September 13, 2010 – Fair, Simple and Sound

Fair, Simple and Sound

I'm going to switch gears here a little and step away from lambasting the ongoing silver manipulation, and instead offer a constructive solution designed to end it. Long-time readers know that I believe it's important not just to criticize, but to offer remedies for what I feel needs change. As is my custom, I will call on you for assistance.

The Commodity Futures Trading Commission (CFTC) is seeking input from interested parties for guidance in setting the proper level for position limits in all commodities of finite supply. Later, the Commission intends to solicit public comments on the issue. This is all a result of the new Financial Regulatory Reform law. The new law is truly comprehensive and the Commission has an incredibly broad array of matters to deal with in its implementation. My interest is incredibly narrow Â? the matter of position limits in silver.

As many of you may know, I have petitioned the CFTC and the COMEX for more than 20 years to get them to institute legitimate position limits in silver. During that time I have always advanced the idea that the proper level for position limits in silver as 1500 contracts (7.5 million ounces), for a variety of reasons. That has never changed. Today, I'll present the best reason yet for the limit being close to that level. In my opinion, this is the key to ending the silver manipulation, along with throwing out phony hedge exemptions to that limit for the big banks. New developments suggest that we may be at an opportune time to convince the regulators to do the right thing. We must be realistic, however, and recognize that there are great forces that will resist any move to legitimate silver position limits and a free market in silver. This is not just about having the regulators do the right thing; it is also about overcoming the influence of the big commercial traders in silver. They will fight, tooth and nail, to maintain their illegal and manipulative control over the price of silver.

Unfortunately, I believe that the CFTC wants to hear my input on this matter about as much as they want to hear from the Grim Reaper. (I consider Chairman Gensler differently). That's why I wasn't allowed to appear before the Commission in March for the public hearing on metals position limits, my signature issue. I'm sure many at the Commission and all at the COMEX will continue to try to block any input from me on this issue. Therefore, I'm going to ask you to review the following proposal and for you to urge the Commission to adopt it, if you find it reasonable. I've tried to make my proposal simple and fair. As always, if anyone has a better proposal for what position limits should be in silver, I'd like to hear it. To my knowledge, no alternative suggestion has been forthcoming at numbers very different from the 1500 contract amount. I find this pretty amazing. Certainly, I've never heard anyone justify the current 30 million ounce COMEX accountability limit, a limit not even enforced.

These can be complicated matters which I am trying my best to make as simple as possible. This is a matter incredibly specific to silver; no other commodity needs as radical a position limit overhaul as does silver. And if you think I'm exaggerating, please consider this; the current 6,000 contract accountability level (30 million ounces) is almost equal to the entire annual production of the US. What kind of crazy limit exists, that any single speculator can buy or sell more than all the silver any single US mining company can take out of the ground over an entire year? And some speculators, like JPMorgan, hold short many times that amount.

If you are unclear about my proposal in any way, please let me hear from you. As always, it's my responsibility to make sure you understand my premise. You don't have to agree with me, but if you do, please lend your weight behind the effort to convince the Commission. I guarantee to you, just like every other time I've asked you to contact them, that by writing to the Commission, you will be dealing on a very high level concerning substantive matters that can make a great difference. Make no mistake, this is important stuff. Ask them to adopt my one percent solution, or explain why not. Write to them in your own words, or just ask them to adopt my solution by sending a copy of this. I do intend to put this in the public domain shortly to ask all to contact the CFTC. The following letter is, hopefully, self explanatory.

September 13, 2010

US Commodity Futures Trading Commission

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Dear Chairman Gensler and Fellow Commissioners,

The new Financial Regulatory Reform law mandates that the Commission institute hard position limits in the derivatives trading of all commodities of finite supply; energies, metals and agricultural products. The Commission has sought input to help guide it in determining the proper levels of speculative position limits in these commodities. It is important that the formula for determining such levels be consistent, economically sound, fair, and readily understood by all market participants. These same principles must also be applied to the granting of exemptions to any limits for bona fide hedging purposes.

The economic legitimacy behind commodity futures and derivatives trading is to permit the producers and consumers of commodities the opportunity to offset price risk. Hedgers transfer unwanted price risk to those speculators willing to assume it. The purpose of position limits is to guard against concentration and manipulation, without unduly restricting the liquidity provided by speculators to our derivatives markets. The key to ensuring economic legitimacy and guarding against manipulation without unnecessarily crimping liquidity is setting position limits at appropriate levels; not too high and facilitate manipulation, not too low and choke off liquidity.

All commodities of finite supply are physically produced and consumed. That's what makes them finite. Therefore, any formula for determining the proper level of position limits should be based upon world production and consumption. The simplest formula would be one based upon a uniform percentage of the world production of all commodities of finite supply. Position limits should be established based upon a set percentage level of world production that must not be exceeded in any commodity. By insisting that the same percentage figure be applied across all commodities of finite supply, the Commission will assure consistency and fairness in the process.

