Proposed Rules

Federal Register
Vol. 62, No. 213
Tuesday, November 4, 1997

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 3, 32, and 33

Trade Options on the Enumerated Agricultural Commodities

AGENCY: Commodity Futures Trading Commission.

ACTION: Notice of proposed rulemaking.

SUMMARY: Generally, the offer or sale of commodity options is prohibited except on designated contract markets. One of several specified exceptions to the general prohibition on off-exchange options is for ''trade options.'' Trade options are defined as off-exchange options ''offered by a person having a reasonable basis to believe that the option is offered to'' a person or entity within the categories of commercial users specified in the rule, where such commercial user ''is offered or enters into the transaction solely for purposes related to its business as such.'' Trade options, however, are not permitted on the agricultural commodities which are enumerated in the Commodity Exchange Act (Act).

The Commodity Futures Trading Commission (Commission or CFTC) is proposing to remove the prohibition on off-exchange trade options on the enumerated agricultural commodities pursuant to a three-year pilot program. The Commission is proposing initially to permit agricultural trade options which, if exercised, will result in delivery of the commodity and which may not be resold, repurchased, or otherwise cancelled other than through the exercise or natural expiration of the contract. The Commission is also proposing to permit only those entities which handle the commodity in normal cash market channels to offer to buy or sell such options. Such entities, in order to sell agricultural trade options (puts and calls), would be required to become registered as agricultural trade option merchants, to report to the Commission on their transactions, to provide their customers with disclosure statements, and to safeguard their customers' premiums. The Commission is also proposing to exempt from the prohibition and these proposed rules individuals or entities which meet a substantial financial requirement. Finally, the Commission is proposing to remove the prohibition on the offer or sale of exchange-traded options on physicals on these commodities.

DATES: Comments must be received by December 4, 1997.

ADDRESSES: Comments should be mailed to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581, attention: Office of the Secretariat; transmitted by facsimile at (202) 418–5521; or transmitted electronically at [secretary@cftc.gov]. Reference should be made to ''Agricultural Trade Options.''

FOR FURTHER INFORMATION CONTACT: Paul M. Architzel, Chief Counsel, Division of Economic Analysis, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581, (202) 418–5260, or transmitted electronically at [PArchitzel@cftc.gov].

SUPPLEMENTARY INFORMATION:

I. Background

A. The Prohibition of Agricultural Trade Options

In 1936, responding to a history of large price movements and disruptions in the futures markets attributed to speculative trading in options, Congress completely prohibited the offer or sale of option contracts both on and off exchange in all commodities then under regulation.[1] Over the years, this statutory bar continued to apply only to the commodities originally regulated under the 1936 Act. The specific agricultural commodities originally regulated under the 1936 Act included, among others, grains, cotton, butter, eggs, and potatoes. Later, fats and oils, soybeans and livestock, as well as others, were added to the list of enumerated agricultural commodities. Any commodity not so enumerated, whether agricultural or not, was not subject to regulation. Thus, options on such nonenumerated commodities were unaffected by the prohibition.[2]

A history of abusive practices and fraud in the offer and sale of off-exchange options in the nonenumerated commodities was one of the catalysts leading to enactment of the Commodity Futures Trading Commission Act of 1974 (1974 Act), which substantially strengthened the Commodity Exchange Act and broadened its scope by bringing all commodities under regulation for the first time.[3] Under the 1974 amendments, the newly-created CFTC was vested with plenary authority to regulate the offer and sale of commodity options on the previously unregulated, nonenumerated commodities.[4] The Act's statutory prohibition on the offer and sale of options on the enumerated agricultural commodities was retained.

Shortly after its creation, the Commission promulgated a comprehensive regulatory framework applicable to off-exchange commodity option transactions in the

[1] Commodity Exchange Act of 1936, Pub. L. No. 74–675, 49 Stat. 1491 (1936). *See,* H. Rep. No. 421, 74th Cong., 1st Sess. 1, 2 (1934); H. Rep. No. 1551, 72d Cong., 1st Sess. 3 (1932).

[2] Examples of nonenumerated commodities would include coffee, sugar, gold, and foreign currencies. Before 1974, the Act covered only those commodities enumerated by name. The 1936 Act regulated transactions in wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghum, mill feeds, butter, eggs, and Solanum tuberosum (Irish potatoes). Act of June 15, 1936, Pub. L. 74–675, 49 Stat. 1491 (1936). Subsequent amendments to the Act added additional agricultural commodities to the list of enumerated commodities. Wool tops were added in 1938. Commodity Exchange Act Amendment of 1938, Pub. L. 471, 52 Stat. 205 (1938). Fats and oils, cottonseed meal, cottonseed, peanuts, soybeans, and soybean meal were added in 1940. Commodity Exchange Act Amendment of 1940, Pub. L. 818, 54 Stat. 1059 (1940). Livestock, livestock products, and frozen concentrated orange juice were added in 1968. Commodity Exchange Act Amendment of 1968, Pub. L. 90–258, 82 Stat. 26 (1968) (livestock and livestock products); Act of July 23, 1968, Pub. L. 90–418, 82 Stat. 413 (1968) (frozen concentrated orange juice). Trading in onion futures on United States exchanges was prohibited in 1958. Commodity Exchange Act Amendment of 1958, Pub. L. 85–839, 72 Stat. 1013 (1958).

[3] Congress accomplished this by adding to the list of enumerated commodities an expansive catch-all definition of ''commodity'' which included all ''services, rights, or interests in which contracts for future delivery are presently or in the future dealt in.'' The definition of commodity is currently codified in section 1a(3) of the Act.

[4] Section 4c(b) of the Act provides that no person ''shall offer to enter into, or confirm the execution of, any transaction involving any commodity regulated under this Act'' which is in the nature of an option ''contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe.'' 7 U.S.C. 6c(b).

nonenumerated commodities.[5] This comprehensive framework exempted ''trade options'' from most of its provisions except for a rule prohibiting fraud (rule 32.9).[6] In contrast, commodity options on the enumerated commodities—the domestic agricultural commodities listed in the Act—were prohibited both as a consequence of the continuing statutory bar as well as Commission rule 32.2, 17 CFR 32.2. This prohibition made no exceptions and applied equally to trade options.

The attempt to create a regulatory framework to govern the offer and sale of off-exchange commodity options was unsuccessful. Because of continuing, persistent, and widespread abuse and fraud in their offer and sale, the Commission in 1978 suspended all trading in commodity options, except for trade options.[7] Congress later codified the Commission's options ban, establishing a general prohibition against commodity option transactions other than trade and dealer options.[8]

The Commission subsequently permitted the introduction of exchange-traded options on the nonenumerated commodities by means of a three-year pilot program.[9] Based on that successful experience, Congress, in the Futures Trading Act of 1982, eliminated the statutory bar to transactions in options on the enumerated commodities, permitting the Commission to establish a similar pilot program to reintroduce exchange-traded options on those agricultural commodities.[10] When establishing the pilot program, the Commission declined to relax the prohibition on off-exchange trade options on these commodities.[11]

The Commission has reconsidered the issue of whether to remove the prohibition on the offer and sale of trade options on the enumerated commodities several times.[12] On December 19, 1995, the Commission hosted a public roundtable (December Roundtable) to consider this issue once again and to provide a forum for members of the public to provide their views. Subsequently, the Commission instructed the staff to study this issue and to forward its analysis to the Commission.

B. The Advance Notice of Proposed Rulemaking

On June 9, 1997, the Commission published an advance notice of proposed rulemaking (advance notice) in the **Federal Register** seeking comment on whether it should propose rules to lift the prohibition on trade options on the enumerated agricultural options subject to conditions and, if so, what conditions would be appropriate (62 FR 31375). The Commission based the advance notice on a study by the Commission's Division of Economic Analysis (Division).[13]

The advance notice discussed the potential benefits and risks that may result from lifting the prohibition on agricultural trade options. The benefits include greater customization, a known cost of the instrument at the outset, and an increase in possible types of vendors, permitting greater convenience and more flexible financing arrangements. The risks identified in the study include fraud, credit risk, liquidity risk, operational risk, systemic risk, and legal risk.

In addition, the advance notice offered a variety of regulatory protections or conditions which could be used to address many of the risks identified in the study. Those conditions included possible restrictions on the parties permitted to enter into these transactions, restrictions on the instruments or their use, and/or regulation of their marketing. The advance notice noted that several of the risks could be reduced by imposing eligibility limitations, such as to restrict the availability of agricultural trade options to sophisticated individuals or entities; to require that those marketing these instruments be registered with, or identify themselves to, the Commission or be commercial users themselves; and/or to impose an education requirement on either buyers or agricultural trade option vendors or both.

The advance notice also discussed possible restrictions on the types of options permitted as a possible means of ensuring that commercials enter into such transactions ''solely for purposes related to (their) business as such.'' Moreover, the possible regulation of marketing, including disclosure requirements and account confirmation requirements, was considered. Additional issues addressed by the advance notice included possible requirements for cover or other methods for limiting the risk of possible default and requirements regarding the establishment of appropriate internal controls. In order to focus comment on these issues, the advance notice invited commenters to respond to 30 specific questions relating to the above topics.

II. Comments Received

In response to its request for public comment, the Commission received a total of 76 comment letters from 82 commenters. The commenters were almost evenly divided with 35 commenters in favor and 36 opposed to lifting the ban.[14] Those favoring lifting the prohibition on agricultural trade options included a futures exchange (with qualifications); a futures industry association; a derivatives industry association; five risk management firms; a commodity trading advisor; a bank; six agriculture-related businesses; 15 trade and farm associations, including both

[5] 17 CFR part 32. *See*, 41 FR 51808 (Nov. 24, 1976) (Adoption of Rules Concerning Regulation and Fraud in Connection with Commodity Option Transactions). *See also*, 41 FR 7774 (February 20, 1976) (Notice of Proposed Rules on Regulation of Commodity Option Transactions); 41 FR 44560 (October 8, 1976) (Notice of Proposed Regulation of Commodity Options).

[6] As noted above, trade options are defined as off-exchange options ''offered by a person having a reasonable basis to believe that the option is offered to the categories of commercial users specified in the rule, where such commercial user is offered or enters into the transaction solely for purposes related to its business as such.'' *Id*. at 51815; rule 32.4(a) (1976). This exemption was promulgated based upon an understanding that commercial users of the underlying commodity had sufficient information concerning commodity markets insofar as transactions related to their business as such, so that application of the full range of regulatory requirements was unnecessary for business-related transactions in options on the nonenumerated commodities. *See*, 41 FR 44563, ''Report of the Advisory Committee on Definition and Regulation of Market Instruments,'' appendix A–4, p. 7 (January 22, 1976).

[7] 43 FR 16153 (April 17, 1978). Subsequently, the Commission also exempted dealer options from the general suspension of transactions in commodity options. 43 FR 23704 (June 1, 1978).

