June 22, 2011 – Start Me Up

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A good number of subscribers have asked me about the retail gold and silver trading ban on many leveraged transactions, effective July 15. The ban was built into the Dodd-Frank Act, signed into law last year by President Obama. It seems some misperceptions about the intent and potential impact of the ban were spread by early Internet blog posts. Other commentators have attempted to set the record straight and are to be commended for their efforts. In terms of any harm to the public or negative impact on the silver market, this trading ban was all much ado about nothing.

Briefly described, these transactions are highly leveraged (as much as 100 to 1) and usually very short term bets on the direction of gold and silver by individuals operating through foreign exchange trading companies. They don't involve the actual metal, but are quick bets in a trading environment separate from any exchange or wholesale OTC (Over the Counter) market. With such low margin requirements, this trading was almost exclusively reduced to day trading, where few overnight positions were held. These transactions are as far removed from long term investment as is possible. No one invests long term on a one percent deposit. About the closest example I can give you about this highly leveraged day trading is the infamous Â?bucket shopsÂ? that existed before the great stock market crash of 1929. These bucket shops involved stock market bets that never found their way to any stock exchange or actual security, but were strictly trading bets between customers or the house.

The early Internet reports on the retail OTC precious metals trading ban concluded, among other things, that the trading ban was an example of the government intruding on our basic rights or as a precursor to a ban on actual purchases of precious metals. I would disagree. Others suggested that the ban would result in a price smash for silver, as traders rushed to unload positions. That seems unlikely as little real metal was ever purchased. Instead, this was clearly an instance of the government doing the right thing. The only thing wrong was that it took so long for the ban to come into effect. This retail OTC gold and silver trading is strictly gambling; nothing more, nothing less. I am not opposed to it on moral grounds nor am I happy if some is deprived of trading income, but society has come to demand that any type of gambling be licensed and regulated (and taxed) by a government entity. You can't open a casino or a horse track or a betting parlor in the US without some type of government approval and regulation, usually at the state level. There was no government approval process for these retail OTC precious metals trading arrangement; they just sprung up.

What about the CFTC regulating these modern day bucket shops? The problem here is that there is an underlying economic justification to commodities futures trading, namely, to allow real producers and consumers the opportunity to hedge price risk. Our commodity futures markets were not created so that speculators could gamble. Speculators are certainly needed for our futures markets to work, but it is the hedging function that gives our markets their legitimacy. To my knowledge, there was no real hedging that occurred in retail OTC gold and silver trading. That makes it pure gambling, no different than a sudden Three Card Monte game set up on a city street. I know those trading these markets successfully (including subscribers) will mourn the ban and I can empathize with them. But in the bigger picture, this was a market devoid of economic legitimacy.

I had planned on this simple statement in response to subscriber questions, but I got to thinking about it and it started me up in a completely different direction. I got to thinking about retail OTC trading and it brought me to the current scourge of the silver market, high frequency trading (HFT). While there are some differences between retail OTC trading and HFT, there are some disturbing similarities.

The biggest differences are that the retail OTC traders were many in number, unrelated to one another and didn't intentionally influence the price of silver on world markets. In spite of these merits, retail OTC trading is being banned while HFT is being permitted an even stronger strangle hold on the silver market. HFT trading is much more harmful to the markets than retail OTC trading could ever be, yet the CFTC is banning the less harmful version, while allowing the corrupt CME Group to further advance HFT trading in silver.

It is in comparing the similarity between retail OTC trading and HFT that shows how inconsistent the Commission is being in applying the spirit of commodity law. Neither form of trading has anything to do with legitimate producers and consumers transferring price risk to speculators. Both retail OTC trading and HFT are largely day trading operations, with little overnight positioning. Real producers and consumers don't hedge by day trading. Therefore, the economic justification of hedging is not present in either form of trading. This makes both forms of trading illegitimate. How the Commission can crack down on one and not the other is troubling. Once again, it creates the impression that the Commission caters to big industry interests ahead of the public interest. Talk about un-American.

