

May 19, 2008

Honorable Joe Lieberman
United States Senate
Washington, D.C. 20510

Re: Homeland Security and Governmental Affairs Committee
Financial Speculation in Commodity Markets Hearing

Dear Senator Lieberman,

I was recently contacted by your aide Ryan McCormick, Counsel/Legislative Assistant for Economic Policy, in regards to my views on financial speculation in the commodity markets.

I am the Chief Investment Strategist for Managed Account Research, Inc., an Introducing Broker, and Principal/Managing Director for Cervino Capital Management LLC, a Commodity Trading Advisor. Both companies are registered with the Commodity Futures Trading Commission and are members of the National Futures Association. These businesses are involved with commodity futures speculation.

The purpose of this letter is to provide a unique perspective in regards to speculation in the commodity futures markets, as well as outline some concerns regarding the current environment which has, of late, resulted in widespread debate regarding commodity prices. Justice Felix Frankfurter once said, "Judicial judgment must take deep account of the day before yesterday in order that yesterday may not paralyze today." It is with this thought in mind that I present my viewpoint.

1. Background/Context

"Managed futures" is the moniker for a niche segment of the financial industry that has since its inception in the 1970s been a pioneering domain for alternative investments.¹ The description refers to professionally managed assets in the commodity futures and financial futures markets.

Management of client assets is directed by Commodity Trading Advisors (CTAs) and Commodity Pool Operators (CPOs), and facilitated by Futures Commission Merchants (FCMs) and Introducing Brokers (IBs). These entities are required to be registered with and regulated by the Commodity Futures Trading Commission (CFTC) under the legal framework of the Commodity Exchange Act of 1936 (1936 Act).

It is interesting to note that many of the trailblazers in the hedge fund universe trace their roots to similar beginnings alongside futures speculation. In fact, the first alternative investment fund was not Alfred

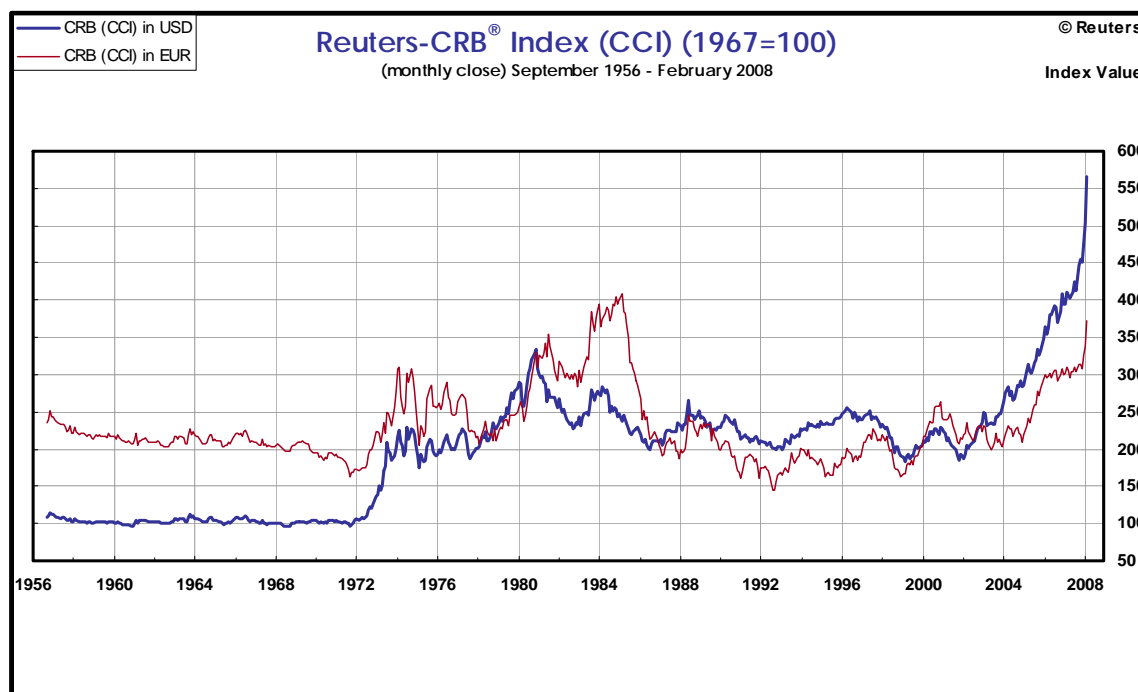
¹ "Alternative investments" are generally regarded as supplementary assets or trading strategies other than long-only exposure to "traditional assets" such as stocks, bonds and/or cash. Alternative investments include various assets such as commodities, currencies, emerging markets, private equity and real estate, etc., as well as a variety of methodologies including but not limited to convertible arbitrage, distress securities, global macro, long-short equities, managed futures, premium capture, risk arbitrage, short selling, etc. A commonly stated assumption by adherents of alternative investments is that it has a low to negative correlation compared to traditional investments, historical performance which reflects the potential for attractive positive expected returns, and is capable of acting as a hedge against inflation.

Winslow Jones' "hedge fund" established in 1949,² but Richard B. Donchian's Futures Inc., a commodity fund established in 1948.³ For size comparison, in 1990 there was an estimated \$10.5 billion invested in managed futures versus \$67 billion invested in hedge funds. Notably, as of the end of 2007 there is an estimated \$205.3 billion in managed futures compared to \$2,107.8 billion allocated to hedge funds.⁴

Hedge funds⁵ clearly represent the juggernaut within the alternative investment space. Nevertheless, managed futures' impact upon the financial industry is writ large in two significant and related ways: first, unlike its brethren hedge funds, managed futures operate in a highly regulated environment; second, this same regulated environment which imposes disclosure and reporting requirements, compelled the data on managed futures to be made public, which in turn helped academics advance early studies on alternative investments, prior to developing any substantial research on hedge funds.

In effect, the institutionalization of alternative investments can be traced back to the Commodity Futures Trading Commission Act of 1974 (1974 Act). The 1974 Act resulted in the official formation of the managed futures industry, which in turn provided the source data upon which Harvard Business School professor, Dr. John E. Lintner, based his seminal and oft-cited study, "The Potential Role of Managed Commodity-Financial Futures Accounts (and/or Funds) in Portfolios of Stocks and Bonds."