The One Percent Solution

I propose that the Commission adopt a hard position limit in the contract equivalent amount of no more than one percent of the world annual production of any commodity of finite supply. This 1% speculative position limit would apply to all related derivatives on an aggregate (across all markets) and on an all-months-combined basis. No single speculative trading entity could control on a net basis, long or short, a total derivatives position greater than one percent of the annual world production of any commodity. Such a limit would be large enough to accommodate all but a handful of traders in every market. Importantly, such a level, evenly enforced, would make concentration and manipulation impossible. This is the primary mission of the Commission.

To be sure, so sensible is the one percent solution that it is largely in force already across most commodities of finite supply. This is as it should be. Currently, only a very few commodities have speculative position limits greater than one percent of world production. Therefore, no radical revision in overall position limits is required. This should mute concerns about market disruptions, loss of liquidity, or trading migrations to foreign bourses. Truth be told, the levels of position limits in most commodities are where they should be. That's because most commodities have current or proposed position limits much less than one percent of annual production.

For example, the largest and most important commodity of finite supply, crude oil, has a current de facto position limit of close to one-tenth of one percent of annual world production. With an annual world crude oil production of 30 billion barrels, a position limit of one percent would result in any one trader being allowed to hold 300 million barrels, or 300,000 contracts of the standard 1000 barrel-sized contract. Clearly, that's way too high and the exchanges have established accountability limits closer to one-tenth of one percent, or 30,000 contracts or less instead. Recently proposed energy position limits by the Commission (withdrawn as a result of the new law) appear to adhere to the one tenth of one percent threshold in crude oil.

In those commodities where the Commission has set federally-mandated position limits, such as the grains and oilseeds, those limits are all well under one percent of world production. For example, corn has a position limit of 0.35% of world production, wheat is at 0.15%, cotton at 0.5% and soybeans are at 0.62% of world annual production. I'm not suggesting that those limits be raised to one full percent; I'm just demonstrating that the Commission has seen fit to traditionally set hard position limits at less than one percent across a broad range of commodities.

Since most commodities already fall well under the one percent of world production threshold, it is only necessary to bring the few commodities which have position or accountability levels greater than one percent into line. There are only four commodities of finite supply which currently have position limits or accountability levels greater than one percent of world production. Three of them trade on the Intercontinental Exchange (ICE) and one on the COMEX, owned by the CME Group, Inc.

The three ICE commodities include cocoa, coffee and frozen orange juice. Cocoa currently has an accountability limit of 6000 contracts, or 2% of current world cocoa production, coffee 5000 contracts, or 1.5% of world production and FCOJ, with a 3200 contract limit is at 1.25% of world production. It should be a relatively simple matter to bring their respective position limits down to the one percent level.

However, the current accountability level of COMEX silver is more problematic. The current silver accountability level is 6000 contracts, or 30 million ounces. This is 4.3% of world annual silver mine production of roughly 700 million ounces, head and shoulders above any other commodity of finite supply. Based upon the one percent formula, the position limit in silver should be no greater than 7 million ounces or the equivalent of 1400 contracts (each silver contract is 5000 troy ounces).

It is perplexing why the CME does not bring silver position limits into line with the other major metals contracts traded on the COMEX. In copper, the current accountability level is equal to 0.4% of world copper production. Why should silver's level be more than ten times greater than copper's? The COMEX gold contract has an accountability level of 6000 contracts, or 600,000 ounces, based upon the 100 troy ounce contract size. This represents 0.75% of world production of 80 million ounces. Why does silver have an accountability limit more than 5 times greater than gold in terms of world production? As I previously informed the Commission, silver's accountability level compared to gold's is also four to five times larger than it should be in terms of volume, open interest and exchange inventories. On each and every measure, silver's accountability level is out of line.

The Commission recently received almost 3000 public comments on position limits in metals, with more than 90% of the comments asking the Commission to enact a position limit of 1500 contracts in COMEX silver. Based upon a fair and consistent cap of one percent of world production for all commodities, those writing to the Commission were justified in their collective opinion. It is a matter of public record that I have urged the Commission and the exchange to adopt a position limit of 1500 contracts in COMEX silver, for more than 20 years. There has never been, in all that time, any logical explanation for not adopting such a level. In light of the mandate given to you by congress and the President, isn't it time to institute this limit?

As far as the matter of bona fide hedging exemptions to legitimate position limits, the granting of exemptions should be as fair and consistent as the setting of the amount of limits. Any legitimate producer or consumer of any commodity of finite supply should be able to hedge its risk up to the amount of its own annual production or consumption. If a farmer grows, or a miner produces, more than 1% of world production, that entity can hedge up to the actual annual amount produced. If an entity owns the physical commodity and is at price risk with that holding, that entity should be allowed to hedge that actual inventory, even if it is more than 1% of world annual production. But close attention must be paid by regulators to ensure that such an entity is not gaming the market. Any thought that financial middlemen, such as large banks, should be included in the legitimate producer or consumer category must be resisted. Our futures markets were not created so that big financial institutions could manipulate them. The whole thrust of the Dodd-Frank financial reform law was to get the big banks to stop interfering in our markets.

The Commission has a unique opportunity to finally set position limits on all commodities of finite supply in a manner that is fair, simple and economically sound. A formula based upon a straight one percent or less of world production would accomplish just that.

Ted Butler

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