Oct. 4, 2009 – The Box Canyon

The Box Canyon

This is the conclusion of the discussion in Â?More Alphabet Soup.Â? I wrote about two important short term factors in that article, namely, the current configuration in the COT and developments in the big silver ETF, SLV. Today, I'd like to discuss the third short term factor that promises to greatly influence the price of silver. This factor could be the most important of all. I'm speaking of the coming showdown between the CFTC and the CME Group (owner of the COMEX) on the matter of position limits in silver.

When I was a child back in the mid- 1950's, there was a strong cultural focus on Western US history, the cowboy variety. Many of the TV shows and movies had this theme. I had a Hopalong Cassidy bicycle (complete with saddlebags) and a Roy Rogers cowboy hat, even though I grew up in New York City (the Inwood section of northern Manhattan). Being thoroughly immersed in all the nuances of western lore, even as a city kid I knew that a box canyon was a geographical formation that could be miles long, but could only be entered and exited from the same opening. I knew there was going to be a lot of action whenever the Calvary chased the Indians (Native Americans) or vice versa into a box canyon. Because there was only one way in and one way out, you knew the bullets and arrows would be flying from the certain clash to come. I can't help but think that the issue of silver position limits is the box canyon for the CFTC and the CME.

I know this is a complicated issue for most people. But it is also an extremely important issue; one that I believe could dramatically impact the price of silver. Therefore, I will attempt to simplify it as much as I can. Should any subscriber have any questions, please email me. It is important for you to understand this as much as possible. I will also send this article to Chairman Gensler at the CFTC, certainly not because he needs anything explained to him, but because I offer a further suggestion that may help him in achieving the mission I perceive he is on. That mission is to protect the American people and our markets from fraud, abuse and manipulation.

Let me first summarize the issue, set the timeline, detail some new facts in silver, and then describe the political dynamics as I see them. It is an issue that is incredibly specific and goes to the heart of commodity law. As I have written previously, this is a signature issue and is a deeply personal one as well; an issue that I have been petitioning the regulators about for more than 20 years. I know that the vast majority of readers and public commentators disagree with my great esteem for Chairman Gensler. The main reason for my high regard for him is because he is the only regulator in the past two decades to address the issue of concentration and position limits in a fair and open manner. He puts the right emphasis on the issues that are important. Mark the words of someone who has formerly been the harshest critic of the CFTC Â? assuming he does not stray from his mission; Gary Gensler is destined to be the greatest Chairman in the agency's history. I believe he is a true public servant in the fullest meaning of the term.

As I have written about endlessly, manipulation is all about concentration. Manipulation is an artificial price structure caused by the very large position of one or a few market participants. Without a large and concentrated position, manipulation is not possible. There are no exceptions to that statement. All market regulators are concerned with concentrated positions. For instance, the Securities and Exchange Commission (SEC) dictates that owners of stocks publicly report their holdings over thresholds of 5% and 10% total ownership of a company. The primary commodity regulator (the Commodity Futures Trading Commission) closely monitors concentration in all the markets it regulates and reports that concentration weekly, in its Commitment of Traders Report (COT) and in its monthly Bank Participation Report. The goal is to make any market concentration as transparent as possible and to dismantle it if it threatens to manipulate the price of anything.

In commodity futures, the only known preventative to concentration is speculative position limits. By limiting the size of the positions any trader may hold in any commodity, concentration can be prevented or dismantled. It is this very principle of market concentration and position limits that led to the creation of the Commodity Exchange Act (CEAct) in 1936. For a fascinating description of the history of commodity regulation in this country over the past century, I strongly recommend you read this testimony by Dan Berkovitz, General Counsel of the CFTC, dated July 28, 2009
http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/berkovitzst

What I learned from Mr. Berkovitz's testimony was that the primary impetus behind the enactment of the CEAct in 1936 was due to a crackdown on concentrated short selling in the grain markets during the late 1920's and early 1930's, which severely depressed prices. Sound familiar? Also learned from the testimony was how back then, like now, it was a Chicago exchange protecting the interests of the big short sellers and opposing any implementation of legitimate position limits. Further, there is a very interesting review of the causes of the silver manipulation of 1980, and how that manipulation was the direct result of a failure on the part of the exchange and government regulators to enforce legitimate position limits. This allowed the Hunt Brothers to amass a large concentrated long position. One of the highlights of Mr. Berkovitz's testimony was something I had previously discussed, namely, the threat that a large concentrated position holds for the market in the event of sudden liquidation.

It is from Mr. Berkovitz's testimony that we can grasp the showdown at hand between the CME and the CFTC. Let's tell it like it is. The exchange doesn't want any real restrictions on trading of any type, as they fear it will cut into trading revenues. As a for-profit organization, they are concerned with their profits, not regulation or manipulation or the rights of the public. That's the conflict I had written about previously. The CFTC is not in it for profit; it exists to enforce the law. Hence, the Box Canyon.

