

By direction of the Commission.

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*Acting Secretary.*

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## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Parts 3, 32 and 33

#### Trade Options on the Enumerated Agricultural Commodities

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Interim final rules.

**SUMMARY:** Generally, the offer or sale of commodity options is prohibited except on designated contract markets. 17 CFR 32.11. One of several specified exceptions to the general prohibition on off-exchange options is for "trade options." Trade options are off-exchange options "offered by a person having a reasonable basis to believe that the option is offered to" a person or entity within the categories of commercial users specified in the rule, where such commercial user "is offered or enters into the transaction solely for purposes related to its business as such." 17 CFR 32.4(a). Trade options, however, are not permitted on the agricultural commodities which are enumerated in the Commodity Exchange Act (Act). 7 U.S.C. 1a(3).

The Commodity Futures Trading Commission (Commission or CFTC) is removing the prohibition on off-exchange trade options on the enumerated agricultural commodities pursuant to a three-year pilot program. Because it intends to reexamine these rules during and at the conclusion of the pilot program, these rules are being promulgated as interim final rule (interim rules). The interim rules, like the proposed rules, permit only agricultural trade options which, if exercised, will result in delivery of the commodity. Such options may not be resold, repurchased, or otherwise cancelled other than through the exercise or natural expiration of the contract.

Also, the interim rules permit only those entities which handle the commodity in normal cash market channels to solicit, to offer to buy or sell, or to buy or sell such options. Vendors of such options would be required to become registered as agricultural trade option merchants, to report to the Commission on their transactions, to provide their customers with disclosure statements, and to

safeguard their customers' premiums. The interim rules substantially streamline requirements contained in the proposed rules, particularly the proposed registration, reporting rules, particularly the proposed registration, reporting and customer fund segregation requirements. The Commission is exempting from the prohibition and these interim rules individuals or entities which meet a substantial financial requirement, as it proposed. Finally, the Commission is removing the prohibition on the offer or sale of exchange-traded options on physicals on these commodities.

CFTC will publish at a late time a document in the **Federal Register** requesting comments on these interim rules.

**EFFECTIVE DATE:** June 15, 1998.

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

#### SUPPLEMENTARY INFORMATION:

#### I. Background

##### A. *The Prohibition of Agricultural Trade Options*

In 1936, responding to a history of large price movements and disruptions in the futures markets attributed to speculative trading in options, Congress completely prohibited the offer or sale of option contracts both on and off exchange in the specific list of agricultural commodities then under regulation.<sup>1</sup> Any commodity not so enumerated was unaffected by the prohibition.

A history of abusive practices and fraud in the offer and sale of off-exchange options in the non-enumerated commodities was one of the catalysts leading to enactment of the Commodity Futures Trading Commission Act of 1974 (1974 Act). The 1974 Act created the Commission, substantially strengthened the Commodity Exchange Act and broadened its scope by bringing all commodities under

<sup>1</sup>The specific agricultural commodities originally regulated under the 1936 Act included, among others, grains, cotton, butter, eggs, and potatoes. Later, fats and oils, soybeans and livestock, as well as others, were added to the list of enumerated agricultural commodities. Commodity Exchange Act of 1936, Public Law No. 74-675, 49 Stat. 1491 (1936). See, H. Rep. No. 421, 74th Cong., 1st Sess. 1, 2 (1934); H. Rep. No. 1551, 72d Cong., 1st Sess. 3 (1932). A more complete statement of the statutory and regulatory history of the ban is provided in the Notice of Proposed Rulemaking, 62 FR 59624 (November 4, 1997).

regulation for the first time. The newly-created CFTC, vested with plenary authority to regulate the offer and sale of commodity options,<sup>2</sup> promulgated a comprehensive regulatory framework applicable to off-exchange commodity option transactions in the non-enumerated commodities.<sup>3</sup> This comprehensive framework exempted "trade options" from most of its provisions except for a rule prohibiting fraud (rule 32.9).<sup>4</sup> In contrast, the prohibition on the offer and sale of all options on the enumerated agricultural commodities remained as a consequence of both statutory provision and Commission rule. See, 17 CFR 32.2.

However, the attempt to create a regulatory framework to govern the offer and sale of off-exchange commodity options was unsuccessful and was suspended.<sup>5</sup> In 1982, based on the separate, successful pilot program to introduce exchange-traded options on the non-enumerated commodities, Congress eliminated the statutory prohibition on options on the enumerated agricultural commodities.<sup>6</sup> As a consequence, the Commission

<sup>2</sup>Section 4c(b) of the Act provides that no person "shall offer to enter into, or confirm the execution of, any transaction involving any commodity regulated under this Act" which is in the nature of an option "contrary to any rule, regulation, or other of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe." 7 U.S.C. 6c(b).

<sup>3</sup>17 CFR part 32. See 41 FR 51808 (Nov. 24, 1976) (Adoption of Rules Concerning Regulation and Fraud in Connection with Commodity Option Transactions). See also, 41 FR 7774 (February 20, 1976) (Notice of Proposed Rules on Regulation of Commodity Option Transactions); 41 FR 44560 (October 8, 1976) (Notice of Proposed Regulation of Commodity Options).

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

<sup>5</sup>Because of continuing, persistent, and widespread abuse and fraud in their offer and sale, the Commission in 1978 suspended all trading in commodity options, except for trade (and subsequently, dealer) options. 43 FR 16153 (April 17, 1976). Congress later codified the Commission's options ban, establishing a general prohibition against commodity option transactions other than trade and dealer options. Public Law No. 95-405, 92 Stat. 865 (1978).

<sup>6</sup>Public Law No. 97-444, 96 Stat. 2294, 2301 (1983).

initiated a pilot program to permit the reintroduction of exchange-traded options on those agricultural commodities. The Commission declined at that time to permit the trading of the specified agricultural options off-exchange.<sup>7</sup>

### B. The Advance Notice of Proposed Rulemaking

On June 9, 1997, the Commission published an advance notice of proposed rulemaking (advance notice) in the **Federal Register** seeking comment on whether it should propose rules to lift the prohibition on trade options on the enumerated agricultural options subject to conditions and, if so, what conditions would be appropriate (62 FR 31375).<sup>8</sup> In order to focus comment on the relevant issues, the advance notice invited commenters to respond to 30 specific questions.

The Commission received a total of 76 comment letters from 82 commenters in response, almost evenly divided between those in favor and those opposed to lifting the ban. In addition to the written comments, the Commission received oral and written statements during two public field meetings at which members of the public had an opportunity to address the Commission and to answer its questions regarding these issues. One of the meetings was held in Bloomington, Illinois, and the other was held in Memphis, Tennessee. A third informational briefing was held in conjunction with a general membership meeting of the National Cattlemen's Beef Association. Generally, speakers at these events reflected the range of views expressed in the written comments and were likewise equally divided in their support or opposition to lifting the prohibition on agricultural trade options.<sup>9</sup>

<sup>7</sup> 48 FR 46797 (October 14, 1983). Although the Commission noted that "there may be possible benefits to commercials and to producers from the trading of these 'trade' options in domestic agricultural commodities," it determined that "in light of the lack of recent experience with agricultural options and because the trading of exchange-traded options is subject to more comprehensive oversight," "proceeding in a gradual fashion by initially permitting only exchange-traded agricultural options" was the prudent course. *Id.* at 46800.

<sup>8</sup> The Commission based the advance notice on a study by the Commission's Division of Economic Analysis (Division). The complete text of that study, entitled "Policy Alternatives Relating to Agricultural Trade Options and Other Agricultural Risk-Shifting Contracts," was forwarded to the Commission by the Division on May 14, 1997. It is available through the Commission's Internet site at <http://www.cftc.gov/ag8.htm>.

<sup>9</sup> Transcripts of the proceedings at all three events were included in the Commission's comment file and are available through the Commission's internet web site.

Many of the comments responding to the advance notice expressed the view that the potential risk of permitting trade options clearly outweighed any benefit which they might provide. These commenters typically assumed that agricultural trade options would be offered under the same level of regulation currently applicable to other trade options.<sup>10</sup> An approximately equal number of commenters expressed the view that the prohibition on trade options should be lifted, particularly in response to the new challenges agriculture faces as a result of changes in government programs. The vast majority of commenters, both those favoring and opposing lifting the prohibition on agricultural trade options, urged caution.

### C. The Proposed Rules

The Commission, based upon the analysis in the Division's study, the comments responding to the advance notice and the commentary presented during its field meetings, proposed rules establishing a pilot program to permit the offer and sale of trade options subject to a number of strict regulatory conditions. 62 FR 59624. The Commission's proposed rules were based on its evaluation of the likely risks associated with lifting the prohibition on agricultural trade options, the likely immediate uses for agricultural trade options and the level of regulation appropriate to both. The Commission proposed initially to include within the pilot program options between commercial parties in the normal merchandising chain for the underlying commodity, the exercise of which would require delivery from one party to the other either by immediate transfer of title or by transfer of a forward contract commitment. 62 FR 59628.

The Commission further proposed to require vendors of agricultural trade options to register as agricultural trade options merchants and their sales forces to register as associated persons. The Commission proposed a minimum net worth requirement of \$50,000 for registration as an agricultural trade option merchant and passing a proficiency test for individuals to be registered as an associated person. As proposed, agricultural trade option merchants also would have been required to keep records, to report to the Commission and to disclose risks to customers. The Commission also proposed several restrictions on

<sup>10</sup> Currently, trade options and those offering them are subject only to regulations regarding fraud. See, 17 CFR 32.4.

agricultural trade option contracts' permissible structure and use.

