or repaired so that the performance of the requirements of this AD is affected, the owner/operator must request approval for an alternative method of compliance in accordance with paragraph (d) of this AD. The request should include an assessment of the effect of the modification, alteration, or repair on the unsafe condition addressed by this AD; and, if the unsafe condition has not been eliminated, the request should include specific proposed actions to address it.

Compliance: Required as indicated in the body of this AD, unless already accomplished.

To prevent failure of the elevator pushrod caused by corrosion damage, which could result in loss of control of the sailplane, accomplish the following:

(a) Within the next 3 calendar months after the effective date of this AD, drill a drainage hole in the elevator pushrod in accordance with Alexander Schleicher Technical Note No. 26, dated July 1, 1993.

(b) Within the next 3 calendar months after the effective date of this AD, inspect the elevator pushrod for corrosion damage in accordance with Alexander Schleicher Technical Note No. 26, dated July 1, 1993.

(1) If no corrosion damage is found or corrosion damage is found that does not exceed the amount specified in the service bulletin, prior to further flight after the inspection required by paragraph (b) of this AD, apply a corrosion agent as described in the service bulletin.

(2) If corrosion damage is found that exceeds the amount specified in the service bulletin, prior to further flight after the inspection required by paragraph (b) of this AD, replace the elevator pushrod in accordance with the maintenance manual, and apply a corrosion agent as described in the service bulletin.

(c) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the sailplane to a location where the requirements of this AD can be accomplished.

(d) An alternative method of compliance or adjustment of the compliance time that provides an equivalent level of safety may be approved by the Manager, Small Airplane Directorate, FAA, 1201 Walnut, suite 900, Kansas City, Missouri 64106. The request shall be forwarded through an appropriate FAA Maintenance Inspector, who may add comments and then send it to the Manager, Small Airplane Directorate.

Note 2: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Small Airplane Directorate.

(e) Questions or technical information related to Alexander Schleicher Technical Note No. 26, dated July 1, 1993, should be directed to Alexander Schleicher Segelflugzeugbau, 6416 Poppenhausen, Wasserkuppe, Federal Republic of Germany; telephone: 49.6658.890 or 49.6658.8920; facsimile: 49.6658.8923 or 49.6658.8940. This service information may be examined at the FAA, Central Region, Office of the Regional Counsel, Room 1558, 601 E. 12th Street, Kansas City.

Note 3: The subject of this AD is addressed in German AD No. 93–186, dated September 15, 1993.

Issued in Kansas City, Missouri, on December 11, 1997.

Michael Gallagher,

Manager, Small Airplane Directorate, Aircraft Certification Service.

[FR Doc. 97–33147 Filed 12–18–97; 8:45 am]

BILLING CODE 4910–13–U

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1 and 33

Proposed Rulemaking Permitting Future-Style Margining of Commodity Options

AGENCY: Commodity Futures Trading Commission.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Commodity Futures Trading Commission (''Commission'') is proposing the repeal of Commission Regulation 33.4(a)(2) which requires the full upfront payment of commodity option premiums. The effect of the repeal would be to permit the futures-style margining of commodity options traded on regulated futures exchanges. Futures-style margining offers several potential benefits over the current margining system, including the possibility for more efficient cash flows across markets. The Commission is publishing notice of the proposed rulemaking and requesting public comment.

DATES: Comments on the proposed rulemaking must be received by February 2, 1998.

ADDRESSES: Comments should be mailed to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581; transmitted by facsimile to (202) 418–5521; or transmitted electronically to (secretary@cftc.gov).

FOR FURTHER INFORMATION CONTACT: Thomas Smith, Attorney, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. Telephone (202) 418–5495.

SUPPLEMENTARY INFORMATION:

I. Introduction

The Commission is proposing the repeal of Commission Regulation 33.4(a)(2). Regulation 33.4(a)(2) requires that, when a commodity option is purchased, each clearing member must pay to the clearinghouse, each member must pay to the clearing member, and each option customer must pay to the futures commission merchant (''FCM'') the full option premium.[1] The Commission is considering repealing this regulation in order to permit the ''futures-style margining'' of commodity options.

A futures-style margining system for options would include two components: Original margin, set according to the underlying risk, and variation margin, reflecting the daily change in the value of the option premium. Consistent with the current treatment of futures positions, long and short option positions would be marked-to-market, and gains and losses would be paid and collected daily. Futures-style margining may benefit market participants by improving cash flow in futures and options markets generally, thereby increasing liquidity and efficiency.

II. Background

A. Option Pilot Program

In 1981 the Commission instituted a pilot program for exchange-traded options on non-agricultural futures contracts. 46 FR 54500 (November 3, 1981). Concurrently, the Commission adopted Part 33 of its regulations, including the full-payment-of-premium requirement of Regulation 33.4(a)(2).

