NAUTICAL CAPITAL MANAGEMENT

August 5, 2009

Position paper on the current CFTC review process on position limits

The current hearings on speculative activity in the energy futures markets have caused some concern over how potential changes in the regulatory landscape may affect all participants in the commodity markets. We start this paper with portions of two articles written by John Kemp, a journalist closely following these events for Reuters.

The Nautical outlook follows and points out the likely scenarios and their potential effects on our business plan going forward.

CFTC lifts lid on large commodity positions (1)

Posted by: John Kemp – July 29, 2009

Complete article at: http://in.reuters.com/article/columnistNews/idINTRE56S2DS20090729

LONDON, July 29 (Reuters) - Data presented to yesterday's public hearing on energy markets show the U.S. Commodity Futures Trading Commission (CFTC) and exchanges have granted so many exemptions from hard position limits and soft position accountability levels that the traditional position-limiting system has become meaningless.

CFTC chairman Gary Gensler noted that exemptions have become so numerous they risk "swallowing the rule". There's no danger, the rule has disappeared without trace. The scale and frequency it has been broken has seen to that.

It's clear from the figures that traders' positions can be big enough to raise the risk of distorting prices which set fuel costs across the globe.

Gensler's slide presentation provided the first comprehensive insight into how exemptions have been used — giving detailed data on the number of times limits have been exceeded since mid-2008 for the Big Four energy contracts on NYMEX (crude oil, natural gas, heating oil and RBOB gasoline).

Last week (July 21) there were 37 exemptions in force in the crude contract for an average of almost 5,700 lots (5.7 million barrels of crude oil), and 43 exemptions in force for natural gas for an average of 2,930 lots (29.3 trillion BTUs or 28.5 billion cubic feet).

These were exemptions from spot-month limits (contracts approaching expiry and therefore most vulnerable to squeezes or settlement failure). They take no account of exemptions in force for contracts further out along the curve.

For the 12 months between July 2008 and June 2009, 43 traders received dispensations from the single-month limit on the NYMEX crude contract, exceeding the notional limit by an average of 10,000 contracts (10 million barrels) and with excursions lasting an average of 87 days. In other words, it was routine practice to run positions in a single month at twice the notional "accountability level" set by the exchange.

For natural gas, 26 traders received dispensations from the combined all-months limit, and exceeded it by an average of 32,000 lots (311 billion cubic feet) (four times the usual limit) with excursions lasting an average of 80 days at a time.

Positions on this scale utterly defeat the objective of setting limits.

As Gensler noted, the CFTC's avowed aim has always been "to ensure that markets were made up of a broad group of diverse participants with a diversity of views. The intent was to avoid the concentration of positions of any single party".

"In 1980, the CFTC reiterated its goal to prevent market concentration. In its rulemaking, the Commission stated that 'a trader's net position has a continued effect on price, and if sufficiently large can become a perceptible market factor'".

"Speculative position limits serve to decrease the potential for positions to influence the general price level".

But massive exemptions have produced the opposite effect. For NYMEX natural gas, the CFTC data shows 13 traders had positions amounting to more than 10 percent of the open interest in a single month at some point over the last year, 4 traders had positions over 20 percent, and 3 traders had positions over 30 percent. With this much concentration, price setting is hardly the result of a "diversity" of views.

For the CFTC, the policy question is whether to make minimal changes to the process for setting limits and granting exemptions to restore public confidence in the system's integrity, or be more aggressive and try to use tighter limits and more narrowly drawn exemptions to reduce the average position size and cut concentration levels.

CFTC set to recommend only minor changes (2)

Posted by: John Kemp – July 30, 2009

Complete article at: http://www.reuters.com/article/reutersComService4/idUSTRE56T2RB20090730

The most likely changes to emerge from it are probably:

(a) CFTC rather than exchanges will set position limits and be responsible for granting exemptions.

(b) Position limits will apply on an aggregate basis that will cover an entity's positions across all exchanges and OTC. To enforce this system, CFTC will demand data on OTC positions and on positions that are "near to" those on markets it regulates (ie Significant Price Discovery Contracts).

(c) Position limits on contracts close to expiry may be "hardened" to become fully binding (with few or no exemptions other than for physical hedgers intending to make or take delivery).

(d) Position accountability levels on contracts further away from delivery may be hardened somewhat but unlikely to become absolutely binding. CFTC will almost certainly demand more documentation and proof to back up claims that they being held for "bona fide hedging" purposes.