Four hundred forty-eight commenters responded to the notice of proposed rulemaking, submitting a total of 441 comment letters to the Commission. Commenters remain divided on whether the Commission should lift the prohibition on agricultural trade options. Twelve commenters, including among them an agricultural marketing cooperative, two exchanges and a risk-management firm opposed lifting the prohibition in any form. In their view, existing exchange-traded products are adequate to manage agricultural risk, and trade options would merely replicate existing exchange products, but in a less safe environment. The remaining commenters supported lifting the prohibition, but differed in their assessment of the conditions proposed by the Commission.

Of those supporting lifting the prohibition, three agreed fully with the Commission's proposed rules. They included an association of introducing brokers and two producer associations. The remaining commenters opposed to varying degrees the conditions proposed by the Commission. Twenty-four comment letters submitted by producer associations and agribusinesses opposed as unduly restrictive or burdensome most, if not all, of the proposed rules.<sup>11</sup> Others took exception, or offered suggestions relating, to specific rule provisions. Two United States Senators suggested that the pilot program be modified to permit cash settlement of option contracts and not to limit potential vendors to those able to take delivery of the commodity.

## II. The Interim Rules

### A. Over-all Structure

#### 1. Pilot Program

Based upon thorough and careful consideration of the comments to the notice of proposed rulemaking, the responses to the advance notice of proposed rulemaking, the written and oral statements provided at the field hearings and the Division's study, the Commission is promulgating interim rules establishing a three-year pilot program to permit the trading of agricultural trade options subject to the conditions discussed below. A number

<sup>11</sup> The Commission also received 395 identical letters from individual producers opposing the proposed rules on the grounds that they result "in the most extensive, far reaching regulatory requirements ever imposed on cash grain marketing contracts. \* \* \* mak[ing] it virtually impossible for my local grain company to make these contracts available. \* \* \*"

of commenters expressed concern that a three-year pilot program might discourage the Commission from evaluating the interim rules and considering their amendment until the conclusion of the full three-year pilot period. To the contrary, however, the Commission views the pilot program as an opportunity to monitor and to assess the efficacy of these rules on an ongoing basis and "to amend them as experience warrants."<sup>12</sup> 62 FR 59627. (Similarly, the Commission's implementation of the 1982 pilot program to reintroduce exchange-traded commodity options included a number of rule amendments during the program and before its termination.)

Several commenters expressed concern that the Commission, in connection with its final consideration of permanent rules, is unlikely to revisit or to reconsider the fundamental policy decisions relating to its present determination of the pilot program's overall structure. They suggested that the Commission delay promulgating interim rules and repropose an entirely different set of regulatory conditions which would apply to the trading of agricultural trade options, including permitting them to be cash-settled.

The Commission disagrees with this suggested approach. The Commission views the pilot program as an experiment, has not foreclosed the reconsideration of any specific issue and, by determining that particular rules are appropriate at the initiation of the pilot program, has made no judgment regarding the permanent rules that it ultimately will promulgate. The Commission believes that proposing a new set of rules without any market-based experience would foster delay and provide little additional substantive information to inform its decision on how to proceed. For this reason, the Commission believes that the public interest will best be served by making agricultural trade options available to the market now under the regulatory structure as proposed and by consideration of possible amendment of the interim rules based upon actual market experience.

## 2. Physical Delivery

The overall structure of the interim rules adheres closely to the proposal.

<sup>12</sup>The Commission noted in the notice of proposed rulemaking that "it will evaluate the efficacy of the interim final rules at the conclusion of the pilot program." 62 FR 59627, n. 19. That does not suggest, however, that the Commission will not consider altering the interim rules during this period, but only that it is the Commission's intention not to make the interim rules final until a full review of the pilot program experience.

The interim rules, like the proposed rules, permit only the trading of off-exchange agricultural options that if exercised, would require physical delivery from one commercial party to another in the normal merchandising chain. In proposing this provision, the Commission reasoned that such options would explicitly include a merchandising function which exchange-traded contracts did not, that such options would be between those having pre-existing cash market relationships and that the mechanics of these options were likely to be well-understood. See, 63 FR at 59627.

A number of comments, including one from two United States Senators and a joint comment of seven farm and commodity representative organizations (joint comment), suggested that the Commission also include within the pilot program cash-settled options. However, not all commenters agreed with this view. For example, one state-level farm organization strongly supported the proposed provision requiring physical delivery, noting that it was:

in complete agreement \* \* \* that the off-exchange agricultural trade option be settled by either delivery of the physical commodity or by the writing of a forward contract which will guarantee delivery. To allow a cash-settled instrument would potentially foster cash speculation between vendors and buyers.

Many of those advocating inclusion of cash-settled options suggested that the proposed physical delivery requirement would preclude any flexibility in the type of options that could be offered, making it impossible, for example, to offer options combining production and price protection—so called "revenue" contracts. Revenue option contracts would enable producers to lock in a minimum revenue for production on their farms. An association representing grain elevators reasoned that:

[t]he rules, as written, provide no apparent authority to write revenue contracts combining both yield and price risk management into one contract. \* \* \* [R]evenue contracts that could utilize the yield contracts offered by the Chicago Board of Trade to shift a substantial part of this risk are, in our view, very important to the farmer. They are also important to the cash grain industry in having the opportunity to work along side the insurance industry in offering a more "complete" line of futures-based revenue contracts. We strongly urge the CFTC to include revenue contracts (and other legitimate agricultural trade option contracts where physical delivery is not possible) under the pilot program. (Emphasis omitted.)

The physical delivery requirement does not preclude development of

revenue-type option contracts. Nothing in the rules requires that the trade option specify the underlying commodity by referencing an absolute number of bushels or other delivery unit. The amount of the commodity underlying the option could be expressed by referencing the yield on a designated number of acres, based either on the producer's actual yield or a reported average yield, thereby providing a minimum return to a producer per acre without running afoul of the rules' requirements. If the total price for the amount of commodity required to be delivered were above the guaranteed price, the producer would let the option expire and deliver outside of its terms. If the total price were below the option's strike price, the producer would exercise the option, delivering his or her production to the option writer.<sup>13</sup> The Commission anticipates that a wide variety of option structures could be designed to offer additional forms of revenue protection under the pilot program's rules and invites those interested in developing such instruments to seek its guidance if questions arise regarding their permissibility.

A number of commenters similarly objected that the proposed rule requiring that agricultural trade options be settled only by physical delivery further unduly restricted their potential flexibility and utility by forbidding their early termination through offset. This requirement was proposed as a means to ensure that agricultural trade options maintain a close relationship to the cash market activities of participants and to dissuade speculative use of the contracts. Several commenters, however, argued that a producer's ability to capture any remaining value left on the option by selling the option back to the issuer under the terms of the original contract when the optional price protection was no longer wanted was not inconsistent with these objectives.

However, permitting the offset of an option prior to its expiration would render meaningless the provision requiring physical delivery of the option, if exercised. The right to offset would eviscerate the physical delivery requirement by enabling the option

<sup>13</sup>It is common practice for certain commodities to provide a cash adjustment where the commodity delivered departs from quality or other contract specifications, including tolerances for the actual amount or weight delivered compared to the contract amount. Similarly, if a state-wide average yield were used as a reference and the producer's actual production fell somewhat short, the total price could be adjusted to account for the relative shortfall without abrogating its fundamental nature as a delivery contract.

holder at any time to avoid delivery, essentially cash-settling the option.<sup>14</sup> This would undermine the Commission's efforts to develop a pilot program to reintroduce agricultural trade options under controlled conditions.

Although the interim rules have not been modified to permit the offset of agricultural trade options, the rules as proposed permitted a degree of flexibility to capture an option's remaining value prior to its expiration. The proposed rules recognized that agricultural trade option contracts could be amended to "reflect changes \* \* \* [in] activity or commitments in the underlying cash market or to reflect the carrying of inventory." 62 FR at 59638.<sup>15</sup> Such amendments could include deferral of an option contract's delivery date with alteration of the contract's price to reflect, among other adjustments, any remaining value on the original option.<sup>16</sup>

The proposed rules also contemplated that delivery on an option contract, if exercised, could be by the "immediate transfer of title to the commodity or by transfer of a forward contract commitment." 62 FR 59627. Proposed rule 32.13(a)(3)'s requirement that the "option can only be settled through physical delivery of the underlying commodity" should be read as permitting termination of the option contract prior to its expiration through entry into a forward contract commitment as well as permitting use of a forward contract upon exercise. Once the forward contract has been substituted for the trade option, the forward contract is a firm commitment to deliver, and the optional "walk-away" nature of the option cannot be reestablished. The substitution of a forward contract for the physical delivery option prior to the option's expiration is consistent with the overall purpose of the rule of maintaining a close relationship between the option transaction and the participant's cash market activities and of dissuading use of agricultural trade options as speculative vehicles. The Commission is

modifying the interim rule to clarify that settlement of the option by physical delivery does not preclude the option contract's amendment, or its termination by entry into a forward contract, prior to expiration with an appropriate adjustment to the contract price.<sup>17</sup>

### 3. Eligible Vendors

A number of commenters also advocated expansion of those eligible to be agricultural trade option merchants to additional classes of vendors. Specifically, for example, the joint comment suggested that all "financial institutions with a direct interest in production agriculture" be permitted to become agricultural trade option vendors. Other commenters supported the Commission's proposed limitation, suggesting that trade options appropriately should be limited to "producers and buyers of the enumerated commodities."