In approving the pilot program, the Commission was cognizant of the history of fraudulent practices associated with the offer and sale of commodity options to the general public. In this connection, the Commission proceeded cautiously by, among other things, prohibiting the margining of option premiums. The Commission viewed the full payment of option premiums ''as essential to the protection of option purchasers who otherwise could reasonably expect that an initial payment of margin on an option contract constituted the full

[1] Regulation 33.4 in pertinent part states:

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

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

(a) Such board of trade * * *

(2) Provides that the clearing organization must receive from each of its clearing members, that each clearing member must receive from each other person for whom its clears commodity option transactions, and that each futures commission merchant must receive from each of its option customers, the full amount of each option premium at the time the option is purchased.

extent of their obligations on the option.'' 46 FR 54504.

The pilot program was made permanent effective August 1, 1986. 51 FR 17464 (May 13, 1986). Subsequently, the Commission approved trading of options involving agricultural futures contracts and options involving non-agricultural physicals on designated contract markets. 52 FR 777 (January 9, 1987). The proposed futures-style margining would apply to each of these exchange-traded commodity option categories.

B. Previous Commission Considerations of Futures-Style Margining of Commodity Options

In June 1982 the Coffee, Sugar & Cocoa Exchange, Inc. (''CSCE'') petitioned the Commission to repeal Regulation 33.4(a)(2). The Commission denied CSCE's petition, but resolved to reconsider margining of option premiums ''after the Commission and industry ha[d] gained some experience with the trading of options under the pilot program.'' [2]

The following year, the Commission solicited comments concerning ''[t]he advantages and disadvantages of permitting margining of option premiums paid by floor traders.'' 48 FR 10857, 10858 (March 15, 1983). After considering comments made in response to the **Federal Register** release, the Commission published a ''Notice of Proposed Rulemaking'' in which it proposed to allow contract markets to adopt rules permitting their members to make a deposit with respect to option premium. 49 FR 8937 (March 9, 1984). However, the intervening circumstances of the margin default in the gold futures option market on the Commodity Exchange, Inc. raised concerns about option margining which caused the Commission to defer further consideration of futures-style margining.[3]

In July 1988 the Chicago Board of Trade (''CBT'') and the Chicago Mercantile Exchange filed separate petitions with the Commission requesting repeal of Regulation 33.4(a)(2). The petitioners noted that, as a result of a study of the October 1987 market break, the President's Working Group on Financial Markets recommended that market participants and regulators study the potential for improving liquidity through the use of futures-style margining of options.[4] The petitions were published, and the public was invited to file written comments. 54 FR 11233 (March 17, 1989). The Commission received numerous comments supporting and opposing the proposal. Futures exchanges and futures clearing organizations favored it. Securities exchanges and securities clearing organizations opposed it. FCMs and introducing brokers (''IBs'') expressed varying views, with some in support and some in opposition. With a few exceptions, commenters from the agricultural industry generally opposed the proposal. The Commission took no further action on the petitions.

Since 1988, a great deal of experience has been gained with option trading in numerous products. Industry officials have continued to indicate to the Commission that implementation of futures-style margining might be beneficial. The Commission notes that futures-style margining has been in place at the London International Financial Futures and Options Exchange (''LIFFE'') for over ten years. Moreover, LIFFE contracts executed in Chicago pursuant to the CBT/LIFFE link have been subject to futures-style margining since May 1997 with no adverse consequences.

III. Comparison of Option Margining Systems

Under the current ''stock-style'' option margining system, the option buyer or ''long'' must pay the entire premium when the transaction is initiated. No further payments are required. The premium is credited to the account of the option seller or ''short,'' who must keep it posted as margin. The option seller also must put up risk margin to cover potential adverse market moves in his obligation. If the option increases in value, the short must deposit additional funds into the account. These funds, however, are not transferred to the long, who must exercise or offset the option in order to realize any increase in its value. By contrast, if the option value decreases, the short may withdraw any excess funds from its account.

Under the proposed ''futures-style'' margining system, both the long and short position holders would post risk-based original margin upon entering into their option positions. During the life of the option, the option value would be marked-to-market daily. Any increase in value would result in a credit to the long option holder's account and a corresponding debit against the short's account. Conversely, any decrease in value would result in a credit to the short's account and a corresponding debit to the long's account. Thus the cash flows in option contracts would be symmetric, as is the case for futures. The change in the margin system, however, would not alter the fundamental nature of each party's overall obligation. A long's potential for loss would remain limited to the full option premium and transaction costs. As is the case now, a short's potential for loss would not be so limited.

