# May 30, 2012 – Hedging and Market-Making

Hedging and Market-Making

To my mind, there appear to be two great issues facing silver, gold and other markets presently. More than just issues, it would be closer to the truth to label them as the excuses being offered by the financial industry (particularly JPMorgan and the CME Group) to resist regulatory reform. The two excuses, hedging and market-making, go to the heart of what's really wrong in our markets, especially the continuing silver market manipulation. I think it is important grasp the full meaning of these terms, as they are on the front line of a battle being waged, mostly in secret up until now, by financial industry lobbyists and lawyers,

Hedging and market-making are closely related to each other and are inextricably connected to the important matters of position limits, concentration and market manipulation. I'm going to break them apart for the purpose of explanation, but the market participants involved in each can easily overlap. Hedging is the time-honored practice of real commodity producers and consumers transferring price risk to speculators willing to accept those risks. Think of a farmer pre-selling the coming crop on the futures market to lock in prices and preserve operation margins. As new financial markets have developed, hedging has come to include not just commodity producers and consumers but those dealing in financial instruments, like currencies and interest rate products. Hedging is the economic justification behind derivatives trading. If there was no legitimate hedging in any market, that market would have scant reason to exist. After all, Congress didn't authorize futures trading as a pure speculative or gambling exercise.

US commodity law recognizes the difference between hedgers and speculators and seeks to maintain a level playing field by attempting to restrict undue influence by speculators. For instance, position limits are speculative position limits, as the only limits on legitimate hedging is to the extent of an entity's actual production, consumption or inventory. Since it is accepted that hedging is the practice that legitimizes futures and derivatives trading, the term itself has morphed into a knee-jerk defense when the largest speculators are suspected of holding too large or too dominant a market position. Â?We were just hedgingÂ? has become the go-to excuse in a pinch.

Normally, clarifying the distinction between a speculative or legitimate hedging position is something done behind the scenes and in private between the regulators and the very largest traders. I've tried for years to shine the light on and persuade the regulators at the CFTC to crack down on the phony hedging excuse behind the ongoing silver manipulation, admittedly with only limited results, because the Commission has not been transparent on the matter. Now, the recent derivatives blow up at JPMorgan has thrust the excuse of hedging into the limelight. The debacle has exposed some Â?hedgingÂ? transactions to be nothing more than massive speculative bets by a federally-insured deposit institution. Because the transaction blew up publicly, it has resulted in a rare and unplanned moment of transparency.

As the details of JPMorgan's aggressive and complex bet became known, the standard tried and true excuse of Â?we were just hedgingÂ? was quickly revealed to be a lie. There were no legitimate explanations given to the open question put to JPMorgan Â? what the heck were you hedging? Having asked that same question in silver for years, this appears like it could be an important inflection point in large speculators, like JPMorgan, hiding behind the hedging excuse. What JPMorgan was doing with its massive losing bet on complex credit derivatives is similar to its outsized concentrated short position in COMEX silver futures over the years. Call it anything that you want, but just don't call it legitimate hedging.

The dollar loss aside, JPMorgan's large speculative bet in silver is infinitely worse than its losing speculative bet in credit derivatives. That's because JPM's massive silver short position has been instrumental in the ongoing manipulation of silver, a global commodity and not a narrowly based specialty index. Neither of JPMorgan's speculative bets was legitimate hedging, but only one has involved market manipulation of a world commodity for the past four years. I can't help but think that JPMorgan's credit derivatives blunder has done more to expose the fallacy of the hedging excuse than anything I could have exposed.

Market-making is the other excuse that big traders like JPMorgan and the exchanges owned by the CME hide behind in maintaining the silver manipulation and in illegally influencing other markets. In fact, market-making is the prime excuse given in the industry-sponsored lawsuits against the CFTC to prevent position limits from being enacted. The financial industry's argument warns of market turbulence to come if large traders like JPMorgan are restricted in any way. In other words, if JPMorgan and other large commercial traders are restricted by position limits in providing counter party transactions when speculators come into the market to buy or sell, then markets will become disorderly.

In large measure, the financial industry is correct that there could be price turbulence if the large commercials are restricted from selling unlimited numbers of contracts when, for instance, technical funds come into a market to buy. But it is important to recognize, at least in silver (and gold), that the previously unlimited contracts sold by JPMorgan and other commercials are what enabled the silver manipulation to be maintained for as long as it has been. Certainly, there is always price turbulence when a manipulation is terminated. In essence, what the industry lawsuit against position limits seeks is a continuation of the silver manipulation. This is the real purpose behind the market-making excuse.

