March 25, 2010- An Historic Meeting

An Historic Meeting

The CFTC's public meeting on precious metals position limits will start in a few hours. Here's the link for instructions for how to watch via the web broadcast. http://www.capitolconnection.net/capcon/cftc/032510/CFTCwebcast.htm Also listed are the links for written testimony by staff and panelists (at this time many appear inoperative, but will be fixed shortly).

As I indicated previously, my written statement on the issues, which I had submitted to the CFTC follow this article. Please remember, I am trying to be as specific as possible and meaningfully impact the discussion in a positive manner. Early press reports suggest that the exchange is going to go with the argument that no changes in position limits should be made because it will drive business away from the exchange. If that's true, I am amazed they would advance such a weak argument. But let's reserve judgment. That's the beauty of a public hearing Â? all the arguments are put on the table for consideration.

Over the next few days I will offer commentary on this public meeting and the private meeting I had with senior CFTC staff yesterday in Washington, DC. I doubt I will hold much back in my analysis of the public meeting. The private meeting was off the record, so I'm going to be circumspect on what I report on that meeting. I will, however, give much credit to the CFTC for the invitation and for hearing me out. I'll be watching closely to sense how my main points, namely, the mismatch between the current COMEX gold and silver accountability position limits and the concentration on the short side of COMEX silver are covered in today's hearing.

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March 25, 2010

Precious Metals Position Limits:

Analysis and Recommendations

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Introduction

Tremendous volatility in energy and other commodity prices during 2008 and the resultant public outcry suspecting excessive speculation to be at the root of that volatility led to attempts to rein in future commodity price volatility. With the swearing in of Gary Gensler as the new Chairman of the Commodity Futures Trading Commission (CFTC) on May 26, 2009, attention was quickly focused on reviewing whether a revamping of speculative position limits might help prevent future commodity price volatility. On July 7, 2009, Chairman Gensler announced plans for a thorough review on the matter of position limits, including public hearings, principally in regards to energy markets and other commodities of finite supply.
http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/genslerstatement070709_b.pdf

At the center of the Commission's review of hard speculative position limits were three basic issues; who should set position limits (the CFTC or the exchanges), at what level position limits be set, and who should be exempt from speculative position limits for bona fide hedging purposes. On January 14, 2010, the Commission voted to proceed with and opened for public comment a staff proposal that the agency set hard limits in four energy markets. The proposed limits were based chiefly upon a formula consisting of a percentage of total open interest, including a set of restrictions concerning who would be eligible for exemptions to the proposed limits for bona fide hedging purposes. Also on January 14, the Commission announced a public hearing on position limits in precious metals, now scheduled for March 25, 2010.

A brief word on the purpose of speculative position limits in general. As the term implies, the intent of position limits is to limit speculative trading entities from artificially influencing the price of traded commodities. Limits are not designed to undermine or unnecessarily restrict the important role that speculators play in the risk-transfer process that marks the economic purpose of the futures trading. Speculative position limits serve an important purpose; to protect the market from concentration and manipulation. Much like the reduced speed limits in an elementary school zone are designed to save the lives of school kids and not just inconvenience drivers, position limits are not designed to punish speculators. The trick in both cases is to set the limits low enough to serve the intended purpose, but not so low as to impede the price discovery process or local traffic flow.

One further point concerns the definition of who is a speculator and who is a hedger. Many assume that all positions held in the commercial category of the CFTC's weekly Commitment of Traders Report (COT) are bona fide hedge positions. But that is virtually impossible, as the largest traders in COMEX gold and silver futures are US commercial banks, which trade both for clients and on a proprietary basis. Because these banks' positions are reported as a single trading entity, legitimate hedge positions are commingled with proprietary trading positions, thereby blurring the true nature of large concentrated positions. This heightens concern that concentrated positions in COMEX gold and silver futures may be manipulative in nature.