Several commenters opposed the conditions for registration as an agricultural trade option merchant on the assumption that eligibility would be restricted to "first handlers" of the commodity. Although first handlers typically would be eligible to become agricultural trade option merchants, other categories of commercial users would also be eligible to apply for registration. For example, as one commenter noted, "[w]e assume the CFTC would also permit cash grain merchandisers, which have no facilities, but do take title to commodities, to also write options." As discussed above, the requirement that the option contracts, if exercised, be physically delivered does not require that the agricultural trade option merchant accept delivery only in an over-the-scales operation. To the contrary, delivery of the commodity can occur through any *bona fide* means of conveying legal ownership of the commodity, including the transfer of warehouse receipts. Accordingly, grain

merchants, investment bankers with active commodity trading operations and various types of agricultural processors or commercial users of the commodity might be eligible to register to operate as an agricultural trade option merchant. In light of the potential diversity of eligible registrants, the Commission believes that the interim rules will not result in lack of competition among vendors.<sup>18</sup>

The Commission is convinced that the overall structure of the interim rules is both a necessary and appropriate means to introduce this new class of instrument. Recent experience with various types of agricultural marketing schemes and contracts indicates that a degree of caution is required. Introducing these instruments as a pilot program, limited initially to option contracts which upon exercise result in physical delivery, traded between commercials in the underlying commodity, should provide a degree of protection to the parties and a solid foundation upon which to lift the current prohibition on such instruments.

As discussed above, the proposed rules provided greater flexibility than credited by many of the commenters. Moreover, in the interim rules the Commission has modified or clarified the rules as proposed, providing further avenues for flexibility. The Commission is convinced that the interim rules will provide the market with room to innovate and to create useful risk-management tools within its overall structure.

Moreover, the interim rules have been modified from the proposed rules in a number of important respects apart from issues relating to the pilot program's overall structure. In response to specific suggestions by commenters, the interim rules clarify and streamline several specific regulatory requirements. In several instances, the interim rules significantly lessen the burden that the proposed rules would have imposed on those who register as agricultural trade option merchants and their sales forces, as well as the requirements relating to

<sup>14</sup> See, CFTC Interpretive Letter No. 96-41, Division of Economic Analysis Statement of Policy in Connection with the Unwinding of Certain Existing Contracts for the Delivery of Grain, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,691 (Division of Economic Analysis) for a discussion of impermissible offset provisions.

<sup>15</sup> Proposed rule 32.13(a)(7)(i) (paragraph of required disclosure statement entitled "Business Use of Trade Options").

<sup>16</sup> Accordingly, proposed rule 32.13(a)(7)(ii)(D) required disclosure of the worst possible financial outcome where "through amendments to the option contract it is possible to lose more than the amount of the initial purchase price." 62 FR 59638.

<sup>17</sup> A price adjustment to reflect the remaining value of the trade option contract upon substitution of a fixed-price forward contract for the option is consistent with the treatment accorded minimum price guaranteed forward contracts by Commission staff. The Division of Economic Analysis in CFTC Interpretive Letter 96-23, (Re: Sections 1a(11) and 2(a)(1) of the Commodity Exchange Act—Request for Guidance Regarding Producer Option Contract), [1994-1996 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶ 26,646, expressed the view that, within a forward delivery contract offering a guaranteed minimum price, the holder of the contract could elect to eliminate the upside pricing potential (the option-like pricing component) in the contract in return for establishing a fixed price forward contract, the price of which was adjusted to reflect the liquidated remaining value of the option component. The option-like pricing component could not, however, be reestablished in the contract.

<sup>18</sup> One comment letter questioned whether agricultural cooperatives would be able to meet the net worth requirement for registration as an agricultural trade option merchant by combining the individual net worth of each member. Generally the rules do not distinguish cooperatives from any other type of enterprise. Accordingly, the cooperative must itself have a net worth of \$50,000 to meet the applicable requirement. To the extent that cooperatives act on behalf of members as a commodity merchandiser, they may purchase agricultural trade options in connection with their merchandising function. Of course, in doing so they would have to have the contractual right to deliver the commodity to settle those options which they choose to exercise.

the merchant's on-going business operations. These modifications are intended to achieve the same regulatory goals, and provide a similar degree of protection, as the rules as proposed, but in a less costly or burdensome manner. The specific changes are discussed in greater detail below.

### B. Regulation of Agricultural Trade Option Merchants

#### 1. Registration

Registration of commodity professionals is an important means by which the Commission polices the futures and option industry and is the primary mechanism for reassuring the public of the honesty and proficiency of futures professionals. As the Commission noted in its notice of proposed rulemaking, "registration \* \* \* will be critically important in the decentralized market permitted under the pilot program." The notice further noted, however, that the need for extensive registration requirements is offset by the fact that the offer and sale of trade options would be a complement to the first-handler's existing cash market businesses. Accordingly, the Commission proposed a streamlined form of registration, consisting of a single application form covering both the agricultural trade option merchant as an entity and its authorized sales force.

The Commission also proposed to delegate administration of the registration function to the National Futures Association (NFA). Although some commenters opposed this on the grounds that it would "permit another user-fee based regulator \* \* \* to initiate far-reaching regulatory activities among cash market businesses," the delegation to the NFA is narrow, confined to administration of the registration function,<sup>19</sup> and necessary to conserve Commission resources.

Based upon its administrative experience, NFA suggested a number of modifications to the proposed registration rules. In its view, a single application for registration of the agricultural trade option merchant and its sales force "rather than providing a streamlined registration process, \* \* \* will unduly complicate and actually hinder the registration of ATMs." Because the Commission's ultimate goal is for the overall registration process to be streamlined, the Commission has incorporated the NFA's suggestions into the interim rules. Accordingly, agricultural trade option merchants and their associated persons will be required

to file separate registration applications, each focussed specifically on the requirements for that category of registrant. Separate forms in support of the agricultural trade option merchant's application for registration are also required of the natural persons who are its principals. Individual application forms for each category should result in greater simplicity for each and not in an increase in the total length of the applications or in the amount of information provided.

NFA also suggested a number of rule clarifications, including the addition of definitions of the registration categories and incorporation by explicit reference of the procedures for denial, suspension and revocation of applications for registration which are applicable to all classes of registrant under the Commission's rules. The interim rules have been modified to reflect these technical changes.<sup>20</sup>

Many commenters offered the view that the proposed registration requirements for agricultural trade option vendors should be relaxed. This view was shared by both potential customers and vendors alike. The joint comment noted the agricultural associations' "concern () that the high level of specific regulation \* \* \* will impose excessive costs \* \* \* that are not reflective of, or proportionate to, the risks associated with removing the ban \* \* \* for a narrowly defined range of products." Specifically, the joint comment suggested that the fingerprint requirement was unnecessary and that the proficiency and ethics training requirements be relaxed. A company

<sup>20</sup> The Commission's explicit application of various of its procedural rules to agricultural trade option merchants and their associated persons in no way limits the applicability of any other statutory or regulatory provision which is applicable to Commission registrants. In this regard, the Act and many of the Commission's rules impose requirements or prohibitions on Commission registrants using the phrase "any person or registrant who is registered under this Act" or similar words. For example, Section 14 of the Act provides aggrieved customers with the opportunity to bring before the Commission for adjudication disputes involving violations of the Act or rules by "any person registered under this Act." See also, 17 CFR 3.34, 3.56, 3.60. Although "agricultural trade option merchant" and "associated person of an agricultural trade option merchant" are not registration categories defined by the Act, they are nevertheless registration categories "under the Act" by virtue of the Commission's promulgation of rules creating these registration categories under section 4c(b) of the Act (its plenary authority over the regulation of options) and under section 8a(5) of the Act (its general rulemaking authority). The Commission's reparations program under section 14 of the Act will therefore be available to customers of agricultural trade option merchants and their associated persons as it is for all other categories of Commission registrant. Customers will be apprised of this right in the required summary disclosure document.

active in the cash grain business noted that "[r]egistration for those organizations offering ATOs in the pilot program period seems reasonable, but the imposition of testing requirements, ethics training, and fingerprinting push the regulatory oversight of these products beyond a reasonable limit."

The Commission has reconsidered these proposals in light of similar comments received from a broad range of commenters. The reason that fingerprints typically are required of registrants is to perform a background check verifying the information submitted on the registration application. This requirement may be less necessary in the context of agricultural trade options where a likely characteristic of the market is a pre-existing commercial relationship between the vendor and customer. The likelihood of such a relationship is reinforced by the requirement that options, if exercised, must be physically delivered. That requirement generally will tend to keep the markets local, where there is a greater likelihood that customers will have personal knowledge of the background of the agricultural trade option merchant and its sales force.<sup>21</sup> Accordingly, the Commission has removed this requirement from the interim rules, and because the primary delay in processing registration applications has been associated with fingerprint checks, the Commission has also removed from the interim rules provisions relating to temporary licensing of registrants.

The interim rules modify the requirement that persons applying for registration pass a competency test and fulfill an ethics training requirement. Many commenters representing both potential customers and vendors suggested that the testing requirement would dissuade individuals from registering, particularly because this would be a sideline to their core cash-businesses. Several commenters specifically objected that the Series 3 examination, which was included in the proposed regulations as a permissible alternative to a more focussed test not yet developed, would not be relevant to these products.