It is important to recognize the role that market-making plays or should play in the silver market. Commodity futures markets were structured as open-outcry (now electronic) auction markets, not as the specialist markets that exist in securities. It was never intended that the futures markets be a NY Stock Exchange-style specialist market to smooth prices out. This is a role that JPMorgan and other large commercials naturally grew into as a result of their continued manipulation of the silver price. No one voted them into this role or bequeathed it upon them; it just went along with the role of a manipulator. This market-making excuse had the added benefit of creating the false aura of liquidity depth that speculators seek out. This illusion of liquidity is one of the main premises why the tech funds and other speculators don't abandon the COMEX, namely, they think it's a legitimate and liquid market.

It is under the guise of market-making that one of the truly great scourges of our times has been allowed to fester. Of course, I'm referring to High Frequency Trading (HFT), the mindless and manipulative computerized trading that epitomizes everything evil in modern markets. That we have allowed a few deliberately disruptive traders to seize pricing control of our important markets is bewildering; until you recognize HFT for what it really is. HFT is nothing more than a manipulative tool designed to benefit a few and victimize the majority of market participants. HFT proponents claim it enhances liquidity, but the increased price volatility it produces suggests the opposite.

Nowhere is the destructive nature of HFT more evident than in the silver market, where silver investors are regularly subjected to sudden large price moves for no legitimate economic reason other than it being just another deliberate HFT barrage, usually to the downside. Most disturbing is that the HFT moves aid greatly in allowing JPMorgan and the other collusive COMEX commercials to rearrange favorable changes in existing positions. Of course, JPM and the collusive commercials are HFT practitioners as well, so they get to have their cake and eat it over and over. They disrupt the market short term and long term to boot. To call it a racket is an understatement.

Hedging and market-making are the two prime excuses being used by JPMorgan and the financial industry to fight the true regulatory reforms required at this time. The derivatives blow up at JPM would appear to shed light on what is really going on behind the scenes and in private. In that sense, the blow up may have come at an opportune time. But it is amazing that without this derivatives debacle, there would probably be no chance that the excuse of hedging and market-making would be seriously challenged of understood.

At the low point today, silver was down by more than a dollar from Friday's close, while gold was down more than $40, before both came back somewhat. I'd attribute the decline to HFT manipulation and further attempts to induce speculators to sell into collusive commercial buying. Considering the dreadful news from Europe, I wouldn't know what else to attribute the decline to. In a sense, I feel sorry for those who don't believe in the manipulation premise, because if it wasn't manipulation behind this decline, any other reason would sound hollow. Yes, I'm still living in a sort of twilight zone where world financial conditions are more conducive to strong gold and silver prices than at any time in my personal experience, yet those prices are weak instead.

This has not been an easy time for silver (and gold) investors, mainly due to this counterintuitive and debilitating price action. My own view is that none of this price weakness is accidental or coincidental. I sense the recent takedowns have been designed to break the spirit of silver and gold investors. Sadly, I fear the manipulators, led by JPMorgan, have succeeded in demoralizing some investors, all under the lie of hedging and market-making. I suppose this is as it must be in a manipulated market. I can only speak for myself in that I wouldn't think of selling here and I know that the ingredients for an explosive rally are in place. I don't know the timing or circumstances of that explosive rally to come, so I am not going to dwell on that aspect.

Instead, my thoughts have been occupied by a vision of a city block where an impressive police headquarters is located. It seems that nearly every day another old woman is brutally mugged and sometimes murdered right in front of the police headquarters. On some days, more than one old woman is left battered and bleeding on the sidewalk. Every day, all the policemen and higher ups enter and exit the headquarters in a purposeful manner, carefully stepping around and over the mugged old women. Many public speeches are given by the police chief stressing the need to protect old women from muggers. Once in a while, one concerned-sounding high police official will stop to assure a beaten old woman that they are investigating the muggings and that the investigation should be completed fairly soon, even though the investigation has been open for years. Still, the muggings continue. The bad part is that it is not a nightmare that disappears when I awake.

I don't know what the heck happened to the CFTC and the rule of law when it comes to silver and gold. Maybe those that claim the silver manipulation is a government run operation are correct and JPMorgan is manipulating silver at the government's request. Maybe the Commission is politically divided and conflicted by the hedging and market-making excuses. Perhaps the agency is so embarrassed to have denied the silver manipulation for so many years that they are too frightened to admit it exists today, no matter how many complain to them or how obvious the evidence of manipulation has become. In any event, the CFTC's lack of action will not deter me from petitioning or insulting them into doing the right thing. Hopefully, you will not be deterred either from writing to the agency and your elected officials.

Ted Butler

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Silver – $28

Gold – $1567

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