(e) CFTC may revisit the classification of traders as commercial/non-commercial. For firms with both hedging and trading operations, it may require the two to be separated out for reporting and regulating purposes. The system would then regulate positions rather than entities.

Changes that are NOT likely to happen:

(a) CFTC is unlikely to withdraw the hedging exemption from swap dealers and index funds entirely. This would in effect bar many pension funds and others from using commodities as an asset class to diversify etc. It is possible that the CFTC might condition the hedging exemption for swap dealers on the nature of their counterparties (ie a swap dealer who has sold swap contracts to a commercial enterprise can hedge them without limit in the futures market, but limits would apply if the counterparty was a pension fund or hedge fund). But even this is very unlikely for the same reason as above — it would essentially shut down commodities as an asset class. It is more likely that the CFTC will continue to allow swap dealers to claim a hedging exemption — PROVIDED they can show the position is being managed on a passive basis — AND with suitable documentation.

(b) CFTC unlikely to impose binding limits on the total position that can be held across all months without generous exemptions.

If true, then any changes in the regulatory regime will be fairly incremental. Funds will continue to have reasonably unrestricted access to the market and appetite for commodities is unlikely to diminish. Commercial hedging will not be hampered.

London MIGHT gain a slight competitive advantage if CFTC goes ahead with limits while FSA does not. But on the basis of the above analysis, any advantage would be very slight. So the distribution of trade volumes between London and the United States would probably NOT be affected significantly.

Given the limited changes the CFTC is contemplating the FSA could probably hold its current position. It depends on how far the CFTC eventually shifts from its "no evidence" of speculative impact on prices. If the CFTC simply says the situation is unclear, the FSA could probably hold the current line, and argue that London's "dominant position" management system provides a similar level of protection to the position limits. If the CFTC moves further and says there has been some indication of a speculative impact on pricing, the FSA would probably have to move somewhat. But given the limited changes contemplated in Washington, any changes in London would be modest. More should become clear when the CFTC releases its statistical review, promised for next month.

Key Facts related to Nautical Capital Management

1) Nautical will typically be a "speculator" and subject to all CFTC and exchange limits for positions held by "speculators"
2) There are certain scenarios related to the Active Commodity Index where Nautical might apply for Commercial/Index hedger exemptions. These would likely be granted as most discussions have NOT talked about limiting the large global dealers from providing index linked hedge-exempt exposure. However these exposures would also have to be disclosed and documented.
3) Position limits reflect net long and net short positions. These rule changes have almost no effect on the market neutral product except when those spreads are inter-commodity spreads (i.e. crude oil/heating oil)
4) In the unlikely event that the CFTC eliminates the "no exemption" rule for indexers, Nautical can manage $3 billion tracking the ACI at current market prices and limits.
5) Each fund as a separate credit entity can maintain these limits, thus the dollar values found in the table below can be applied to each of the remaining three commodity hedge fund strategies.

NAUTICAL CAPITAL MANAGEMENT ACTIVE COMMODITY INDEX (ACI) POSITION LIMIT ANALYSIS

Ex. Fund Size $ 3,000,000,000

Position Limits Section

Commod	Contract Weight	Exchange	ACI Weights	Spot	in delivery period	In delivery period # of days prior to expiry	Single (non-Spot)	All months
Wheat	50	CBOT	5.670%	5,000	600	N/A	5,000	6,500
HRW Wheat	50	KCBOT	0.290%	500	600	N/A	500	6,500
Corn	50	CBOT	6.460%	13,500	600	N/A	13,500	22,000
Soybeans	50	CBOT	6.110%	6,500	600	N/A	6,500	10,000
Live Cattle	400	CME	5.910%	5,400	450 / 300	(450) First business day after the 1st Friday of contract month: (300) 5 business days before end of contract month	5,400	5,400
Lean Hogs	400	CME	2.750%	900	950	First business day after the 1st Friday of contract month	4,100	4,100
HG Copper	250	NYMEX	6.150%	1,500	1,500	N/A	5,000	5,000
Gold	100	NYMEX	4.730%	3,000	3,000	N/A	6,000	6,000
Silver	50	NYMEX	2.460%	1,500	1,500	N/A	6,000	6,000
Cocoa	10	ICE	2.480%	6,000	1,000	2nd business day after the expiration of the options contract	6,000	6,000
Sugar #11	1120	ICE	4.380%	5,000	5,000	2nd business day after the expiration of the options contract	10,000	15,000
Coffee	375	ICE	4.010%	5,000	500	2nd business day after the expiration of the options contract	5,000	5,000
Cotton	500	ICE	4.510%	3,500	300	2nd business day after the expiration of the options contract.	5,000	5,000
Crude Oil	1000	NYMEX	31.070%	10,000	3,000	3 days	10,000	20,000
Natural Gas	10000	NYMEX	13.020%	12,000	1,000	3 days	12,000	12,000