[8] Pub. L. No. 95–405, 92 Stat. 865 (1978). Pursuant to the 1978 statutory amendments, option transactions prohibited by new section 4c(c) could not be lawfully effected until the Commission transmitted to its congressional oversight committees documentation of its ability to regulate successfully such transactions, including its proposed regulations, and 30 calendar days of continuous session of Congress after such transmittal had passed.

[9] 46 FR 54500 (November 3, 1981).

[10] Pub.L. No. 97–444, 96 Stat. 2294, 2301 (1983).

[11] Although the Commission noted that ''there may be possible benefits to commercials and to producers from the trading of these 'trade' options in domestic agricultural commodities,'' it determined that ''in light of the lack of recent experience with agricultural options and because the trading of exchange-traded options is subject to more comprehensive oversight,'' ''proceeding in a gradual fashion by initially permitting only exchange-traded agricultural options'' was the prudent course. 48 FR 46797, 46800 (October 14, 1983).

[12] For example, in 1991 the Commission proposed deleting the prohibition on trade options on the enumerated commodities and including them under the same exemption applicable to all other commodities. 56 FR 43560 (September 3, 1991). The Commission never promulgated the proposed deletion as a final rule.

[13] The complete text of that study, entitled ''Policy Alternatives Relating to Agricultural Trade Options and Other Agricultural Risk-Shifting Contracts,'' was forwarded to the Commission by the Division on May 14, 1997. It is available through the Commission's Internet site at http://www.cftc.gov/ag8.htm.

[14] Five letters offered commentary on the issue without taking a position on the overall wisdom of lifting the prohibition.

national organizations and state-level affiliates; three individuals; and an accounting firm. Those opposed included two futures exchanges; a futures industry trade association; ten futures professionals; two producer associations; a grower-owned marketing cooperative; a country elevator; an academician; and 18 individuals, eight of whom were producers.

Commenters opposed to lifting the ban generally expressed the view that existing exchange-traded products are adequate to manage agricultural risk and that agricultural trade options are likely merely to replicate those existing products but in a less safe environment. In this regard, the commenters stressed the higher likelihood of fraud occasioned by the unsophisticated nature of the possible counterparties to agricultural trade option transactions, the decentralized nature of the market, and the lack of regulatory oversight of possible agricultural trade option vendors. Several commenters also opined that, as a result of operating in a less regulated environment, agricultural trade options would enjoy an unfair competitive advantage over exchange-traded instruments, thereby adversely affecting exchange liquidity. Others expressed the concern that problems arising as a consequence of the less regulated environment for the trading of agricultural trade options could damage public confidence in all risk management products, including exchange-traded instruments. A final concern expressed by several commenters was that lifting the prohibition on agricultural trade options will advantage larger, more sophisticated agricultural companies over smaller, independent businesses, hastening a trend toward greater consolidation and concentration in agricultural markets.

Those commenters favoring lifting the prohibition on agricultural trade options generally expressed the view that recent developments in domestic and foreign agricultural markets have increased the need for agricultural trade options. In particular, several commenters noted that agricultural trade options already are being offered outside of the United States to the competitive advantage of foreign producers and agricultural businesses.

Other commenters noted that the recent removal of many of the long-standing government support programs may result in increased price uncertainty and volatility, thereby increasing the need for a variety of risk-management and marketing tools. In this regard, the Division staff in its study noted that the overall impact of the Federal Agricultural Improvement and Reform Act of 1996 likely will be to leave farm incomes more exposed to changes in market prices and that in response to these changes ''new risk management tools are being developed, a trend which is likely to continue.'' [15]

The greater interest by some segments of the agricultural sector in managing risks that was noted in the Division's study is also reflected in many of the comments. Several commenters who favor lifting the ban generally noted that the increasing size and complexity of producers' operations also have given rise to the need for more innovative and flexible risk management products. For example, one commenter noted that:

> All facets of agricultural production whether grain, cotton, fruits, vegetables or livestock are becoming more specialized and targeted toward niche markets. Producing for these markets often requires a greater degree of coordination and long-term commitment between the producer and processor. Having the flexibility to write marketing contracts that are now banned would be of great benefit in facilitating the coordination required.

These rapid and profound changes taking place in these markets are a key factor in the Commission's determination to propose these rules.[16]

In addition to the written comments, the Commission received oral comments during two public field meetings at which members of the public had an opportunity to address the Commission and to answer its questions regarding these issues. One of the meetings was held in Bloomington, IL, and the other was held in Memphis, TN. A third informational meeting was held in conjunction with a general membership meeting of the National Cattlemen's Beef Association. Transcripts of the proceedings at all three events were included in the Commission's comment file and are available through the Commission's internet web site. Generally, the participants in these meetings reflected the range of views expressed in the written comments and were likewise equally divided in their support or opposition to lifting the prohibition on agricultural trade options.

III. The Proposed Rules

A. Three-Year Pilot Program

Based upon the analysis in the Division's study and the comments filed in response to the advance notice, including the comments presented to the Commission during its field meetings, the Commission is proposing to promulgate rules establishing a pilot program to permit the offer and sale of trade options subject to a number of strict regulatory conditions. Many commenters expressed the view that the potential risk of permitting trade options clearly outweighed any benefit which they might provide. These commenters, however, typically assumed that agricultural trade options would be offered under the same level of regulation currently applicable to other trade options.[17] An approximately equal number of commenters expressed the view that the prohibition on trade options should be lifted, particularly in response to the new challenges agriculture faces as a result of changes in government programs. Nevertheless, the vast majority of commenters, both those favoring and opposing lifting the prohibition of agricultural trade options, urged caution.

The Commission successfully permitted the reintroduction of exchange-traded options under a three-year pilot program after their nearly half-century ban. *See*, 46 FR 54500 (November 13, 1981). Many at that time expressed concerns similar to those expressed in connection with the Commission's consideration of lifting the prohibition on agricultural trade options. The Commission determined that a pilot program best addressed those concerns, permitting the introduction of exchange-traded options subject to strict regulatory controls. By structuring its action as a pilot program, the Commission was able to test the efficacy of its regulations and to adjust them as experience warranted. The use of a pilot program proved to be a highly successful means of reintroducing exchange-traded options. Today, those markets constitute an important part of the futures industry.[18]

Based upon that successful experience, the Commission is proposing to lift the ban on agricultural trade options under a similarly structured pilot program. As under the previous pilot options program, the program being proposed for agricultural trade options will run for three years. During that time the Commission will closely monitor the efficacy of its rules and their implementation by the industry. Although the Commission currently intends that the rules promulgated by the Commission under

[15] *See* the Division's study at pp. 23–24, 28.

[16] *Id.* at p. 31.

[17] Currently, trade options and those offering them are subject only to regulations regarding fraud. *See*, 17 CFR 32.4.

[18] Overall year-to-date volume through July 1997 for exchange-traded futures and option contracts is 314,068,673 contracts. Of the total number of contracts traded, approximately 20 percent are option contracts.

the pilot program will remain in effect at the termination of the pilot program, it will amend them as experience warrants.[19]

During the course of the pilot program, the Commission anticipates that it will direct the Division to conduct at least two reviews of trading experience. The conduct of such reviews may require the issuance by the Division of industry-wide special calls for information from agricultural trade option vendors. Such information requests, although used sparingly, were an integral part of the Commission's successful monitoring of the prior pilot program and can be expected in connection with the Commission's evaluation of the relative success of this pilot program as well.

B. Overall Structure of Proposed Rules

The advance notice identified a number of risks associated with lifting the prohibition on options on the enumerated agricultural commodities and the possible regulatory responses to those risks, ranging from little or few regulatory protections to the full panoply of protections mirroring those that are applicable to exchange-traded options. It also identified likely immediate uses for trade options on these commodities and a number of more theoretical possible uses. In proposing the structure for this pilot program, the Commission determined to include within the pilot program initially those forms of trade options the terms of which are likely to be most widely understood and which are closest to current cash market practices. Accordingly, the Commission is proposing to lift the trade option ban on enumerated agricultural commodities for physically-settled contracts between commercial parties in the normal merchandising chain for the underlying commodity. Exercise of an option between these parties would involve the delivery of the underlying commodity from one party to the other either by immediate transfer of title to the commodity or by transfer of a forward contract commitment.

Since at least 1985, when the Commission's General Counsel issued an interpretative statement entitled, ''Characteristics Distinguishing Cash and Forward Contracts and 'Trade' Options,'' 50 FR 39656 (September 30, 1985) (1985 OGC Interpretation), there has been wide understanding that one form of trade option prohibited by the ban involved a transaction whereby a producer, in return for payment of a premium, would have the right but not the obligation to deliver his crop to an elevator at the specified price. The producer would have the choice to deliver the commodity elsewhere or at the original elevator for a higher price.[20] In addition to being commonly understood, this form of trade option is a logical extension of other, permitted cash market practices.[21]

Option contracts can be used for a variety of purposes depending on the structure and settlement characteristics of a particular contract and the nature of the option customer's cash market commitments or position. Upon exercise, options can settle either by physical delivery of the underlying commodity or by cash payment. Cash-settled options upon exercise result only in the exchange of cash; a separate marketing arrangement is necessary to merchandize the underlying commodity. In this respect, because they are distinct from marketing contracts, cash-settled options bear a resemblance to exchange-traded contracts. In contrast, upon exercise of a physical delivery option, the purchaser of a put or the seller of a call actually delivers the underlying commodity to the counterparty. Thus, like a forward contract, a physical delivery trade option can be used as a means of merchandizing the commodity.[22]

Commenters suggested a number of additional reasons for inclusion of physical delivery options within the pilot program. Several commenters opined that one of the primary benefits of agricultural trade options will be to permit producers to enter into such agreements directly with those with whom they share trusted cash market business relationships. A second often suggested benefit of agricultural trade options is the producer's ability to enter into enhanced forms of merchandizing agreements. Several commenters, for example, expressed the desirability of being able to enter into option contracts that would give them the right but not the obligation to deliver on the contract. Such individual could ''walk away'' from delivery to avoid the purchase or sale of the commodity at too high or low a price during a production shortfall or for any other reason. The ability to avoid delivery in the case of a production shortfall, in the view of these commenters, would allow producers to contract (through options) for a higher percentage of their expected production. Including first handlers of the commodity underlying agricultural trade options within the pilot program and including all physical delivery agricultural trade options as eligible for the pilot program would allow producers to achieve these benefits.