Many provisions in the Commission's proposed energy position limit initiative should effectively deal with this problem. However, the thrust of the Commission's proposal in energy contracts is designed to prevent concentration in those markets in the future, as there is no apparent concentration in any of those markets currently. In the case of precious metals, particularly in COMEX silver on the short side, the issue of concentration is of present concern. Accordingly, it behooves the Commission to take the opportunity in the open public hearing and otherwise, to closely examine the issue of concentration in the COMEX silver market with a degree of urgency not required currently in energy markets.

By virtue of the staff proposal at the January 14 meeting having been passed, let's assume the issue of who should set position limits, the exchange or the Commission, has been answered. Now, the only remaining questions are at what level position limits in precious metals should be set, and what would constitute bona fide hedging exemptions to those limits.

The Level of Position Limits

The COMEX gold and silver futures markets are the highest volume exchange traded precious metals derivatives markets in the world. As such, they are at the center of the position limit hearing. Previously, I have made the public case that the level of the current exchange-dictated accountability silver limit is out of line with either the exchange accountability level or federally-imposed hard position limit for every other regulated commodity. On every rational basis of comparison, including world annual production and world inventory levels, the COMEX silver accountability limit registers as an aberration compared to all other commodities. Such comparisons are valid and adhere to the spirit of setting position limits in a fair and consistent manner. Since the Commission has voted to proceed with an energy proposal which includes the setting of hard position limits by a formula related to a percent of total open interest, I'm going to do the same here. Furthermore, since the CME Group, Inc. (owner of the COMEX and NYMEX) also proposed a formula around open interest, but also included volume and deliverable inventory considerations, I'm also going to include volume and deliverable inventory considerations.

Since the March 25 public hearing concerns precious metals, I'm going to confine my comments to just gold and silver position limits. First, I will address the current accountability level in each and what CFTC hard position limits should be, based upon a fair and consistent formula. Then I will address what form bona fide hedging exemptions to hard limits should take. I will do this by comparing the current accountability levels in gold and silver with the objective of proving that the position level in silver needs to radically altered relative to gold.

Presently, the COMEX maintains the same accountability level of 6,000 contracts in both gold and silver. The size of one COMEX gold contract is 100 troy ounces, while the size of the COMEX silver contract is 5,000 troy ounces. This means that the current accountability level in gold is equal to 600,000 ounces (6,000 contracts x 100 oz contract size), while silver's accountability limit is the equivalent of 30,000,000 ounces (6,000 contracts x 5,000 ounces). At current prices (approximately $1100 in gold and $17 in silver); a gold contract equals a dollar amount of $110,000, while a silver contract has a notional dollar value of $85,000, roughly comparable amounts.

That's where the similarities stop.

Using data from the most recent COT report, for positions held as of March 16, the total open interest of COMEX gold futures was 496,481 contracts, giving that market a total notional value of almost $55 billion. COMEX silver futures on that date had a total open interest of 114,192 contracts, giving silver a total notional value of less than $10 billion. In terms of total open interest, the COMEX gold futures market is 4.35 times as large as the silver market. If the CME Group is advancing the idea that position limits be determined by a formula based upon open interest, then how could two markets with radically different open interests have the exact same position accountability level? In terms of total notional value (open interest x contract dollar value) COMEX gold is more than 5.5 times larger than COMEX silver. Why isn't gold's accountability limit proportionately larger than silver's or silver's limit proportionately lower?

Using the key principle of the CFTC's (and the CME's) energy formula proposal, namely, that position limits be set as a percentage of total open interest, any hard position limit in precious metals would require silver's position limit to be less than a quarter of whatever the position limit is in gold. It does not matter what percentage rate is used, as long as the same rate is used. But it doesn't stop with an open interest comparison. In terms of volume, the average daily trading volume in COMEX gold runs 4 to 5 times the volume in COMEX silver. Once again, the fact that each market has the same position limit is absurd.