Commod	Recent Spot Month Price	Single contract $ Value	Single Contract Allowable Position Limit in $$$	All Months Allowable Position Limit in $$$	For Example Fund Size, Required Hedge $ Amount	ACI Weighted contract threshold (using all months)	Position OK (1=Yes)	All Months Available Position %
Wheat	516.25	$ 25,813	$ 129,062,500	$ 167,781,250	$ 170,100,000	6,589.83	0	-1.38%
HRW Wheat	549.50	$ 27,475	$ 13,737,500	$ 178,587,500	$ 8,700,000	316.65	1	95.13%
Corn	331.25	$ 16,563	$ 223,593,750	$ 364,375,000	$ 193,800,000	11,701.13	1	46.81%
Soybeans	971.00	$ 48,550	$ 315,575,000	$ 485,500,000	$ 183,300,000	3,775.49	1	62.25%
Live Cattle	89.95	$ 35,980	$ 194,292,000	$ 194,292,000	$ 177,300,000	4,927.74	1	8.75%
Lean Hogs	52.60	$ 21,040	$ 86,264,000	$ 86,264,000	$ 82,500,000	3,921.10	1	4.36%
HG Copper	256.40	$ 64,100	$ 320,500,000	$ 320,500,000	$ 184,500,000	2,878.32	1	42.43%
Gold	937.30	$ 93,730	$ 562,380,000	$ 562,380,000	$ 141,900,000	1,513.92	1	74.77%
Silver	1348.5	$ 67,425	$ 404,550,000	$ 404,550,000	$ 73,800,000	1,094.55	1	81.76%
Cocoa	2898	$ 28,980	$ 173,880,000	$ 173,880,000	$ 74,400,000	2,567.29	1	57.21%
Sugar #11	18.75	$ 21,000	$ 210,000,000	$ 315,000,000	$ 131,400,000	6,257.14	1	58.29%
Coffee	125.00	$ 46,875	$ 234,375,000	$ 234,375,000	$ 120,300,000	2,566.40	1	48.67%
Cotton	60.11	$ 30,055	$ 150,275,000	$ 150,275,000	$ 135,300,000	4,501.75	1	9.97%
Crude Oil	66.94	$ 66,940	$ 669,400,000	$ 1,338,800,000	$ 932,100,000	13,924.41	1	30.38%
Natural Gas	3.750	$ 37,500	$ 450,000,000	$ 450,000,000	$ 390,600,000	10,416.00	1	13.20%

Anticipated implications for Nautical

1) If stricter limits are opposed, they are not considered to be onerous to Nautical until the firm is a multi-billion asset manager.
2) If hedge exemptions are removed for index hedgers, a cottage industry of new players would develop to offer hedging solutions below the thresholds and Nautical is perfectly positioned to profit from that new business.
3) Further to that point, if overall fund and speculator limits are reduced sharply it increases the likelihood of investors placing assets with Nautical due to fewer choices being available when investors who choose to stick with the asset class move toward firms that are not up against limits. The "start up" tag currently associated with Nautical can be viewed as an asset.
4) Structuring and transaction costs may increase in the future as the industry devises ways to circumvent the rules, whether that be through the development of offshore trading or legal structures designed to separate exposure as calculated by the CFTC and/or exchanges.
5) Tracking error risk may have to be incurred to "hedge" exposures above some exchange limits. This risk may be treated as a positive or a negative value-added, but in any case changes the overall risk profile.
6) These discussions in no way alter the three to five year projected revenue profiles for any of our strategies (provided asset growth isn't in the multiple billions – a good "problem" to have).
7) Nautical has future strategies in the works that eliminate this discussion altogether by turning all investors into commercial hedgers. The longer range goal at Nautical has always been to anticipate events in the commodity asset space and prepare well in advance to be successful in any investment environment.