The difference between the current stock-style margining system and the proposed futures-style margining system are illustrated by the following examples. In each example assume that an at-the-money call option with an exercise price of 270 and sixty days to expiration is purchased for a premium of $5,000. Further assume that the minimum price tick in both the futures and the option is $500.

Example 1: Option Value Decreases

At expiration the futures price has fallen below the exercise price, and the option expires out-of-the-money. Under both stock-style and futures-style margining, the long's loss is limited to the $5,000 option premium. Only the timing of the payments differs.

[2] Letter dated July 2, 1982, from Jane K. Stuckey, Secretary, Commodity Futures Trading Commission, to Bennett J. Corn, President, CSCE.

[3] See Report on Volume Investors Corporation, Division of Trading and Markets, July 1986.

[4] Interim Report of the Working Group on Financial Markets, submitted to the President of the United States, May 1988.

Long	Short
Stock-Style Margining	
Day 1—Pays full premium of $5,000	Day 1—Posts full $5,000 premium received from long plus initial margin.
Day 2–59—Pays no additional funds	Day 2–59—May withdraw amount equal to decrease in value of option position since day of purchase. Total amount withdrawn may not exceed $5,000 premium.
Day 60—Option expires valueless. Nothing is returned	Day 60—Option expires valueless. Initial margin is returned.
Futures-Style Margining	
Day 1—Posts initial margin	Day 1—Posts initial margin.
Day 2–59—Pays aggregate variation of $5,000	Day 2–59—Collects aggregate settlement variation settlement of $5,000.
Day 60—Option expires valueless. Initial margin is returned	Day 60—Option expires valueless. Initial margin is returned.

Example 2: Option Value Increases

By expiration the futures price has risen above the exercise price to 285. The option is in the money by 15 points, and the premium is $7,500 ($500 X 15 points) per contract. Under both systems, the long's profits are the same. Again, only the timing of the payments differs.

Long	Short
Stock-Style Margining	
Day 1—Pays full premium of $5,000	Day 1—Posts full $5,000 premium received from long plus initial margin.
Day 2–59—Collects nothing over life of option	Day 2–59—Posts additional funds equal to the increase in value of option position over the life of the option.
Day 60—Liquidates position by selling the option for $7,500 for a gain of $2,500.	Day 60—Liquidates position by buying the option for $7,500 for a loss of $2,500. Total margin payments are returned.
Futures-Style Margining	
Day 1—Posts initial margin	Day 1—Posts initial margin.
Day 2–59—Over life of option collects pays aggregate settlement variation of $2,500..	Day 2–59—Over life of option pays aggregate settlement variation of $2,500.
Day 60—Liquidates position. Initial margin is returned.	Day 60—Liquidates position. Initial margin is returned.

The long also may choose to exercise the in-the-money call instead of liquidating the option position. Exercising a futures-style option is analogous to taking delivery on a futures position. In order to receive a cash commodity by taking delivery on a futures contract, the long must pay the settlement price of the futures contract prevailing at the time of delivery. Similarly, in order to obtain a futures position by exercising an option, the long must pay the settlement of the option prevailing at the time of exercise. In other words, the long must pay the full premium marked-to-market on the day of exercise. Under a futures-style margining system, this payment is offset by the variation payments received by the long during the life of the option. The difference between this procedure and the exercise of stock-style options are demonstrated in a final example.

Example 3: Exercise of In-The-Money Option.

As in Example 2, the futures price has risen to 285 by expiration. The long option holder decides to exercise the call.

Long	Short
Stock-Style Margining	
Exercises option	Option is exercised.
Receives long futures position at strike price of 270. Futures position is marked-to-market by the clearinghouse, and the long is credited $7,500 ((285–270)X $500.	Receives short futures position at strike price of 270. Futures position is marked-to-market market by the clearinghouse, and short is debited $7,500.
Futures-Style Margining	
Exercises option	Option is exercised.
Clearinghouse debits account for premium settlement price of $7,500	Clearinghouse credits short with $7,500 settlement of premium.
Receives long futures position at option strike price of 270. Futures position is marked-to-market by the clearinghouse, and the long is credited with $7,500 ((285–270)X $500.	Receives short futures position at option price of 270. Futures position is marked-to-market by the clearinghouse, and the short is debited $7,500.
Option position is closed through exercise, but risk margin is retained until the futures position is offset.	Option position is closed through exercise, but risk marign is retained until the futures position is offset.

