short option positions and that, subsequent to the adoption of Rule 1.17(c)(5)(iii), the SPAN margining system was developed. SPAN uses option pricing models to calculate the theoretical gains and losses on an option at various market prices of the underlying commodity and is a significant improvement in measuring the risk of an option. All U.S. commodity exchanges and many foreign exchanges have adopted SPAN to assess option risk. In addition, SPAN recognizes trading strategies in which short option positions are risk reducing and SPAN has been tested and proven to assess adequately the risk in the customer's portfolio.

B. Large Trader Positions

Commenters also noted that the commodity exchanges closely monitor large trader positions in each contract market to identify those market participants that may pose a financial risk to the FCM carrying their account. This includes option positions at clearing firms carrying option customers' accounts. Safeguards such as intraday variation margin calls, continuous monitoring of the markets and direct contact with the FCMs alert the exchanges to any potential problems.

C. Financial Surveillance

Commenters further noted that additional protection exists in the form of capital and segregation requirements for FCMs. Commission regulations require FCMs not only to maintain a minimum amount of adjusted net capital, but also to maintain a sufficient amount of excess adjusted net capital. In the event an FCM's adjusted net capital falls below an early warning level, generally 150% of the minimum dollar amount (e.g., 6% of customer segregated funds), the FCM is required to notify the Commission within five (5) business days. The FCM must continue filing financial reports monthly until the FCM's adjusted net capital is at or above the early warning level for three consecutive months. In calculating adjusted net capital, FCMs must deduct deficits and any undermargined amounts in customer accounts. With respect to the segregation requirements, an FCM is required to deposit customer funds in accounts designated for the benefit of customers. The FCM must also make a daily calculation showing whether there are sufficient funds in segregated accounts.

III. 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 of those rules on small businesses. The Commission has previously determined that FCMs are not ''small entities'' for purposes of the RFA.[2] Therefore, 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.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995[3] 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 this proposed rule has no burden, the group of rules (3038–0024) of which this is a part has the following burden:

Average burden hours per response: 128.

Number of respondents: 235.

Frequency of response: Monthly.

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

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Net capital requirements, Reporting and recordkeeping requirements.

In consideration of the foregoing and pursuant to the authority contained in the Commodity Exchange Act and, in particular, Sections 4f, 4g and 8a(5) thereof, 7 U.S.C. 6d, 6g and 12a(5), the Commission hereby amends 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, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24.

[2] 47 FR 18619–18620 (April 30, 1982).

[3] Pub. L. No. 104–13, 109 Stat. 163 (1995).

§ 1.17 [Amended]

2. Section 1.17(c)(5)(iii) is removed and reserved.

Issued in Washington, DC on June, 10, 1998, by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 98–15975 Filed 6–15–98; 8:45 am]

BILLING CODE 6351–01–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1 and 33

Final Rulemaking Permitting Futures-Style Margining of Commodity Options

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (''Commission'') is repealing Commission Regulation 33.4(a)(2) and amending Commission Regulation 33.7(b). The Commission also is implementing technical amendments to its regulations imposing financial and segregation requirements on futures commission merchants (''FCMs'') and introducing brokers (''IBs'').

Regulation 33.4(a)(2) requires the purchaser of a commodity option to pay the full option premium at the initiation of the transaction. Regulation 33.7 requires an FCM, or an IB in the case of an introduced account, to provide each option customer with a written option disclosure statement prior to the opening of the account.

The repeal of Regulation 33.4(a)(2) will permit commodity options to be margined using a ''futures-style'' margining system. Futures-style margining requires both the purchaser (''long'') and the seller (''short'') of a commodity option to post risk-based, original margin upon entering into an option position. During the life of the option, the option value is marked to market daily, and gains and losses are posted to the accounts of the long and short position holders. The repeal does not impose an obligation on exchanges to adopt futures-style margining for commodity options. Exchanges may continue to use their current option margining systems. Any exchange wishing to implement futures-style margining must submit proposed rules for Commission review pursuant to Section 5a(a)(12)(A) of the Commodity Exchange Act (''Act'') and Commission Regulation 1.41.

Regulation 33.7(b) sets forth the terms of the disclosure statement and

currently reflects the prohibition against the margining of long option positions. The Commission is amending the disclosure statement to reflect the permissibility of futures-style margining for options.

EFFECTIVE DATE: July 16, 1998.

FOR FURTHER INFORMATION CONTACT:
Thomas Smith, Attorney, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. Telephone: (202) 418–5495; or electronic mail: tsmith@cftc.gov.