Several commenters registered their concern that, if permitted, trade options would merely replicate exchange-traded options in all respects, but in a less-regulated environment. They argued that on that basis the risks associated with trade options do not outweigh their potential benefits. Physical delivery trade options, however, will not simply replicate exchange-traded instruments. As noted above, physically-settled trade options offer the opportunity to combine a marketing and risk management tool. In this respect, physical delivery trade options on the enumerated commodities would be similar in character to forward contracts in that each would be an individually

[19] In this regard, the Commission anticipates that, if it promulgates final rules, it will promulgate them as ''interim final rules,'' denoting its intention to revisit them three years after implementation. It is not proposing to limit the time during which the rules will remain effective in order to avoid issues of contracts extending beyond the three-year period. Instead, it will evaluate the efficacy of the interim final rules at the conclusion of the pilot program and reissue them if amendments are needed. Any such amendments would not affect the validity of contracts entered into prior to the issuance of such amendments.

[20] The 1985 OGC Interpretation described this form of trade option as a contract that ''establishes a minimum contract price determined when the contract is written, and [for which] a premium is collected, either at the initiation of the contract, during the life of the contract or, together with interest accumulated over the life of the contract, at the time of settlement. In return for the premium, the producer has the right to require the merchant to accept delivery of and pay a minimum contract price for the crop. However, the producer may forfeit the premium and seek a higher price for, and deliver, the crop elsewhere.'' 50 FR 39656, 39660.

[21] For example, the same 1985 OGC interpretation discussed two other examples of delivery contracts having minimum price characteristics, finding them to be within the forward contract exclusion of the Act. Section 1a(11) of the Act, the forward contract exclusion, provides that futures contracts which are regulated under the Act do ''not include any sale of any cash commodity for deferred shipment or delivery.'' These two contracts, although having some option pricing characteristics, were determined to be forward contracts because, unlike option contracts, they were intended to be a means of merchandizing the commodity, obligating the parties to the contract to make or take delivery. 50 FR 39660.

[22] This is not to suggest that the pay-out characteristics of forwards and futures resemble those of physically-delivered or cash-settled options, respectively. To the contrary, futures and forwards share a similar risk/return profile which differs markedly from the risk/return profile shared by all options. Rather, the resemblance between forwards and physical-delivery options is the ease of their use as a form of marketing arrangement that can also be used to hedge price risk.

For those not wishing to combine a merchandizing arrangement with a risk-management function, cash-settled options offer greater settlement ease. This is true whether settlement is a result of the option's offset or its exercise.

negotiated contract involving, if exercised, the merchandising of the commodity through normal marketing channels. This potential additional cash market function [23] of physical delivery trade options argues in favor of their inclusion under the pilot program.

After having determined, for the above reasons, that trade options between counterparties in normal cash market channels requiring physical delivery are appropriate for inclusion within the pilot option program, the Commission has matched the level of regulation being proposed to the risks associated with those instruments. Not only is this approach intended to strike the appropriate balance of regulation of the instruments included within the pilot program, but it provides a solid foundation for analyzing and comparing the regulatory approaches which should be applied in the future when considering other possible uses of trade options. Accordingly, were the Commission to propose to permit additional forms of trade options, it would re-examine the adequacy of the proposed regulatory provisions of the pilot program. The major components of the proposed regulations governing the pilot option program are as follows: regulation of agricultural trade option vendors, including net capital, recordkeeping and streamlined registration, and proficiency testing requirements; required risk disclosure to option customers; and several restrictions on the market strategies or contract structure. These proposed components of the pilot regulations are discussed below.

C. Regulation of Agricultural Trade Option Merchants

A primary regulatory protection of the pilot program is its restriction of option counterparties to agricultural commercial participants. Thus, agricultural trade option vendors—those persons or entities engaged in the business of the offer or sale of agricultural trade options—as a matter of course, will be businesses active in agricultural cash markets. Agricultural trade option vendors, by virtue of their cash market operations, should have achieved some level of financial soundness and proficiency with respect to risk management strategies. In addition, the Commission is proposing streamlined or targeted requirements relating to agricultural trade option vendors' financial soundness, competency, and probity, including the requirement that such vendors be registered with the Commission under the new registration category of ''agricultural trade option merchant.''

1. Net Asset and Other Financial Requirements

By their nature, agricultural trade options, like all commodity futures or option instruments, involve risk, particularly the risk arising from the need for performance at a future date by the counterparty to the contract. Typically, the greatest financial risk assumed by an option purchaser is credit risk. Credit risk is the risk that the seller of the option may fail to perform on the obligation if the purchaser chooses to exercise the option contract. In the event of such nonperformance, the option purchaser stands to lose the option premium if it has already been paid plus any opportunity gain that would have been achieved if the option were exercised.[24]

In an exchange environment, the clearinghouse and regulations requiring minimum net capital for market intermediaries reduce counterparty credit risk. Off-exchange transactions do not have the safety of the clearinghouse to reduce credit risk. In an off-exchange environment, counterparties can take a variety of steps to help assure that a counterparty is able to perform and performs on its obligation. Sophisticated counterparties may have the means formally to evaluate the creditworthiness of their counterparties. They also may require the posting of collateral or a third party guarantee. Less sophisticated counterparties may simply rely on trust, choosing to deal only with known counterparties with whom they have ongoing business relationships. Another approach to enhancing an agricultural trade option merchant's ability to perform on a trade option is to require the merchant to manage the market risk of trade options through exchange-traded options.

Because many agricultural trade option customers will not have the resources to conduct formal creditworthiness evaluations of their counterparties, some degree of regulatory financial protections are desirable. Accordingly, the Commission is proposing a requirement that agricultural trade option merchants maintain a minimum level of net worth. In addition, the Commission is proposing that agricultural trade option merchants segregate from their own funds premiums paid by customers at initiation of an option contract. The Commission, however, is not proposing specific forms of covering the agricultural trade option merchant's market exposure.

a. Net Worth. Minimum financial requirements have been used by government regulators to establish a base level for entry or access to a market by individuals and companies. Such requirements are intended to assure that companies or entities conducting business offer some assurance of having the financial wherewithal to perform on their obligations. The Commission places minimum financial requirements on futures commission merchants (FCMs) and introducing brokers (IBs) as a condition of registration with the Commission. The United States Department of Agriculture (USDA) and various states impose minimum financial requirements in the cash grain markets on federally-licensed grain warehouses.[25]

Although many commenters favored minimum financial requirements,[26] others opposed them on the grounds that such minimum financial requirements would exclude smaller entities from the agricultural trade option business, possibly accelerating a trend to greater concentration in cash grain markets. Some commenters argued that the financial requirements currently imposed by the various states would be sufficient to foster financial integrity in the trade option markets. However, not all states have minimum financial requirements for those involved in the cash trade, and the requirements of those that do vary widely. Accordingly,

[23] Although, as discussed below, the Commission also is proposing to permit exchanges greater flexibility in offering agricultural options, physical-delivery trade options entered into between those who have a cash-market relationship are apt to be different in nature than exchange-traded contracts—that is, they are more likely to be more highly customized, including calling for delivery at widely scattered facilities.

[24] For example, consider the case of a producer who had paid a premium of $.10 per bushel for a put option giving him the right to sell corn at a price of $2.80 per bushel. At harvest the price of corn is $2.70 per bushel, and the producer decides to exercise the option. If the option seller defaults on the contract, the producer stands to lose the $.10 per bushel paid for the option. In addition the producer loses the opportunity to sell corn at $2.80 per bushel, instead having to accept the market price of corn at $2.70 per bushel.

[25] A number of states require entities to meet a specified net worth requirement as a condition of obtaining a state grain warehouse's or grain dealer's license. The minimum net worth requirements range up to a minimum of $50,000 in Illinois. Some states also require that grain warehouses obtain a surety bond and have established indemnity funds to offset producer losses on grain stored in warehouses. Such indemnity funds, depending upon the state, are funded either by the producers or the elevators. For example, the indemnity fund in Illinois is funded by grain elevator contributions, while in Indiana producers contribute to the fund.

[26] Of those favoring minimum financial requirements, some specifically suggested that trade option vendors be required to meet the same financial requirements currently applicable to FCMs and IBs.

the Commission believes that a common federal minimum standard should apply to all those involved in the business of offering agricultural trade options, regardless of geographic location or the agricultural commodity.

Accordingly, the Commission is proposing that agricultural trade option merchants, as a condition for offering such contracts, have and maintain a minimum of $50,000 of net worth.[27] This requirement corresponds to the overall minimum financial requirement established by USDA as a condition of obtaining a federal grain warehouse license. The Commission is proposing this minimum net asset level based upon the observation that these warehouses already enter into forward contracts as part of their cash business and that the USDA requirement appears to have been adequate. As noted above, the physical delivery agricultural trade options being included under the pilot program are similar in nature to forward contracts, including the financial risk to the warehouse or other first handler.[28]

As noted above, the proposed net asset requirement is ongoing in nature. Accordingly, agricultural trade option merchants would be required to maintain the specified level of net worth in order to enter into new trade option contracts and to notify the Commission at any time if they have fallen below prescribed levels. The Commission is also proposing that agricultural trade option merchants be required to perform a reconciliation of their financial position at least monthly to determine compliance with this requirement.[29]

Because agricultural trade option merchants are primarily engaged in a cash market business, this proposed rule does not require them to change accounting procedures to conform to specific Commission accounting requirements, provided they use ''fair value'' accounting under generally-accepted accounting principles.[30] It is the Commission's understanding that this accounting method is used by most firms in the cash market business.

b. Segregation of Customer Premiums. The Commission is proposing an additional financial protection—requiring that agricultural trade option merchants segregate customer premiums from their own capital. The advance notice noted the potential financial and regulatory concerns which arise from the asymmetric credit risk of option contracts. That asymmetry exists when the party purchasing the option pays the cost of the option—the option premium—in advance of the counterparty's having to perform on its obligation.[31] The purchaser then faces the risk that the seller of the option might fail to perform on the contract, if exercised. Under such circumstances, not only does the option purchaser lose the opportunity gain that would have been realized through the exercise of the option, but also would be subject to the out-of-pocket loss of the option premium. This is in contrast to forward contracts, where both parties have reciprocal obligations and neither makes a payment in advance of performance. The ability to collect an up-front payment of premiums may also give merchants an incentive to sell options in order to generate option premiums for immediate use as operating funds.

In order better to safeguard customers' up-front premium payments and to discourage the writing of trade options in order to generate immediate operating funds by a firm experiencing financial difficulties, the Commission is proposing that option premiums be held in segregation while an option contract is open, and that option premiums not be available to the agricultural trade option merchant for use in its business during the period an option is open. The Commission is proposing that the premium associated with an option must be separately accounted for and segregated in an account held for the benefit of option customers. Such funds, when deposited in a bank, trust company, or other financial institution, must be deposited under an account name which clearly identifies them as segregated customer funds and shows that they are segregated as required by Commission regulations.

c. Cover of Market Risk. The advance notice posed several specific questions relating to whether the Commission should require that agricultural trade option merchants cover the market risk of the agricultural trade options which

[27] The minimum net worth requirement, as proposed, is a continuing requirement. If an agricultural trade option merchant's net worth falls below this amount, the merchant would not be permitted to offer to buy or to sell additional trade options until coming into compliance with the requirement. Moreover, in such a situation the agricultural trade option merchant must immediately cease offering or entering into new option transactions and must notify customers having premiums which the agricultural trade option merchant is holding under § 32.13(a)(4) of the proposed rules that such customers can obtain an immediate refund of that premium amount, thereby closing the option position.