IV. Potential Benefits and Costs of Futures-Style Margining

A. Potential Benefits

Futures-style margining of options could enhance financial integrity and market liquidity by providing for more efficient cash flows across markets. Currently, certain spread or risk neutral positions can give rise to substantial funds requirements due to asymmetrical cash flows. The problem arises, for example, where a short futures position is hedged with a long call option. If the price of the futures position increases, the value of the call also increases. However, the trader cannot apply the increased option value toward the

corresponding loss in the futures position.[5] Instead, the trader must put up funds to pay the futures variation requirement. Similar cash flow shortages can arise for traders holding arbitrage positions such as conversions, reverse conversions, and box spreads. Such problems may be particularly acute when there are major market moves.

With futures-style margining of options, these asymmetrical cash flows could be reduced. Each increase in an option position's value (long or short) would result in a related variation payment which would be accessible to the option trader. The trader could in turn use the option gains to contribute to margin payments on other positions with losses.

Futures-style margining also may reduce financing requirements for market participants and, thus, financing risk for FCMs and clearinghouses. Under the current margining system, financing risk is created because long option equity cannot be used to make variation margin payments on short option or futures positions. Moreover, financing based on option equity may not be readily available to market participants because banks may be reluctant to provide such financing. Futures-style margining of options, with its variation pay and collect feature, would reduce the need for market participants to borrow against their long option equity. Thus, FCMs no longer would be exposed to the resulting credit risk beyond their control.

Market liquidity may increase under a futures-style margining system for two reasons. First, the ability of traders to participate in option markets could be less dependent on their ability to obtain financing. Second, the incentive for early exercise of options could be reduced. Under the present system, an option purchaser can realize increases in the value of an option only by offsetting or exercising that option. Thus, some long option holders may choose to exercise their options early in order to obtain the option profits. This possibility of early exercise may act as a disincentive to writing options due to the uncertainty it creates. The daily pay and collect feature of the futures-style system could reduce the incentive for early exercise.

[5] Of course, the trader may obtain the excess funds by exercising or offsetting the option, but this would eliminate the original hedge strategy or require reestablishing the option with the potential for a less favorable price and additional transaction costs.

B. Potential Costs

Futures-style margining would increase leverage in the option markets. A long would be required to put up a smaller initial payment to purchase a given option than he or she would under the current system. This would introduce a risk of default that does not exist today. The Commission notes, however, that futures and short options currently may be margined. It is anomalous that long options, which entail less risk, are subject to a more stringent standard. Under futures-style margining, the total risk of a long option would still be fixed at the time of purchase. Moreover, FCMs would remain free to require an initial payment equal to the value of the option premium.

Over the years, the Commission has brought enforcement actions involving the fraudulent offer and sale of options on exchange-traded futures contracts to unsophisticated retail customers. Futures-style margining may provide unscrupulous individuals with an additional opportunity to mislead unsophisticated option customers. Such customers may not fully understand that they are liable for the full premium payment if the market moves against their option position. In addition, less well-capitalized customers could be persuaded to invest since the initial margin would be lower than currently required. Institution of futures-style margining would require efforts to educate market participants. Of course, consistent with Commission Regulation 1.55, full and accurate disclosure of potential liability also would be necessary at the time an option position was entered in order to ensure investor protection. The Commission welcomes comments on what measures might be appropriate to address these concerns.

Implementation of futures-style margining would alter option pricing which could adversely affect certain market participants. Option premiums potentially would be higher under a futures-style margining system because shorts likely would demand a higher price to compensate for the loss of interest income on the full premium and longs would be willing to pay a higher price because they would be gaining such interest income. Some market participants believe that this could affect various trading strategies by potentially diminishing the usefulness of certain option writing strategies.

Implementation of futures-style margining might also create issues for participants in the securities markets. To the extent the latter retained the current system, customer confusion could result.[6] In addition, certain intermarket strategies such as ''buy-write'' might be less useful because option grantors would not receive the full option premium upfront.

Finally, there could be costs to the industry in making a transition to futures-style margining. FCMs would have to adjust their risk management systems to address the increased leverage and altered cash flow features. Moreover, insofar as small retail firms currently only handle long option positions, such firms would have to install risk management systems if they planned to allow margining of premiums. In addition, if all exchanges were not ready or willing to switch from stock-style option margining to futures-style margining at the same time, FCMs might incur operational costs in order to maintain multiple option margining systems and to comply with different disclosure requirements for different exchanges. Furthermore, even if all exchanges introduced futures-style margining simultaneously, there would be a necessary transition period during which exchanges and market participants would be required to deal with both margining systems.

In addition, because of the impact of the futures-style margining on option pricing, only a newly-issued option series could be margined in the proposed manner. Any previously issued option series would require margining under the existing stock-style system. Thus, a change to futures-style margining would necessitate the maintenance of a two-tiered margining system for a period of time.