As noted in the advance notice, a competency test is only one means for ensuring the market vendors have the

<sup>21</sup> The local nature of cash marketing channels is typical for many, but certainly not all, commodities. The interim rule's requirements must generally be understood within the normal cash marketing channels for each commodity. For some commodities, normal cash marketing channels include delivery obligations being undertaken as to processors or users at a considerable distance from producers.

<sup>19</sup> Fees will be limited to the cost of this one function and are expected to be modest.

requisite professional and market knowledge. Development of a testing program specifically focussed on this market may be premature in light of the unknown number or composition of potential vendors and the existing tests' admitted lack of direct relevance to these products. However, almost all those commenting agreed that education was needed. Many organizations representing both likely customers and potential vendors suggested that this education be voluntary and stated an intention to offer educational training opportunities to their members.

As the Commission noted in its notice of proposed rulemaking, "customers have the right to expect that such merchants and their sales forces will have successfully demonstrated mastery of the issues relevant to the offer or sale of these instruments." 62 FR 59630, n. 35. In order to provide customers with some assurance that this expectation will be met, the interim rules substitute for the proposed competency test a requirement that those seeking registration as associated persons of an agricultural trade option merchant complete six hours of instruction in the requirements of the Act and rules promulgated thereunder, the economic functioning and risks of agricultural trade options, and the registrant's responsibility to observe just and equitable principles of trade relating to such options. This course of instruction includes among others, the subjects which would have been specified by the proposed ethics training requirement. Accordingly, that proposal has been deleted. Instruction can be by videotape or electronic media and need not be through classroom attendance.

The applicant for registration as an associated person must include in the application evidence provided by an eligible instructional provider that the applicant completed this instructional requirement. This evidence of completion must include a certification that the instructor has three years of relevant experience, is not subject to a statutory or other disqualification and a disclaimer that the Commission or the NFA has not approved the course of study's content.<sup>22</sup> Instructors must notify the NFA of their intent and

eligibility to offer such training prior to doing so, and must maintain appropriate documentation of applicants' completion of the requirement.

There is no educational requirement for customers. However, as the Commission previously stated:

it strongly urges private sector organizations to provide a variety of means of fulfilling this need. The success of the pilot program will depend, in part, on the success of various organizations in educating potential trade option customers.

*Id.*

## 2. Financial Requirements

The Commission, in proposing various financial protection requirements, noted that agricultural trade options, like all commodity futures or option instruments, involve risk arising from the need for performance at a future date by the contract's counterparties. Off-exchange transactions such as these, however, do not have the safety of an exchange clearinghouse to reduce credit risk. Because many agricultural trade option customers will not have the resources to conduct formal credit worthiness evaluations of their counterparties, the Commission proposed that agricultural trade option merchants be required to maintain a minimum level of net worth and to segregate from their own funds premiums paid by customers at initiation of an option contract. It did not propose requiring agricultural trade option merchants to cover their market exposure. 62 FR 59628-59630.

The Commission proposed the minimum net worth requirement "to establish a base level for entry or access to a market \* \* \* to assure that companies or entities conducting business offer some assurance of having the financial wherewithal to perform on their obligations." 62 FR 59628. Commenters on the advance notice were not unanimous in support of such a minimum financial requirement. Some were opposed in order not to exclude smaller entities, and others argued that various state financial requirements would be sufficient. Believing that a common federal minimum standard should prevail, the Commission proposed to apply to agricultural trade option merchants the \$50,000 minimum net worth requirement established by the United States Department of Agriculture (USDA) (and many states) as a condition of obtaining a federal grain warehouse license.

A number of commenters took issue with the \$50,000 minimum net worth requirement, suggesting that it was too low. The joint comment suggested that

agricultural trade option merchants be required to "maintain a bond equal to \* \* \* premiums of all customer options less the current cash value of the contracted commodities in addition to existing state or federal bonding requirements." One potential vendor recommended a minimum net worth of \$1 million with adjustments "to require that the risk exposure of a seller of options has an appropriate relationship to the seller's net worth," reasoning that "one of the greatest risks to the development of an efficient agricultural trade option market is that undercapitalized sellers of the options will default." Other commenters supported the proposed net worth requirement as an appropriate minimum level.

The Commission agrees that the \$50,000 net worth requirement will offer only limited protection from counterparty default risk. However, the price risk to the agricultural trade option merchant of an option position will be similar to that of a forward contract position. Greater financial protection would indeed be achieved, as suggested by several commenters, by requiring vendors to post bond or to maintain increasing levels of net worth as the degree of exposure rises. Nevertheless, constructing a meaningful regulatory scheme to achieve that goal, however appealing the concept, would result in rules which are far more complex than any of those proposed, including rules on uniformly valuing various risks. In this regard, the rules governing computation of regulatory capital which must be maintained by futures commission merchants are among the most complex of all of the Commission's rules. In addition, such a dynamic valuation requirement would require a degree of regulatory supervision that would be difficult if not impossible to achieve in this decentralized, over-the-counter market.<sup>23</sup> In these circumstances, the suggested bonding requirement might lull market participants into a false sense of security. Accordingly, the Commission is adopting the minimum net worth requirement as proposed.

The interim rules, as proposed, provide that the net worth requirement is ongoing in nature, requiring

<sup>23</sup>The regulated futures markets provide a high level of financial protection through their clearinghouses. Each exchange has a compliance and audit staff, and clearing members and futures commission merchants devote significant resources to auditing for compliance with the various financial requirements. The Commission cannot offer comparable protection for transactions outside of the regulated exchange environment. Customers must accept the fact that trading off-exchange entails greater counterparty risk.

<sup>22</sup> At least one commenter, a large grain merchant, commented that it provided in-house ethics and business training for its employees. In-house training by an agricultural trade option merchant for its associated persons is not precluded by these rules, nor is the use of employees as instructors. Employee-instructors meeting the requisite requirements will be qualified to certify fulfillment of the training requirement for other employees. Such employee-instructors, however, cannot be the direct supervisor of the associated person applying for registration.

agricultural trade option merchants to maintain the specified level of net worth in order to enter into new trade option contracts and requiring them to notify the Commission at any time if they have fallen below prescribed levels. In addition, the agricultural trade option merchant must perform a reconciliation of its financial position at least monthly to determine compliance with this requirement. It need not change accounting procedures to conform to specific Commission accounting requirements, provided it uses "fair value" accounting under Generally-Accepted Accounting Principles, the accounting method generally used by cash market businesses.<sup>24</sup>

However, the interim rule has been modified from the proposed rule which required agricultural trade option merchants to hold in segregation all premiums paid by customers at the initiation of the option contract. Several commenters suggested that the requirement as proposed would discourage vendors from responsibly covering the risk of the transaction and suggested that the Commission permit vendors to use customer premiums to hedge that risk. The Commission proposed the segregation requirement both as a means of discouraging a business in financial difficulty from writing options to generate immediate cash and as a means of better safeguarding customer funds. 62 FR 59629. Permitting the vendor to hedge the option's risk using the customer's funds, particularly if the covering transaction is exchange-traded, also achieves these objectives. Accordingly, although the Commission is not mandating that agricultural trade option merchants cover their risk, the interim rules permit the merchant to use up-front customer premiums to hedge those risks using exchange-traded instruments. Customer funds not used for this purpose, as proposed, must be

treated as the funds of the customer and be kept in a segregated account.<sup>25</sup>

### 3. Recordkeeping and Reporting Requirements

In proposing recordkeeping requirements, the Commission reasoned that "the maintenance of full, complete, and systematic books and records by agricultural trade option merchants is crucial to the Commission's ability to respond to complaints of customer abuse arising from such transactions and is necessary to the agricultural trade option merchant's establishment of appropriate internal controls of their financial operations." 62 FR 59633. Most commenters agreed and supported the requirements as proposed. At least one commenter, however, questioned the requirement that a record of unfilled or canceled contract orders be kept. It reasoned that "[r]ecording all orders and cancellations will likely provide little insight to the CFTC when compared to the arduous task of tracking these records for those offering these products." This recordkeeping requirement, however, serves a different purpose than informational reporting to the Commission. The keeping of complete books and records is necessary to resolve particular customer disputes, if they arise, and is a sound business practice. The Commission therefore is adopting the recordkeeping rule as proposed.<sup>26</sup> However, the Commission has modified the interim rule by deleting the NFA's proposed authority to inspect books and records at the request of the NFA and as suggested by other commenters.

In addition to the keeping of books and records, the Commission proposed two distinct reporting requirements—routine and special call reporting. Routine reports are required for general market surveillance purposes, to permit the Commission to construct a picture of the market and to evaluate the impact of activity in the trade option market on the cash and exchange-traded markets.<sup>27</sup>

One commenter suggested that information on the total premiums collected and the total value of all fees, commissions, or other charges during the reporting period was not necessary to this surveillance function. The Commission agrees, and the interim rules do not require the routine reporting of premiums, fees, commissions, or other charges. However, this information may be helpful to a complete understanding of the market's operation, particularly during the pilot phase of the rules. Accordingly, the Commission is retaining the authority to request such information on a special call basis.