SUPPLEMENTARY INFORMATION:

I. Background

On December 19, 1997, the Commission published for public comment in the **Federal Register** a proposal to repeal Commission Regulation 33.4(a)(2) and proposed amendments to the option disclosure statements in Regulation 33.7(b) and Appendix A to Regulation 1.55(c).[1] The original comment period was scheduled to end on February 2, 1998, but was extended by the Commission until March 4, 1998.[2]

Regulation 33.4(a)(2) is one of several regulations that were implemented as part of a pilot program for the exchange trading of options on non-agricultural futures instituted by the Commission on November 3, 1981.[3] Regulation 33.4(a)(2) requires the purchaser of an option to pay the full premium at the initiation of the transaction. Overall, the Commission's experience with the pilot program was positive, and the trading of options on non-agricultural futures was made permanent on August 1, 1986.[4]

Regulation 33.4(a)(2) requires commodity options to be subject to a ''stock-style'' margining system that obligates the option buyer to pay the full purchase premium when the transaction is initiated.[5] The long is not required to make any additional payments during the life of the option. The option premium is credited to the account of the option seller, who must keep it posted with his or her FCM. The short also must deposit risk margin with his or her FCM to cover potential adverse market moves in the option position. 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.

Futures-style margining of commodity options will require that both the long and the short position holders post risk-based, original margin upon entering into their option positions. The option value will be marked to market daily during the life of the option. Any increase in value will result in a credit to the long option holder's account and a corresponding debit against the short option seller's account. Conversely, any decrease in value will result in a credit to the short's account and a corresponding debit to the long's account.

Thus, under futures-style margining, the cash flows associated with option contracts will be symmetric, as is the case for cash flows for futures. Futures-style margining, however, will not alter the fundamental nature of each party's overall obligation. A long's potential for loss will remain limited to the full option premium and transaction costs. As is the case now, a short's potential for loss will not be so limited.

In the Notice of Proposed Rulemaking, the Commission identified several potential benefits and potential costs that may result from the adoption of futures-style margining. The potential benefits included the enhancement of the financial integrity and market liquidity that may result from the more efficient cash flows associated with futures-style margining. The potential costs included an increase in the use of leverage in the futures markets, an increase in customer confusion, including an increase in the opportunity for unscrupulous individuals to mislead unsophisticated option customers, and transition costs to the industry in adopting futures-style margining.[6]

II. Comments Received

The Commission received 27 comment letters on the proposal. Supporting comments were submitted by six futures exchanges, four trade associations, one clearing organization, one FCM and one law firm.[7] Eight commercial firms, two securities options exchanges, one FCM and one investment management firm submitted opposing comments.[8] Two FCMs submitted comments that, while not opposing the proposal, raised concerns about the implementation and operation of futures-style margining.[9]

The material issues raised by the comment letters are set forth below. In most instances, the issues raised were previously identified by the Commission in the Notice of Proposed Rulemaking.

One commenter stated that many of the cash flow benefits identified in the Notice of Proposed Rulemaking could be achieved by expanding the availability of cross-margining between futures markets and securities markets. Another commenter stated that the Standard Portfolio Analysis of Risk (''SPAN'') margining system provides market participants with many of the cash flow benefits that are identified with futures-style margining.[10]

The Commission recognizes that cross-margining and the SPAN margining system provide cash flow benefits to market participants. The Commission believes, however, that futures-style margining could provide additional cash flow benefits not

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[1] 62 FR 66569 (December 19, 1997).

[2] 63 FR 6112 (February 6, 1998).

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

[4] 51 FR 17464 (May 13, 1986); 51 FR 27529 (August 1, 1986). Subsequently, the Commission approved the exchange trading of options on agricultural futures and options on non-agricultural physicals effective February 9, 1987. 52 FR 777 (January 9, 1987). On April 8, 1998, the Commission approved a three-year pilot program for the off-exchange trading of certain agricultural trade options and also approved exchange trading of options on agricultural physicals. 63 FR 18821 (April 16, 1998).

[5] Regulations 33.4 in pertinent part states:

§ 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 regulations, 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 it 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.

[6] *See*, 62 FR 66571–66572

[7] Supporting comments were submitted by: Chicago Board of Trade; Chicago Mercantile Exchange; New York Mercantile Exchange; Coffee, Sugar & Cocoa Exchange, Inc.; New York Cotton Exchange; Minneapolis Grain Exchange; National Grain Trade Council; Commodity Floor Brokers & Traders Association; National Grain and Feed Association; Futures Industry Association; Board of Trade Clearing Corporation; ABN Amro Chicago Corporation; and Philip McBride Johnson of Skadden, Arps, Slate, Meagher & Flom, and a former Chairman of the Commission.