It is interesting to note that the commodity markets during the 1970s were experiencing volatility similar to our present period. A commonly cited factor influencing volatility during that time was President Nixon's unilateral cancellation in 1971 of the Bretton Woods Agreement of 1944, which stopped direct convertibility of the U.S. dollar to gold. Likewise, the recent decline in the U.S. dollar since 2002-2003 is also cited as a contributing factor to present-day across-the-board volatility in commodities.



² John Russell, "Alfred W. Jones, 88, Sociologist And Investment Fund Innovator" New York Times, June 3, 1989.

³ Obituaries, "Richard B. Donchian; Commodities Specialist, 87" New York Times, April 28, 1993.

⁴ Sources: Barclay Hedge, Ltd.; Van Hedge Fund Advisors International, Inc.

⁵ According to an April 1999 report by the *President's Working Group on Financial Markets* on "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," the term "hedge fund" is not statutorily defined, and encompasses any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.

In 1978, Congress amended Section 17 of the 1936 Act to expressly permit the National Futures Association (NFA) to have rules requiring mandatory membership. By virtue of CFTC Rule 170.15, membership is mandatory in the NFA for any FCM, IB, CPO and CTA that transacts futures business with the public. Consequently, NFA Bylaw 1101 prohibits members of the NFA from accepting futures orders from another person (except a direct customer) unless that other person belongs to the NFA. The requirement focuses on the flow of customer orders and, in effect, interrupts that flow if an ineligible person becomes involved.

Throughout the 1980s and 1990s the managed futures industry grew in insular fashion, largely due to CFTC Rule 170.15 and NFA Bylaw 1101, all the while maintaining its stewardship as professional speculators and counterparty to commercial bona fide hedgers. An “Interpretive Notice” from NFA Staff dated March 19, 1987 (revised July 1, 2000) reflects the importance of Bylaw 1101 as a cornerstone of the NFA’s regulatory structure. To emphasize this point, I provided below excerpts from this Notice:

Mandatory membership in NFA is the cornerstone of NFA's regulatory structure. From the earliest stages of its formation, NFA's founders recognized that the creation of a meaningful and effective industry-wide self-regulatory organization would be completely impossible unless all persons required to be registered as FCMs, IBs, CPOs or CTAs were required to be Members. The founders of NFA considered the issue to be of such critical importance that they not only prohibited the conduct of customer business with non-Members through NFA Bylaw 1101, but included that prohibition as one of NFA's fundamental purposes in Article III, Section 1(f) of NFA's Articles of Incorporation.

Given the importance of the mandatory membership concept, NFA Bylaw 1101, which tracks the language of Article III, Section 1(f), states the prohibition in the strongest possible terms. The rule by its terms imposes strict liability on any Member conducting customer business with a non-Member that is required to be registered. The rule does not require proof that the Member firm was at fault or failed to exercise due diligence, simply that it transacted customer business with a non-Member that is required to be registered. NFA Bylaw 1101 requires Members to make two determinations: whether it is doing business with an entity which is required to be registered, and if so, whether that person is a Member of NFA. The second of these determinations is relatively simple. Any Member can check the BASIC system on NFA's web site at nfa.futures.org, send a request to NFA through the “contact” feature of the web site, or call NFA's Information Center at a toll-free number (800) 621-3570 to receive current and accurate information concerning the membership status of any person. The determination of whether a particular person is required to be registered can obviously be much more difficult. Any Member could, despite its best efforts, be transacting customer business with a person who is actually required to be registered as an FCM, IB, CPO or CTA. In such a case, the Member is in technical violation of the strict liability terms of NFA Bylaw 1101.

Accordingly, while recognizing the legion of futures traders who do not hold themselves out to the public (institutional and retail), CTAs and CPOs provide the most transparent window into actual speculative practices in the futures market. Hence, managed futures provides an opportunity for insight.

One of the things I proudly point out to interested parties is the fact that the futures industry operates in a highly regulated market. The CFTC and the NFA, on the whole, deserve recognition for their accomplishments as regulators operating within the “principles-based” paradigm. Their efforts and leadership since the 1970s have served its constituents and members, as well as protected the public.

Recently, however, there have been financial innovations involving the commodity futures markets which for various reasons have developed outside the direct oversight of the CFTC and NFA. This has been disconcerting because I believe such developments have served to undermine the integrity and authority of the CFTC as well as the NFA to oversee the commodity markets and its participants.

In 2000, the Commodity Futures Modernization Act (2000 Act) was put into law. This legislation enacted needed clarification to CFTC regulations as a result of financial innovation that had taken place during the previous couple of decades. Additionally, it brought forex trading under the jurisdiction of the CFTC and the NFA. The 2000 Act also broadened the scope of certain exclusions and exemptions under the 1936 and 1974 Acts, which in addition to factors such as globalization, technology and innovation, resulted in a paradigm shift in how the futures markets, and by implication the forward markets, historically operated.

As the graph on page two illustrates, the commodity markets have since entered into uncharted price territory in a volatility spike not seen since 1972-1973. To call it a “perfect storm” is no exaggeration. In addition to fundamental demand-supply factors affecting commodity prices, there are systemic concerns regarding market structure that likewise may be influencing commodity prices. The reflexive interaction between these two primary dynamics has resulted in a complexity we predicted in our working paper, “Is Managed Futures an Asset Class? The Search for the Beta of Commodity Futures.”⁶

The purpose of the Homeland Security and Governmental Affairs Committee Hearing, “Financial Speculation in Commodity Markets,” is to examine the role of institutional investors and hedge funds in commodity markets. Questions include: What is the effect of these investors on current food and energy prices? Are financial speculators having a net positive or negative effect on the functioning and long-term stability of the commodity markets? Are food and energy price increases being driven by irrational speculative behavior, a rational response to market fundamentals, or a combination of both? Are rising prices creating an economic incentive for speculators to accumulate and hold stocks of food and energy commodities?

By implication, for better or worse, there is a *crisis of confidence* in regards to the price discovery mechanisms operating in the commodity markets. That said, a debate as to the “rationality” or “irrationality” of commodity pricing is at its essence a philosophical distraction.⁷ Rather, I propose that the focus should be on an understanding that supports the economic purpose of the commodity markets, and illuminates the practices and interaction between commercial bona fide hedgers and their counterparty, the speculators.

2. Hedging Response Model

Commodity futures contracts are intrinsically different instruments than securities which are derived from the capital markets (e.g., fixed income or equities).