[28] That is not to suggest that the risks to the first handler are precisely the same between trade options and forward contracts. In the case of options, the first handler is not assured of actually receiving delivery of the commodity in contrast to a forward contract. However, the means available to the first handler to cover the financial risk of the transactions are similar.

[29] At least three commenters urged that daily mark-to-market of all positions should be required. The Commission is not proposing this requirement at the current time, although that is certainly the best practice and should be encouraged.

Under the proposed rules, agricultural trade option contracts can be exercised only by delivery and cannot be purchased back, resold or otherwise offset before the expiration of the contracts. While the net value of an agricultural trade option merchant's option position will fluctuate on a daily basis, the option contracts themselves will tend to be long term commitments similar to forward contracts. In this respect, an agricultural trade option merchant will not be faced with the daily potential of large shifts in its option position due to rapid changes in market prices. Moreover, the price risk to the agricultural trade option merchant of an unhedged option position will be similar to that of an unhedged forward contract position. For example, elevators selling unhedged put options to producers face the risk that prices fall, thereby resulting in the elevator purchasing a commodity at a relatively high price when producers exercise their options. This is the same risk faced by an elevator entering into unhedged forward contracts.

Because of the similarities in long-term price risk between the options which can be offered under the proposed rule and forward contracts, the availability of hedging tools and the expectation that agricultural trade option merchants will hedge their option positions in a manner similar to their forward contract positions and because of varying levels of sophistication among those who may be involved in offering agricultural trade options, the Commission is not now proposing a daily net worth calculation. Nonetheless, the Commission seeks comments on this issue, asking commenters to focus in particular on the needed sophistication of potential agricultural trade option merchants to mark assets and liabilities to market on a daily basis, whether daily marking-to-market is desirable or necessary in light of the long-term nature of the option positions and whether current standards used by these entities in operating in forward markets are sufficient for operating in the market for physical options given the similarity in the risks faced by the merchants.

[30] The Commission believes that the guidance provided in the American Institute of Certified Public Accountant's Audit and Accounting Guide, entitled, ''Brokers and Dealers in Securities,'' provides the relevant guidance which should be followed in connection with assigning a fair value to agricultural trade options. It states: ''Under generally accepted accounting principles, fair value is measured in a variety of ways depending on the nature of the instrument and the manner in which it is traded. Many financial instruments are publicly traded, and end-of-day market quotations are readily available. Quoted market prices, if available, are the best evidence of the fair value of a financial instrument. If quoted market prices are not available, management's best estimate of fair value should be based on the consistent application of a variety of factors available to management.'' A complete discussion of the factors is provided in the audit guide.

[31] Generally producers have used forward contracts as a means of hedging price risk (in addition to merchandizing the commodity), obviating the need for the producer to maintain a futures position or incur out-of-pocket expenses. Under this arrangement, the elevator generally covers the price risk of the forward contract by entering into a futures position and paying the required margin obligations on the position. The elevator may then recoup this cost implicitly. To the extent first handlers structure agricultural trade options in this manner as well, there will be no up-front payment, and no funds will be segregated. Of course, because under a trade option a producer may elect not to deliver the commodity, the elevator would be expected to establish some other means of recovering the cost of the option premium if it is not paid up front.

they write. One commenter, a futures exchange, suggested that the Commission require that agricultural trade option merchants be required to cover the market risk of their trade options one-for-one with exchange-traded options. Other commenters, however, disagreed, pointing out that agricultural trade options may be offered for commodities in which there is no actively-traded exchange market or may be written for a form, grade, expiration, or delivery location not provided under exchange-traded instruments. In such instances, a one-to-one cover requirement using exchange-traded instruments may be economically inefficient or impossible.

In general, it is the Commission's view that the market risks faced by entities offering trade option contracts will be similar to those currently associated with the offer of forward contracts. For example, an elevator entering into a forward contract to purchase grain from a producer faces the risk that the price of grain at the time of delivery will be lower than the contract price, requiring the elevator to pay the producer a higher price than the elevator can obtain when it resells that grain. Balancing this risk is the possibility that prices will rise making the contract price relatively cheap. Elevators may choose to bear this risk, chancing the fall in cash prices against the opportunity to profit if cash prices rise, or they may offset the market exposure of rising prices by selling a futures contract on one of the futures exchanges.

An elevator selling a put option to a producer faces similar market risk as one entering a forward contract; that is, that spot market prices will be lower than the price at which the option is exercised. As with forward contracts, the elevator may choose to bear the market risk or to cover the market risk by purchasing an exchange-traded put option. Whether or not the elevator chooses to bear the market risk associated with the trade option, however, it always receives the premium from the producer regardless of whether prices rise or fall.

The Commission assumes that current cover practices common to forward contracting will be applied to agricultural trade options. The Commission is aware of no reason why those offering trade option contracts would be any less likely to cover market exposure on trade option contracts than is currently the case with those offering forward contracts. In light of the similarities of such option contracts to forward contracts as discussed above, the Commission is of the view that elevators can determine individually the manner in which they will cover their exposure to market risk, if at all.

2. Probity and Competency Requirements for Agricultural Trade Option Merchants

a. Registration. Registration of commodity professionals is an important means by which the Commission polices the futures and option industry and is the primary mechanism for reassuring the public of the futures professional's probity and proficiency.[32] Registration is an indisputably important safeguard to the public and will be critically important in the decentralized market permitted under the pilot program. However, the offer and sale of trade options will be a complement to the first-handler's existing cash market businesses, to some extent offsetting the need for extensive registration requirements. Accordingly, the Commission is proposing that those engaged in the business of the offer and sale of agricultural trade options must register under the new registration category of ''agricultural trade option merchant.'' The Commission is proposing a streamlined form of registration covering both the agricultural trade option merchant as an entity and its authorized sales force.[33]

The streamlined registration requirement being proposed consists of the single filing of a form identifying the agricultural trade option merchant, its principals (if the agricultural trade option merchant is an entity), and on separate pages, information identifying its sales agents, a certification that none of the individuals is statutorily disqualified from engaging in a commodity-related business under the statutory disqualification provisions of section 8a(2) or 8a(3) of the Act, a set of fingerprints for each individual, a copy of the entity's certified financial statements completed within the prior 12 months, and evidence that individuals have completed successfully a proficiency test specifically geared toward agricultural trade options. Amendments of such registration applications for new associated persons can be filed as necessary.

The Commission is seeking comment on whether this registration function should be delegated to the National Futures Association (NFA). NFA has been delegated responsibility by the Commission to administer the registration procedures for all futures industry professionals. The possible delegation to NFA of responsibility for processing the registration applications of agricultural trade option merchants would be consistent with this practice and, should NFA agree to accept this responsibility, this delegation would conserve Commission resources, as well.

b. Competency Testing. A second important customer protection is competency testing of futures professionals. Because agricultural trade option merchants will not be engaged in other facets of futures and option sales, the series 3 examination which is generally required for futures professionals would not be necessary. Accordingly, the Commission is proposing that a specialized examination targeted at agricultural trade options be developed.[34] The Commission, as it has with all other similar testing programs, proposes to delegate this testing function to the NFA. In light of the proposed competency test for agricultural trade option merchants, the Commission is not proposing an explicit educational requirement. Successful completion of this targeted examination would evidence proficiency in those areas relevant to the offer and sale of agricultural trade options.[35]

[32] In this regard, by virtue of the required registration of their counterparty as agricultural trade option merchants, customers will have available to them under section 14 of the Act the Commission's reparations program for the resolution of disputes arising under agricultural trade option contracts. As proposed, customers will be apprised of this right in the disclosure document.

[33] The Commission has not proposed to permit FCMs to substitute FCM registration for registration as an agricultural trade option merchant based on the assumption that few, if any, FCMs would qualify to be an agricultural trade option merchant by virtue of the requirement that such entities also be a commercial user of the underlying commodity. The Commission requests comment on whether this assumption is not correct and, if so, whether registration as an FCM should be permitted in lieu of registration as an agricultural trade option merchant. The Commission also requests comment on whether Commission rule 1.19 should be amended to permit FCMs to conduct such a business.

[34] Although agricultural trade option merchants would only be required to pass the more specialized agricultural trade option examination, passing the series 3 examination would also be acceptable as a condition of registration.

[35] Many commenters opposed mandatory educational requirements for either agricultural trade option merchants or customers. The Commission is of the view that customers have the right to expect that such merchants and their sales forces will have successfully demonstrated mastery of the issues relevant to the offer or sale of these instruments. Although the Commission is not proposing an educational requirement for customers, it strongly urges private sector organizations to provide a variety of means of fulfilling this need. The success of the pilot program will depend, in part, on the success of various organizations in educating potential trade option customers. In this regard, a participant at the

c. Ethics Training Requirement. The final protection relating to both probity and competency is the ethics training requirement applicable to all Commission registrants. A few commenters expressed concern that without this requirement, if the prohibition on agricultural trade options were lifted, regulatory oversight of agricultural trade option merchants could be inadequate. The Commission carefully considered what degree of ethical instruction would be necessary and appropriate for registered agricultural trade option merchants and is proposing to apply to agricultural trade option merchants the same mandatory ethical training requirements currently required by the Act for all other registrants. See, 17 CFR 3.34.[36]

Under this requirement, Commission registrants are required to attend ethics training within six months of being granted registration and, thereafter, every three years. This ethics training must be at least four hours in duration for the initial session and one hour in duration for subsequent periodic sessions. Training is available from a variety of sources and can be undertaken through videotape, computer programs, or other similar means, in addition to attendance in person. *See,* 17 CFR 3.34(b)(3)(iii). These requirements apply equally to all Commission registrants and are being proposed to apply to agricultural trade option merchants as well.[37]

D. Restrictions on the Instruments or Market Strategies

The Commission posed a series of questions in the advance notice related to restrictions on the use of option contracts by various parties. In particular, the Commission asked whether it would be appropriate under a trade option exemption for producers to write covered calls and whether agricultural trade options should be permitted to be bundled to create risk-return payouts different from a simple put or call.

Several commenters expressed the opinion that option customers should have unfettered freedom over the types of options available and the manner of their use, ceding only the restriction that trade options should be related to a business purpose. Others, however, expressed concern that more complex instruments or trading strategies might lead to high levels of fraud and abuse. Although many of these commenters favored a continuance of the prohibition as the remedy, their concern over fraud and abuse was shared by many commenters who favored lifting the prohibition. These commenters accepted the wisdom of some limitations or conditions on the types of options and trading strategies that might be used, particularly in connection with a pilot program.