[8] The opposing comments were submitted by: André & CIE S.A. Lausanne; Transcatalana De Comercio, S.A.; Garnac Grain Co., Inc.; Refinadora De Óleos Brasil LTDA.; SAROC S.P.A.; Compagnie Commerciale André; La Plata Cereal; Andre & CIE (Singapore) PTE LTD.; The Options Clearing Corporation; The Chicago Board Options Exchange; The Clifton Group; and FIMAT Futures USA, Inc.

[9] The two comments were submitted by Lind Waldock & Company and DKB Financial Futures Corp.

[10] The SPAN margining system was developed by the Chicago Mercantile Exchange and is currently used by all domestic futures exchanges and clearing organizations, except the Philadelphia Board of Trade.

available through cross-margining or SPAN. For example, cross-margining is restricted to specified products with offsetting risk characteristics that are traded on different exchanges that have cross-margining arrangements. In contrast, futures-style margining could be available for any futures exchange-traded options, and the cash flow benefits would not be dependent on preexisting arrangements between exchanges. Similarly, under SPAN, the long is still obligated to pay the full option premium at the inception of the transaction regardless of the portfolio's risk calculation. Thus, a trader who hedged a short futures position with a long option would be required to pay the full option premium at the initiation of the transaction under the stock-style margining system, even though SPAN would calculate the margin on the two positions on a portfolio basis.

Two commenters expressed a concern that futures-style margining will result in an increase in the use of leverage in the futures market. As the Commission stated in the Notice of Proposed Rulemaking, futures-style margining will result in an increase in the amount of leverage in the futures market. The purchaser of an option will be able to acquire an option position upon payment of less than the full option premium at the initiation of the transaction. The option position will then be marked to market on a daily basis, with gains or losses posted to the respective accounts of the long and short position holders. The substitution of a margining system for the full, up-front payment of the option also will introduce a risk of default by the long that does not exist under the stock-style margining system.

The Commission believes, however, that the leverage associated with long options will not substantially increase the risk to the financial integrity of the markets. First, as the Commission noted in the Notice of Proposed Rulemaking, long option positions entail less total risk than short options or long or short futures positions. Under futures-style margining, the maximum loss that a long may incur on an option position will continue to be limited to the full option premium at the initiation of the transaction. In contrast, holders of short options or long or short futures positions will continue to be subject to much greater risk from adverse market moves.

Second, with respect to the added risk of default, FCMs that currently hold customer accounts that include short options and long and short futures positions assess the creditworthiness of each customer as part of their normal business practices. Requiring such firms to assess the creditworthiness of potential option purchasers should not require any significant adjustments in such firms' operating procedures in this regard.

Third, the Commission is not requiring that exchanges adopt futures-style margining for options. The exchanges may continue to use their current margining systems and require option purchasers to pay the option premium at the initiation of the transaction. The Commission expects that exchanges will not propose adopting futures-style margining until they have developed appropriate systems and/or procedures to monitor the margining of long option positions and have considered the views and market needs of their members and other market participants.

Finally, an FCM may require that option purchasers pay the full option premium at the initiation of the transaction even if the exchange permits futures-style margining. Therefore, FCMs that do not have the systems or procedures to monitor the margining of long option positions may elect to retain the stock-style margining system even though an exchange might permit futures-style margining.

Several commenters expressed a concern that futures-style margining would benefit option buyers at the expense of option sellers. The primary concern of these commenters is that the Commission did not demonstrate that expected increases in option premiums would sufficiently compensate option sellers for their loss of interest income.

In the Notice of Proposed Rulemaking, the Commission noted that a futures-style margining system may alter option pricing. Sellers of options may charge a higher premium to compensate for the loss of interest income. Conversely, option buyers may be willing to pay a higher premium because they will not have to pay the full premium up-front. The Commission believes, however, that market forces should ensure that pricing changes will not benefit longs at the expense of shorts. In this regard, commenters did not submit any support for the assertion that futures-style margining would benefit option buyers at the expense of option sellers.

One commenter stated that permitting futures-style margining, which does not require the up-front payment of option premiums, may result in additional low-capital customers entering the option markets. The commenter argued that such customers may not be very knowledgeable about futures markets and may be susceptible to unscrupulous individuals seeking to take advantage of them.