VI. Proposed Regulatory Changes

A. Repeal of Commission Regulation 33.4(a)(2)

The Commission believes that futures-style margining could provide substantial benefits to the marketplace and that steps are available to minimize the potential costs. Accordingly, the Commission is proposing to delete Regulation 33.4(a)(2) which requires full payment of the option premium at the time of purchase. This would not impose future-style margining on the industry but would merely make it available. Any exchange or clearinghouse that wished to implement it would be required to submit appropriate rule changes to the Commission pursuant to Section

[6] In May 1996 the Board of Governors of the Federal Reserve amended Regulation T to allow securities exchanges to adopt, pursuant to Securities and Exchange Commission approval, rules permitting the margining of options on securities. 61 FR 20386 (May 6, 1996). To date, no exchange has submitted such a rule.

5a(a)(12)(A) of the Act and Commission Regulation 1.41. The Commission would review any such proposal to ensure that adequate safeguards were in place. In particular, the Commission would reemphasize the need to use systems and procedures that took into account the unique risk characteristics of options. Moreover, as previously mentioned, exchange margin requirements are minimums. Any FCM would remain free to collect the full premium at the time of purchase just as it is currently free to collect more than the exchange minimum margin on futures positions.

B. Amendment of Commission Regulations 1.55 and 33.7

The Commission is proposing several amendments to the language of the generic futures and option risk disclosure statement set forth in Appendix A of Commission Regulation 1.55(c) and the more detailed domestic exchange-traded option disclosure statement set forth in Regulation 33.7. The proposed amendments would inform potential investors that option transactions may be subject to either a stock-style or futures-style margining system. The proposed amendments would not relieve an FCM or IB from any other disclosure obligation it may have under applicable law.

C. Technical Amendments

Implementation of futures-style margining will require changes to other Commission requirements to provide for appropriate accounting treatment of options. See, Financial and Segregation Interpretation No. 8, Comm. Fut. L. Rep., (CCH) ¶ 7118 (August 12, 1982), relating to the proper accounting, segregation and net capital treatment of options, and Commission Regulation 1.17 relating to minimum financial requirements for FCMs and IBs. The Commission requests comments on the appropriate technical amendments to these provisions. The Commission also request comments on any other technical changes to its regulatory requirements.

VII. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. 601 *et seq.*, requires that agencies, in proposing rules, consider the impact on small businesses. The rules discussed herein will affect FCMs and IBs. The Commission has already established certain definitions of ''small entities'' to be used by the Commission in evaluating the impact of its rules on such small entities in accordance with the RFA. FCMs have been determined not to be small entities under the RFA.

With respect to IBs, the Commission has stated that it is appropriate to evaluate within the context of a particular rule proposal whether some or all IBs should be considered to be small entities and, if so, to analyze that economic impact on such entities at that time. The proposed rule amendments would not require any IB to alter its current method of doing business as FCMS have the responsibility of administering customer funds. Further, these rule amendments, as proposed should, impose no additional burden or requirements on IBs and, thus, if adopted would not have a significant economic impact on a substantial number of IBs.

Therefore, the Chairperson, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b), that the action taken herein would not have a significant economic impact on a substantial number of small entities. The Commission nonetheless invites comments from any person or entity which believes that the proposal would have a significant impact on its operations.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 [7] imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the Paperwork Reduction Act.

While proposed Rule 1.55 has no burden, the group of rules (3038–0024), which Rule 1.55 is a part, has the following burden:

Average burden hours per response: 128.

Number of Respondents: 3,148.

Frequency of responses: 36.

While proposed Rule 33.7 has no burden, the group of rules (3038–0007), which Rule 33.7 is a part, has the following burden:

Average burden hours per response: 50.57.

Number of Respondents: 190,422.

Frequency of responses: 1,111.

Copies of the OMB approved information collection package associated with these rules may be obtained from Desk Officer, CFTC, Office of Management and Budget, Room 10202, NEOB, Washington DC 20503, (202) 395–7340.

[7] Pub. L. 104–13 (May 13, 1995).

List of Subjects

17 CFR Part 1

Commodity Futures, Domestic exchange-traded commodity option transactions.

17 CFR Part 33

Commodity Futures, Domestic exchange-traded commodity option transactions.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act and, in particular, sections 2(a)(1), 4b, 4c, and 8a thereof, 7 U.S.C. 2a, 6b, 6c, and 12a, the Commission hereby proposes to amend Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

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

Authority: 7 U.S.C. 1a, 2, 2a 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 9, 12, 12a, 12c, 13a, 13a–-, 16, 16a, 19, 21, 23, 24.