The Commission remains concerned that, in lifting the prohibition on agricultural trade options, it not also open the door to fraudulent dealing. Although additional risk management instruments may assist the agricultural sector in meeting the new challenges which it faces, opening up this long-restricted market to all types of options may unnecessarily expose participants to abuse. In order to balance these concerns, the Commission is proposing several limitations on the structure of option contracts and on permitted trading strategies or uses. First, the Commission is proposing a prohibition on the writing of covered call options by producers. Covered call options are short call positions written by an individual who has a long position in the underlying commodity. The option is covered in the sense that, if the option is exercised, the writer of the option has the commodity in his or her possession to deliver on the contract. While an individual writing a covered call has limited risk in the sense that he or she possesses a commodity which can be delivered against the option contract, the call does not provide downside price risk protection on the long commodity position except to the extent that a premium has been paid by the purchaser. Moreover, the short call caps any gains that the producer might earn on the long commodity position. Although such a strategy may be appropriate in certain instances, it is susceptible to abuse to the extent that producers do not appreciate the extent to which downside price protection and upside pricing potential is surrendered for a premium payment and is not appropriate for inclusion in the pilot program. It is also the Commission's opinion that the writing of put options by agricultural producers is not an appropriate business-related use of options. The Commission, therefore, is proposing a prohibition on the writing of such options.

However, trade option customers would be permitted to enter into options that simultaneously combine long put and short call option positions only to the extent that the size of the delivery quantity associated with the short call option position does not exceed the size of the delivery quantity associated with the long put option position. Thus, for example, an agricultural trade option could give the producer the right to deliver 5,000 bushels of corn at harvest time at a price of $2.50 per bushel and the elevator the right to call for the delivery of 5,000 bushels at $3.00 per bushel. Under such an option, if at harvest time the price of corn was below $2.50, the producer would exercise the option to deliver the 5,000 bushels of corn at $2.50 per bushel. If, however, the price of corn was above $3.00 per bushel, the elevator would exercise its option to call for the delivery of 5,000 bushels of corn at $3.00 per bushel. If the price of corn was between $2.50 and $3.00, it would not be economically rational for either party to call for or to make delivery of corn. In this example, the producer has purchased a put option from the elevator for 5,000 bushels of corn with a strike price of $2.50 per bushel. The producer has also sold a call option to the elevator for 5,000 bushels of corn at a strike price of $3.00. This transaction would be permissible under the proposed restriction that the delivery amount of the short call option portion of the contract cannot exceed the delivery amount of the long put option. However, the elevator could not obtain the right to call for the delivery of more than 5,000 bushels of corn. Moreover, the Commission is proposing that under no circumstances would a producer be permitted to write a put option, even if such option was combined with a long call option.

In addition, the Commission is proposing to limit the termination and reestablishment of agricultural trade option positions. Some commenters expressed the view that agricultural trade options should not be used as a means to speculate in commodities. One manner in which speculation might be possible would be to move into and out of trade option positions based on updated predictions of expected price moves. Although some commenters argued that such strategies could enhance the price of the commodity being merchandised, the ultimate success of such a strategy would depend upon one's ability accurately to foresee

Commission's open meeting in Memphis, Tennessee, representing the National Grain and Feed Association stressed her organization's commitment to these efforts.

[36] In 1992, section 210 of the Futures Trading Practice Act of 1992 (FTPA) amended section 4p of the Act to mandate ethics training for persons required to be registered under the Act. On April 15, 1993, the Commission adopted regulation 3.34 to implement the requirements of FTPA section 210. 58 FR 19575. Commission regulation 3.34 requires natural persons registered under the Act to attend ethics training to ensure that they understand their responsibilities to the public under the Act.

[37] Those functions relating to ethics training delegated to NFA for all Commission registrants will also be proposed to be delegated to NFA for agricultural trade option merchants.

future price movements. Limiting the ability to enter and exit trade option contracts is consistent with the Commission's desire to include within the pilot program those trade options which are closest in nature to forward contracts, contracts for which offset is not permitted. Thus, the Commission is proposing that, once a trade option contract is purchased or sold, that position cannot be offset prior to expiration.

E. Risk Disclosure, Required Contract Terms and Required Account Information

1. Risk Disclosure Statements

The Commission in its advance notice noted that required risk disclosures are a customer protection generally used in the regulation of futures and option trading and requested comment on whether, and in what form, risk disclosure should be required if the prohibition on agricultural trade options were lifted. The majority of the commenters responding to these questions agreed that mandated written risk disclosure would be appropriate, but varied in their view of the degree of detail which should be required. Some commenters suggested that the mandated risk disclosure statement should disclose all financial risks, including a description of worst possible scenarios. Others were of the view that a more general statement of risk would be sufficient.

The Commission is of the view that a mandatory written risk disclosure statement for agricultural trade options is necessary and appropriate. Such a written statement is essential to ensuring that trade option customers receive knowledge of and understand the risks involved in entering into such transactions. Because of the current ban on agricultural trade options, customers initially will have had no experience using such instruments. Moreover, agricultural trade options may attract customers with little or no experience trading on designated futures or option markets. In light of this, the risk disclosure statement being proposed by the Commission addresses the full range of risks that were identified in the Division's study. This disclosure statement has two parts. The general disclosure is brief and is intended to cause a customer to ask additional questions of the agricultural trade option merchant or to seek additional information from other sources, as necessary. For example, the Commission is proposing that the disclosure statement include mandatory language regarding the requirement that trade options must be entered into in connection with the conduct of the business of the agricultural trade option merchant and its customers. This discussion would also provide producers in particular with guidance regarding prudent, business-related uses of trade options.

In addition, a transaction-specific portion of the disclosure is designed to provide specific information relating to the terms of a particular transaction. In this portion of the disclosure statement, the Commission is proposing to require that, where the full option premium or purchase price of the option is not collected up front or where through amendments to the option contract it is possible to lose more than the amount of the initial premium, the agricultural trade option merchant must disclose the worst possible financial outcome that could be suffered by the customer. In this regard, the provision of the mandatory risk disclosure statement will not relieve the agricultural trade option merchant of the responsibility to avoid material misstatements or omissions or any other form of fraudulent misconduct. This Commission and the courts have repeatedly stated that provision of a mandatory risk disclosure statement will not necessarily cure what is otherwise fraud. *See, e.g., Clayton Brokerage Co.* v. *Commodity Futures Trading Commission*, 794 F.2d 573, 580–581 (11th Cir. 1986). In particular, agricultural trade option merchants may need to make such additional disclosures as necessary in light of all the particular circumstances, including the nature of the instrument and the customer.

The Commission is proposing that the full disclosure statement must be delivered to the customer prior to the customer's first transaction with the particular agricultural trade option merchant, as is customary with respect to current practice in futures and option trading. In subsequent transactions, only the transaction-specific portion need be provided. The Commission is requesting comment on whether this requirement should allow its fulfillment through electronic media. Moreover, the agricultural trade option merchant must retain a written acknowledgment which has been signed and dated by the customer evidencing receipt of the disclosure statement by the customer.

2. Required Contract Terms

In addition to delivery of the required disclosure statement, the Commission is also proposing to require that the option contract itself (a) be written and (b) contain certain specified provisions. Generally, the terms of designated futures and option contracts are contained in the rules of an exchange, which under the Act are required to be approved by the Commission. In the case of trade options, like forward contracts, the particular terms are left to individual negotiation between the counterparties. However, in connection with its issuance of guidance relating to ''hedge-to-arrive'' contracts, CFTC Interpretative Letter No. 96–41, Comm. Fut. L. Rep. ¶ 26,091 (May 15, 1996), the Division observed that such contracts often contained few or insufficiently expressed terms and conditions. The lack of written terms and conditions in these contracts led to widespread disagreement among parties over the terms of the instruments, complicating the resolution of various issues. To reduce the chance for disputes over vaguely defined contract terms in connection with agricultural trade options, the Commission is proposing to require that the trade option contracts be written and include a number of specified terms. In particular, the Commission is proposing that such contracts must include terms specifying the procedure for exercise of the option contract, including the expiration date and latest time on that date for exercise; total quantity and grade of commodity to be delivered if the contract is exercised and any adjustments to price for deviations from stated quality or grade; listing of elements comprising the purchase price to be charged, including the premium, mark-ups on the premium, costs, fees, and other charges; the strike price(s) of the option contract; additional costs, if any, which may be incurred if the commodity option is exercised; and delivery location, if the contract is exercised.

An important means of safeguarding the public from abusive transactions is the requirement that transactions be confirmed in writing at the time of contract initiation. This provides the customer effective notice of the terms of the agreement, permitting the customer to object to transactions. Moreover, such a requirement likely would be beneficial to the merchant as well by providing an effective means of avoiding disputes over the terms initiating the transaction. The Commission, therefore, is proposing that agricultural trade option merchants provide trade confirmation and verification of information relating to specified contract terms within 24 hours of executing a contract. *See,* proposed § 32.13(a)(6).

3. Report of Account Information to Customers

The Commission is proposing that agricultural trade option merchants be required to furnish a monthly account statement to all customers with open option positions. This statement would include a complete listing of all individual agricultural trade option transactions entered into by the customer, all outstanding requests to enter into an agricultural trade option at the time of issuance of the statement, a current commodity price related to all open option positions or open orders held by the customer and the amounts of any funds owed by or to the customer related to the purchase or sale of option contracts or to the delivery of physical commodity related to the exercise of an option.

Agricultural trade option merchants will also be required to indicate clearly expiration dates of options and to highlight those options which will expire within the next month. This may be done by highlighting the expiration information on such account statements, by using boldface type for such information, by separating these contracts from other contracts on the account statement, or by listing contracts chronologically by expiration date or by some similar method. The Commission is proposing this requirement as a means to assist agricultural trade option customers in managing their option accounts. Even though agricultural trade options cannot be offset, it is important for customers to know the current status of their option contracts with respect to which options may be approaching expiration and whether options are in or out of the money.

In addition, the Commission is proposing to require that agricultural trade option merchants supply current commodity price quotes or other information relevant to an option customer's positions within 24 hours of a request. In the case of options that may be exercised at any time, it is important that customers obtain timely commodity price quotes in order to be able to make decisions regarding exercise of the options. Although the Commission anticipates that price information typically would be available immediately, other information might require the agricultural trade option merchant to search its records to obtain the requested information. The Commission believes that a 24-hour period should be sufficient to enable agricultural trade option merchants to retrieve the information and to respond to the customer.

F. Recordkeeping and Reporting Requirements

1. Required Books and Recordkeeping

The maintenance of full, complete, and systematic books and records by agricultural trade option merchants is crucial to the Commission's ability to respond to complaints of customer abuse arising from such transactions and is necessary to the agricultural trade option merchant's establishment of appropriate internal controls of their financial operations. Although most merchants will already have recordkeeping systems in place, the proposed pilot program for agricultural trade options involves a number of regulatory protections, such as furnishing customers with disclosure statements, which may require records which have not been customary for first handlers as part of their cash market businesses. Accordingly, the Commission is proposing to require that records relating to agricultural trade options including covering transactions must be kept and maintained for a period of five years and must be readily accessible during the first two years of that five-year period. *See,* 17 CFR 1.31.