Lastly, the hard position limit for the spot delivery month does somewhat reflect that silver requires a lower limit than gold's limit. The exchange does limit speculators to 3000 contracts in gold in the spot month and 1500 in silver. But even though silver's spot limit is 50% of gold's spot limit, that doesn't go far enough. Spot month position limits are largely a reflection of the level of potential deliverable supply, or inventory in exchange-approved warehouses. As of Friday, March 19, 2010, there were 10,022,064 ounces of gold in COMEX-approved warehouses, or the equivalent of 100,221 contracts. The total amount of silver in COMEX-approved warehouses on that date was 116,621,449 ounces, or the equivalent of 23,324 contracts. Therefore, there is 4.3 times more contract equivalent gold in COMEX-approved warehouses than there is silver. If the proper spot delivery month position limit for COMEX gold is 3000 contracts, then silver's spot month limit should be less than 750 contracts, not 1500.

I agree, in principle, with the objective nature of the CFTC's (and CME's) open interest formula in the energy proposal, although I do think the core percentage rate of 2.5% was too high. In my opinion, the core rate should have been in the 1.5% to 2% range, but it is not worth quibbling about. One thing that does bother me, however, is that the actual energy formula from both the CFTC and he CME Group calls for the position limit be calculated by taking 10% of the first 25,000 contracts of open interest, and then 2.5% of open interest above that. This calculation is not so critical in the energy markets where open interest can exceed one million contracts. But in a market with an open interest much lower (like silver), such a provision would necessarily distort the actual resultant position limit. In a smaller market the 10% of the first 25,000 contracts of open interest would be correctly viewed as a gimmick designed to evade the principle of a fair and consistent approach across all commodities of finite supply. The Commission would be making a serious error if it adopted a formula which included 10% of the first 25,000 contracts of open interest in silver.

The conclusion is simple – gold and silver are sufficiently similar so as to require their position limits be fairly and consistently applied. COMEX gold is four to five times larger than COMEX silver in terms of open interest, volume, deliverable supplies and total notional value amounts. There is no conceivable reason why they should have the same 6,000 contract position limit, except for manipulative purposes. The only real question is that should gold's position limit be raised, or should silver's limit be lowered. I have publicly argued that silver's position limit should be lowered and still believe strongly in that. Even if the Commission adopted the exact same formula it used in its energy proposal, the resultant position limit in silver would drop substantially from the current 6,000 contract accountability limit, although not to the 1500 contract level that I advocate. However, a case could be made for raising gold's position limit instead, and I would like to comment on that.

If the Commission strictly adopted the same formula in COMEX gold that it proposed in energy (2.5% of total open interest after 10% of the first 25.000 contracts) gold would have a position limit of 14,275 contracts at current open interest levels. (Silver's limit would be under 4800 contracts). Is it reasonable that gold's position limit be raised from 6,000 to 14,275 contracts (and silver's limit lowered to 4800) in order to redress the obvious disparity in their respective position limits? I don't think so.

Some common sense must be applied in deciding on the proper level of position limits. The proposed maximum position limits for crude oil, for instance, would amount to no more than a day's world production or some fraction of that. A position limit in COMEX gold of 14,275 contracts would be the equivalent of 1,427,500 ounces, or almost seven times daily world gold mine production. In silver, the current 30 million ounce accountability limit is 16 times larger than daily world silver mine production. It is important to remember that the economic justification for futures trading is to allow hedgers to transfer risk to speculators, so speculative positions must be viewed relative to legitimate hedging.

Gold mining companies are the natural hedgers on the sell side (aside from jewelry manufacturers, I'm not sure who are the natural gold hedgers on the buy side). No more than 25 mining companies in the world produce 600,000 ounces annually (the current accountability limit). Any gold or silver miner, as a natural producer, could easily get a bona fide hedge exemption with no great difficulty. Currently, the miners are holding their lowest short hedge position in the forwards market in 20 years, so this is moot, as the mining community is not interested in hedging for the most part. The other class of potential bona fide hedger would be a holder of gold or silver inventory at risk in a price decline. Similar to a large miner, such a large inventory holder should be able to get a bona fide hedge exemption regardless of the speculative position limit. Of course, regulatory care must be taken so that such a large Â?hedgeÂ? seller is not unduly influencing the market, intentionally or otherwise.