Commodity-linked derivatives are risk management tools, a “zero-sum game,” fundamentally different from the “rising tide raises all ships” concept of the capital formation markets.⁸ While, there is

⁶ Frankfurter, Mack and Accomazzo, Davide, “Is Managed Futures an Asset Class? The Search for the Beta of Commodity Futures” (December 31, 2007). Available at SSRN: <http://ssrn.com/abstract=1029243>

⁷ It is generally understood by economists that neoclassical economic models have inherent limitations related to the analysis of markets within the context of rational equilibrium systems. Such systems are based on perfect competition, assume that the economy is stable, and that markets naturally return to equilibrium after a disturbance. Hence, such models maximize utility and/or profits in a world of constraints based on the choices of “rational” economic agents. By definition then, these models relegate speculators to the role of that very agent which maintains equilibrium. Yet a survey of *real-life* speculators reveals that these practitioners do not as a general rule use academic models in their day-to-day speculative trading decisions (an exception to this assertion is the Black-Scholes option pricing model, which is widely used by practitioners). Paradoxically, this same group plays a key influence upon the selfsame price data from which these models are constructed. So if the price data series is assumed to represent equilibrium and “the future is merely the statistical reflection of the past,” then one could inversely argue that perfect competition and rational expectations minimizes these models’ usefulness as a mechanism from which to make speculative decisions. In other words, rational expectations compel such models to simply validate that current price data is equal to equilibrium; unless the opposite is true—that markets are in fact imperfect and rational expectations is untenable, which in turn undermines the veracity of these models.

⁸ Elizabeth L. Ritter, Assistant General Counsel, CFTC, “The Securitization of Commodities: Crossing a Gold (or Silver) Line in the Sand” Business Law Brief, Fall 2005.

an established theoretical basis and considerable empirical evidence that link investment in capital market assets to positive expected returns over time, notwithstanding the recent surge in commodity prices, a legacy of academic debate and inconsistent results from empirical studies⁹ supports the claim that, on an inflation-adjusted basis, the same cannot be said about commodities.

Ironically, not more than five years ago, mainstream thinking about commodities was largely negative. Schneeweis and Spurgin (1996) stated at the time that the low level of investment in managed futures (then the only way to participate in professionally managed commodity investing) was due to the fact that investors required both a theoretical basis and supporting empirical results.¹⁰ In other words, the prevailing wisdom in the investment community has historically been against speculation in commodities.

This understanding was based on the premise that—if there were excess returns to speculative capital in futures trading, assuming there are participants such as risk averse hedgers willing to lose money over time, then since barriers to entry is low, so much capital would flow to this area that returns would be driven to zero over time, and as a result returns would be spread so thinly that profits would not be possible.¹¹

As noted by Greer (1997), the inherent problem is that commodities are not capital assets but instead consumable, transformable and perishable assets with unique attributes.¹² Hence, speculative trading, by definition any commodity trading facilitated for financial rather than commercial reasons, likely results in “zero systematic risk,” essentially meaning an expected return of zero over time.

The conundrum for financial “investors” is that for every buyer of a commodity futures contract there is a seller—*sine qua non*, there is no intrinsic value in futures/forward contracts—they are simply agreements which commit a seller to deliver an asset to a buyer at some place/point in time. Accordingly, the derivatives and securities markets require two different types of regulation.

Nevertheless, it is generally assumed that organized futures markets provide important economic benefits. This premise, that properly functioning futures markets serve a valuable economic purpose, is validated by government policy.¹³ The *secondary* benefit provided by the futures market is that it functions as a mechanism for transparent price discovery and liquidity, therefore mitigating price volatility.

The *primary* benefit provided by these markets, however, is that it allows commercial producers, distributors and consumers of an underlying cash commodity to hedge. Hedging reduces the risk of adverse price fluctuations that may impact business operations, which in turn theoretically results in increased capacity utilization. It is indispensable to the well-being of our financial system.

Commodity pricing theory mainly focuses on the transference of a “risk premia” from risk-averse hedgers to speculators. This insurance-like context was first proposed by Keynes (1930) in his theory of

⁹ Allen, Cruickshank, Morkel-Kingsbury and Souness (1999) stated, “there is no consistent evidence about the existence of normal backwardation despite a long tradition of research which dates back to Keynes (1930), Hardy (1940), Working (1948, 1949), Houthakker (1957), Telser (1958, 1967), Cootner (1960, 1967), Rockwell (1967) and Dusak (1973).” According to Ebrahim and Rahman (2004), “this discrepancy between theoretical assertions and empirical behavior is a puzzle. Is there something missing in the theory?” A similar sentiment is echoed by Bray (1992), Sheffrin (1996) and Malliaris and Stein (1999). Gorton and Rouwenhorst (2006), however, claim otherwise.

¹⁰ Schneeweis, Thomas; Spurgin, Richard (1996). “Multi-Factor Models in Managed Futures, Hedge Fund and Mutual Fund Return Estimation” University of Massachusetts, School of Management.

¹¹ Spurgin, Richard (2000), “Some Thoughts on the Source of Return to Managed Futures” Draft Article, Clark University and CISDM.

¹² Greer, Robert J. (1997), “What is an Asset Class, Anyway?” *Journal of Portfolio Management*, Winter, pp. 86-91.

¹³ Reuben Jeffery III, Chairman U.S. Commodity Futures Trading Commission. Testimony on November 2, 2005 before the Committee on Energy and Commerce United States House of Representatives.

normal backwardation. Essentially, Keynes believed that hedgers have to pay speculators a risk premium to convince them to accept their risk. Dr. Richard Spurgin (2000) explained it in the following way.¹⁴

There are four types of participants in futures markets: short hedgers, long hedgers, speculators and arbitrageurs. Short hedgers are commercial producers and long hedgers are commercial consumers.

Arbitrageurs perform a special function, and exist to ensure consistent pricing across different types of instruments relating to a particular asset and its relationships (e.g., cash, futures, forwards, options, etc.). [A discussion of commodity pricing theory as it relates to price convergence between the futures and spot price is a technical topic and overly complicates the purpose of this letter. Suffice it to say that the futures-spot convergence is the *principal* objective that validates the futures markets' economic purpose.]

Speculators, on the other hand, are assumed to “hold the difference between the long hedger, short hedger and arbitrageur positions.” Accordingly, speculators are key to ensuring the futures markets operate smoothly, as shall be illuminated by Dr. Spurgin’s “hedging response function.”

The hedging response model is both intuitive to understand, and I believe serves as a good basis for understanding the functionality of the futures market, as well as for framing legislation that ensures the proper functioning of the commodity markets without hindering innovation in related derivatives.

