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VIA ELECTRONIC MAIL

David Stawick
Secretary of the Commission
Commodities Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581
secretary@cftc.gov

COMMENT

Dear Mr. Stawick:

Attached are my comments on the "Concept Release on Whether To Eliminate the Bona Fide Hedge Exemption for Certain Swaps Dealers and Create a New Limited Risk Management Exemption From Speculative Position Limits" (Federal Register / Vol. 74, No. 55 / Tuesday, March 24, 2009 / Proposed Rules / pages 12282-12286).

Thank you very much for accepting and considering my comments.

Sincerely,

Michael W. Masters

Michael W. Masters
Portfolio Manager / Managing Member
Masters Capital Management, LLC
P.O. Box 224229
Christiansted, VI 00822
(340) 692-5102

III. Request for Comments

Commenters responding to this Concept Release are encouraged to provide their general views and comments regarding the appropriate regulatory treatment of swap dealers with respect to the existing bona fide hedge exemptions and a potential conditional, limited risk management exemption. In addition, commenters are requested to provide their views in response to the following specific questions.

General Comments

The futures markets for non-financial consumable commodities[1] exist strictly for the benefit of bona fide physical hedgers. Speculators should only be permitted in these markets to the extent that they provide a level of liquidity sufficient to enable the smooth functioning of these markets. Speculators have never been entitled to unlimited access to the futures markets.

Farmers produce crops that are essential to life. Energy companies produce oil and natural gas that are essential to industry and to our economy's health. In so doing, these physical commodity producers incur risk due to the daily fluctuation in prices for these commodities. The futures markets exist so that they can hedge their price risk.

Price risk is inherent in the day-to-day business operations of bona fide physical producers and consumers, as they provide the vital commodities that feed our citizens and power our economy. In contrast, speculators incur price risk only when they choose to, in the pursuit of personal trading profits. Speculators can eliminate their price risk simply by unwinding their speculative positions. This option is not available to bona fide physical hedgers whose livelihood is the production of the vital commodities that our entire populace relies upon.

Commodity swap dealers, in their purest form, function as middlemen, bundling and packaging baskets of commodity futures into swaps. This often involves some basis risk in the form of time, place or quality of the physical commodity referenced.

When this function is performed on behalf of bona fide physical hedgers, these swap dealers provide a valuable service that benefits the economy as a whole. When this function is performed on behalf of speculators seeking to take positions that exceed limits on the exchanges, then swap dealers contribute to excessive speculation. This speculation, when left unchecked, will cause price bubbles to form in the affected commodities.

For these reasons, swap dealers are not intrinsically good or bad. An effective regulatory regime must look through the swap dealers to the ultimate counterparty in order to effectively apply aggregate speculative position limits. These limits are necessary to prevent excessive speculation – not just manipulation. It is also critical to note that swap dealers speculating for their own account by taking proprietary positions or by managing an unbalanced swaps book must face speculative position limits just like all other speculators.

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[1] Commodities that are consumed, such as agricultural (corn, cattle, etc.), energy (crude oil, natural gas, etc.) and non-precious metals (copper, zinc, etc.).

The best solution for effective regulation of the over-the-counter (OTC) derivatives markets for consumable commodities is to mandate that all derivatives clear through a Derivatives Clearing Organization (DCO) with novation, so that the DCO becomes the central counterparty to both sides of the trade. This would allow every OTC position to be seen by regulators. Unfortunately, this would most likely require Congress to pass new legislation in order to be implemented.

In the meantime, I commend the efforts of the CFTC to do more to combat excessive speculation by requiring more transparency in the OTC markets.

I would propose that any entity that wants to exceed aggregate speculative position limits on the exchange and/or over-the-counter (OTC) must agree to the following two conditions as part of their exemption.

1. They must agree that all of their counterparties / clients will fill out Form 40 with the CFTC declaring (under penalty of law) what category of trader they are. The CFTC will then issue their counterparties / clients a Large Trader Identification Number (LTIN).
2. They must agree to report to the CFTC on a daily basis:
    a. A list (by LTIN) of all traders with futures-equivalent positions that exceed the limit for Reportable positions
    b. An aggregate amount of all remaining futures-equivalent positions distinguishing between counterparty / client positions and proprietary trading positions

        Note that this aggregate amount should not exceed aggregate speculative position limits.

The only way a non-commercial entity (be it a swap dealer, commodity mutual fund or some other intermediary) can exceed aggregate speculative position limits is to agree to the above two conditions. Otherwise, they should be treated like every other speculator who exceeds position limits.

Every trader with a Reportable position on the futures exchanges must also fill out Form 40 with the CFTC and obtain a Large Trader Identification Number (LTIN). LTINs apply at the control-entity level and no entity can have more than one LTIN.

Once this reporting system is in place, the CFTC can compile futures and futures-equivalent positions by LTIN in order to ensure that no speculator is exceeding aggregate speculative position limits. The use of LTINs will make it much simpler and faster for the CFTC to compile this information when compared with other methods.