Specifically, the Commission is proposing that trade option merchants be required to maintain full, complete, and systematic records of all agricultural trade option transactions. Such books and records should include all orders (filled, unfilled, or cancelled), books of record, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements required by proposed § 32.13(a)(7), solicitation or advertising material or other such communications with agricultural trade option customers or potential customers. All such books and records must be kept for a period of five years from the date of their creation and must be readily accessible during the first two years of the five-year period. All such books and records must be open to inspection by any representative of the Commission or the U.S. Department of Justice or the NFA in connection with functions delegated to it.

2. Routine Reports

In addition to the maintenance of books and records, the Commission is proposing to require quarterly reporting by all agricultural trade option merchants of information relating to their agricultural trade option transactions. These reports are intended to enable the Commission to evaluate the success of the pilot program on an ongoing basis. The information required to be reported will enable the Commission to determine the overall size of the market, the types of contracts being offered, the costs to customers, the amount of commodity being merchandized through options, and the number of customers using trade options. Routine quarterly reporting from all agricultural trade option merchants also will permit the Commission to construct a more complete picture of the market and will better allow the Commission to evaluate the impact of activity in the trade option market on that in the cash and exchange-traded markets.

Specifically, the Commission is proposing that reports shall be filed quarterly by any registered agricultural trade option merchant having an open trade option contract during the reporting period. The Commission is proposing to delegate to the NFA responsibility for receiving and maintaining these reports. NFA will make the information in this data base available to the Commission upon request. Initially, the Commission anticipates that such reports may be filed manually, including by facsimile or electronically, by dial-up transmission or via the Internet. Commenters are requested specifically to address issues relating to the means of filing reports and their capability to file electronically.

3. Special Calls for Information

During the course of the pilot program, in addition to routine quarterly reports, the Commission anticipates that it will direct the Division to conduct two special calls for information from agricultural trade option merchants during the course of the pilot program. The Commission will use the information it gathers through these special calls to conduct a study to evaluate the success of the pilot program.

Under a special call, every agricultural trade option merchant will be required to provide the Commission with the information specified in the special call. Such information may include: (a) Positions and transactions in agricultural trade options; (b) positions and transactions in commodity options and/or futures on all contract markets entered to cover agricultural trade options; (c) positions and transactions in cash commodities, their products, and by-products and; (d) customer identification information. Such information may include the name, address, and position of each

customer of the agricultural trade option merchant. All agricultural trade option merchants should maintain a current listing of such customer identification information.[38]

G. Internal Controls

The Commission noted in the advance notice that generally requirements regarding internal controls are a condition of registration. These include the requirement that FCMs provide audited financial statements, have in place a system of internal controls, and supervise the conduct of all employees. The Commission also noted that many country elevators and others at the first-handler level of the marketing chain do not now have in place adequate internal controls to engage in a variety of off-exchange transactions nor are they subject to a regulatory scheme requiring such controls.[39]

The Commission posed a series of questions on this issue in the advance notice, asking specifically for comment on the minimum types of internal controls that an agricultural trade option merchant should have in place; the regulatory oversight mechanisms that would be necessary to assure implementation of such minimum levels of internal controls; and the most cost-effective means by which such internal controls could be implemented. Of the 13 commenters responding to these questions, the majority were of the opinion that, although prudent business practice necessitates use of internal controls, the Commission should not require them. Several commenters, however, supported Commission-mandated audits of agricultural trade option merchants. In this regard, one commenter, noting that state grain warehousing agencies may already require annual audits and that state and Federal warehouse regulators already visit every licensed grain dealer, suggested that the Commission consider developing audit procedures which existing agencies can implement on the Commission's behalf.

The Commission is proposing to mandate an internal controls requirement for agricultural trade option merchants similar to that applicable to FCMs. In mandating such a requirement, the Commission believes that agricultural trade option merchants will be made aware of the importance of maintaining internal controls without being subjected to regulations that are unduly burdensome. As proposed, agricultural trade option merchants will be required to be audited on a yearly basis in accordance with generally-accepted accounting principles and to inform the Commission within three business days of the discovery by a certified public accountant of any material inadequacies in the agricultural trade option merchant's internal controls. As proposed, the agricultural trade option merchant must file a written report with the Commission stating what steps have been taken or are being taken to correct the material inadequacy within five days of such a notification.

In addition, the Commission is proposing to require that the agricultural trade option merchant must maintain and preserve a written record of internal trading and supervisory controls. Such internal controls must include any systems and policies that the agricultural trade option merchant has for supervising, monitoring, reporting and reviewing trading activities in agricultural trade options, any policies it has for covering, hedging or managing risk created by trading activities, including a description of the reviews it conducts to monitor positions, and policies that relate to restrictions or limitations on trading activities.

H. Regulatory Oversight

Several commenters expressed the concern that the Commission would not be able to provide adequate regulatory oversight of trading in agricultural trade options. Specifically, commenters questioned whether the Commission's existing staff and financial resources would be sufficient to monitor trading activity effectively in such a decentralized market.

The Commission is proposing this three-year pilot program based, in part, on its belief that it will be joined in its efforts to promote a safe and responsible trading environment by many sectors of agriculture. During the Commission's public hearings, several producer associations and other agriculture industry associations pledged their assistance in promoting sound practices by both merchants and producers. The Commission has also determined to seek the assistance of NFA in undertaking responsibility for performing certain specified functions. These delegations should do much to aid the Commission in maintaining adequate levels of oversight, given its resource limitations. In addition, the various states and USDA conduct oversight of warehouses, and the Commission will cooperate with them in those efforts. The Commission will also devote an appropriate level of its resources to the conduct of sales practice audits and other forms of oversight.

In this regard, the Commission is seeking comment on the number of entities which may offer such contracts under the rules as proposed. Should this potentially create too large a burden on Commission resources, the Commission will explore additional delegations of oversight or other means of conserving its resources while providing adequate oversight coverage. The Commission is optimistic that, with these cooperative efforts, it will be able to foster the growth of responsible trading of agricultural trade options using its available resources and without harming existing programs or compromising its ability to achieve its overall regulatory mission. It would not proceed with the pilot program if it thought otherwise.

I. Exemption for Sophisticated Entities

Some commenters expressed the opinion that the prohibition on agricultural trade options should be lifted with few or no constraints. These commenters maintained that participants in these markets possess sufficient sophistication with respect to contracting so as not to require regulatory oversight. The agricultural sector, however, includes a diverse group of entities with different levels of sophistication, ranging from the small family farmer to highly sophisticated multinational corporations. Although any one of these individuals or entities might be entirely capable of understanding and managing the risks associated with entering into a trade option contract, only the larger and better financed entities will consistently have available the legal and financial resources needed to protect their interests in an unregulated environment. The Commission is of the view that an exemption from regulatory conditions similar to that available for trade options on other commodities may be appropriate for those entities having a very high net worth.[40] However, a greater level of regulatory protection is appropriate for transactions involving less well-financed entities. Congress adopted a similar approach for Commission determinations of the

[38] Of course, such information is a routine business record and is required to be maintained as such by the agricultural trade option merchant. This information would be available to the Commission by special call for information or through inspection on an as needed basis. The separate listing would be encouraged as a means of responding to a request for a total enumeration of this information relating to an in-depth analysis in connection with evaluating the pilot program.

[39] 62 FR 31381.

[40] Such an exemption would be from the requirements relating to agricultural trade options being proposed. Any such transaction, however, would not be exempt from the prohibition of fraud contained in 17 CFR 32.9.

availability of exemptive relief under section 4(c) of the Act.

In setting the eligibility requirements for exemption from these rules, the Commission considered the current levels of net worth or total worth required of eligible participants under parts 35 and 36 of its rules. Under parts 35 and 36, corporations or partnerships having total assets exceeding $10 million or net worth of $1 million in cases where the transaction was entered into in connection with the conduct of its business or to manage the risk of an asset or liability, are considered eligible for the exemption. Some have observed, however, that these qualifying amounts when applied to entities in agriculture are too low given the relatively large investment in land and equipment needed to operate a farm. The concern is that a relatively large number of individuals engaged in agriculture might meet these financial criteria based not so much on their investment sophistication and ability to gather and manage a sizable asset portfolio, but rather simply reflecting the need to acquire a threshold level of land and machinery to operate successfully a farm or agricultural enterprise. Accordingly, the Commission is proposing that, to qualify for this exemption, individuals or entities should have a net worth of at least $10 million.

In order to qualify for this proposed exemption, both counterparties must meet the eligibility requirements. If any one counterparty is not eligible for this exemptive relief, the counterparties must comply with all of the regulatory requirements.

J. Relief for Exchange-Traded Instruments

Representatives of several futures and option exchanges have expressed the concern that lifting the ban on agricultural trade options would put the exchanges at a competitive disadvantage. They note that exchanges are currently prohibited from offering options on physicals for these same commodities.[41] They further maintain that the current prohibition on exchange trading of options on physicals for the enumerated commodities restricts their ability to offer more flexible exchange-traded instruments that would be competitive with agricultural trade options.[42]

The Commission agrees that the restriction on options on physicals in these commodities can be removed. At the time of the pilot program for exchange-traded options on agricultural commodities, based on comments received from industry participants and the U.S. Department of Justice and taking into consideration the history of abuse in option markets, the Commission followed a cautious approach by not allowing options on physicals for agricultural commodities.[43] The Commission, however, did express its willingness to revisit the possibility of allowing exchange-traded options on physicals for agricultural commodities after gaining experience in the trading of options on agricultural futures. Given the success of exchange-traded options on futures, the lack of widespread abuse in these markets, the permissible flexibility of many option terms under current rules, and the exchanges' desire to experiment with offering new forms of more flexible, physical delivery option contracts, the Commission is proposing to amend § 33.4 to permit exchanges to trade options on physicals on the enumerated agricultural commodities.

IV. Other Matters

A. Paperwork Reduction Act (PRA)

When publishing proposed rules, the PRA of 1995 (Pub. L. 104–13 (May 13, 1996)) imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. In compliance with the Act, the Commission, through this rule proposal, solicits comments to:

1. Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including the validity of the methodology and assumptions used.

2. Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information including the validity of the methodology and assumptions used.

3. Enhance the quality, utility, and clarity of the information to be collected.

4. Minimize the burden of the collection of the 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.

The Commission has submitted the proposed rule and its associated information collection requirements to the Office of Management and Budget. The burden associated with this new collection, including these proposed rules, is as follows:

Average burden hours per response—5.359
Number of respondents—5105
Frequency of response—Daily

Persons wishing to comment on the information which would be required by this proposed/amended rule should contact the Desk Officer, CFTC, Office of Management and Budget, Room 10202, NEOB, Washington, DC 20503, (202) 395–7340. Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, (202) 418–5160.