According to Dr. Spurgin’s hedging response function, there are four asymmetric scenarios which theoretically produce excess return to speculators, and two symmetric scenarios which are zero-sum:

(A) a rise in commodity price (beneficial to producers) generates more initiative from producer short hedgers to lock in higher prices, hence a *net* short hedging position is established;

(B) a rise in commodity price (detrimental to consumers) causes consumers to be more concerned about guarding against margin pressure than producers are concerned about locking in higher prices, hence a *net* long hedging position is established;

(C) a drop in commodity price (beneficial to consumers) generates more initiative from consumer long hedgers to lock in lower costs, hence a *net* long hedging position is established;

(D) a drop in commodity price (detrimental to producers) causes producers to be more concerned about guarding against margin pressure than consumers are concerned about locking in lower costs, hence a *net* short hedging position is established;

(E) a symmetric response results when the transaction is ‘speculator versus speculator,’ or (F) a ‘long hedger versus a short hedger.’ Theoretically, most futures transactions result in a symmetric response.

In accordance with Dr. Spurgin’s hedging response model, speculators fulfill an economic purpose by plugging the asymmetrical difference between a *net* long or *net* short hedging response. This is the reason why speculators provide an economically important role in the functionality of these markets.

Anecdotally, “Scenario B” seems to be the current predominant “hedging response function.” If that is the case, then the question is, who are the “long hedgers” that are reflexively reacting or producing higher prices? There is evidence to suggest that a major constituency in this regard is the financial “investors”¹⁵

¹⁴ Spurgin, Richard (2000), “Some Thoughts on the Source of Return to Managed Futures” Draft Article, Clark University and CISDM.

¹⁵ Section 3 of this letter examines the differences between “investor” and “speculator” psychology and practices.

seeking to hedge inflationary expectations vis-à-vis index funds.¹⁶ Another key constituency according to various news media accounts has been international governments who are ensuring they have sufficient stockpiles of a particular commodity.¹⁷ This is in addition to traditional commercial long hedgers who can add to upside price pressure, as well as speculators engaged in “trend-following” strategies.

However, the lynchpin is that *if* the hedging response is “Scenario B,” then on a net basis it is the speculators who are actually the main sellers of futures contracts versus long hedgers. These speculators are betting against the bullish trend on the speculation that prices will drop. But in order to be enticed to do so, they must be paid an excess premium for making such a bet, resulting in upward price pressure.

If one agrees with this analysis as well as the viability of Dr. Spurgin’s model to provide insight into the workings of the futures markets, then the next logical question is whether the categorization of various constituencies accurately reflects a bona fide hedger or more accurately speculators.

For example, should index funds continue to be categorized as a commercial, or re-categorized as either a non-commercial, or a separate category? The euphemism amongst veteran futures traders is that index funds represent “dumb money,” and that nobody wants “to get run over by a stampede of cattle.” Yet, an argument can also be made that long-bias index funds provide a “hedge” against inflation. On the other hand, the term “bona fide hedger” implies a commercial that is capable of making or taking spot delivery.

There is an additional scenario referred to as a “market squeeze” which Dr. Spurgin does not discuss in his paper on the hedging response function. For example, commercial short hedgers who initially entered positions at a lower price by selling futures under “Scenario A,” get caught in a “short squeeze” whereby increasing upward pressure *forces* “short covering” (i.e., buying). Again, however, it is speculators who ultimately provide the liquidity which allows these market participants to exit their positions.

This particular scenario often causes spikes in volatility, similar to what we experienced during February and March of this year in the wheat contract.



¹⁶ A common underlying theme running through recent comment letters to the CFTC, from institutional investors advocating the increase of speculative position limits, is that passive long-only trading in a basket of diversified commodities represents an *inflation hedge* for investors in such products. According to Barclays Global Investors in a letter dated February 12, 2008, “Ordinary citizens, whose current and retirement incomes are significantly affected by physical commodity prices, have an equal stake in their ability to obtain asset management services designed to managed the corresponding risks to which their current and retirement savings are subject.”

¹⁷ Bloomberg, “Wheat Rises to Record as Ukraine Cuts Exports, Stockpiles Low” (9/27/07); Financial Times, “Analysis: Precious grains” (4/14/08); Bloomberg, “India Buys More Wheat From Farmers, Boosting Reserves” (4/17/08).

3. Speculative Trading Practices

It is a generally accepted assumption amongst veteran participants in the futures industry, including myself, that the best arbiter of price is an open out-cry auction market. “A man’s word is his bond.” How else can a raucous pit of traders shouting prices result in an industry with a reputation for integrity,¹⁸ which is trusted by individuals and institutions to transact at the CME Group alone, a daily volume of 14 million contracts notionally valued at \$5 trillion per day.¹⁹ The futures industry is a cornerstone of our country’s financial system. Speculation runs deep in America’s culture, and the futures pits embody that tradition.

Unfortunately, this culture and tradition is not well understood by *outsiders*. As a result, “speculators,” and by implication the “futures industry,” too often gets broadly tarnished by the same paintbrush which should be more carefully applied to specific exceptions and circumstances. In my humble opinion, *the career of commodity futures speculation is an honorable trade if practiced honorably.*²⁰

Building on the concepts presented in the prior section, the balance of this section examines the types of participants involved in commodity speculation, and various speculative strategies employed.

It should be first noted that categorizations of participant types and instruments employed is a direct consequence of the definitions, characterizations, and jurisdictional boundaries established by law under the 1936 Act, the 1974 Act and the 2000 Act, including regulations promulgated thereunder.

As previously described, the futures industry and its investment management offshoot, managed futures, was until the turn of the decade an insular industry as determined by law. The futures industry’s rules dictate that one cannot hold oneself out as a “commodity professional,” unless registered as such. The strict application of these rules became subject to a dispute involving the First Amendment, which culminated in a March 28, 2000 D.C. Federal District Court ruling that, the CFTC’s CTA registration requirement for persons who disseminate general advice on the futures market was unconstitutional.²¹

The situation has become further complicated by the “totality of the circumstances” required to determine the characterization of a transaction. In other words, financial innovation has led to confusion over the practical definitions of a ‘futures contract,’ ‘forward contract,’ ‘spot contract,’ ‘event contract,’ and ‘securities contract.’²² Accordingly, along with “exclusions” and “exemptions” written into the law, the jurisdictional boundaries which guide regulatory oversight have experienced a systemic breakdown.