By amending the option disclosure statement in Regulation 33.7 to reflect the permissibility of futures-style margining, the Commission is attempting to ensure that potential option customers receive adequate notice concerning the risks of trading in commodity options. In addition, the distribution of the disclosure statement does not relieve an FCM or IB from any other disclosure obligations that it may have under applicable law.

One commenter stated that futures-style margining will require some FCMs to increase staff and upgrade systems capabilities in order to perform continuous intraday monitoring of long option positions. The commenter further stated that the increased costs may be passed on to option customers, thereby making trading more expensive. The commenter also claimed that exchanges should not be permitted to offer futures-style margining until they are able to provide continuous, updated information regarding the volatility levels of their options to their member firms.

The Commission recognizes that certain FCMs may be required to expend additional capital to monitor properly long option positions with the implementation of a futures-style margining system. However, many firms already have such systems in place. As noted above, short option positions are currently margined and marked to market on a daily basis. Firms that carry short option positions on their books must have monitoring and margining systems in place in order to track properly the short option positions. In addition, futures-style margining has been in place at the London International Financial Futures and Options Exchange for over ten years.

In addition, the Commission anticipates that the exchanges will take into consideration the views of their members and other market participants prior to proposing any changes to their option margining systems. Moreover, any proposal to adopt a futures-style margining system must be submitted to the Commission for review pursuant to Section 5a(a)(12)(A) of the Act and Commission Regulation 1.41. As part of the review process, the Commission may determine that publication of the proposal in the **Federal Register** is necessary in order to obtain the views and comments of interested persons.

One commenter stated that the Commission's proposal lacked specificity with respect to the implementation and operation of a futures-style margining system. The commenter argued that a lack of specificity may result in the adoption of different margining systems or standards for each exchange or different systems within one exchange. In contrast, two other commenters stated that exchanges should have discretion to determine which option contracts should be subject to a stock-style or futures-style margining system as part of the contract design process. In addition, one of these two commenters stated that an exchange should be afforded the flexibility of designing margining systems that result in a hybrid of the stock-style and futures-style system. For example, an exchange should have the discretion to design an option contract that would require the option buyer to pay the full premium at the time of purchase (stock-style) while also allowing that customer to withdraw any subsequent option value gains from the account (futures-style).

By repealing Commission Regulation 33.4(a)(2), the Commission does not intend to require that an exchange use a uniform margining system for all of its listed option markets or that the exchanges adopt futures-style margining in a concerted manner. While the Commission recognizes that a uniform margining system across all futures markets might increase efficiency and reduce potential confusion among market participants, the Commission believes that it is not its role to mandate such a result. Each exchange should have the discretion to design margining systems that it believes are appropriate for its option markets. Accordingly, the Commission will review each proposal to implement a futures-style margining system on an individual basis.

III. Amendments to the Option Disclosure Statement

A. Amendments to the Option Disclosure Statement in Regulation 33.7(b)

Commission Regulation 33.7 was issued as part of the initial option pilot program in November 1981 and requires an FCM, or an IB in the case of an introduced account, to provide each option customer with a detailed disclosure statement prior to the opening of an account. The customer is required to sign an acknowledgment indicating that he or she read and understood the document before any transaction is effected for that customer's account.

The disclosure statement, which is set forth in Regulation 33.7(b), contains a detailed description of option trading and the risks associated with option positions. The statement was drafted to reflect the prohibition against the margining of long option positions.

In the Notice of Proposed Rulemaking, the Commission proposed several amendments to the disclosure statement to reflect the permissibility of futures-style margining. The Commission has determined to adopt the amendments with one modification.

The Commission's proposed amendments included adding the following language to the option disclosure statement:

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"). (Emphasis added.)

One commenter stated that the statement—THE PURCHASER'S TOTAL MARGIN OBLIGATION, HOWEVER, WILL NOT EXCEED THE ORIGINAL OPTION PREMIUM—while strictly true, could be open to honest misinterpretation. The commenter stated that under certain circumstances a long option position holder may incur margin payment obligations that exceed the initial option premium. For example, an FCM may require risk margin that exceeds the option premium. In addition, a bought option may first increase substantially in value immediately after purchase and then lose nearly all of its value on the next day. If the option owner had withdrawn the initial value increase from the account, he or she would be required to make a large daily variation margin payment to the FCM to settle the subsequent value loss. In such situations, the variation margin payments on the second day may exceed the initial option premium. Accordingly, the commenter proposed that the sentence be modified to state:

THE PURCHASER'S TOTAL SETTLEMENT VARIATION MARGIN OBLIGATION OVER THE LIFE OF THE OPTION, HOWEVER, WILL NOT EXCEED THE ORIGINAL OPTION PREMIUM, ALTHOUGH SOME INDIVIDUAL PAYMENT OBLIGATIONS AND/OR RISK MARGIN REQUIREMENTS MAY AT TIMES EXCEED THE ORIGINAL OPTION PREMIUM.