It is not necessary, nor advisable to increase the gold position limit from the current 6,000 contract accountability limit in order to adjust the extreme relative imbalance between gold and silver accountability limits. It is necessary to radically reduce silver's position limit from the current 6000 contract accountability limit to 1500 contracts on an all-months-combined basis and 750 contracts in the spot month. Although it shouldn't be necessary to point this out, these limits must apply to both long and short holders.

Exemptions from Position Limits

Next is the remaining important consideration before the Commission; the allowance of exemptions from hard speculative position limits for bona fide hedge positions. In fact, this is the most important issue, as COT concentration data indicate several traders in COMEX gold futures hold both net long and short positions well in excess of the current 6000 contracts. In silver, there are several traders holding short positions above the current 6000 contract accountability limit, and no more than one long trader holding such a position. Further, separate Bank Participation Report data, since August 2008, indicate it is primarily one or two US banks holding the largest net short positions in both COMEX gold and silver futures.

The concentration data from the CFTC is so extreme in COMEX silver futures that it set off a formal investigation by the Commission's Enforcement Division in September 2008, which is still ongoing. This current investigation follows extensive silver reviews in 2002, 2004 and 2008, by the Commission's Division of Market Oversight (DMO). All these silver reviews can be traced to public allegations by me that there was a downward price manipulation underway in the silver market. All the allegations of silver manipulation and subsequent DMO reviews involved the same issues currently being considered in the March 25 public hearing, namely, concentration, position limits and bona fide hedge exemptions. In every DMO review, it was found that no silver manipulation was in place. Yet, the issue, obviously, won't go away. In addition, numerous public and private complaints to the Commission's Inspector General concerning the methodology behind the DMO's reviews have been lodged and ignored.

The current formal silver investigation by the Enforcement Division is now 18 months old. This investigation is believed to have been set off by analyses of the August 2008 Bank Participation Report.
http://news.silverseek.com/TedButler/1219417468.php

http://news.silverseek.com/TedButler/1220376924.php

The data in that and other Bank Participation Reports revealed that an unusually large net short position was held by one or two US banks in both silver and gold for the first time. In silver, the net short position held by one or two US banks, has amounted to as much as 30% of world annual mine production and as much as 40% of the entire COMEX open interest (net of spreads) at times. So compelling was the factual evidence that it resulted in a formal silver investigation. In reality, no one requested a formal silver investigation, involving valuable resources and taxpayer funds. Instead, the simple question was asked, Â?how can such a large concentrated position, held by one or two entities, not be manipulative?Â? A year and a half later, we still await the answer.

The facts revealed in the Commission's own statistics go to the heart of the exemption issue. Whether the silver hard speculative position limit is set at 6000 contracts or reset to a more equitable 1500 contracts, either limit will be rendered ineffective if hedge exemptions are granted in the manner currently permitted by the exchange. All that it will mean is by how many multiples the big silver shorts exceed the limit. Any exemption that allows for one or two entities to hold a 30% to 40% share of any market is permitting an end-run around the purpose of position limits and the spirit of commodity law. As indicated in the introduction, the Commission's energy proposal, if applied in precious metals, should remedy the obvious current circumstance of allowing big US banks to masquerade as hedgers when they are clearly speculating on a proprietary trading basis. In silver, hedge exemptions should be limited to those who produce or consume the actual metal, or hold real metal inventory known to be at price risk.

While the Commission is to be commended for holding a public hearing on the matter of position limits in precious metals, if there is a problem that needs to be resolved, that problem is centered on COMEX silver. In reality, it nearly boils down to this being a silver-specific issue. Simply stated, the COMEX has abrogated its responsibility to impose legitimate position limits in silver and has further compounded the problem by refusing to rein in an obvious concentration on the short side of the market.

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