Further, regulatory jurisdiction is now further complicated due to the globalized nature of derivatives transactions, which involve either futures and or forwards contracts.²³

¹⁸ According to the National Futures Association, “Customer losses due to the insolvency of a futures brokerage firm have been virtually non-existent. Indeed, such losses have totaled less over 50 years than the Securities Investor Protection Corporation has paid, on the average, to reimburse customers of the securities industry for member firm insolvency losses each year.” <http://www.nfa.futures.org/investor/Storybehind.asp>

¹⁹ Emily Lambert, Forbes Magazine, “CME Group: Up From the Pits” January 28, 2008.

²⁰ Safehaven.com, “The Mysterious Case of the Commodity Conundrum, Securitization of Commodities and Systemic Concerns” Part 1: 4/21/2008, Part 1; Part 2: 4/22/2008; Part 3: 4/28/2008. (Also available at marketoracle.co.uk)

²¹ Taucher et al. v. CFTC et al., United States District Court for the District of Columbia, March 28, 2000. Accordingly, CFTC Rule 4.14(a)(9) was promulgated, wherein “context” is an important consideration of whether information provided is general in nature or “based on or tailored to” within the meaning of Section (a)(9)(ii).

²² Generally, futures contracts and transactions come under the jurisdiction of the CFTC, whereas forward contracts (e.g., over-the-counter derivatives, synthetic futures, swaps, etc.) are at best indirectly regulated by the CFTC and SEC.

²³ General convention is that the term “futures” references exchange-traded derivatives regulated by the CFTC; the term “forwards” references over-the-counter derivatives not regulated by the CFTC; and the term “derivatives” references the combination of instruments and transactions involving both/either futures and forward contracts.

This issue of definitions under the law and jurisdictional boundaries is, in my opinion, the crux of the matter. As epitomized in a CFTC petition for rehearing before the U.S. Court of Appeals for the Sixth Circuit in the matter of CFTC vs. Ross Erskine, et al.,²⁴ the scope of jurisdiction under which regulators have historically had authority is eroding, and market participants are migrating to unregulated “dark markets,” partly in order to escape the yoke of laws and rules which they claim inhibit innovation.

Let me be on record as stating that I am a strong proponent of innovation and entrepreneurialism—this ethic has guided my professional career. However, in my opinion, an *unfair playing field* has evolved in which “exclusions” and “exemptions” promulgated under the 2000 Act have put at a disadvantage CPO and CTA registrants as well as commercial bona fide hedgers who play by the rules and endeavor to adhere to the full intent of regulations under the 1936 Act, 1974 Act and 2000 Act.

For clarification, the following is an informal classification of the various participants involved in the commodity futures and forwards markets as currently surveyed (this is not necessarily a complete list):

- Commercial bona fide hedgers involved in the actual *production* of, or *use* of actual commodity goods, and who use the derivatives markets for bona fide hedging purposes by making or taking delivery;
- Commercial bona fide hedgers involved in the *distribution* of the actual commodity goods, and who by the nature of their activities operate in the capacity of an arbitrageur within the delivery process (such arbitrageurs can include financial institutions with subsidiaries trading in the actual cash commodity);
- Floor brokers who execute futures orders on behalf of customer instructions;
- Floor traders who execute futures transactions on behalf of their own proprietary accounts, thereby providing a “market maker” role and responsibility, in addition to speculation;
- Broker-dealers who execute over-the-counter derivatives on behalf customers either in the capacity of a principal to the transaction or as a broker between counterparties;
- Broker-dealers who construct securitized structured notes or similar products involving either futures and/or over-the-counter derivatives, which in turn are sold to retail and institutional investors;
- Onshore and offshore ‘persons’ who trade for their own account and take speculative positions in commodity interests either through regulated exchange traded futures or through non-regulated derivatives;
- Non-regulated “hedge funds” who are not registered with the CFTC in any capacity by means of either operating entirely offshore, or restricting their trading activities to over-the-counter derivatives;
- Commodity trading advisors who are registered with the CFTC and are members of the NFA (this category can be further divided into subsets who operate under Section 4m(1), Rule 4.7 exemptions and Rule 4.14 exemptions, versus those who do not operate under any exemptions);
- Commodity pool operators (a.k.a., regulated “hedge funds”) who are registered with the CFTC and are members of the NFA (this category can be further divided into subsets who operate under Rule 4.7 exemptions and Rule 4.13 exemptions, versus those who do not operate under any exemptions);
- Commodity pool operators who operate under Rule 4.5 exclusions related to the 1940 Act, and manage funds or trusts that are privately placed with institutional investors, or publicly offered to retail investors vis-à-vis mutual funds or exchange traded funds (ETFs) securitized under the 1933 Act; and
- Investors, either retail or institutional (e.g., pension funds, endowments, etc.), who “invest” in commodities vis-à-vis CTAs, CPOs, or securitized products offered by Rule 4.5 CPOs.

As this survey reveals and Dr. Spurgin’s hedging response model supports, critics who scapegoat “speculators” for excessive speculation in commodities are oversimplifying the complexities which evolve from economic motivations, as well as institutional innovation as a result of “regulatory arbitrage.”

²⁴ Commodity Futures Trading commission, Plaintiff-Appellant vs. Ross Erskine, et al., Defendants-Appellees. On Appeal from the United States District Court for the Northern District of Ohio for the Sixth Circuit, No. 06-3896.

Our contention is that reflexive interaction between regulatory structure, traded instruments, product development and price action is systemic. At the same time, this perfect storm of volatile commodity markets is *no doubt also* due to both intrinsic and extrinsic fundamental demand-supply factors which, for better or worse, are emanating from globalization. Arguably, most of these issues have systemic root causes.

The United States must heed the warning of speculators and not put its head in the sand. Pandering²⁵ has led to unsound economic policies which in turn has led to a grossly weakened U.S. dollar, as well as long-term misallocation and under-investment in resource development and conservation, alternative energies and conservation, publicly-used infrastructure, and education which focuses on developing human resource capital in these areas (all which, by-the-way, incorporate into the “aggregate wealth portfolio of all agents in the economy”²⁶ and therefore imputes into the “beta” of the stock market).

If anything, high commodity prices will lead to a renewed discipline in our great country to sound economic priorities at both the public and private level. But the Government and financial industry mutually need to take steps to *restore public confidence* in the markets’ ability as the best means to price assets.