2. Section 1.55(c) is amended by revising section 3 of Appendix A to read as follows: [8]

Appendix A to CFTC Rule 1.55(c)—Generic Risk Disclosure Statement

Risk Disclosure Statement for Futures and Options

* * * * *

Options

3. Variable degree of risk.

Transactions in options carry a high degree of risk. Purchasers and sellers of options should familiarize themselves with the type of option (i.e. put or call) which they contemplate trading and the associated risks. You should calculate the extent to which the value of the options must increase for your position to become profitable, taking into account the premium and all transaction costs.

The purchaser of options may offset or exercise the options or allow the options to expire. The exercise of an option results either in a cash settlement or in the purchaser acquiring or delivering the underlying interest. If the option is on a future, the purchaser will acquire a futures position with associated liabilities for margin (see the section on Futures above). If the purchased options expire worthless, you will suffer a total loss of your investment which will consist of the option premium plus transaction costs. If you are contemplating purchasing deep-out-of-the-money options, you should be aware that the chance of such options becoming profitable ordinarily is remote.

[8] The Commission will republish the entire appendix in the final rule.

Selling (''writing'' or ''granting'') an option generally entails considerably greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of that amount. The seller will be liable for additional margin to maintain the position if the market moves unfavorably. The seller will also be exposed to the risk of the purchaser exercising the option, and the seller will be obligated to either settle the option in cash or to acquire or deliver the underlying interest. If the option is on a future, the seller will acquire a position in a future with associated liabilities for margin (see the section on Futures above). If the position is ''covered'' by the seller holding a corresponding position in the underlying interest or a future or another option, the risk may be reduced. If the option is not covered, the risk of loss can be unlimited.

Certain exchanges, domestic and foreign, permit deferred payment of the option premium, exposing the purchaser to liability for margin payments not exceeding the amount of the premium. The purchaser is still subject to the risk of losing the premium and transaction costs. When the option is exercised or expires, the purchaser is responsible for any unpaid premium outstanding at that time.

* * * * *

PART 33—REGULATION OF DOMESTIC EXCHANGE TRADED COMMODITY OPTION TRANSACTIONS

3. The authority citation for Part 33 continues to read as follows:

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

§ 33.4 [Amended]

4. Section 33.4 is amended by removing and reserving paragraphs (a)(2).

5. The disclosure statement in paragraph (b) of § 33.7 is amended by revising the text preceding paragraph (1) and paragraph (2)(v), (4) and (5) to read as follows:

§ 33.7 Disclosure.

* * * * *

(b) The disclosure statement must read as follows:

OPTION DISCLOSURE STATEMENT

BECAUSE OF THE VOLATILE NATURE OF THE COMMODITIES MARKETS, THE PURCHASE AND GRANTING OF COMMODITY OPTIONS INVOLVE A HIGH DEGREE OF RISK. COMMODITY OPTION TRANSACTIONS ARE NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC. SUCH TRANSACTIONS SHOULD BE ENTERED INTO ONLY BY PERSONS WHO HAVE READ AND UNDERSTOOD THIS DISCLOSURE STATEMENT AND WHO UNDERSTAND THE NATURE AND EXTENT OF THEIR RIGHTS AND OBLIGATIONS AND OF THE RISKS INVOLVED IN THE OPTION TRANSACTIONS COVERED BY THIS DISCLOSURE STATEMENT.

BOTH THE PURCHASER AND THE GRANTOR SHOULD KNOW WHETHER THE PARTICULAR OPTION IN WHICH THEY CONTEMPLATE TRADING IS AN OPTION WHICH, IF EXERCISED, RESULTS IN THE ESTABLISHMENT OF A FUTURES CONTRACT (AN ''OPTION ON A FUTURES CONTRACT'') OR RESULTS IN THE MAKING OR TAKING OF DELIVERY OF THE ACTUAL COMMODITY UNDERLYING THE OPTION (AN ''OPTION ON A PHYSICAL COMMODITY''). BOTH THE PURCHASER AND THE GRANTOR OF AN OPTION ON A PHYSICAL COMMODITY SHOULD BE AWARE THAT, IN CERTAIN CASES, THE DELIVERY OF THE ACTUAL COMMODITY UNDERLYING THE OPTION MAY NOT BE REQUIRED AND THAT, IF THE OPTION IS EXERCISED, THE OBLIGATIONS OF THE PURCHASER AND GRANTOR WILL BE SETTLED IN CASH.