A. General Advisability of Eliminating the Existing Bona Fide Hedge Exemption for Swap Dealers in Favor of a Limited Risk Management Exemption

1. Should swap dealers no longer be allowed to qualify for exemption under the existing bona fide hedge definition?

Swap dealers must not receive what amounts to a blanket exemption from position limits. They absolutely should be required to divulge the composition of their entire swaps book in order to exceed position limits on contract markets.

2. If so, should the Commission create a limited risk-management exemption for swap dealers based upon the nature of their clients (e.g., being allowed an exemption to the extent a client is a traditional commercial hedger)?

Swap dealers must be held to a higher standard than that which currently exists. The proposed "limited risk-management exemption" is a good step in the right direction, but it should go even further in terms of the disclosures required of swap dealers. In my general comments, I detail an alternative system that would lead to greater disclosures and simplify the imposition of aggregate speculative position limits.

3. If the bona fide hedge exemption were eliminated for swap dealers, and replaced with a new, limited risk management exemption, how should the new rules be applied to existing futures positions that no longer qualify for the new risk-management exemption? For example, should existing futures positions in excess of current Federal speculative position limits be grandfathered until the futures and option contract in which they are placed expire? Should swap dealers holding such position be given a time limit within which to bring their futures position into compliance with Federal speculative limits? Should swap dealers holding such positions be required to bring their futures positions into compliance with the Federal limits as of the effective date of the new rules?

Any speculator that is determined to exceed aggregate speculative position limits should be immediately placed into "liquidation only" mode. That speculator can then reduce their position, but cannot add to it. They would also not be able to roll that position forward to a different maturity.

In order to effectively accomplish this, all swap dealers and other intermediaries would need to be notified whenever a speculator enters liquidation-only mode so that they know to only perform liquidating trades with that speculator.

B. Scope of a Potential New Limited Risk Management Exemption for Swap Dealers

4. The existing bona fide hedge exemptions granted by the Commission extend only to those agricultural commodities subject to Federal speculative position limits. Should the reinterpretation of bona fide hedging and any new limited risk management exemption extend to other physical commodities, such as energy and metals, which are subject to exchange position limits or position accountability rules?

These new rules must apply to all commodities that are non-financial and consumable, including energy and metals.

Speculative position limits have a role to play in preventing manipulation, but their primary purpose is the elimination of excessive speculation. All non-financial consumable commodities are susceptible to the formation of price bubbles as a result of "irrational exuberance" / speculative euphoria. When a bubble forms in emerging markets or technology stocks, investors feel good as the bubble expands. In contrast, when a bubble forms in food and energy commodities, tremendous pain is inflicted on innocent bystanders who are forced to consume these items at drastically inflated prices.

In most cases, the exchange position limits are currently too high and are designed to prevent manipulation but not excessive speculation. Also, accountability rules are not actual speculative position limits. The CFTC should directly set aggregate speculative position limits for all non-financial consumable commodities. If it is not within their current power to directly set these limits, then the CFTC should direct the exchanges to lower their position limits substantially.

These speculative position limits must apply in aggregate across all trading venues.

C. Terms of a Potential New Limited Risk Management Exemption for Swap Dealers

5. If a new limited risk management exemption were to be permitted to the extent a swap dealer is taking on risk on behalf of commercial clients, how should the rules define what constitutes a commercial client?

As mentioned in my general comments, I believe that all counterparties and clients of those swap dealers and other intermediaries that are receiving an exemption from aggregate speculative position limits must fill out CFTC Form 40 and receive a Large Trader Identification Number (LTIN). This way, each one of those clients would be classified according to the established guidelines of Form 40.

6. How should the Commission (and, if applicable, the responsible industry self-regulatory organization (SRO)) and the swap dealer itself verify that a dealer's clients are commercial? Is certification by the dealer sufficient or would something more be required from either the dealer or the client? If so, what should be reported and how often-- weekly, monthly, etc.?

As mentioned in my general comments, I believe that all counterparties and clients of those swap dealers and other intermediaries that are receiving an exemption from aggregate speculative position limits must fill out CFTC Form 40 and receive a Large Trader Identification Number (LTIN). Therefore, the counterparties and clients themselves will be filling out these forms under penalty of law. They should be required to update their status by filing a new Form 40 any time their status changes. The CFTC should perform audits and spot checks to ensure that fraudulent forms are not being filled out and to make sure that entities update their status as required.

7. For a swap dealer's noncommercial clients, should the rules distinguish between different classes of noncommercials--for example: (1) Clients who are speculators (e.g., a hedge fund); (2) clients who are index funds trading passively on behalf of many participants; and (3) clients who are intermediaries (e.g., another swap dealer trading on behalf of undisclosed clients, some of whom may be commercials)?

As mentioned in my general comments, swap dealers must report (by LTIN) the futures-equivalent positions of all counterparties with positions exceeding the Reportable threshold. If any of these counterparties serve as intermediaries, then they also would be required to comply with the two reporting requirements I outline in my general comments in order to be exempt from speculative position limits in the over-the-counter (OTC) markets. If they do not comply with these reporting requirements, then they should not be allowed to take OTC derivatives positions in excess of aggregate speculative position limits.

