January 11, 2012 – Heat on the CME

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As regular readers know full-well, when it comes to how it regulates the markets (especially silver), I'm not a big fan of the CME Group. My criticism of the CME began a few years ago, after they acquired the NYMEX/COMEX. Of course, my criticism of the COMEX goes back more than 20 years, as a result of it being at the core of the silver manipulation. Oftentimes, my criticism of the CME can be quite harsh, but today I will try to be more measured so as not to send a distorted message.

Now there is new criticism on the CME and I think for good reason. However, I don't think the new criticism has been articulated adequately and I will try to explain why the CME is, and should be, under the spotlight at this time. First, let's look at what others have been saying recently about the CME. In addition to the NY Times link that I referenced on Saturday, which indicated that the CFTC was reviewing the CME's role in the collapse of MF Global, a broadcast on FOX Business News by Charlie Gasparino stated that the CME might be pressured into breaking off its self-regulatory role from its main business of running a for-profit exchange. http://video.foxbusiness.com/v/1377288026001/gasparino-break-up-of-cme-on-the-table/

The broadcast and NY Times article brought a quick and coordinated response from the CME, in an appearance by its chairman, Terry Duffy, on a rival TV network and in an opinion piece in today's NY Times, attempting to quash any suggestion that the CME was deficient in any regulatory matter involving MF Global. http://dealbook.nytimes.com/2012/01/11/cme-chief-speaks-out-on-c-f-t-c-inquiry/?partner=yahoofinance The CME is sticking to its guns in proclaiming it did nothing wrong and all the blame rests on MF Global itself.

I believe there are substantial and easy to demonstrate flaws in the CME's role in the MF Global mess. Those flaws include the failure to audit MF Global properly and, once the auditing error was obvious, the failure of the CME to do what it had always promised it would do, namely, make whole all customers of a clearing member who went bankrupt. The good news, as Mr. Gasparino indicated, is that there is a ready and practical solution that might remedy any shortcomings in the CME's future regulatory role.

The main issue with the CME is the inherent conflict between its role as a for-profit corporation and as a self-regulator. Let's face it, allowing any for-profit entity to, essentially, regulate itself is just asking for trouble. And that is the problem. This conflict is at the heart of the new criticism, yet, curiously, is not mentioned often enough. Instead, observers of the current drama involving the CME and MF Global are misled by sound bites and clutter that fail to mention any inherent conflict of interest on the CME's part. That's because the CME is a master at spin-doctoring.

Because the CME is more interested in profit at any cost, not only has its self-regulatory role been compromised, it has actually enacted and encouraged developments which are downright hostile to the efficient functioning of its markets. You need not look further than the scourge of High Frequency Trading (HFT) for an example of what the CME has done wrong. HFT does nothing to enhance our markets, except generate excessive trading fees for the CME. HFT works against the very purpose for our futures markets of legitimate hedging because HFT is nothing more than day trading gone mad. Legitimate hedgers have no use for frantic day trading. High Frequency Trading also allows for markets to be manipulated easier.

But the catalyst for the new pressure on the CME concerns its role in the MF Global bankruptcy, not HFT. MF Global's failure was truly a worst case situation. For the first time in modern financial history, large numbers of the customers of a clearing company were out money and positions due to a bankruptcy. None of the safeguards that were supposed to be in place operated as intended. After more than two months, a great amount of what was supposed to be segregated customer funds is still missing. Obviously, blame must be assigned for this disaster and changes made. Some of that blame must be attributed to the CME, despite its attempt to push the blame elsewhere. More importantly, the changes that must be made to prevent further failures also involve the CME. This is the good news part. There is already a remedy that exists that promises to usher in the changes necessary to prevent a recurrence of MF Global. The CME must split off its self-regulatory function from its main business of generating profits. There is precedent for such a split-off.

A few years ago, the self-regulatory function of the NASDAQ and the New York Stock Exchange were split off so that little conflict would exist between the regulatory and for-profit business functions. The result of that spin-off, the Financial Industry Regulatory Authority (FINRA), appears to have blossomed into a respected self-regulator as intended. Likewise, the CME should spin off its regulatory function as has the NASDAQ and the NYSE, in order to eliminate any conflicts of interest.

One of the many benefits such a spin-off would create would be to eliminate the adversary role that the CME plays to any potential change in how our markets are regulated. Currently, the CME is always the chief antagonist to any new regulations proposed by congress or the CFTC. The CME has to protect its turf against anything that might infringe on profits, no matter how much merit new regulations may hold (think position limits). With a separate self-regulatory organization, the CME would be removed from its current role as being automatically against new regulations. And the evidence suggests it would be to almost everyone's advantage for the CME to spin off its self-regulatory function.

A case in point is in the MF Global debacle. While the CME completely messed up its auditing responsibility for MF Global, the timeline indicates that among the very first spotting trouble at MFG was none other than FINRA, the spun-off stock market self-regulator. Back in May, it was FINRA who initially questioned how MF Global was financially structured and pressed for change, not the CME. I would submit that had the CME not be conflicted in looking for trouble before it was obvious, it would have and should have uncovered financial inadequacies at MF Global while there was still time. Because of the conflict between profits and regulation, the CME is now reduced to blaming others for its own monumental failure, like a spoiled brat who doesn't get his own way. Instead, the CME should now take the high road and take the lead in having its self-regulatory function spun-off from its main business of generating profits. If it doesn't take the lead, then congress and the CFTC should press the CME to do so.

Certainly, I am not suggesting that silver played a role in the demise of MF Global or in the CME's failure as an auditor or guarantor in that demise. But it's also no secret that the CME has played an important role in the continuation of the silver manipulation started decades earlier at the COMEX. Therefore, any move to spin-off the CME's self regulatory function to a stand-alone organization would have important implications for the silver manipulation. I've always found it amazing that the CME has never even mentioned the outstanding allegations of manipulation in silver, despite an ongoing formal investigation by the CFTC for the past three and a half years. One would think, as a front line self regulator, the CME might have something to say about allegations of the most serious market crime possible in one of its markets. I would wager that if a stand-alone self-regulator existed, like FINRA, such silence would not be maintained.

Considering how powerful and entrenched the CME is, it's hard to guess how likely its self-regulatory function will be spun-off in time. Surely, it will strongly resist any such spin-off, no matter how compelling the merits of such a realignment. But if a spin-off does come to pass, it won't be bad for silver. It may be bad for the silver manipulation; but not for silver.

A number of subscribers have asked about the unusually large premium recently in shares of the Sprott silver ETF, PSLV. There have been a number of Internet reports suggesting the large premium, at times greater than 30% to net asset value (NAV), as indicating extreme tightness in the physical silver market. While there have been some signs of overall tight conditions in the wholesale silver market, the premium in PSLV appears to have a different cause. In checking with the company, it is more probable that the premium is related to a short squeeze of sorts among short sellers of the shares. The shares are hard to procure for borrowing purposes (to sell short) and expensive to borrow. I believe this has forced previous short sellers to buy back short positions and is behind the recent increase in the premium of shares to NAV.

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Silver – $29.90

Gold- $1638

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