Unfortunately, this is a line of thinking that I have arrived at often recently. The ugly conclusion I reach is that the Commission doesn't care to apply the law when it comes to silver. Nor is it concerned with the public interest when it comes to silver. As always, I am not much interested in the possible motivations as to why the Commission is ignoring the public interest in silver, just that the public interest is being ignored. I hope I am wrong in my conclusions, but this is about calling them as I see them.

It is no secret that I have long admired Chairman Gary Gensler and his role in bringing genuine regulatory reform to the commodities and derivatives markets. On the big issues, like working tirelessly and collaboratively to achieve overall reform, he receives the highest ratings possible Â? straight Â?A'sÂ? across the board. Here's a recent Bloomberg article on him that was one the best-written and objective takes that I have read http://www.bloomberg.com/news/2011-06-21/gensler-evolving-in-derivatives-war-sees-no-deed-go-unpunished.html As I have remarked on more than one occasion, anyone who draws the opposition he does from the banking interests must be doing one heck of a job.

That said, Gensler's and the Commission's track record in silver is weak Â? no better than straight Â?D's.Â? A's overall and D's in silver Â? how can this be? Let's look at the record.

First, there is the matter of the ongoing silver investigation, now approaching its third anniversary. This investigation, started in August 2008, followed from my analysis of the Bank Participation of that month, predates Gensler's assumption of office in May 2009. After two previous investigations that ended in May of 2004 and 2008, in which the CFTC concluded no wrongdoing was present in the silver market, about the last thing I or anyone wanted was another long investigation. I was looking for a simple explanation to a simple observation; how could a concentrated short position amounting to 25% of world silver production held by one or two US banks not be manipulative to the price? I have speculated previously that perhaps the Enforcement Division was prevented from bringing charges of manipulation due to a lack of a majority Commission vote. Still, the fact that thousands of members of the public wrote to the Commission on this matter and no answer has been forthcoming for years earns the Commission (and Gensler) a failing grade.

On the ongoing matter of position limits, many thousands of public comments have been submitted and recorded on separate occasions urging the Commission to adopt a silver position limit of no more than 1500 contracts on an all-months-combined basis. Every time the Commission solicits public comments on this matter, the response is overwhelming regarding silver. In fact, the Commission has received public complaints and comments on silver that amount to many times the cumulative total on any other commodity in agency history. Not once has the Commission attempted to openly discuss the merits of a 1500 contract speculative position limit in silver. Not once has the Commission or Gensler even mentioned silver position limits. This also results in a failing grade for Gensler and the Commission.

Finally, after years of public warning that the silver market had been manipulated by JPMorgan and other large traders, the manipulation came into clear focus with the blatant takedown in price starting on May 1. Never before had a commodity market been taken down 12% in minutes or 30% in a week with no fundamental developments. Yet, there was no statement from Gensler or the Commission on the unprecedented decline (save for Commissioner Bart Chilton). There could be nothing but a failing grade for this performance.

As I said, I hope I am wrong about Gensler and the Commission concerning the public interest related to silver, but it's hard not to feel that way. The public submits comments, but those comments don't appear to be reflected in the Commission's statements or thinking. The Commission has held hundreds of private meetings with interested parties, including numerous repeated meetings with those openly alleged to be manipulating silver (JPMorgan, the CME Group and BlackRock, among others). These meetings have all been duly recorded as to having occurred, but with no detail as to what was discussed.

To my knowledge, there have been no meetings between the Commission or staff and members of the public in order to get the other side of the silver story. It's always about the vested interests being given access to the Commission and staff on proposed regulations, never anyone from the public. It's bizarre Â? a federal agency designed to protect the public with absolutely no interest in what the public might want to be protected against. Chairman Gensler talks consistently about transparency and protecting the public. I think it's time for him to be transparent to the public about silver.

I will be embarking on my annual trek to Maine in a couple of days in the search for a cooler climate. I plan a weekly review on Saturday, but it might be delayed somewhat due to travel. Apologies in advance for any inconvenience.

Ted Butler

June 22, 2011

Silver – $36.65

Gold – $1553

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