But I digress... The balance of this section will attempt, as they say, to separate the wheat from the chaff. In order to do that, one should be familiar with the methods employed by speculators in order to gain insight into the behavior of speculators, which in turn is a key influence upon commodity prices.

Generally speaking, the difference between speculating and investing is a spectrum. In fact, that spectrum ranges from gambling (either a low probability bet or a bet that risks everything), to speculation (i.e., active risk management), to speculative investment (e.g., equities), to income investment (e.g., fixed income), to imperfect hedging (i.e., counterparty to speculation), to arbitrage (i.e., perfect hedge).

As established earlier in this letter, derivatives are risk management tools which may be established between two speculators as counterparties, short hedger versus long hedger (i.e., producer versus consumer), or with a speculator operating as a counterparty to a bona fide hedger.

With that in mind, over many decades, a practice has developed around the speculation “art,” which includes, but is not limited to the following strategies: arbitrage, market-making, scalping, spread trading, trend-following, counter-trend anticipation, volatility-based, premium capture, etc. Then there is the trading time horizon: intraday, intra-week, short-term, mid-term and long-term—one trader’s trend is another’s counter-trend. Next is the analysis and framework upon which trading decisions are made: discretionary vs. systematic, fundamental vs. technical, or quantitative vs. behavioral. Not last is the portfolio of assets to be traded: diversified basket of commodity interests, or specialization in a commodity sector such as agriculture, financials, forex, energies, metals, etc. Finally, which instruments are utilized: exchange-traded futures, options on futures, or over-the-counter derivatives traded via broker-dealer or “dark markets.”

The above is a synopsis of how *real-life* traders approach the market. Interestingly, recent academic studies in the area of “investment” in commodity markets cite either three or four sources of return from exposure to commodity assets.²⁷ These “sources of return” have become *conventional wisdom*.

First, there is “collateral yield,” which references fixed income earnings that emanate from the *de minimis* good faith deposit required to trade derivatives. Second, is the “spot return,” which relates to the change in price of the underlying commodity—to the extent that the actual commodity price rises and falls, derivatives tied to the delivery of a cash commodity will fluctuate. Third, is something called the “roll

²⁵ Contention is made without prejudice to constituency, and includes John Q. Public to various corporate interests.

²⁶ Jagannathan, Ravi; Wang, Zhenyu (1993), “The CAPM is Alive and Well” Research Department Staff Report 165, Federal Reserve Bank of Minneapolis; Jagannathan, Ravi; Wang, Zhenyu (1996), “The Conditional CAPM and the Cross-section of Expected Returns” *Journal of Finance*, Vol. 51, No. 1, March, pp. 3-53.

²⁷ <http://www.hardassetsinvestor.com/component/content/article/20/436.html?Itemid=4>

yield” or “roll return,” which refers to a *supposed* risk premium that is captured when a trader “rolls” futures from one contract month to another.²⁸ Occasionally there is also reference to a fourth source, a “strategy return” based on a working paper by Erb and Harvey (2006) which concluded that “how one weights and rebalances the components of a commodity index” is the key to generating “equity-like returns”²⁹ Simply rephrased, their thesis is based on a strategy to sell high and buy low.

In effect, the current crop of academic studies have answered Schneeweis and Spurgin’s (1996) challenge that investors required both a theoretical basis and supporting empirical results.³⁰ But to what extent is this just sophisticated marketing? If “past performance is not necessarily indicative of futures results,” yet these academic studies are based on regression analysis of historical data series, where is the hypothetical disclosure statement which is required by the NFA?³¹

From the perspective of most *real-life* speculators, academic theoretical models have little to do with how traders actually speculate in the futures markets. Furthermore, traders know it is dangerous to extrapolate past performance into multi-factor regression analysis as a means to predict future outcomes. It is a well understood tenet of professional systematic traders that expanding the number of factors, conditions and variables increases the likelihood of curve-fitting to historical data, also referred to as ‘over-optimization.’

In comparing modern finance with behavioral finance, Dr. George M. Frankfurter, Lloyd F. Collette Professor Emeritus Louisiana State University, and Dr. Elton G. McGoun, Professor of Finance Bucknell University, in their article “Resistance is Futile: The Assimilation of Behavioral Finance,” make the following astute observation: “What has happened is that we’ve used these assumptions for so long that we’ve forgotten that we’ve merely made assumptions, and we’ve come to believe that the world is necessarily this way.”³²

This technical discussion of what is driving commodity prices is of more than academic interest. The current viability of the futures markets, whose primary role historically has been to provide a reliable way for producers and consumers of commodities to manage future cash flows, is now being questioned.

A fundamental misunderstanding of commodity market functionality by *novice* long-only “investors” has pitted this new class of participants against *traditional* futures “speculators” and commercial hedgers.

We note that in addition to fundamental reasons, there are institutional pressures and profit incentives which lead to the invention and usage of benchmarks and passive indices. Further, modeling provides justification for creating and bringing to market innovative “beta replication” investment products.

²⁸ Gorton, G.; Rouwenhorst, K.G. (2006), “Facts and Fantasies about Commodities Futures” *Financial Analysts Journal*, 62(2), pp. 47-68; Till, Hilary (2007), “Part I of A Long-Term Perspective on Commodity Futures Returns: Review of the Historical Literature” from “Intelligent Commodity Investing,” (Till, and Eagleeye, Ed.), Published by Risk Books, a Division of Incisive Financial Publishing, Ltd., pp. 39-82.

²⁹ Erb, Claude B.; Harvey, Campbell R. (2006), “The Tactical and Strategic Value of Commodity Futures” Working Paper, Duke University, National Bureau of Economic Research.

³⁰ Schneeweis, Thomas; Spurgin, Richard (1996), “Multi-Factor Models in Managed Futures, Hedge Fund and Mutual Fund Return Estimation” University of Massachusetts, School of Management

³¹ ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

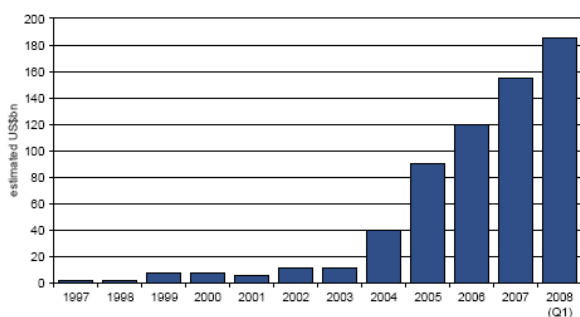
³² Frankfurter, George M.; McGoun, Elton G. (2002), “Resistance is Futile: The Assimilation of Behavioral Finance” Bucknell University, Department of Management.