Special calls are a reporting device used by the Commission for obtaining information only when needed. A special call may be used to elicit information from a particular trader or registrant for market or financial surveillance purposes or to gather data for market-wide studies. As the Commission explained in the notice of proposed rulemaking, it anticipates the need to issue special calls for information during the pilot program to gather data with which to assess its success. 62 FR 59633. At least one commenter suggested that the proposed rule be clarified that the agricultural trade option merchant "be required to report \* \* \* only the 'options' portion of the \* \* \* position." As proposed, rule 32.13(e) in the introductory paragraph stated that special calls were for "information relating to agricultural trade options." However, to clarify further the provision, the Commission is modifying the rule as adopted to provide that the information which can be requested by special call concerning futures or cash transactions must be related to the agricultural trade option position. In this regard, potential agricultural trade option merchants should be assured that the Commission exercises its existing special call authority in other markets with restraint and with an understanding of the costs involved in any such request. As noted in the notice of proposed rulemaking, the Commission encourages agricultural trade option merchants to maintain a current listing of customers names and other identifying information for ease of compliance.<sup>28</sup>

authority to collect these reports, is encouraged to work cooperatively with the industry in advancing appropriate procedures, conventions and standards for electronic transmission.

<sup>28</sup> Generally, a special call for study purposes requests specified information on all positions open on the call date. The Commission expects that any special calls would request information related to a customer's positions in agricultural trade options

<sup>24</sup> The Commission believes that the guidance provided in the American Institute of Certified Public Accountant's Audit and Accounting Guide entitled "Brokers and Dealers in Securities" provides the relevant guidance which should be followed in connection with assigning a fair value to agricultural trade options. It states, "Under generally accepted accounting principles, fair value is measured in a variety of ways depending on the nature of the instrument and the manner in which it is traded. Many financial instruments are publicly traded, and end-of-day market quotations are readily available. Quoted market prices, if available, are the best evidence of the fair value of a financial instrument. If quoted market prices are not available, management's best estimate of fair value should be based on the consistent application of a variety of factors available to management." A complete discussion of the factors is provided in the audit guide.

<sup>25</sup> An agribusiness company commented that the rules "should indicate (like § 1.25) that the seller of the options can invest funds in government obligations to earn interest." The proposed (and interim) rules so provide. See, paragraph (e) of § 32.6, incorporated by reference in proposed rule 32.13(a)(4).

<sup>26</sup> As proposed, the final rules require that records relating to agricultural trade options including covering transactions must be kept and maintained for a period of five years and must be readily accessible during the first two years of that five-year period. See, 17 CFR 1.31.

<sup>27</sup> Initially, the Commission anticipates that such reports will be filed manually, including by facsimile. However, it also anticipates that as the pilot program proceeds, reports will be filed electronically, by dial-up transmission or via the Internet. The NFA, which has been delegated

*C. Customer Protections—Risk Disclosure, Required Contract Terms and Required Account Information*

1. Risk Disclosure Statement

Almost all commenters agreed that required risk disclosure was a valuable and necessary means of protecting customers. In promulgating the interim rule, the Commission has clarified the requirement that both an initial summary risk disclosure statement and transaction-specific disclosure statements be provided.

Many of the commenters opined that the proposed summary risk disclosure was too lengthy and feared that many customers would forego reading it. The Commission after reviewing the proposed summary disclosure statement has shortened it by deleting some redundant information, by further summarizing other information and by simplifying its language.<sup>29</sup>

Some customers opposed the transaction-specific disclosure, objecting that this requirement would prove to be burdensome for the limited sales forces many agricultural trade option merchants may employ. Other commenters strongly supported it, noting that the transaction-specific disclosures are necessary to a customer's understanding of the nature of the option transaction being entered. The Commission concurs. The transaction specific disclosures need not be voluminous, are not required to be in a separate document and can be included as an addendum to the contract form itself. Although some commenters objected to the requirement that the worst possible financial outcome be disclosed, that requirement is only triggered when the option premium is not collected up front or when the contract is amended. The

along with the customer's name and other identifying information. In the past, some firms have maintained some, but not all identifying information at a central location, and branch locations have kept the remaining information in differing formats, creating difficulty in providing the information requested. Accordingly, in setting up their information systems, firms should keep in mind the likelihood of a request for this information during the pilot program.

<sup>29</sup> One commenter opined that the reparations language of the summary disclosure document was unclear as to its impact on the availability of other venues for dispute resolution, such as arbitration offered under the auspices of a trade association. The language of the summary disclosure document has been modified to make clear that all customers have the right to use the Commission's reparations program to resolve disputes. Thus, the customer may not be compelled to waive this right by any other provision in the customer agreement or elsewhere. Customers may, however, voluntarily agree to an alternative method of dispute resolution specified in the customer agreement, the contract or elsewhere. Compare, Commission Regulation 180.3(b)(3).

worst possible outcome need not take into account lost opportunity cost—therefore, it often will only be the potential loss of the premium and other related charges. Where a contract is being amended, such as by rolling the delivery date, the worst possible outcome will include the cost of the additional premium, fees and adjustment to the price resulting from any gain or loss on the contract at the time of the amendment or contract roll. In light of the imperfect understanding many hedge-to-arrive customers had of the effect of rolling on their final contract price, such a disclosure is plainly needed. Accordingly, the Commission is adopting this rule as proposed.

As the Commission explained in the notice of proposed rulemaking, “the provision of the mandatory risk disclosure statement will not relieve the agricultural trade option merchant of the responsibility to avoid material misstatements or omissions or any other form of fraudulent misconduct.” 62 FR 59632. Thus, providing a mandatory risk disclosure statement will not necessarily cure what is otherwise fraud. See, e.g., *Clayton Brokerage Co. v. Commodity Futures Trading Commission*, 794 F.2d 573, 580–581 (11th cir. 1986). Accordingly, agricultural trade option merchants may need to make such additional disclosures as necessary in light of all the particular circumstances, including the nature of the instrument and the customer.<sup>30</sup>

2. Written Contract Terms

Generally, commenters supported the proposed rules requiring that specific contract terms be in writing. However, several commenters objected to the proposed requirement that the written contract terms include the quality or grade of commodity to be delivered if the contract is exercised and any adjustment or price for deviation from stated quality or grade. One commenter, a cash grain merchant, stated that the proposed requirement was not consistent with cash market practice. That commenter stated that:

transactions are established in most instances, for a specific quality of grain. \* \* \* To the degree that the actual grain delivered under these agreements fails to meet the standard grade specified in the contract, the buyer and seller must determine the impact on the value of the commodity delivered, and negotiate discounts/premiums accordingly.

<sup>30</sup> One commenter suggested that the Commission clarify that the disclosure statement could be electronic. The Commission agrees and has clarified that electronic disclosure is permitted.

Others active in the cash markets agreed, nothing that common cash market practice is for a forward contract to specify price for a standard commodity grade and for adjustments to be made for variance from this specification by reference to posted schedules of discounts or premiums. Reportedly, these schedules vary frequently, often daily. In light of these comments, the Commission is modifying the interim rule to make clear that an exact schedule of discounts/premiums need not be specified and that such adjustments can be stated as a range and method for determining adjustments, such as “posted market scale of discounts at delivery.”

3. Customer Account Information

Many commenters supported the proposed requirement that agricultural trade option merchants provide customers with information regarding their positions and accounts. However, several noted that the monthly account statement would impose a costly informational burden for a questionable benefit. They explained that few entities likely to become agricultural trade option merchants have available the information infrastructure to produce monthly account statements valuing the transactions and that such information would be of only marginal utility to customers in light of the requirement that option contracts must be settled by delivery. The Commission finds this persuasive and is modifying the monthly account statement requirement to provide that the agricultural trade option merchant notify customers of the expiration date of each option which will expire within the next month. This should greatly reduce the informational burden on agricultural trade option merchants but nevertheless provide customers with notice sufficient to reduce the occasions on which customers permit in-the-money options to expire due to inattention.<sup>31</sup>

In addition to the monthly account statements, the Commission proposed that agricultural trade option merchants provide customers in writing, within twenty-four hours of a request, current commodity price quotes or other information relevant to the customer's position and account. A number of

<sup>31</sup> At least one commenter representing producers suggested that, although the monthly account statement requirement might be unduly burdensome, agricultural trade option merchants as a matter of best practices should periodically update their customers on market conditions, particularly during times of high volatility. The Commission agrees that this is desirable and will consider further the issue of periodic customer statements based on experience under the pilot rules.

commenters supported this requirement, but others suggested that it could prove to be an undue burden, particularly because it required a written response within so short a time. In light of the modification of the monthly account statement requirement discussed above, the requirement to provide customers with account-related information upon request is of even greater importance. However, the Commission is modifying the interim rule to lessen the burden which it imposes by requiring that all responses be in writing. This may be particularly useful where the requested information relates mainly to market conditions or quotes and the agricultural trade option merchant provides an immediate response by telephone. The customer may ask, however, that the information be supplied in writing, and under the rule as modified the agricultural trade option merchant must do so within 48 hours of the request. These modifications should strike the appropriate balance between providing customers with timely account-related information and the burden on the agricultural trade option merchant of doing so.

#### D. Exemption for Sophisticated Entities

The Commission proposed to exempt individuals or entities who are commercials and have a net worth of at least \$10 million from compliance with the conditions for trading agricultural trade options. Several commenters suggested that the Commission clarify whether a high net worth entity acting as a vendor would be exempt from the rules' requirements. The exemption applies only to high net worth entities trading among themselves. If an option customer does not meet the net worth requirement, the agricultural trade option merchant must comply with all of the rules applicable to such option transactions.