B. Regulatory Flexibility Act (RFA)

The RFA, 5 U.S.C. 601 *et seq.*, requires that agencies, in proposing rules, consider the impact of those rules on small businesses. The Commission has not previously determined whether all or some agricultural trade option merchants should be considered ''small entities'' for purposes of the RFA and, if so, to analyze the economic impact on such entities. However, the Commission is proposing that one of the conditions for registration as an agricultural trade option merchant is maintenance of a minimum level of net worth. The Commission previously found that other entities which were required to maintain minimum levels of net capital were not small entities for purposes of the RFA. *See*, 47 FR 18618, 18619 (April 30, 1982).[44] The Commission has also found, however, that one category of Commission registrant—introducing brokers (IBs)—which is required to maintain a minimum level of net capital may include small entities for purposes of the RFA.[45] Nevertheless, in addition

[41] Commission rule 33.4 provides in part that ''The Commission may designate any board of trade located in the United States as a contract market for the trading of * * * options on physicals in any commodity regulated under the Act other than those commodities which are specifically enumerated in section 1a(3) of the Act * * *''.

[42] Flex options on futures on the enumerated agriculture commodities have recently been proposed by exchanges and approved by the Commission under current rules. These options are flexible in terms of strike prices, last trading days, the underlying futures months, and the style of exercise—American or European. Additional types of flexible terms involving physical delivery would be permitted if the Commission's rule is amended.

[43] *See*, 49 FR 2752 (January 23, 1984).

[44] Specifically, in April 1982 the Commission found that FCMs were required to have a minimum net capital of $50,000.

[45] IBs are required to maintain minimum levels of net capital in the amount of $30,000. *See*, 61 FR 19177 (May 1, 1996).

to the $50,000 minimum net worth required for registration as an agricultural trade option merchant, such registrants must be in business in the underlying cash commodity so that they are able to take physical delivery on those option contracts. This will require that they have additional resources invested in order to qualify as an agricultural trade option merchant, in contrast to an IB whose additional investment beyond the minimum net capital may be relatively small. For this reason, the Commission believes that agricultural trade option merchants are more appropriately treated as not being small entities under the RFA. The Chairperson, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the action taken herein will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the proposed rules will remove a complete ban on the offer or sale of trade options on the agricultural commodities enumerated under the Act. The proposed rules permitting such transactions subject to the specified conditions therefore remove a burden for all entities, regardless of size.

List of Subjects

17 CFR Part 3

Administrative practice and procedure, Brokers, Commodity futures.

17 CFR Part 32

Commodity futures, Commodity options, Prohibited transactions and trade options.

17 CFR Part 33

Commodity futures, Consumer protection, Fraud.

In consideration of the foregoing, and pursuant to the authority contained in the Act, and in particular sections 2(a)(1)(A), 4c, and 8a, 7 U.S.C. 2, 6c, and 12a, as amended, the Commission hereby proposes to amend parts 3, 32, and 33 of chapter I of title 17 of the Code of Federal Regulations as follows:

PART 3—REGISTRATION

1. The authority citation for part 3 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 4, 4a, 6, 6b, 6c, 6e, 6f, 6g, 6h, 6i, 6k, 6m, 6n, 60, 6p, 8, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21, 23; 5 U.S.C. 552, 552b.

2. New § 3.13 is proposed to be added to read as follows:

§ 3.13 Registration of agricultural trade option merchants and their associated persons.

(a) *Registration required.* It shall be unlawful for any person in the business of offering or selling the instruments listed in § 32.2 of this chapter to offer or to enter into transactions in such instruments except if registered as an agricultural trade option merchant or a person associated with such a registered agricultural trade option merchant under this section.

(b) *Duration of registration.* A person registered in accordance with the provisions of this section shall continue to be registered until the revocation or withdrawal of registration.

(c) *Conditions for registration.* Applicants for registration as an agricultural trade option merchant and its associated persons must meet the following conditions:

(1) The agricultural trade option merchant must have and maintain at all times net worth of at least $50,000 computed in accordance with generally accepted accounting principles.

(2) The agricultural trade option merchant must certify:

(i) That none of the natural persons who are principals of the agricultural trade option merchant, directly or indirectly through the beneficial ownership of ten percent or more of a principal which is a non-natural person, nor any of the natural persons who are associated persons is disqualified for the reasons listed in section 8a(2) and (3) of the Act; and

(ii) That such natural persons successfully complete the series 3 examination or another proficiency test administered by the National Futures Association.

(3) Provide access to any representative of the Commission, the U.S. Department of Justice, or the National Futures Association for the purpose of inspecting books and records.

(d) *Application for registration.* Application for registration as an agricultural trade option merchant and its associated persons must be made on the appropriate form specified by the NFA, in accordance with the instructions thereto. Such application:

(1) Must include the agricultural trade option merchant's most recent annual financial statements certified by an independent certified public accountant in accordance with generally accepted auditing standards prepared within the prior 12 months.

(2) Must include the fingerprints, on a fingerprint card obtained from the National Futures Association, of all natural persons who are principals, or the beneficial owners of ten percent or more of a principal which is a non-natural person, of the applicant, and of all natural persons who are to be associated persons of the agricultural trade option merchant and such other identifying background information as specified.

(3) Must include separate certification from each natural person that the person is not disqualified for any of the reasons listed in section 8a(2) and 8a(3) of the Act.

(4) Must include such other information as may be specified on the application form.

(5) This application must be supplemented to include changes in associated persons, a principal, or other required information or conditions.

(e) *Temporary licensing.* Notwithstanding any other provision of this part, the National Futures Association may grant a temporary license to any applicant for registration under this section upon filing of a complete application meeting all of the requirements of paragraph (d) of this section, subject to termination provisions of section 3.60 of this part, *Provided however,* that such temporary license shall terminate:

(1) Immediately upon failure by an applicant to respond to a written request by the Commission or the National Futures Association for clarification or supplementation of any information set forth in the application or for the resubmission of fingerprints.

(2) Immediately upon failure to comply with an order to pay a civil monetary penalty within the time permitted under sections 6(e), 6b, or 6c(d) of the Act.

(3) Immediately upon failure to pay the full amount of a reparation order within the time permitted under section 14(f) of the Act.

(4) Five days after service upon the applicant of a notice by the Commission or the National Futures Association that the applicant may be found subject to a statutory disqualification from registration.

3. Section 3.34 is proposed to be amended by revising paragraphs (a), (d)(1), and (e)(1) to read as follows:

§ 3.34 Mandatory ethics training for registrants.

(a) Any individual registered as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator, leverage trading merchant, associated person, floor broker, floor trader, or agricultural trade option merchant under the Act must attend ethics training to ensure that he or she

understands his or her responsibilities to the public under the Act, including responsibilities to observe just and equitable principles of trade, rules, or regulations of the Commission, rules of any appropriate contract market, registered futures association, or other self-regulatory organization, or any other applicable federal or state law, rule or regulation.

* * * * *

(d) * * *

(1) Any individual granted registration under the Act as a futures commission merchant, introducing broker, commodity trading advisory, commodity pool operator, leverage transaction merchant, associated person, floor broker, floor trader or agricultural trade option merchant after April 26, 1993, who has not been duly registered under the Act at any time during the two year period immediately preceding the date such individual's application for registration was received by the National Futures Association, must attend training referred to in this section within six months after being granted registration, and thereafter every three years.

* * * * *

(e) Evidence of attendance at ethics training, including evidence of completion of videotape or electronic training, must be maintained in accordance with § 1.31 of this chapter by:

(1) An individual registered as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator, leverage transaction merchant, or agricultural trade option merchant;

* * * * *

PART 32—REGULATION OF COMMODITY OPTION TRANSACTIONS

4. The authority citation for part 32 continues to read as follows:

Authority: 7 U.S.C. 2, 6c and 12a.

5. Section 32.2 is proposed to be revised to read as follows:

§ 32.2 Prohibited transactions.

Notwithstanding the provisions of § 32.11, no person may offer to enter into, confirm the execution of, or maintain a position in, any transaction in interstate commerce involving wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice if the transaction is or is held out to be of the character of, or is commonly known to the trade as an ''option,'' ''privilege,'' ''indemnity,'' ''bid,'' ''offer,'' ''put,'' ''call,'' ''advance guarantee,'' or ''decline guarantee,'' except as provided under § 32.13 of this part.

6. New § 32.13 is proposed to be added to part 32 to read as follows:

§ 32.13 Exemption from prohibition of commodity option transactions for trade options on certain agricultural commodities.

(a) The provisions of § 32.11 shall not apply to the solicitation or acceptance of orders for, or the acceptance of money, securities or property in connection with the purchase or sale of any commodity option on a physical commodity listed in § 32.2 by a person who is a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or byproducts thereof, if all of the following conditions are met at the time of the solicitation or acceptance:

(1) That person is registered with the Commission under § 3.13 of this chapter as an agricultural trade option merchant.

(2) The option offered by the agricultural trade option merchant is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or byproducts thereof, and such producer, processor, or commercial user of, or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.

(3) The option can only be settled through physical delivery of the underlying commodity.

(4) To the extent that payment by the customer of the purchase price is made to the agricultural trade option merchant prior to option expiration or exercise, that amount shall be treated as belonging to the customer until option expiration or exercise as provided under § 32.6, *provided however,* that notwithstanding the last sentence of § 32.6(a), the full amount of such payment shall be treated as belonging to the option customer.

(5) Producers may not:

(i) Grant or sell a put option; or

(ii) Grant or sell a call option, except to the extent that such a call option is purchased or combined with a purchased or long put option position, and only to the extent that the customer's call option position does not exceed the customer's put option position in the amount of delivery quantity. *Provided, however,* that the options must be entered into simultaneously and expire simultaneously or at any time that one or the other option is exercised.

(6) All option contracts, including all terms and conditions, offered or sold pursuant to this section shall be in writing and shall contain terms relating to the following:

(i) The procedure for exercise of the option contract, including the expiration date and latest time on that date for exercise;

(ii) The strike price(s) of the option contract;

(iii) The total quantity of commodity underlying the option contract;

(iv) The quality or grade of commodity to be delivered if the contract is exercised and any adjustments to price for deviations from stated quality or grade;

(v) The delivery location if the contract is exercised;

(vi) The separate elements comprising the purchase price to be charged, including the premium, markups on the premium, costs, fees and other charges; and

(vii) The additional costs, if any, in addition to the purchase price which may be incurred by an option customer if the commodity option is exercised, including, but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise) and all similar fees and charges which may be incurred.

