares of an exchange-trade fund ("ETF") without any trademark or other license from the fund's creator.

In its June 16, 2006 decision *Dow Jones v. International Securities Exchange*,[1] the Second Circuit considered whether "an options exchange, by creating, listing, and facilitating the trading of options on shares in an ETF designed to track a proprietary market index, misappropriates intellectual property rights of the creator of the index." *Id*. at *1. Affirming the ruling of the district court, the Second Circuit found no misappropriation or infringement and dismissed all claims. *Id*.

Plaintiffs, Dow Jones & Company and McGraw-Hill Companies, each originate a well-known index reflecting average values of shares of major U.S. companies: the Dow Jones Industrial Average ("DJIA") and the Standard & Poor's 500 Index ("S&P 500"). The plaintiffs license various rights in their indices, including the right to create ETFs based on the indices. Dow Jones has licensed the creation of DIAMONDS,[2] and McGraw-Hill has licensed the creation of SPDRs.[3] By purchasing shares in ETFs, the public is able to buy and sell shares backed by the securities of all the companies making up the indices. The price of the ETF fluctuates with the value of the index on which it is based. The plaintiffs have federally registered trademarks in both their indices (DOW JONES and S&P 500) and the related ETF names.

The first defendant, International Securities Exchange ("ISE"), is an independent options trading exchange that announced plans to offer options in shares of DIAMONDS and SPDRs. The second defendant, Options Clearing Corporation, is an options clearing agency that has stated it would clear such trades.

The plaintiffs sued, each alleging that the defendants' issuance and trading of the options would constitute unfair competition through misappropriation of intellectual property in the underlying index and infringement of the index trademark. The district court consolidated the actions.

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1 *Dow Jones & Company, Inc. v. International Securities Exchange, Inc.*, 2006 WL 1660570 (2d Cir. 2006), *aff'g The McGraw-Hill Companies, Inc. v. International Securities Exchange, Inc.*, Nos. 05 CIV 1129; 05 CIV 4954, 2005 WL 2100518 (S.D.N.Y. 2005).

2 Dow Jones has also exclusively licensed the Chicago Board Options Exchange to create, issue, trade, market, and promote options on DIAMONDS. *See Dow Jones & Company, Inc. v. International Securities Exchange, Inc.*, 2006 WL 1660570 at *3.

3 SPDRs (pronounced "spiders") is an acronym for Standard & Poor Depositary Receipts.

McGraw-Hill argued that any "use of an index requires a license." *McGraw-Hill, Inc. v. International Securities Exchange,* 2005 WL 2100518 at *7. The district court disagreed, explaining that, in the cases relied upon by McGraw-Hill,[4] the defendants proposed to trade in "index-linked financial products" such as futures based on the plaintiff's index. *Id*. at *3. A futures contract is an "obligation to purchase a specific quantity of a particular commodity at a specified date in the future at a fixed price," the value of which is "keyed to" the index and which is settled for cash. *Id*.[5] Therefore, a futures contract is "essentially a bet on how the market will perform [that is] inextricably linked to the index number and ha[s] no independent value." *Id*. at *7. Consequently, use of an index to create a futures contract without a license may be misappropriation. *See id*. at *4.[6]

By contrast, the district court stated, the defendants did not "cop[y] the Index or create[] a product—such as a futures contract—that is linked to the Index." *Id*. at *5. Instead, options are "simply conditional contracts made by private parties to buy or sell shares" of ETFs on or before a specified time, and their value is in the underlying securities, which "still retain value even if the index they track ceases to exist." *Id*. at *8. Listing options does not entail tracing the index stocks or using the index to set prices or settle trades. *See id*. Therefore, the defendants' offer to sell options on ETFs would merely create a market for the resale of ETFs already created and sold by the plaintiffs. Because the creators of ETFs "did not retain a property right in the ETFs after they were issued and sold," they did "not retain a proprietary interest [in] options on the fund . . . offered in the secondary market." Thus, there could be no misappropriation. *Id*. at *5.

The district court also dismissed the plaintiffs' trademark infringement and dilution claims, stating that the accused use of trademarks was to describe the products nondeceptively and thus not a violation of trademark law. *Id*. at *9.

The Second Circuit affirmed on somewhat different grounds. Contrary to the district court, the appeals court stated that options created by ISE *were* new products, distinct from the ETFs. *Dow Jones & Company, Inc. v. International Securities Exchange, Inc.*, 2006 WL 1660570 at *8 (2d Cir. Jun. 16, 2006). The appeals court assumed, without deciding, "that each of the plaintiffs possesses an exclusive intellectual property right in the index it created and in the ETF which has been structured to duplicate the index." *Id*. at *4. Nevertheless, the court found that:

> [b]y authorizing the creation of ETFs using their proprietary formulas, and the sale of the ETF shares to the public, the plaintiffs have relinquished any right to control resale and public trading of those shares, notwithstanding the fact that plaintiffs' intellectual property may be embedded in the shares. Owners and

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4 *E.g.*, *Standard & Poor's Corp. v. Commodity Exch., Inc.*, 538 F. Supp. 1063 (S.D.N.Y. 1982), *aff'd*, *Standard & Poor's v. Commodity Exch., Inc.*, 683 F.3d 704 (2d Cir. 1982); *Board of Trade v. Dow Jones & Co., Inc.*, 98 Ill. 2d 109 (Ill. 1983).

5 All internal citations are omitted.

6 Notably, the district court observed that it is unclear if the courts deciding the cases relied upon by the plaintiffs would have found misappropriation today. 2005 WL 2100518 at *3.

> would-be owners of ETF shares are free to negotiate with one another for the purchase and sale of the ETF shares plaintiffs have sold to the public. Because plaintiffs have permitted the buying and selling of the ETF shares, plaintiffs may not prevent exchanges from offering marketplaces for buyers and sellers to come together to effectuate their transactions.

Id. at *5. The Second Circuit expressly stated that its holding did not address situations where a proprietary index is employed in the creation, issuance, or trading of financial instruments, such as futures contracts, based upon that index. *Id*. at *6 n.9, *8. But:

> once an index creator (or its licensee) has created a fund of securities tracking the index and has sold shares in the fund to the public, those who engage in secondary trading of the fund's shares, or provide a marketplace for such trading, do not infringe on a property interest of the creator of the index and the fund.

Id. at *6. It was "irrelevant," the Second Circuit said, whether an option is itself a new security within the meaning of the securities laws. What is critical is that an option is a "means for trading financial products the plaintiffs have licensed for sale to the public," regardless of whether the trade is eventually settled for cash or requires a transfer of shares. *Id*. at *8.

The Second Circuit also affirmed the district court's dismissal of the trademark infringement and dilution claims, stating that, by merely alleging that their marks had been used by the defendants, the plaintiffs had failed to state a claim. The court noted that trademark rights do "not prevent one who trades a branded product from accurately describing it by its brand name . . . even though the sale is not authorized by the trademark owner." *Id.* at *9. Thus, there was no infringement or dilution in the defendants' use of the ETFs' trademarked names in describing the ETF shares covered by the options. *Id*.

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If you have any questions concerning this memorandum, please contact William M. Ried (212-728-8729, wried@willkie.com), Dorota N. Clegg (212-728-8979, dclegg@willkie.com), or the attorney with whom you regularly work.

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