As far as the timetable for the great confrontation, it is at hand. Now that the CME has issued its self-serving white paper, in which it outlined its spin for what position limits should be on those commodities currently lacking such hard limits, the ball is in the CFTC's court. All that's left is for the CFTC to propose its own Â?numbers.Â? While I am sure there is much debate behind the scenes, this is really a simple process from this point. Sooner, rather than later, we will arrive at the defining moment. That moment is when the hard number of contracts that any one speculator will be allowed to carry is announced in every commodity of finite supply, including silver. From this point, that should take no more than weeks, and, certainly, not more than one or two months. Numbers are funny old dogs, in that they are incredibly specific. At the end of the day in this process, it all comes down to the specific number of contracts that will be set for hard position limits in every commodity.

For most commodities, the actual release of the hard position limits in each market may prove to be somewhat anti-climatic. That's because there is no visible concentration present in most commodities, including the important energy markets. I would imagine that any hard position limits imposed would be close to the current accountability limits, for example, the 20,000 contract limit in crude oil or the 12,000 contract limit in natural gas or the 6,000 contract limit in gold. In this regard, the Commission is to be commended for dealing with this issue before there is another problem in the energy markets, as there was last year. By enacting legitimate position limits before a concentration becomes evident in the energy markets, the CFTC is being proactive and not reactive. This is a trait all too often lacking in normal regulation.

Instead, any drama in the Commission's soon to be announced proposals will have to do with exemptions to position limits for bona fide hedgers. This is a matter that impacts all markets. I hope they stick to their public statements indicating that exemptions will only be granted to real producers and consumers and not to the pretend hedgers, like swap dealers and index funds and other aggregators. Of course, as proscribed in the CEAct, real producers and consumers should also be restricted to hedging no more than 12 months of production or consumption.

I was careful to say that the coming announcement of the actual number of contracts for hard position limits in most commodities would be anti-climatic. That's because the current accountability limits do not appear to be excessive. There is one market, however, in which the announcement will be of high drama, no matter what the proposed number. I speak of COMEX silver futures. Of course, I have no knowledge of what the CFTC will propose for the all-months-combined hard position limit in silver. I only know what the number should be Â? no more than 1500 contracts (7.5 million ounces). I know that the number must be much less than the current 6,000 contract limit, as this limit makes no sense. I have demonstrated in the past why the current accountability limit in silver was out of line with every other traded commodity, in terms of annual world production and compared to above ground inventories, in the case of gold. As a result of this past article, in July, many hundreds of readers wrote to the CFTC asking that the position limits in COMEX silver be reduced to no more than 1500 contracts or to please explain why not.

http://news.silverseek.com/TedButler/1247586939.php

In August, hundreds of readers again wrote to the Commission about the issue of position limits and concentration, this time in response to the CFTC's request for public comment at the conclusion of the three-day hearings on the matter. Fully 90% of the comments had to do with the short concentration in COMEX silver and gold futures. http://news.silverseek.com/TedButler/1251206905.php This is an issue that must, and will be addressed.

I would like to offer new proof that the position limit in COMEX silver futures must be reduced drastically. Interestingly, this time the substantiation for the reduction comes from the CME Group itself, in their recently released self-serving white paper on proposed position limits http://www.cmegroup.com/company/files/PositionLimitsWhitePaper.pdf Basically, the CME proposed a formula for setting hard position limits in energy products based upon volume, open interest and deliverable supplies. Further, the CME stated that they Â?are prepared to consider a similar hard limits regime for metals contracts as well.Â? Using their own words and formula approach, let me explain anew why COMEX silver position limits must be reduced.

The proof lies in comparing COMEX gold and silver futures accountability limits, currently 6,000 contracts in each market. Because the limits are of the exact same size, in terms of contracts in the all-months-combined category, it does not matter what the actual formula the CME proposes to set hard limits. Because COMEX gold has a daily volume approximately four times silver volume, the gold position limit should be 4 times the position limit in silver , or the silver limit should be one-quarter the position limit of gold (1500 contracts). In terms of open interest, because the open interest in COMEX gold has averaged 3.5 to 4 times the open interest in COMEX silver futures, any formula would dictate the position limit in gold should also be four times more than silver's, or silver's position limit be a quarter of gold's position limit. No matter what formula the CME concocts, volume and open interest mandate that gold's position limit be set four times silver, or silver's limit be one-quarter the limit in gold. This is not rocket science, just common sense and simple numbers.

In terms of deliverable supply, the comparisons are equally straight-forward. The level of COMEX-approved gold warehouse inventories is a little over 9.2 million ounces. In contract terms, given the 100-ounce gold contract size, that comes to 92,000 contracts. Therefore, the level of warehouse stocks is a bit over 15 times the level of the current gold accountability limit (92,000 divided by 6,000). In silver, the level of comparable deliverable supply, COMEX-approved warehouse inventories, is just over 115 million ounces. In contract terms, given the silver contract size of 5,000 ounces, that is the equivalent of 23,000 contracts. Compared to the current accountability limit in silver of 6,000 contracts, deliverable silver COMEX inventory is less than 4 times the size the current limit, even though deliverable supplies in gold are more than 15 times larger than gold's limit. Once again, relative to deliverable supplies, silver's position limit should be one quarter of the current accountability limit.