I have outlined extensively, in Congressional testimonies and published research reports, the damaging effects of passive investment in the consumable commodities derivatives markets. My strong belief is that a trader making a passive "investment" in consumable commodities (including indexes) should face an aggregate speculative position limit that is 10% of the limit for non-passive investments. For instance, in Corn, the speculative position limit is 22,000 contracts; therefore, the passive investment limit should be 2,200 contracts.

8. If a swap dealer were allowed an exemption for risk taken on against index-fund clients, how would the dealer satisfy the Commission that the fund is made up of many participants and is passively managed? Is certification by the dealer or fund sufficient or should the dealer or fund be required to identify the fund's largest clients?

The swap dealer would be responsible to make sure that the fund has filled out Form 40 with the CFTC and acquired an LTIN. The fund would then be responsible to fulfill the two reporting requirements I outlined in my general comments in order to exceed aggregate speculative position limits. These reporting requirements include the disclosure by LTIN of every client that has a futures-equivalent position in excess of the Reportable threshold.

9. If a swap dealer were allowed an exemption for risk taken on against another intermediary, how would the dealer satisfy the Commission that its intermediary client does not in turn have noncommercial clients that are in excess of position limits? Is certification by the dealer or second intermediary sufficient or should the dealer or intermediary be required to separately identify the intermediary's largest clients?

The swap dealer would be responsible to make sure that the intermediary has filled out Form 40 with the CFTC and acquired an LTIN. The intermediary would then be responsible to fulfill the two reporting requirements I outlined in my general comments in order to exceed aggregate speculative position limits. These reporting requirements include the disclosure by LTIN of every client that has a futures-equivalent position in excess of the Reportable threshold.

10. What futures equivalent position level should trigger the new limited risk management exemption reporting requirement? For example, under the rules of the on-going special call to swap dealers and index funds described earlier, a swap dealer must report any client in any individual month that exceeds 25% of the spot month limit, or the net long or short position of a client that in all months combined exceeds 25% of the all-months-combined limit.

Any counterparty that has a futures equivalent position that exceeds the Reportable threshold level on an exchange must report this position. All remaining futures equivalent positions can be aggregated and reported in sum as long as these positions do not exceed aggregate speculative position limits.

So as an example, any trader with more than 150 Corn contracts (750,000 bushels) on an exchange has to report this position to the CFTC. The exact same level - 750,000 bushels - should apply to over-the-counter (OTC) transactions as well.

11. If none of a swap dealer's clients exceed required reporting levels in a given commodity, or none of such clients exceed reporting levels in any commodity, what type of report should be filed with the Commission--e.g., a certification by the swap dealer to the Commission to that effect?

If the swap dealer has no clients that exceed a reportable futures equivalent position, then they can send in a report of their total overall positions segmented between counterparty positions and proprietary trading positions. Proprietary trading positions cannot exceed aggregate speculative position limits.

12. Should there be an overall limit on a swap dealer's futures and option positions in any one market regardless of the commercial or noncommercial nature of their clients? For example, ``A swap dealer may not hold an individual month or all-months-combined position in an agricultural commodity named in Sec. 150.2 in excess of 10% of the average combined futures and delta-adjusted option month-end open interest for the most recent calendar year."

Yes, there should be an overall limit for swap dealers, because they wield enormous market power and they are never obligated to run a fully hedged book, which means they often move their hedges around and seek to profit from these maneuvers. A physical hedger puts his hedge on and he's done. A swap dealer is continuously adjusting his hedges and seeking to profit every time he does so. Therefore, each swap dealers' net position should not exceed 5% of open interest.

13. If a new limited risk-management exemption for swap dealers is created, what additional elements, other than those listed here, should be considered by the Commission in developing such an exemption?

Because swap dealers are engaged in physical commodities businesses and proprietary trading for the bank's account, these two elements have to be factored into this monitoring scheme.

All physical commodity producers and consumers, including swap dealers with physical businesses, should be allowed to hedge their physical market risk, but they should not be allowed to "over hedge." Nor should they be allowed to speculate counter to what hedging would dictate.

As an example, if a swap dealer owns an oil refinery, this would naturally make them short crude oil and long refined products. If they refine 50,000 barrels per day, then they could be long up to 54 million barrels of crude oil futures contracts (3 years supply) but they cannot be long 200 million barrels of crude oil since that is clearly a proprietary speculative position. Nor can they be net short crude oil derivatives since that is purely speculative.

D. Other Questions

14. How should the two index traders who have received no-action relief from Federal speculative position limits (see footnote 15) be treated under any new regulatory scheme as discussed herein?

The two index traders should be treated exactly the same as every other entity that wants exemptions from aggregate speculative position limits. They must meet the two reporting requirements that I outlined in my general comments.

15. What information should be required in a swap dealer's application for a limited risk- management exemption?

Please see my general comments.