In addition, a number of commenters suggested that the Commission clarify that the exemption also applies to the associated registration requirement and to the trade option prohibition itself. The Commission has done so. However, it should be equally clear that the exemption from the conditions under which the prohibition is being lifted is not independent of the pilot program, but rather part of it. Thus, the exemption for high net worth individuals and entities will be the subject of Commission oversight and may be reconsidered, as with any other of the interim rules, based upon market experience during the pilot period.

Several commenters questioned the reason for, and the effect of, the higher

dollar level for this exemption than the exemptions applicable to high net worth persons under parts 35 and part 36 of the Commission's rules.<sup>32</sup> The Commission remains convinced that the dollar level of this exemption is appropriate and is adopting it as proposed. The exemptions under parts 35 and 36 were promulgated a number of years ago, and the Commission has announced that it will publish a concept release seeking comment on them. Issues relating to the dollar level of those exemptions are more appropriately considered in that context.

One commenter representing swaps dealers requested that the Commission clarify that the part 35 exemption applies to off-exchange agricultural options rather than this exemption. The Commission disagrees. Any off-exchange option on an enumerated agricultural commodity must comply with Commission rule 32.13(g) for exemption from the Act and Commission rules, and no other exemptive provision is available.<sup>33</sup>

Another commenter suggested that the Commission modify the proposed rule to exempt transactions "between parties whose obligations under the option contract are guaranteed by a high net worth affiliate." The Commission recognizes that certain sophisticated, high net worth entities may choose to conduct business through less well capitalized affiliates or subsidiaries for a variety of reasons. Accordingly, it is modifying the interim rule to permit a

<sup>32</sup> The Commission explained in the notice of proposed rulemaking that, "[u]nder parts 35 and 36, corporations or partnerships having total assets exceeding \$10 million or net worth of \$1 million in cases where the transaction was entered into in connection with the conduct of its business or to manage the risk of an asset or liability, are considered eligible for the exemption. Some have observed, however, that these qualifying amounts when applied to entities in agriculture are too low given the relatively large investment in land and equipment needed to operate a farm. The concern is that a relatively large number of individuals engaged in agriculture might meet these financial criteria based not so much on their investment sophistication and ability to gather and manage a sizable asset portfolio, but rather simply reflecting the need to acquire a threshold level of land and machinery to operate successfully a farm or agricultural enterprise. Accordingly, the Commission is proposing that, to qualify for this exemption, individuals or entities should have a net worth of at least \$10 million." 62 FR 59634.

<sup>33</sup> In supporting its view, the commenter suggested that the Commission "clarify that the restrictions on the use of agricultural trade options do not limit the scope of the Swap Exemption," citing the study of the Commission's Division of Economic Analysis. The commenter further stated that in that way, "the CFTC will eliminate uncertainty." Promulgation of this exemption which explicitly is applicable to options on agricultural commodities eliminates any such uncertainty.

party to qualify for the exemption on the strength of a guarantee by its affiliate which does meet the net-worth requirement.

#### E. Relief for Exchange-Traded Instruments

Representatives of several futures and option exchanges expressed the concern that lifting the ban on agricultural trade options would put the exchanges at a competitive disadvantage. In commenting on the advance notice, an exchange official noted that futures exchanges currently are prohibited from offering options on physicals for these same commodities,<sup>34</sup> thereby restricting their ability to offer certain flexible exchange-traded instruments and to compete with agricultural trade options.<sup>35</sup>

The Commission agreed with the exchange commenter and proposed to remove the restriction on exchange trading of options on physicals on these commodities. A different exchange responded to this proposal, labeling it a "remarkably empty gesture."<sup>36</sup> Whether or not the exchanges choose to compete with physically-settled trade options by offering flexible physically-settled option contracts, the Commission believes that there is no longer a reason to preclude them from doing so by regulation. Accordingly, it is removing the restriction for exchange-traded

<sup>34</sup> Commission rule 33.4 provides in part that "[t]he Commission may designate any board of trade located in the United States as a contract market for the trading of \* \* \* options on physicals in any commodity regulated under the Act other than those commodities which are specifically enumerated in section 1a(3) of the Act \* \* \*"

<sup>35</sup> Flex options on futures on the enumerated agriculture commodities have recently been proposed by exchanges and approved by the Commission under current rules. These options are flexible in terms of strike prices, last trading days, the underlying futures months, and the style of exercise—American or European. Additional types of flexible terms involving physical delivery would be permitted if the Commission's rule is amended.

<sup>36</sup> The exchange further complained that it "is uncertain if there is sufficient demand for exchange-trade[d] options on physicals. In contrast, the present demand for our futures options contracts is measurable, and the [exchange] is justifiably fearful that the Commission's proposed pilot-program will adversely affect such demand." Finally, the exchange notes that the Commission unfairly holds the exchanges to higher regulatory standards than proposed here and failed to include agricultural options within the Part 36 pilot program.

Part 36 was promulgated by the Commission to initiate a pilot program for less regulated exchange markets for professionals. No futures exchange has listed a contract to trade pursuant to those rules. Although the Commission did not include the agricultural commodities in the pilot program initially, had the Part 36 pilot program been successful, the Commission might have reconsidered its scope as it did with the initial 1982 pilot program to introduce exchange-traded options.

physically-settled agricultural contracts, as proposed.

#### IV. Other Matters

##### A. Paperwork Reduction Act (PRA)

When publishing final rules, the PRA of 1995 (Pub. L. 104-13 (May 13, 1995)) imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. In compliance with the Act, these interim final rules inform the public of:

(1) the reasons the information is planned to be and/or has been collected; (2) the way such information is planned to be and/or has been used to further the proper performance of the functions of the agency; (3) an estimate, to the extent practicable, of the average burden of the collection (together with a request that the public direct to the agency any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden); (4) whether responses to the collection of information are voluntary, required to obtain or retain a benefit or mandatory; (5) the nature and extent of confidentiality to be provided, if any; and (6) the fact that an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number."

The Commission previously submitted these rules in proposed form and its associated information collection requirements to the Office of Management and Budget (OMB). OMB approved the collection of information associated with these rules on January 15, 1998 and assigned OMB control number 3038-0048 to these rules. The burden associated with this entire collection is as follows:

*Average burden hours per response:* 74.35.

*Number of respondents:* 3610.

*Frequency of response:* Daily.

Persons wishing to comment on the information required by these interim final rules should contact the Desk Officer, CFTC, Office of Management and Budget, Room 10202, NEOB, Washington, DC 20503, (202) 395-7340. Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street NW, Washington, DC 20581, (202) 418-5160.

##### B. Regulatory Flexibility Act (RFA)

The RFA, 5 U.S.C. 601 *et seq.*, requires that agencies consider the impact of those rules on small businesses. The Commission has not previously determined whether all or some agricultural trade option merchants should be considered "small entities" for purposes of the RFA and,

if so, the economic impact on such entities. However, the Commission is requiring as one of the conditions for registration as an agricultural trade option merchant that the entity maintain a minimum net worth of \$50,000. The Commission previously found that other entities which were required to maintain minimum levels of net capital were not small entities for purposes of the RFA. See, 47 FR 18618, 18619 (April 30, 1982). The Commission has also found, however, that one category of Commission registrant required to maintain a minimum level of net capital—introducing brokers (IBs)—may include small entities for purposes of the RFA.<sup>37</sup> In addition to the \$50,000 minimum net worth required for registration as an agricultural trade option merchant, such registrants must be in business in the underlying cash commodity so that they are able to take physical delivery on those option contracts. This will require that they have additional resources in order to qualify as an agricultural trade option merchant, in contrast to an IB whose additional investment beyond the minimum net capital may be relatively small. For this reason, the Commission believes that agricultural trade option merchants are more appropriately treated as not small entities under the RFA. 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. This certification is based on the fact that the interim final rules will remove a complete ban on the offer or sale of trade options on the agricultural commodities enumerated under the Act. The interim final rules permitting such transactions subject to the specified conditions, therefore, remove a burden for all entities, regardless of size.

#### List of Subjects

##### 17 CFR Part 3

Administrative practice and procedure, Brokers, Commodity futures.

##### 17 CFR Part 32

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

<sup>37</sup> An IB is required to maintain adjusted net capital in the amount of \$30,000, unless it enters into a guarantee agreement with an FCM. Most IBs operate pursuant to such an agreement. See, 61 FR 19177 (May 1, 1996).

##### 17 CFR Part 33

Commodity futures, Consumer protection, Fraud.

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

#### PART 3—REGISTRATION

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

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

2. Part 3 is amended by adding new §§ 3.13 and 3.14 to read as follows:

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

(a) *Definitions.* (1) *Agricultural trade option merchant.* "Agricultural trade option merchant" means any person that is in the business of soliciting, offering to enter into, entering into, confirming the execution of, or maintaining a position in, transactions or agreements in interstate commerce which are not conducted or executed on or subject to the rules of a contract market, and which are or are held out to be of the character of, or are commonly known to the trade as, an "option," "privilege," "indemnity," "bid," "offer," "put," "call," "advance guarantee," or "decline guarantee," involving wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. *Provided, however,* that any person entering into such transactions solely for the purpose of managing the risk arising from the conduct of his or her own commercial enterprise is not considered to be in the business described in this paragraph.