On every measure that the CME would consider in setting hard position limits in metals, namely, volume, open interest and deliverable supplies, the limit in silver should be reduced to 1500 contracts. It does not matter what formula may be utilized, the stated inputs dictate silver's limit must be one-quarter of whatever the limit is in gold. And if anyone would suggest instead that gold's position limit should be quadrupled, let him step forward and make that case. In these serious times, we could all use a good laugh.

In spite of the clear and compelling case for immediately reducing the position limit in silver, it is no sure thing, due to political considerations. On the general matter of the agency taking back the role of setting hard position limits from the CME, the Commission seems split. Of the four commissioners (there is one vacancy, with the nominee awaiting Senate approval), there appears to be a 2 to 2 split, with Commissioner Bart Chilton behind Chairman Gensler's plan for the agency assuming responsibility as mandated by the CEAct. Commissioners Michael Dunn and Jill Sommers, by virtue of their public testimony, seem to be backing the CME. Like the CME, Dunn and Sommers, are worried that business will leave the exchange and move to unregulated markets (overseas). This seems a hollow fear to me, especially considering that a proposal working its way through Congress would empower the CFTC to aggregate all positions, both exchange traded and OTC, held by traders for position limit purposes. Besides, the business that might leave is of the manipulative variety, so who wants to keep it here anyway? I say, let these traders leave. Good riddance and don't let the door smack them in the butt on the way out. Let them go trade on the Iranian Oil Exchange, with the trades guaranteed by the ayatollahs.

Even without a Commission majority, Chairman Gensler appears to have taken the steps necessary to bring positive change to the issue of position limits. His appointment of Dan Berkovitz as General Counsel is an important one. Berkovitz was counsel on the team responsible for the Wheat Report on Excessive Speculation from the Senate Permanent Subcommittee on Investigations http://news.silverseek.com/TedButler/1246302473.php
He has experience and wisdom on this issue.

In addition, in a move that I believe was largely underappreciated, a few weeks ago Chairman Gensler appointed a CFTC- outsider, Steven Schoenfeld, to the post of Director of the Division of Market Oversight (DMO). http://www.cftc.gov/newsroom/generalpressreleases/2009/pr5715-09.html

Not only does Mr. Schoenfeld bring practical industry experience to the agency, a notable departure from past appointments, the DMO is the division that, in both 2004 and 2008, issued lengthy, but largely unresponsive, denials of a silver manipulation. Until this change at the director level, it would have been difficult for the DMO to retract previous findings. With new leadership, it is hard for me to imagine how they won't look at allegations of silver manipulation differently.

My suggestion for Chairman Gensler is a variation of a previous one I offered publicly to him. It has now been several months (plus 20 years) since I have made the case that hard speculative position limits of 1500 contracts be enacted in COMEX silver and phony hedge exemptions be thrown out. Hundreds have written to the CFTC and asked about this as well. To date, I have yet to read or hear of a legitimate argument to the contrary. That's because there is no legitimate reason for a 6,000 contract limit in silver. Plenty of illegitimate reasons, to be sure, just no legitimate reasons. This is very similar to me asking how a US bank, being short 25% of the world production of silver (or any commodity) would not be manipulative to the price. No one could answer that question either. I don't think Chairman Gensler should have to answer either question. He should ask someone else to answer.

My suggestion is that, in light of my new gold versus silver position limit calculations today, the Chairman should direct the CME to publicly explain why the all-months-combined position limit in COMEX silver should not be immediately reduced to 1500 contracts. After all, the CME's own white paper lays out the formula approach and lists the variable inputs; volume, open interest and deliverable supplies. It is my further suggestion that the Chairman call upon Commissioners Dunn and Sommers to offer the same public explanation, in light of their clear support of the CME's general position. It is an explanation I am sure many would be interested in hearing.

If and when the all-months-combined hard position limit in COMEX silver is reduced to 1500 contracts, the issue of the big concentrated short position will be exposed for the fraud and manipulation that it has been all along. Whether it is one big US bank (JPMorgan) holding 30,000 contracts, or the four largest traders holding 15,500 contracts each on average, a 1500 contract limit will prove just how outrageous and excessive these big silver short positions have been. And if the CME or the dissenting commissioners don't have the moxie to step forward with a public defense of the 6,000 contract current limit, the chairman should make the big shorts do so themselves. Drag these big shorts out into the sunshine and have them explain why only 4 traders make up the entire commercial silver net short position. Now that would be real transparency.

Ted Butler

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