The Commission concurs with the commenter and is amending the risk disclosure statement to include the above sentence in lieu of the proposed sentence.

B. Proposed Amendments to Appendix A of Regulation 1.55(c)

Appendix A of Commission Regulation 1.55(c) contains a generic risk disclosure statement applicable to the Commission's disclosure requirements for domestic and foreign commodity futures and commodity option transactions.[11] The disclosure statement includes a discussion of the risks associated with the futures-style margining of options, which has been permitted on certain foreign exchanges, including the London International Financial Futures and Option Exchange.

In the Notice of Proposed Rulemaking, the Commission proposed minor amendments to the risk disclosure statement to reflect explicitly the permissibility of futures-style margining for options traded on U.S. markets. Upon reconsideration, the Commission has determined that the disclosures in the risk disclosure statement, as currently drafted, are appropriate. Accordingly, the Commission is not amending Appendix A to Commission Regulation 1.55(c).

IV. Technical Amendments

In the Notice of Proposed Rulemaking, the Commission requested comment on any amendments that would need to be made to the Commission's regulations governing net capital requirements for FCMs and IBs to reflect the permissibility of futures-style margining. No comments were received on this point.

Several of the Commission's regulations impose financial requirements on FCMs and IBs. In various sections of those regulations, reference is made to the manner in which an FCM's net capital requirement

[11] The disclosure statement was developed by the Commission in cooperation with various international regulators and self-regulatory organizations who also have adopted the statement for use in their jurisdictions. The disclosure statement permits firms doing multinational business to use the same risk disclosure statement for foreign and U.S.-based business. The Commission adopted the disclosure statement on July 5, 1994. 59 FR 34376 (July 5, 1994).

is to be calculated. The calculation excludes the value of long options positions because such options, under current methodologies, are fully paid for and pose no financial risk to the FCM. The Commission, as suggested in the Notice of Proposed Rulemaking, is making technical amendments to these regulations in order to reflect the permissibility of a futures-style margining system for commodity options and to make clear that only the value of fully paid for long options may be excluded from the capital requirement formula. Specifically, the Commission is amending the definition of customer funds in Regulation 1.3(gg) and certain reporting requirements and financial requirements set forth in Regulations 1.12(b)(2), 1.17(a)(1)(i)(B), 1.17(e)(1)(ii), 1.17(h)(2)(vi)(C)(2), 1.17(h)(2)(vii)(A)(2), 1.17(h)(2)(vii)(B)(2), 1.17(h)(2)(viii)(A)(2), 1.17(h)(3)(ii)(B), and 1.17(h)(3)(v)(B).[12]

V. Conclusion

The Commission is repealing Regulation 33.4(a)(2), amending the option disclosure statement in Regulation 33.7(b) and implementing technical amendments to several financial regulations in order to permit the futures-style margining of commodity options. The repeal of Regulation 33.4(a)(2) is consistent with the Commission's ongoing commitment to implement regulatory reforms that reduce unnecessary burdens on the futures industry while also preserving important customer protections and market safeguards. In this regard, it has been seventeen years since the Commission authorized the first option pilot program. During that time, option trading volume has grown from less than 2 million transactions a year to over 100 million transactions a year. During this period of remarkable growth, the Commission, exchanges, FCMs and market participants have gained extensive experience on the operations of the option markets. In light of this experience and upon consideration of all the comments, the Commission believes that with adequate disclosure to public customers it is no longer necessary for the Commission to require option purchasers to pay the full option premium at the initiation of the transaction.

VI. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. § 601 *et seq.*, requires that agencies, in promulgating rules, consider the impact of those rules on small businesses. The rules discussed herein will affect contract markets, clearing organizations, FCMs and IBs. The Commission has 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. Contract markets and FCMs have been determined not to be small entities under the RFA. 47 FR 18616 (April 30, 1982). Furthermore, the then Chairman of the Commission previously has certified on behalf of the Commission that comparable rules affecting clearing organizations do not have a significant economic impact on a substantial number of small entities. 51 FR 44866, 44868 (December 12, 1986).