(2) *Associated person of an agricultural trade option merchant.* "Associated person of an agricultural trade option merchant" means a partner, employee, or agent (or any person occupying a similar status or performing similar functions) that:

(i) Solicits or accepts customers' orders (other than in a clerical capacity) or

(ii) Supervises any person or persons so engaged.

(b) *Registration required.* It shall be unlawful for any person in the business of soliciting, offering or selling the instruments listed in § 32.2 of this chapter to solicit, to offer to enter into, or to enter into, to confirm the execution of, or to maintain transactions in such instruments or to supervise persons so engaged except if registered as an agricultural trade option merchant or as an associated person of such a registered agricultural trade option merchant under this section.

(c) *Duration of registration.* (1) A person registered in accordance with the provisions of this section shall continue to be registered until the revocation or withdrawal of registration.

(2) Agricultural trade option merchants must notify the National Futures Association within twenty days when an associated person has ceased to be so associated.

(3) An associated person who ceases to be associated with a registered agricultural trade option merchant is prohibited from engaging in activities requiring registration under § 32.13 of this chapter or representing himself or herself to be a registrant until:

(i) A registered agricultural trade option merchant notifies the National Futures Association of the person's association; and

(ii) The associated person certifies to the National Futures Association that he or she is not disqualified from registration for the reasons listed in section 8a(2) and (3) of the Act; *Provided however,* no such certification is required when the associated person becomes associated with the new agricultural trade option merchant within ninety days from when the associated person ceased the previous association.

(d) *Conditions for registration.* (1) Applicants for registration as an agricultural trade option merchant must meet the following conditions:

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

(ii) The agricultural trade option merchant must identify each of the natural persons who are the agricultural trade option merchant's principals, as defined in § 3.1(a), and for any principal which is a non-natural person, each natural person who is the holder or beneficial owner of ten percent or more of the outstanding shares of any class of stock or has contributed ten percent or more of the capital of the entity that is principal;

(iii) Each of the natural persons identified in paragraph (d)(1) of this section must certify that he or she is not disqualified from registration for the reasons listed in section 8a(2) and (3) of the Act;

(iv) The agricultural trade option merchant must certify that to the best of its knowledge, information and belief each of its associated persons or persons it intends to employ as an associated person within thirty days of that person's registration meets the requirements for registration as such; and

(v) The agricultural trade option merchant must provide access to any representative of the Commission or the U.S. Department of Justice for the purpose of inspecting books and records.

(2) Applicants for registration as an associated person of an agricultural trade option merchant must meet the following conditions. Such persons must:

(i) Identify the agricultural trade option merchant with whom the person is associated or to be associated within thirty days of the person's registration;

(ii) Certify that he or she is not disqualified from registration for the reasons listed in section 8a(2) and (3) of the Act; and

(iii) Complete six hours of instruction in the requirements of the Act and rules promulgated thereunder, the economic functioning and risks of the transactions permitted in § 32.13 of this chapter, and the registrant's responsibility to observe just and equitable principles of trade relating to such transactions. Such instruction can be by classroom, videotape or electronic presentation.

(e) *Applications for registration.* (1) The agricultural trade option merchant including its principals and associated persons of an agricultural trade option merchant must apply for registration on the appropriate forms specified by the National Futures Association and approved by the Commission, in accordance with the instructions thereto, including the separate certifications from each natural person that he or she is not disqualified for any of the reasons listed in section 8a(2) and (3) of the Act and such other identifying background information as may be specified.

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

(3) An associated person's application must also include written evidence from the person providing the instruction that the applicant completed the six hours of instruction required by paragraph (d)(2)(iii) of this section.

(4) These applications must be supplemented to include any changes in the information required to be provided thereon on a form specified by the National Futures Association and approved by the Commission.

(f) *Withdrawal of application for registration; denial, suspension and revocation of registration.* The provisions of §§ 3.51, 3.55, 3.56 and 3.60 shall apply to applicants for registration and registrants as agricultural trade options merchants and their associated persons under this part 3 as though they were an applicant or registrant in any capacity under the Act.

(g) *Withdrawal from registration.* An agricultural trade option merchant that has ceased or has not commenced engaging in activities requiring registration may withdraw from registration 30 days after notifying the National Futures Association on the specified form of its intent to do so, unless otherwise notified by the National Futures Association or by the Commission. Such a withdrawal notification must include information identifying the location of, and the custodian authorized to release, the agricultural trade option merchant's records, a statement of the disposition of customer positions, cash balances, securities or other property and a statement that no obligations to customers arising from agricultural trade options remain outstanding.

(h) *Dual registration of associated persons.* An associated person of an agricultural trade option merchant may be associated with other registrants subject to the provisions of § 3.12(f).

#### **§ 3.14 Requirements for trainers of associated persons of agricultural trade option merchants.**

(a) A person offering instruction or preparing an instructional videotape or electronic presentation under this section must meet the following conditions:

(1) Has a minimum of three years of relevant experience; and

(2) Is not subject to:

(i) Statutory disqualification from registration under section 8a(2) and (3) of the Act;

(ii) A bar from service on self-regulatory organization governing boards or committees based on disciplinary history pursuant to § 1.63

of this chapter or any self-regulatory organization rule adopted thereunder; or

(iii) A pending adjudicatory proceeding under sections 6(c), 6(d), 6c, 6d or 9 of the Act or similar proceeding under section 8a of the Act or §§ 3.55, 3.56 or 3.60.

(b) Persons offering instruction or preparing an instructional videotape or electronic presentation under this section must provide written evidence of completion of the six hours of instruction required under § 3.13 to those completing this instruction. The written evidence of completion must include:

(1) A certification that the person offering the instruction meets the conditions of paragraph (a) of this section; and

(2) A disclaimer which reads: "The content, quality or accuracy of this training program has not been passed upon or endorsed by the Commodity Futures Trading Commission or the National Futures Association."

(c) Before offering such training, a person must notify the National Futures Association of the intention to do so, provide a certification to the National Futures Association that the person offering such training meets the requirements of each condition of paragraph (a) of this section, and notify the National Futures Association of any subsequent changes in circumstances which would make the certification inaccurate.

(d) Persons offering instruction or preparing an instructional videotape or electronic presentation under this section must maintain in accordance with § 1.31 of this chapter documentation reasonably designed to verify the completion of this training by persons taking instruction.

(e) Persons offering instruction or preparing an instructional videotape or electronic presentation under this section may not represent or imply in any manner whatsoever that the person has been sponsored, recommended or approved, or that such person's abilities or qualification, or the content, quality or accuracy of the person's instructional program have in any respect been passed upon or endorsed, by the Commission or the National Futures Association.

#### **PART 32—REGULATION OF COMMODITY OPTION TRANSACTIONS.**

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

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

4. Section 32.2 is revised to read as follows:

#### **§ 32.2 Prohibited transactions.**

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

5. New § 32.13 is added to part 32 to read as follows:

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

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

(1) That person is registered with the Commission as an agricultural trade option merchant and that person's associated persons and their supervisors are registered as associated persons of an agricultural trade option merchant under § 3.13 of this chapter.

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

(3) The option cannot be off-set and, if exercised, must result in physical delivery of the underlying commodity; *Provided, however*, that nothing in this paragraph precludes amendment of the

option contract's delivery date or the substitution of a forward contract agreement for the option contract prior to the option's expiration or exercise.

(4) To the extent that payment by the customer of the purchase price is made to the agricultural trade option merchant prior to option expiration or exercise, that amount:

(i) May only be used by the agricultural trade option merchant to purchase a covering position on a contract market designated under section 6 of the Act or part 33 of this chapter; and

(ii) Any amount not so used, shall be treated as belonging to the customer until option expiration or exercise as provided under § 32.6, *provided, however*, that notwithstanding the last proviso of § 32.6(a), the full amount of such payment shall be treated as belonging to the option customer.

(5) Producers may not:

(i) Grant or sell a put option; or

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

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

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

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

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

(iv) The quality or grade of commodity to be delivered if the contract is exercised and any adjustments to price for deviations from stated quality or grade, or the range of, and a statement of the method for calculating, such adjustments;

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

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

(vii) The additional costs, if any, in addition to the purchase price which

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

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

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

This brief statement does not disclose all of the risks and other significant aspects of trading in commodity trade options. You are encouraged to seek out as much information as possible from sources other than the person selling you this option about the use and risks of option contracts before entering into this contract. The issuer of your option should be willing and able to answer clearly any of your questions.

#### Appropriateness of Option Contracts

Option contracts may result in the total loss of any funds you pay to the issuer of your option. You should carefully consider whether trading in such instruments is appropriate for you in light of your experience, objectives, financial resources and other relevant circumstances. The issuer of your option contract should be willing and able to explain the financial outcome of your option contract under all market conditions. You should also be aware that you may be able to obtain a similar contract or execute a similar risk management strategy using an instrument traded on a futures exchange which offers greater regulatory and financial protections.

#### Costs and Fees Associated With an Option Contract

Before entering into an option contract, you should understand all of the costs and obligations associated with your option contract. These include the option premium, commissions, fees, costs associated with delivery if the option is exercised and any other charges which may be incurred. All of these costs and fees must be specified in the terms of your option contract and must be explained in the transaction disclosure statement.

#### Business Use of Trade Options

In order to comply with the law, you must be buying this option for business-related purposes. The terms and structure of the contracts must therefore relate to your activity or commitments in the underlying cash market. If a trade option is exercised, delivery of the commodity must occur. Any amendments allowed to the option contract must reflect changes in your activity, in your commitments in the underlying cash market or in the carrying of inventory. Producers are not permitted to enter into short call options

unless the producer is also entering into a long put option contract for the same amount or more of the commodity, at the same time and with the same expiration date. Producers are not permitted to sell put options, whether alone or in combination with a call option.