(7) Prior to the entry by a customer into the first option transaction with an agricultural trade option merchant, the agricultural trade option merchant shall furnish a summary disclosure statement to the option customer. The summary disclosure statement shall include:

(i) The following statements in boldface type on the first page(s) of the disclosure statement:

This brief statement does not disclose all of the risks and other significant aspects of trading in commodity trade options. You are encouraged to seek out as much information as possible from sources other than the person selling you this option about the use and risks of using option contracts before entering into this contract. The issuer of your option should be willing and able to answer clearly any of your questions. If this is not the case, contact someone else to find answers to your questions before entering into a contract. Sources of information include the Commodity Futures Trading Commission (a U.S. Government agency), the U.S. Department of Agriculture, the National Futures Association (a self-regulatory

association in the commodity futures industry), your state extension service, and various agricultural associations.

APPROPRIATENESS OF OPTION CONTRACTS

Option contracts may subject the user to a high degree of price risk including total loss of any funds you pay to the issuer of your option. You should carefully consider whether trading in such instruments is appropriate for you in light of your experience, objectives, financial resources and other relevant circumstances. The issuer of your option contract should be willing and able to explain the financial outcome of your option contract under all market conditions.

COSTS AND FEES ASSOCIATED WITH AN OPTION CONTRACT

All costs and obligations associated with your option contract including the premium, commissions, fees, costs associated with delivery if the option is exercised and any other charges which may be incurred should be specified in the terms of your option contract and are explained in this disclosure statement. Before entering into an option contract, you should obtain a clear explanation of all of these costs and fees and understand them.

BUSINESS USE OF TRADE OPTIONS

In order to comply with the law, you must be buying this option for business-related purposes. As such, the terms and structure of the contracts should relate to your activity or commitments in the underlying cash market. If a trade option is exercised, delivery of the commodity must occur. Delivery dates, grades, quantities, and delivery locations, which are specified in the contract, should relate to your ability to make or take delivery of the commodity. Any amendments allowed to the option contract must reflect changes to your activity or commitments in the underlying cash market or to reflect the carrying of inventory. Producers are not permitted to sell call options unless the producer is also entering into a put option contract at the same time with the same expiration date. In those situations, the contracts cannot give the person buying the call option the right to call for the delivery of an amount of commodity greater than the producer would have the right to deliver if he or she exercises the delivery option. Producers are also not permitted to sell put options, whether alone or in combination with a call option.

RISK OF FRAUD

You should be aware that trade options are offered in a relatively unregulated and decentralized environment, which may allow for a higher incidence of fraud than in a more regulated and restricted market. You should be aware that you may be able to obtain a similar contract or execute a similar strategy using an instrument offered on a more highly regulated futures exchange. Moreover, exchange products will likely be more transparent and the current prices on which are likely to be reported on a more regular basis. In addition, exchange options are highly liquid and may be offset at any time. In contrast, trade options legally may only be satisfied if exercised through physical delivery.

COUNTERPARTY PERFORMANCE RISK

If you are purchasing an option contract (*i.e., acquiring the right* to sell or purchase the commodity), be aware that you face the risk that the other party to the contract may not perform on its obligation to purchase or sell the commodity. If this occurs, you may lose any price protection the option contract would have offered you. You should take this risk into account in selecting an agricultural trade option merchant.

DISPUTE RESOLUTION

If a dispute should arise under the terms of this trade option contract, you may be able to use the reparations program run by the Commission in addition to any other dispute resolution forums provided to you under law or under the terms of your customer agreement. For more information on the Commission's Reparations Program contact: Office of Proceedings, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581, (202) 418–5250.

ACKNOWLEDGEMENT OF RECEIPT

The Commodity Futures Trading Commission requires that all customers receive and acknowledge receipt of a copy of this disclosure statement. The Commodity Futures Trading Commission does not intend this statement as a recommendation or endorsement of agricultural trade options. These commodity options have not been approved or disapproved by the Commodity Futures Trading Commission, nor has the Commission passed upon the accuracy or adequacy of this disclosure statement. Any representation to the contrary is a violation of the Commodity Exchange Act and Federal regulations;

(ii) The following additional information must be provided prior to entry by a customer into every option transaction with an agricultural trade option merchant:

(A) The procedure for exercise of the option contract, including the expiration date and latest time on that date for exercise;

(B) A description of the elements comprising the purchase price to be charged, including the premium, mark-ups on the premium, costs, fees and other charges, and the services to be provided for the separate elements comprising the purchase price;

(C) A description of any and all costs in addition to the purchase price which may be incurred by an option customer if the commodity option is exercised, including, but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise) and all similar fees and charges which may be incurred;

(D) Where the full option premium or purchase price of the option is not collected up front or where through amendments to the option contract it is possible to lose more than the amount of the initial purchase price, a description of the worst possible financial outcome that could be suffered by the customer; and

(E) The following acknowledgment section:

I hereby acknowledge that I have received and understood this risk disclosure statement.

Date _____

Signature of Customer _____

(b) *Report of account information.* Registered agricultural trade option merchants must provide in writing to customers with open positions the following information:

(1) Within 24 hours of execution of an agricultural trade option confirmation of the transaction, including a copy of the written contract and all information required in paragraph (a)(6) of this section;

(2) Within 24 hours of a request by the customer, current commodity price quotes or other information relevant to the customer's position and account; and

(3) Monthly, a current account statement including a complete listing of all individual agricultural trade option transactions which clearly states the expiration date of each option and clearly distinguishes and draws attention to those options which will expire within the next month, all orders to enter into such transactions not yet filled, a current commodity price related to all open option positions or open orders, and the amount of any funds owed by, or to, the customer.

(c) *Recordkeeping.* Registered agricultural trade option merchants shall keep full, complete and systematic books and records together with all pertinent data and memoranda of or relating to such transactions, including customer solicitation and covering transactions, maintain such books and records for the period specified in § 1.31 of this chapter, and make such reports to the Commission as provided for in paragraphs (c) and (d) of this section and as the Commission may otherwise require by rule, regulation, or order. Such books and records shall be open at all times to inspection by any representative of the Commission, the Department of Justice, or the National Futures Association.

(d) *Reports.* Registered agricultural trade option merchants must file reports quarterly with the National Futures Association, in the form and manner specified by the National Futures Association and approved by the Commission, which shall contain the following information:

(1) By commodity and put, call or combined option:

(i) Total number of new contracts entered into during the reporting period;

(ii) Total quantity of commodity underlying new contracts entered into during the reporting period;

(iii) Total number of contracts outstanding at the end of the reporting period;

(iv) Total quantity of underlying commodity outstanding under option contracts at the end of the reporting period;

(v) Total premiums collected on options during the reporting period;

(vi) The value of all fees, commissions, or other charges other than option premiums, collected on trade options during the reporting period;

(vii) Total number of options exercised during the reporting period;

(viii) Total quantity of commodity underlying the exercise of options during the reporting period.

(2) Total number of customers by commodity with open option contracts at the end of the reporting period.

(e) *Special calls.* Upon special call by the Commission for information relating to agricultural trade options offered or sold on the dates specified in the call, each agricultural trade option merchant shall furnish to the Commission within the time specified the following information as specified in the call:

(1) All positions and transactions in agricultural trade options including information on the identity of agricultural trade option customers.

(2) All positions and transactions for future delivery or options on contracts for future delivery or on physicals on all contract markets.

(3) All positions and transactions in cash commodities, their products, and by-products.

(f) *Internal controls.* (1) Each agricultural trade option merchant registered with the Commission shall prepare, maintain and preserve information relating to its written policies, procedures, or systems concerning the agricultural trade option merchant's internal controls with respect to market risk, credit risk, and other risks created by the agricultural trade option merchant's activities, including systems and policies for supervising, monitoring, reporting and reviewing trading activities in agricultural trade options; policies for hedging or managing risk created by trading activities in agricultural trade options, including a description of the types of reviews conducted to monitor positions; and policies relating to restrictions or limitations on trading activities.

(2) The financial statements of the agricultural trade option merchant must on an annual basis be audited by a certified public accountant in accordance with generally accepted auditing standards.

(3) The agricultural trade option merchant must file with the Commission a copy of its certified financial statements within 90 days after the close of the agricultural trade option merchant's fiscal year.

(4) The agricultural trade option merchant must perform a reconciliation of its books at least monthly.

(5) The agricultural trade option merchant:

(i) Must report immediately if its net worth falls below the level prescribed in § 3.13 of this chapter, and must report within three days discovery of a material inadequacy in its financial statements by the independent public accountant or any state or federal agency performing an audit of its financial statements promptly to the Commission and National Futures Association by facsimile, telegraphic or other similar electronic notice; and

(ii) Within five business days after giving such notice, the agricultural trade option merchant must file a written report with the Commission stating what steps have been taken or are being taken to correct the material inadequacy.

(6) If the agricultural trade option merchant's net worth falls below the level prescribed in § 3.13(c)(1) of this chapter, it must immediately cease offering or entering into new option transactions and must notify customers having premiums which the agricultural trade option merchant is holding under paragraph (a)(4) of this section that such customers can obtain an immediate refund of that premium amount, thereby closing the option position.

(g) *Exemption.* (1) The provisions of this section shall not apply to a commodity option offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by products thereof, and that such producer processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such, and that both parties to the contract have a net worth of not less than 10 million dollars.

(2) *Provided, however,* that § 32.9 of this part continues to apply to such option transactions.

PART 33—REGULATION OF DOMESTIC EXCHANGE-TRADED COMMODITY OPTION TRANSACTIONS

7. The authority citation for part 33 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 4, 6, 6a, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 7, 7a, 7b, 8, 9, 11, 12a, 13a, 13a–1, 13b, 19, and 21.

8. The first sentence of the introductory text of § 33.4 is proposed to be revised to read as follows:

§ 33.4 Designation as a contract market for the trading of commodity options.

The Commission may designate any board of trade located in the United States as a contract market for the trading of options on contracts of sale for future delivery or for options on physicals in any commodity regulated under the Act, when the applicant complies with and carries out the requirements of the Act (as provided in § 33.2), these regulations, and the following conditions and requirements with respect to the commodity option for which the designation is sought:

* * * * *

Issued this 29th day of October 1997, in Washington, DC, by the Commodity Futures Trading Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 97–29037 Filed 11–3–97; 8:45 am]

BILLING CODE 6351–01–P

DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

30 CFR Parts 707 and 874

RIN 1029–AB94

Enhancing Abandoned Mine Land (AML) Reclamation

AGENCY: Office of Surface Mining Reclamation and Enforcement, Interior.

ACTION: Advanced notice of proposed rulemaking; notice of public meetings.

SUMMARY: The Office of Surface Mining Reclamation and Enforcement (OSM) is announcing times and locations of meetings open to the public to discuss its early draft of a proposal for adding to the reclamation of abandoned mine lands already being accomplished under Title IV of the Surface Mining Control and Reclamation Act of 1977 (SMCRA). OSM is seeking to involve the public in the development of a proposed rule