August 16, 2009 – The Method to the Madness

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I've written a great deal about position limits in COMEX silver lately. In addition to writing several articles on this topic, I also have submitted public comments to the CFTC and encouraged others to do so. My message has been simple: reduce the speculative position limit in COMEX silver futures to no more than 1500 contracts (from 6000) and disallow hedge exemptions from that limit for the big shorts. That, and take away the conflicted ability of setting limits from the exchange and let the CFTC do so directly.

What I haven't done, up until now, is to spell out the market implications if the Commission does take up my recommendations, other than assert that it will end the silver manipulation. I know I am in a distinct minority (perhaps of only one) in my expectation that the CFTC will do the right thing, thanks primarily to its new chairman, Gary Gensler. Yes, it is entirely possible that I will be proven wrong in my high expectations for the Commission. I suppose they could enforce legitimate position limits and crack down on phony hedge exemptions in all commodities, except silver. I think this may be what many expect. That, admittedly, is the worst case outcome. To that, I say so what? It won't make things worse for anyone but the Commission. The effort to bring about legitimate change will still have been worth the effort. Nothing ventured, nothing gained. That said; let's assume something positive, namely, that the Commission does what it should.

Recently, I've mentioned in articles and interviews that the issue of speculative position limits is something I am very close to, perhaps too close, due to my long involvement with this issue. Just the other evening, I had the urge to test my memory and I pulled out some correspondence from a long time ago. I could hardly believe my eyes. I quickly found official responses from the CFTC, the COMEX and the Chicago Board of Trade from 1990-1992, all saying there was no problem with the level of position limits in silver futures. Their responses were inconsistent with one another and, in my opinion, weak. There is no way such responses would be offered today, given the high level of the debate on this issue in the recent CFTC public hearings. It is remarkable (even to me) how consistent my opinion was on this issue, then and now. I mention these responses to give some depth and time perspective to my interest in the issue of position limits in silver. Like most people, I prefer to avoid embarrassing myself, whenever possible. You can be sure that I studied and deeply reviewed the issue back then (and now), before writing to the regulator. The significant difference today is that I am no longer the sole advocator of change in position limits. That banner is now being flown by several Senators and the new chairman of the CFTC, to say nothing of the hundreds of readers who took the time to contact the Commission regarding the position limits in COMEX silver.

As an aside, it is remarkable how quiet the exchange and the Commission have been publicly on the specifics of position limits in COMEX silver and on anything silver related. Additionally, we are just about at the one-year mark of the publication of my article, Â?The Smoking GunÂ?
http://news.silverseek.com/TedButler/1219417468.php This is the article that disclosed the unusual level of concentration on the short side of silver (and gold) by one or two US banks, in COMEX futures. This, in turn, led to the ongoing silver investigation, the third in five years. For those curious, I have not been contacted by the CFTC in this, or past, investigations, even though I am the instigator behind all such silver inquiries.

Now that the August 12 deadline for submitting public comments to the CFTC on position limits has passed, there is not much to do, except to wait and see what the Commission decides on this important issue. Perhaps there will be another opportunity for public comment in the future, but most likely the CFTC will take action on the information garnered to date. I suspect that they have already largely made up their minds. Therefore, I'd like to discuss what I'll think they will do. Most importantly, I'd like to discuss the method to my madness about position limits, and what this may mean to silver investors.

First off, it's not even necessary for the position limits to be lowered in COMEX silver, for the manipulation to be broken. If all the CFTC did was to throw out the phony hedge exemptions that allow JPMorgan and other large shorts to hold their present large concentrated positions, that would be enough. Currently, the four largest trades in COMEX silver hold over 49,000 futures contracts net short, or over 12,000 contracts each, on average. (According to the most recent COT data). Enforcing the existing 6,000 contract accountability limit would require these four traders to hold no more than 24,000 contracts in total. This means that this group would have to buy back 25,000 contracts (125 million ounces) of their current short position. This would exert powerful buying pressure to the price of silver and remove the price-capping ability of these big shorts.

In sharp contrast to the dominant concentrated net short position of the four largest traders on the COMEX, the corresponding net long position by the four largest long traders is tiny in comparison. The total long position held by these traders is less than 14,000, or less than 3500 contracts per entity on average. Since this is well under the current accountability limit of 6,000 contracts, the big longs wouldn't need to sell anything on average.

I don't want to confuse anyone by getting too detailed, but this circumstance is unique to silver. COMEX gold does have a concentration on the short side, with the four largest traders holding 40,000 contracts on average, well above the 6,000 contract accountability limit. Even the next four largest short traders hold a position more than double the current accountability limit in gold. If forced to buy back the short positions in excess of the current accountability limit, great buying pressure should propel gold prices higher, all things being equal. The problem is that all things are not equal in gold, as the four largest long traders hold, on average, almost 24,000 contracts each; also well above the 6,000 contract accountability limit. Therefore, it is possible that the regulators may put more pressure on the gold longs to liquidate contracts in excess of the current accountability limits, than they do on the shorts. This could blunt the price impact of the buying pressure from the big shorts covering their short positions, even though those positions are larger than the excess positions of the big gold longs. This situation does not exist in COMEX silver.

Even though it is not necessary for the CFTC to lower speculative position limits in COMEX silver to 1500 contracts to end the manipulation (if they throw out the phony exemptions), it is still the correct and lawful thing to do. I've yet to hear any legitimate defense of the current 6,000 contract accountability limit. One important outcome of a reduction would be to highlight just how big the current concentrated short position really is. If a 1500 contract position limit was enacted, then the current total excess short position of the Big Four of 49,000 contracts, would be 43,000 contracts in excess of the new position limit of 6,000 (1500 x 4). So, 43,000 contracts (215 million oz) would need to be bought back. True, the Big Four long traders would need to sell 8.000 contracts in that case, but that's no big deal.

Large long traders not being able to buy as many long futures contracts as they may desire, due to reduced position limits, also goes to the method of my madness. It would be the best thing in the world, from the bull side, to limit these paper buyers of silver futures. All these mostly technical traders seem to do is buy as the price is climbing and sell when it is falling. Who needs them? Besides, if any large buyer is restricted by position limits, then there is something he can do about it Â? buy real silver and not the paper variety. Most importantly, the sellers of such silver will have to possess the physical silver in order to sell, not paper silver created at will. I didn't want to harp on this powerful point during the ongoing debate, so as not to create obstacles for the Commission doing the right thing.

In summary, adjusting position limits in COMEX silver to a level fair and consistent with the level of all other commodities, as well as trashing the phony exemptions will free the price of silver. I have studied the issue closely for two decades, and I can tell you I don't see any other commodity whose limits need to be lowered, including gold. Just silver. If the CFTC does not do the right thing and reduce the limit in COMEX silver, they will be jumping into a tar pit when they try to explain why.

I discuss the COT Report and the China situation in this new interview from Friday with King World News

http://www.kingworldnews.com/kingworldnews/Broadcast_Gold+/Entries/2009/8/14_Ted_Butler_on_the_Metals_M

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