Securitized investment products based on traditional investments for the most part are justifiable since their underlying investments are capital assets. In addition, equity and fixed income proxies can serve a valuable purpose in measuring traditional portfolio risk and return on a relative basis. More importantly, why should an investor pay exorbitant fees for so-called “alpha” (i.e., skill-based returns) when that investor can obtain the same or similar asset exposure through an inexpensive “beta” vehicle?

Innovation should not be discouraged, and in response to research and investor demand, financial institutions will continue with their efforts to securitize all identifiable combinations of assets and replicable strategies into “exotic beta” products, commodities included. But do these investments, often modeled on hypothetical regression analysis and employing a predefined passive methodology, always serve investors’ best interest with respect to constructing well-diversified portfolios? Commodity markets do not operate in a vacuum, and high commodity prices have spilled over into broader economic policy concerns.

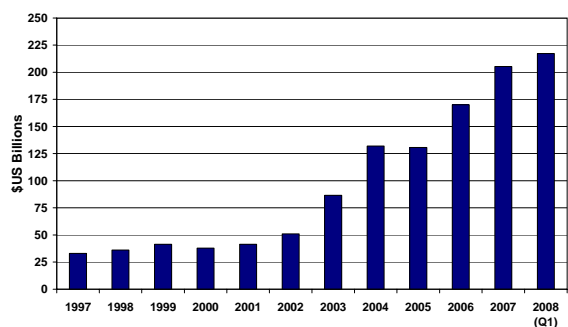
Rather, commodities have a tendency to rise and fall in ranges as a result of underlying supply and demand fundamentals. Hence, we assert that the mere act of trying to isolate a persistent source of return via continual ownership but non-usage of a hard asset will eventually result in any previously identified source of return slipping away. This thesis is already proving itself in the form of generalized commodity inflation, rumors of hoarding, breakdown of trade and the rise of protectionism, increased input and production costs, all which invariably leads to declining margins and productivity.

Figure 13. Funds invested in Commodity Indexes



Source: Citi Investment Research

Funds Invested in Managed Futures



Source: Barclay Hedge, Ltd.

We contend that securitized products based on long-only exposure to commodities will prove over time to *not* be the reliable and consistent source of positive expected returns as is proposed, much less a means to properly gauge the relative performance of speculative commodity trading. Ownership of hard assets does not generate a yield, but a cost-of-carry, as well as commissions to do so via futures/forward contracts.

Our research indicates that commodity pricing models have inherent shortcomings in being able to pinpoint a definitive source of structural risk premium within the complexity of the real world global macro economy. Further, commodity pricing is an observable materialization of behavioral finance, where risk, return, leverage and skill operate un-tethered from the anchor of *beta*, such as that which may be assumed by investors when “investing” in a commodity-linked ETF.

The current popularity of “investing” in commodities vis-à-vis commodity index funds reminds us of the everlasting debate between investors as to the extent passive asset class exposure is the primary driver of risk and return, versus to what extent does a tactical approach play a positive, negative or neutral role in managing risk and return. In the not-so-distant past, the demise of the 1980s–1990s bull market in equities left many investors disputing the case for a pure “buy and hold” (i.e., “beta”) strategy.

We believe that passive long-only commodity investment is nearing a similar juncture, one where “investors” will come to realize that the primary “source of return” in commodity exposure is based on an amalgamation of trading strategies, tactics and skill. Old school called it “edge;” new school calls it “alpha.”

The ironic twist is that the Wall Street paradigm of multiple *betas* has ported the *alpha* decision to the investors. If there is a persistent source of return at this stage in the commodity bull, it is likely now being paid by consumers (society) in the form of inflation. For this, the U.S. monetary policy is not without blame.

In that sense, perhaps this phase of the commodity bull market may simply be a real world incarnation of the Thomas theorem: “If men define situations as real, they are real in their consequences.” But in the meantime, it would be highly imprudent to not trust the *wisdom in the madness of crowds*.

4. Conclusion/Recommendations

The genie is out of the bottle and it is not going to be put back. There is more than enough blame to go around for high commodity prices, and trying to identify a scapegoat, much less find an answer to the commodity conundrum, is a fruitless exercise that will yield just more of the same old arguments.

“To rely on a tidy formula for the easy determination of what is a fundamental right for purposes of legal enforcement may satisfy a longing for certainty but ignores the movements of a free society.”³³ Accordingly, we cannot ignore the simple truth that speculators are just canaries in a coal mine pointing to systemic issues of both a fundamental and financial nature.

As established, there is a *crisis of confidence* in the financial market’s price discovery mechanism. All parties at this table including the financial services industry, the commercial bona fide hedgers, and the government and regulators need to work together to *restore public confidence* in open and freely traded competitive markets as the best means to price commodity assets and reallocate resources accordingly.

The following is a set of recommendations which encompass our systemic concerns:

(1) The law of unintended consequence rules the market.

It would be reckless and irresponsible to raise margin requirements under current market conditions, specifically with respect to the crude oil markets. As our analysis reveals using Dr. Spurgin’s model, the oil market currently indicates that there is a net hedging response where long hedgers are willing to pay short speculators excess premia to enter into a contract. The predominant long hedgers may very well be the fully-funded index funds which will not be affected by any increase in margin. Hence, while this may be causing the market to steadily rise, it is prudent to err on the side of caution. If our thesis is correct, then raising margin requirements will result in a disastrous short covering rally.

(2) The intersection between law and jurisdiction is messy.

Legal clarification is needed with respect to the definition of a futures contract, forward contract, spot contract, event contract, and securities contract, such that the “totality of the circumstances” that determines the characterization of these transactions are more readily apparent to the courts, regulators and practitioners. Further, jurisdictional oversight of over-the-counter derivatives traded by/through financial institutions, including event contracts, should come under CFTC regulations. However, a slow-go approach is suggested in order to forge a robust regulatory framework, which does not inhibit innovation.

In addition, mandatory membership in the NFA, or similar organization such as a spinoff of the International Swaps and Derivatives Association, Inc. (ISDA), should also be made a requirement of professionals involved in forward (over-the-counter derivatives) and event contract transactions which are facilitated by/through financial institutions. This would close a key loophole in CFTC Rule 170.15. The above effort with respect to regulating over-the-counter derivatives will not be successful unless done in coordination with the Financial Services Authority and other foreign regulators.