BOTH THE PURCHASER AND THE GRANTOR SHOULD KNOW WHETHER THE PARTICULAR OPTION IN WHICH THEY CONTEMPLATE TRADING IS SUBJECT TO A ''STOCK-STYLE'' OR ''FUTURES-STYLE'' SYSTEM OF MARGINING. UNDER A STOCK-STYLE MARGINING SYSTEM, A PURCHASER IS REQUIRED TO PAY THE FULL PURCHASE PRICE OF THE OPTION AT THE INITIATION OF THE TRANSACTION. THE PURCHASER HAS NO FURTHER OBLIGATION ON THE OPTION POSITION. UNDER A FUTURES-STYLE MARGINING SYSTEM, THE PURCHASER DEPOSITS INITIAL MARGIN AND MAY BE REQUIRED TO DEPOSIT ADDITIONAL MARGIN IF THE MARKET MOVES AGAINST THE OPTION POSITION. THE PURCHASER'S TOTAL MARGIN OBLIGATION, HOWEVER, WILL NOT EXCEED THE ORIGINAL OPTION PREMIUM. IF THE PURCHASER OR GRANTOR DOES NOT UNDERSTAND HOW OPTIONS ARE MARGINED UNDER A STOCK-STYLE OR FUTURES-STYLE MARGINING SYSTEM, HE OR SHE SHOULD REQUEST AN EXPLANATION FROM THE FUTURES COMMISSION MERCHANT (''FCM'') OR INTRODUCING BROKER (''IB'').

A PERSON SHOULD NOT PURCHASE ANY COMMODITY OPTION UNLESS HE OR SHE IS ABLE TO SUSTAIN A TOTAL LOSS OF THE PREMIUM AND TRANSACTION COSTS OF PURCHASING THE OPTION. A PERSON SHOULD NOT GRANT ANY COMMODITY OPTION UNLESS HE OR SHE IS ABLE TO MEET ADDITIONAL CALLS FOR MARGIN WHEN THE MARKET MOVES AGAINST HIS OR HER POSITION AND, IN SUCH CIRCUMSTANCES, TO SUSTAIN A VERY LARGE FINANCIAL LOSS.

A PERSON WHO PURCHASES AN OPTION SUBJECT TO STOCK-STYLE MARGINING SHOULD BE AWARE THAT, IN ORDER TO REALIZE ANY VALUE FROM THE OPTION, IT WILL BE NECESSARY EITHER TO OFFSET THE OPTION POSITION OR TO EXERCISE THE OPTION. OPTIONS SUBJECT TO FUTURES-STYLE MARGINING ARE MARKED-TO-MARKET, AND GAINS AND LOSSES ARE PAID AND COLLECTED DAILY. IF AN OPTION PURCHASER DOES NOT UNDERSTAND HOW TO OFFSET OR EXERCISE AN OPTION, THE PURCHASER SHOULD REQUEST AN EXPLANATION FROM THE FCM OR IB. CUSTOMERS SHOULD BE AWARE THAT IN A NUMBER OF CIRCUMSTANCES, SOME OF WHICH WILL BE DESCRIBED IN THIS DISCLOSURE STATEMENT, IT MAY BE DIFFICULT OR IMPOSSIBLE TO OFFSET AN EXISTING OPTION POSITION ON AN EXCHANGE.

THE GRANTOR OF AN OPTION SHOULD BE AWARE THAT, IN MOST CASES, A COMMODITY OPTION MAY BE EXERCISED AT ANY TIME FROM THE TIME IT IS GRANTED UNTIL IT EXPIRES. THE PURCHASER OF AN OPTION SHOULD BE AWARE THAT SOME OPTION CONTRACTS MAY PROVIDE ONLY A LIMITED PERIOD OF TIME FOR EXERCISE OF THE OPTION.

THE PURCHASER OF A PUT OR CALL SUBJECT TO STOCK-STYLE OR FUTURES-STYLE MARGINING IS SUBJECT TO THE RISK OF LOSING THE ENTIRE PURCHASE PRICE OF THE OPTION—THAT IS, THE PREMIUM CHARGED FOR THE OPTION PLUS ALL TRANSACTION COSTS.

THE COMMODITY FUTURES TRADING COMMISSION REQUIRES THAT ALL CUSTOMERS RECEIVE AND ACKNOWLEDGE RECEIPT OF A COPY OF THIS DISCLOSURE STATEMENT BUT DOES NOT INTEND THIS STATEMENT AS A RECOMMENDATION OR ENDORSEMENT OF EXCHANGE-TRADED COMMODITY OPTIONS.

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(2) * * *

(v) An explanation and understanding of the option margining system.

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(4) Margin requirements. An individual should know and understand whether the option he or she is contemplating trading is subject to a stock-style or futures-style system of margining. Stock-style margining requires the purchaser to pay the full option premium at the time of purchase. The purchaser has no further financial obligations, and the risk of loss is limited to the purchase price and transaction costs. Futures-style margining requires the purchaser to pay initial margin only at the time of purchase. The option position is marked-to-market, and gains and losses are collected and paid daily. The purchaser's risk of loss is limited to the initial option premium and transaction costs.