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.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 [13] 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 Rules 1.3, 1.12, and 1.17 do not effect the burden, the group of rules (3038–0024) of which Rules 1.3, 1.12, and 1.17 are a part have the following burden.

Average burden hours per response: 128.

Number of respondents: 3,148.

Frequency of responses: on occasion.

While Rule 33.7 does not effect the burden, the group of rules (3038–0007) of 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: on occasion.

Copies of the information collection submission to the Office of Management and Budget are available from the CFTC Clearance Officer, 1155 21st Street, N.W., Washington, D.C. 20581, (202) 418–5160.

List of Subjects

17 CFR Part 1

Commodity Futures, Reporting and recordkeeping requirements.

17 CFR Part 33

Commodity Futures, Domestic exchange-traded commodity option transactions, Consumer protection, Fraud.

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 amends 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, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24.

2. Section 1.3 is amended to revise paragraph (gg)(2)(iv) to read as follows:

§ 1.3 Definitions

* * * * *

(gg) * * *

(2) * * *

(iv) Representing accruals (including, for purchasers of a commodity option for which the full premium has been paid, the market value of such commodity option) to an option customer.

* * * * *

3. Section 1.12 is amended by revising paragraph (b)(2) to read as follows:

[12] The Commission's Division of Trading and Markets previously has issued guidance on the proper accounting and segregation treatment of exchange-traded options subject to a stock-style margining system. *See, Financial and Segregation Interpretation No. 8—Proper Accounting, Segregation and Net Capital Treatment of Exchange Traded Option Transactions*, Comm. Fut. L. Rep. (CCH) ¶ 7118 (Division of Trading and Markets, August 12, 1982). The Commission may determine that it would be appropriate to revise this Interpretation if exchanges seek to implement futures-style margining.

[13] Pub. L. 104–13 (May 13, 1995).

§ 1.12 Maintenance of minimum financial requirements by futures commission merchants and introducing brokers.

* * * * *

(b) * * *

(2) 6 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and foreign futures or foreign options secured amount, less the market value of commodity options purchased by such customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each such customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

4. Section 1.17 is amended by revising paragraphs (a)(1)(i)(B), (e)(1)(ii), (h)(2)(vi)(C)(2), (h)(2)(vii)(A)(2), (h)(2)(vii)(B)(2), (h)(2)(viii)(A)(2), (h)(3)(ii)(B) and (h)(3)(v)(B) to read as follows:

§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.

* * * * *

(a)(1)(i) * * *

(B) Four percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

(e) * * *

(1) * * *

(ii) For a futures commission merchant or applicant therefor, 7 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

(h) * * *

(2) * * *

(vi) * * *

(C) * * *

(2) For a futures commission merchant or applicant therefor, 7 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

(vii) * * *

(A) * * *

(2) For a futures commission merchant or applicant therefor, 7 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

(B) * * *

(2) For a futures commission merchant or applicant therefor, 10 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

(viii) * * *

(A) * * *

(2) For a futures commission merchant or applicant therefor, 6 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

(3) * * *

(ii) * * *

(B) For a futures commission merchant or applicant therefor, 6 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

(v) * * *

(B) For a futures commission merchant or applicant therefor, 7 percent of the following amount: The customer funds required to be segregated pursuant to the Act and the regulations in this part and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade for which the full premiums have been paid: Provided, however, That the deduction for each customer shall be limited to the amount of customer funds in such customer's account(s) and foreign futures and foreign options secured amounts;

* * * * *

PART 33—REGULATION OF DOMESTIC EXCHANGE TRADED COMMODITY OPTION TRANSACTIONS

5. 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]

6. Section 33.4 is amended by removing and reserving paragraph (a)(2).

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

§ 33.7 Disclosure.

* * * * *

(b) * * *

Options 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 SETTLEMENT VARIATION MARGIN OBLIGATION OVER THE LIFE OF THE OPTION, HOWEVER, WILL NOT EXCEED THE ORIGINAL OPTION PREMIUM, ALTHOUGH SOME INDIVIDUAL PAYMENT OBLIGATIONS AND/OR RISK MARGIN REQUIREMENTS MAY AT TIMES 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.

* * * * *

(2) * * *

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

* * * * *

(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.

* * * * *

Issued in Washington, D.C., on this 10th day of June, 1998, by the Commodity Futures Trading Commission.

Jean A. Webb,

Secretary of the Commission.

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