#### Dispute Resolution

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

#### Acknowledgement of Receipt

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

(ii) The following acknowledgment section:

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

Date

Signature of Customer

(8) Prior to entry by a customer into each option transaction with an agricultural trade option merchant, the agricultural trade option merchant shall furnish, through written or electronic media, a transaction disclosure statement to the option customer. The transaction disclosure statement shall include the following information:

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

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

(iii) A description of any and all costs in addition to the purchase price which may be incurred by an option customer if the commodity option is exercised, including, but not limited to, the

amount of storage fees, interest, commissions (whether denominated as sales commissions or otherwise) and all similar fees and charges which may be incurred;

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

(v) The following acknowledgment section:

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

Date

Signature of Customer

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

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

(2) Within 24 hours of a request by the customer, or 48 hours of a request for a response in writing, current commodity price quotes, all other information relevant to the customer's position or account, and the amount of any funds owed by, or to, the customer;

(3) Written notice of the expiration date of each option which will expire within the subsequent calendar month.

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

(d) *Reports.* Registered agricultural trade option merchants must file reports quarterly with the National Futures Association, in the form and manner

specified by the National Futures Association and approved by the Commission, which shall contain the following information:

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

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

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

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

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

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

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

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

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

(1) All positions and transactions in agricultural trade options including information on the identity of agricultural trade option customers and on the value of premiums, fees, commissions, or charges other than option premiums, collected on such transactions.

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

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

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

restrictions or limitations on trading activities.

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

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

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

(5) The agricultural trade option merchant:

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

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

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

(g) *Exemption.* (1) The provisions of §§ 3.13, 32.2, 32.11 and this section shall not apply to a commodity option offered by a person which has a reasonable basis to believe that:

(i) The option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or byproducts thereof;

(ii) Such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such; and

(iii) Each party to the option contract has a net worth of not less than \$10 million or the party's obligations on the

option are guaranteed by a person which has a net worth of \$10 million and has a majority ownership interest in, is owned by, or under common ownership with, the party to the option.

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

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

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

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

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

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

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

\* \* \* \* \*

Issued this 8th day of April, 1998, in Washington, D.C., by the Commodity Futures Trading Commission.

**Jean A. Webb,**

*Secretary of the Commission.*

#### Concurring Remarks of Commissioner David D. Spears on Trade Options on the Enumerated Agricultural Commodities

I respectfully concur with my colleagues on the promulgation of interim final rules that permit the offer and sale of agricultural trade options off-exchange between commercial users, subject to certain regulatory conditions. I am pleased to say that the interim rules reflect a significant improvement from the proposed rules of November 4, 1997. I think that the industry will agree that the rules are more streamlined and impose less regulatory conditions than the rules as proposed in November.

Nevertheless, in seeking to strike the balance between reasonable regulation and undue regulatory burdens, I am of the view that the interim rules remain somewhat restrictive in certain respects. Therefore, I would encourage the Commission to review, at least on an annual basis, the progress of the agricultural trade option pilot program and to pay careful attention to the program's regulatory provisions to assess their usefulness and necessity.

In making its reviews of the pilot program, the Commission should focus specific attention on the restrictions imposed on option contract design and strategies. The success of risk management tools is partly dependent upon the ability of users to tailor contracts to meet specific business concerns. The Commission has made some changes from its proposed rules to provide additional flexibility in contract design. However, the pilot program should afford participants even greater flexibility to negotiate specific contract terms and strategies, subject only to general guidelines.

In addition, the \$10 million net worth requirement necessary to trigger an exemption from the regulations should be scrutinized more closely. My view is that there may be a more appropriate net worth level at which to set exemption eligibility. I therefore would recommend a reconsideration of the net worth amount within one year following the effective date of the interim rules, if not sooner.

Finally, I believe we have made significant progress towards transforming the November proposal into a less complex, shorter and more workable program. The fact that the program is, by its terms, a pilot program, provides the Commission and the industry with an opportunity to address individual situations that arise in the marketplace. To this end, I am hopeful that the agricultural community, the futures exchanges and others involved in the futures industry will remain in close contact with the Commission during the interim period. It is important that we maintain open lines of communication and that the Commission is apprised of the needs of the private sector. In this manner, adjustments to the pilot program may be made, as appropriate.

Dated: April 7, 1998.

David D. Spears.

Commissioner.

**Concurring Remarks of Commissioner Barbara Pedersen Holum, Interim Final Rules, Trade Options on the Enumerated Agricultural Commodities**

I agree with and join in the action the Commission is taking to permit exchange trading of options on physicals on the enumerated agricultural commodities. In particular, I believe this important initiative recognizes the potential of exchanges in offering more flexible option contracts. Exchanges in the past have demonstrated an exceptional ability to meet the demands of the market. I am therefore confident, now that the prohibition is to be lifted, the exchanges will work with the end-users to develop option contracts with the necessary flexibility to meet their individualized needs.

While I also join in the Commission's lifting of the prohibition on the offer and sale of off-exchange trade options on the enumerated agricultural commodities, I have serious concerns about the extensive regulatory provisions included in the interim rules. Specifically, these interim rules create a regulatory infrastructure essentially duplicating that which already exists on the exchanges. While the Commission has acted to exempt other off-exchange transactions from much of the centralized regulatory

structure, these interim rules impose new, extensive, and costly regulatory mandates. In my opinion, the imposition of this far-reaching regulatory structure, and its additional costs, will limit participation and deny producers and processors the very risk management tools that lifting the ban envisions.

Dated: April 8, 1998.

Barbara Pedersen Holum,

Commissioner.

[FR Doc. 98-9879 Filed 4-15-98; 8:45 am]

BILLING CODE 6351-01-M

**DEPARTMENT OF HEALTH AND HUMAN SERVICES**

**Food and Drug Administration**

**21 CFR Part 558**

**New Animal Drugs for Use In Animal Feeds; Bambermycins**

**AGENCY:** Food and Drug Administration, HHS.

**ACTION:** Final rule.

**SUMMARY:** The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect approval of a supplemental new animal drug application (NADA) filed by Hoechst Roussel Vet. The supplement provides for using bambermycins Type A medicated articles to make a bambermycins free-choice Type C medicated feed for pasture cattle (slaughter, stocker, and feeder) for increased rate of weight gain.

**EFFECTIVE DATE:** April 16, 1998.

**FOR FURTHER INFORMATION CONTACT:** Jack Caldwell, Center for Veterinary Medicine (HFV-126), Food and Drug Administration, 7500 Standish Pl., Rockville, MD 20855, 301-827-0217.

**SUPPLEMENTARY INFORMATION:** Hoechst Roussel Vet, 30 Independence Blvd., P.O. Box 4915, Warren, NJ 07059, filed supplemental NADA 141-034 which provides for using 10-grams per pound Flavomycin® (bambermycins) Type A medicated articles to make free-choice Type C medicated feeds for pasture cattle (slaughter, stocker, and feeder). The Type C medicated feeds are fed to provide 10 to 20 milligrams bambermycins per head per day for increased rate of weight gain. The supplement is approved as of March 10, 1998, and the regulations are amended by adding 21 CFR 558.95(d)(4)(iv) to reflect the approval.

As required by 21 CFR 510.455, each use of a Type A medicated article to make a free-choice medicated Type C feed requires an approved NADA or supplemental NADA. Under section

512(m) of the Federal Food, Drug, and Cosmetic Act (the act) (21 U.S.C. 360b(m)), as amended by the Animal Drug Availability Act of 1996 (Pub. L. 104-250), free-choice medicated Type C feeds must be manufactured in a licensed feed mill.

In accordance with the freedom of information provisions of 21 CFR part 20 and 514.11(e)(2)(ii), a summary of safety and effectiveness data and information submitted to support approval of this application may be seen in the Dockets Management Branch (HFA-305), Food and Drug Administration, 12420 Parklawn Dr., rm. 1-23, Rockville, MD 20857, from 9 a.m. to 4 p.m., Monday through Friday.

Under section 512(c)(2)(F)(iii) of the act, this supplemental approval for food-producing animals qualifies for 3 years of marketing exclusivity beginning March 10, 1998, because the supplement contains substantial evidence of the effectiveness of the drug involved, studies of animal safety or, in the case of food-producing animals, human food safety studies (other than bioequivalence or residue studies) required for approval of the supplement and conducted or sponsored by the applicant. The 3 years of marketing exclusivity applies only to the use of bambermycins with the proprietary free-choice Type C feeds as approved in this supplemental NADA.

The agency has determined under 21 CFR 25.33(a)(3) that this action is of a type that does not individually or cumulatively have a significant effect on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

**List of Subjects in 21 CFR Part 558**

Animal drugs, Animal feeds.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 558 is amended as follows:

**PART 558—NEW ANIMAL DRUGS FOR USE IN ANIMAL FEEDS**

1. The authority citation for 21 CFR part 558 continues to read as follows:

**Authority:** 21 U.S.C. 360b, 371.

2. Section 558.95 is amended by adding paragraph (d)(4)(iv) to read as follows:

**§ 558.95 Bambermycins.**

\* \* \* \* \*

(d) \* \* \*

(4) \* \* \*