An individual granting options under either a stock-style or futures-style system of margining should understand that he or she may be required to pay additional margin in the case of adverse market movements.

(5) Profit potential of an option position. An option customer should carefully calculate the price which the underlying futures contract or underlying physical commodity would have to reach for the option position to become profitable. Under a stock-style margining system, this price would include the amount by which the underlying futures contract or underlying physical commodity would have to rise above or fall below the strike price to cover the sum of the premium and all other costs incurred in entering into and exercising or closing (offsetting) the commodity option position. Under a future-style margining

system, option positions would be marked-to-market, and gains and losses would be paid and collected daily, and an option position would become profitable once the variation margin collected exceeded the cost of entering the contract position.

Also, an option customer should be aware of the risk that the futures price prevailing at the opening of the next trading day may be substantially different from the futures price which prevailed when the option was exercised. Similarly, for options on physicals that are cash settled, the physicals price prevailing at the time the option is exercised may differ substantially from the cash settlement price that is determined at a later time. Thus, if a customer does not cover the position against the possibility of underlying commodity price change, the realized price upon option exercise may differ substantially from that which existed at the time of exercise.

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Issued in Washington, D.C., on this 15th day of December, 1997, by the Commodity Futures Trading Commission.

Jean A. Webb,

Secretary of the Commission.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–105163–97]

RIN 1545–AV15

Certain Investment Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of certain investment income under the qualifying income provisions of section 7704(d) and the application of the passive activity loss rules to publicly traded partnerships. The regulations would affect the classification of certain partnerships for federal tax purposes and would also affect the passive activity loss limitations with respect to items attributable to publicly traded partnerships. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by March 19, 1998. Requests to speak (with outlines of oral comments) at a public hearing scheduled for April 28, 1998, at 10 a.m., must be received by April 7, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–105163–97), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–105163–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax__regs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Christopher Kelley, (202) 622–3080; concerning submissions and the hearing, Evangelista Lee, (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Introduction

This document proposes to add § 1.7704–3 to the Income Tax Regulations (26 CFR part 1) relating to the definition of qualifying income for publicly traded partnerships under section 7704(d) of the Internal Revenue Code (Code). This document also proposes to amend § 1.469–10 of the Income Tax Regulations relating to the application of section 469 of the Code to publicly traded partnerships.

Explanation of Provisions

Qualifying Income

Section 7704 of the Code provides that a publicly traded partnership is generally treated as a corporation for federal tax purposes unless 90 percent or more of the gross income of the partnership consists of qualifying income. Section 7704(d) defines qualifying income to include certain types of passive investment income, such as interest, dividends, real property rents, and income that would qualify under the regulated investment company provisions in section 851(b)(2) or the real estate investment trust provisions in section 856(c)(2). Since section 7704 was enacted, however, several new types of financial instruments have been developed that generate passive-type investment income similar to interest and dividends. The preamble to the regulations under § 1.7704–1, issued December 4, 1995, (regarding the definition of public trading) requested comments from the public on the definition of qualifying income for investment partnerships and other partnerships engaged in various types of securities transactions.

In response to comments received, the proposed regulations provide that qualifying income for purposes of section 7704(c) includes income from holding annuities, income from notional principal contracts (as defined in § 1.446–3), and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Qualifying income, however, includes income from a notional principal contract only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership. The proposed regulations also confirm that capital gain from the sale of stock is qualifying income, regardless of whether the stock pays dividends. The proposed regulations also provide that qualifying income (as defined in the proposed regulations) does not include income derived in the ordinary course of a trade or business by a broker, dealer, or market maker. Income derived by traders and investors can be qualifying income under the proposed regulations. The proposed regulations, including the trade or business restriction, are consistent with the legislative history of section 7704, which indicates that the exception for passive investment income was intended to distinguish between partnerships engaged in investment activities and those partnerships engaged in active business activities that are more typically conducted in corporate form. See H.R. Rep. No. 391 (Part 2), 100th Cong., 1st Sess. 1066–69 (House Report). The IRS also requests comments on the appropriate way to determine how gains should be measured for purposes of determining whether 90 percent or more of the partnership's gross income is qualifying income when a partnership makes a mixed straddle account election under § 1.1092(b)–4T. The IRS believes that use of the daily mark-to-market method provided for by § 1.1092(b)–4T would be inconsistent with the congressional purpose behind section 7704.

Passive Activity Loss Rules

Section 469(a) generally provides that if for any taxable year the taxpayer is an individual, estate, trust, closely held C corporation, or personal service corporation, neither the passive activity loss nor the passive activity credit for the taxable year is allowed. Section