³³ Justice Felix Frankfurter, delivered opinion of the Court, *Wolf v. People of the State of Colo.* 338 U.S. 25 (1949)

Further, Rule 4.5 exclusion from the definition of a CPO for entities qualifying as “an investment company registered as such under the Investment Company Act of 1940” should be eliminated. This is another major loophole where funds and trusts effectively operate as CPOs trading commodity interests, and therefore should come under the primary oversight of the CFTC.

Additionally, Series 7 “registered representatives” should not be allowed to solicit on behalf of such funds or trusts unless they are also registered with the CFTC as a Series 3 or 31 “associated person,” and are “associate members” of the NFA. Proper education and understanding as to why commodity markets are different from capital markets needs to be understood by professionals who are selling these investments. In addition, NFA Rule 2-29 provides marketing guidelines which are appropriate for such investments.

With the exception of Section 4m(1) exempt CTAs which permits small business innovation, Rules 4.7, 4.13 and 4.14 exemptions for CTAs and CPOs should be reviewed as to their fairness in comparison to CTAs and CPOs who operate without the benefit of such exemptions. I suggest that certain of these exemption rules are in essence unfair as they provide undeserving registrants easy loopholes from full oversight, and therefore have become subject to widespread abuse.

There are two philosophies and practical reasons which guide the above recommendations. First, as Justice Louis D. Brandeis once said, “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” Second, registrants who endeavor to operate under the full weight of the law are at an unfair disadvantage compared to exempt registrants who unnecessarily exploit loopholes. The practical reason is that the second point has resulted in a migration of registrants seeking exemptions. As a result, my observation is that the investing public is at a disadvantage with respect to disclosures.

Until the 2000 Act, hedge funds that traded futures contracts were required to be registered as CPOs, effectively operating as “regulated hedge funds.” It seems odd then that the U.S. Government, which had recently encouraged the SEC to impose registration requirements upon hedge funds, at the turn of the decade passed legislation expanding exemption rules under the 2000 Act, effectively permitting a subset of hedge funds which were at the time registered to then operate in a registration grey area.

If anything, the SEC should look to the CFTC as an existing example of a regulatory framework for hedge funds which allows innovation, but also provides oversight. At minimum, hedge funds over \$500 million and/or distributed vis-à-vis large broker-dealers, known as “wirehouses,” should be regulated.

(3) Sunlight is said to be the best of disinfectants...

The CFTC has in the past solicited recommendations from the public in regards to the Commitment of Traders (COT) report. In response to public comments, the CFTC has made strides in improving this all-important reporting tool which is used by both regulators and by speculators as a fundamental data point. There are admittedly logistical and budgetary issues in creating more accurate reporting, but there is no doubt that greater transparency would be helpful to the market. We therefore recommend that further improvements be made to the COT report in order to enhance the credibility and usefulness of this report. Two such improvements include segregating index funds as a separate category apart from commercials and non-commercials, and second, to add a swap dealer category for tracking purposes.

In general, economic statistics are the life-blood of fundamental analysis which in turn helps drive “rational” speculative decisions. In this respect, most governments generally get a failing grade. Given the importance of the financial service sector in the U.S. economy, the U.S. Government should make a greater investment into the gathering of economic data, and increase credibility by not making seasonal adjustments which distort such data. Government agencies and private analysts can interpret for themselves. In fact, many speculators continue to track older reporting methods, including M-3. This has led to credibility issues.

As the world has become globalized, the need for reliable statistics from foreign governments becomes more important. The U.S. should lead by example and press upon the international community the need for accurate economic data reporting from other nations, most importantly developing countries.

(4) Aggregate wealth portfolio of all agents in the economy.

There has been much discussion and debate within the industry as to the whether or not to lift the ceiling on position limits. Such ceilings, in my analysis, act much like artificial price ceilings, and therefore may be distortive to price discovery. On the other hand, there is veracity to the argument that commodity markets are small markets. I believe a compromise can be forged by slowly increasing position limits, with the goal of eliminating position limits on liquid commodity interests at such point that money inflows/outflows in these commodities no longer have a distortive effect on commodity pricing. Equally, the tool of position limits is arguably the most effective regulatory tool to combat “excessive speculation” at a macro-level. On the other hand, changes in margin requirements due to expediency, will lead to unintended consequences.

(5) Some things are best left up to the experts...

Certain issues such as “convergence” are best left to the industry to forge the best answers. There is one aspect that should be considered by Congress and the industry, however, and that is the involvement of financial institutions through subsidiaries as cash arbitrageurs. This involvement by financial institutions helps facilitate convergence, but the market may benefit by further regulatory oversight of such activities.

(6) Expand the CFTC’s principles-based regulatory regime.

The derivatives market in certain respects is now much larger than the securities markets. For that reason, the CFTC should have permanent authorization, its regulatory powers expanded, and provided with sufficient budget and staffing resources to fulfill its mandate in an industry critical to the global economy.

In conclusion, the futures industry has served as a beacon of a well-regulated marketplace. The principles-based paradigm under which the CFTC and NFA operate has served its constituents and members, as well as protected the public. Unfortunately, it is an easy scapegoat. Blanket allegations are unfair in large part because Congress, the courts and globalization have eroded the futures industry’s boundaries.

In light of the growth of the derivatives markets, which in some respects now surpasses that of the securities industry, reauthorization of the CFTC’s charter should be made permanent, and its powers expanded to encompass both forward and event contracts that are traded by/through financial institutions.

As previously discussed, globalization has had a material influence on the fundamentals underlying commodity prices. But Government laws have also played a role in fermenting systemic issues, as has a variety of policies which in effect are distortive to commodity valuations, not least U.S. monetary policy. All the while, government subsidies (both domestic and foreign) prevent the full force of market economics to properly play out the reallocation of resources. I therefore urge Congress to affect considered policies in light of their ramifications, and continue to encourage the international community to develop regulations which foster open and competitive markets that are fair to both its participants and the public.

Undoubtedly, concerns will be raised about over-regulation, as well as impediments to competition and innovation. I trust, however, that the Democratic and Republican Parties will work together to pass laws that enhance, rather than inhibit, the functioning of the derivatives industry.

Very truly yours,



Michael “Mack” Frankfurter
Chief Investment Strategist
Managed Account Research, Inc.
Principal/Managing Director
Cervino Capital Management LLC