

Oct. 22, 2009 – The Bomb Squad

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In a speech yesterday, CFTC Commissioner Bart Chilton outlined his thinking on the all-important showdown coming on the issue of position limits and hedge exemptions to those limits. In a related interview he reaffirmed the timeline of the showdown, said by him to be by late November. He expressed a fear that the Commission might set position limits too low and this might cause big traders to migrate away from regulated exchanges. This is a recurring, if ill-founded fear. In the interview (by Dow Jones), the CME Group added that it was "dismayed" that statements from the CFTC are, "already driving liquidity away." (If there is one thing I think I know, it is that whenever a commodity exchange is dismayed, it is when the public's interest is about to be served.) Here's the actual speech

<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opachilton-28.pdf>

Contrast Commissioner Chilton's remarks to a speech made by Chairman Gary Gensler to the Futures Industry Association on the same day. Chairman Gensler doesn't seem particularly afraid of trading moving overseas and for good reason "it isn't going to happen. He has much experience on Wall Street, being made a partner of Goldman Sachs at age 30. Many would hold that against him, but in my experience, such an achievement is not bestowed without legitimacy. In this speech, his words are clear and convincing, as usual. Chairman Gensler speaks of his deep concern for the American public and how we were harmed by the financial crisis. As an architect of the deregulation that created the problems we face today, he knows he will be judged by his resolve to bring about much needed reform to the commodity markets. He has admitted that deregulation went too far, and appears sincere when he says he has learned from the experience. While I'm allowed to be wrong, I believe he means what he says.

<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-14.pdf>

Commissioner Chilton is correct in that care must be taken so that position limits are not set so low as to impede legitimate trading and restrict liquidity. But he should also have mentioned that limits must not be set so high as to become ineffective against manipulation and concentration (my old 100 mph speed limit in a school zone example). After all, preventing manipulation and concentration is the primary purpose for having position limits in the first place. The fact is that the current levels of accountability limits in energy and metals contracts do not appear to be a problem, with one glaring example – COMEX silver. Set the level of hard position limits in energy and metal contracts at whatever level the Commission deems appropriate, the sooner the better. Just be sure that those levels are set, in the words of Chairman Gensler, “in a manner fair and consistent across all commodities of finite supply.” That’s the problem, namely, there is no obvious concern with the level of position limits in most commodities, just the level of silver position limits. That, and the phony exemptions to position limits. While the phony exemptions to position limits are a problem in all markets, in silver they also take the award, where one US bank, JPMorgan, holds the largest concentrated short position ever.

Let me try to convey what I see in a different way. I’m going to ask for your indulgence for a few moments, and ask you to engage in a bit of fantasy. I want you to play along with me in this imaginary exercise, as I think it will help me explain the real world silver situation. First, the imaginary circumstance.

It is learned that a great population and financial center has been rigged with a series of powerful explosives by terrorists of unknown background. The explosives have been set in such a sophisticated and destructive manner that it is quickly determined that it is impossible to disarm them all completely. There is going to be a certain number of detonations and great damage will result in the best of potential outcomes. The difficult question of whether to inform the public is but one complication. All that can be hoped for is that all the weapons are not set off and damage is kept to the minimum possible. That hope rests on the right choices being made as to which bombs to disarm first and the skill of those who will do the defusing. Any miscalculation and all the explosives will detonate. After the best plan for disarming is determined, enter the Bomb Squad.

I'll leave it up to you to finish the imaginary bomb crisis situation. Since I'm an optimist, I'll choose an imaginary happy ending. Likewise, I'm going to root for a happy ending in the real world situation that I'm about to describe. The real world powder keg that is destined to explode is the COMEX silver manipulation. The imaginary city is the real-world silver market. The terrorist who rigged the explosives is JPMorgan. The Bomb Squad is led by Gary Gensler, chairman of the Commodity Futures Trading Commission (CFTC). I don't see how the situation can be completely defused with no damage. But I believe, if enough care and skill are employed, much damage can be contained. Any serious miscalculation, however, will make matters very bad indeed.

Why do I liken the silver market to a city beset with explosives that can't be completely disarmed? That's because, no matter what occurs in the future, this baby is going to blow up. Nothing and nobody can prevent that. The only question is of timing and consequence. It all comes down to the concentrated short position in COMEX silver. Nothing else really matters at this point. Any analysis of silver in which this isn't the prime focus is missing the mark, in my opinion. You can't have any trading market, where one (or two) participant controls 40% of that market and pretend that is a free market. (Based upon the most recent Bank Participation Report and adjusting for spread positions). With that level of control, manipulation is the only possible conclusion.

The clearest proof that the concentrated COMEX short position is manipulative to the price of silver is that it can't be dissolved without a major silver price event. Otherwise, it would have been made to go away by now. Far from being dissolved, the concentrated short position has actually grown more extreme over time. It is so extreme that it can't just go away without a large price impact. Forget about being dissolved quietly, it can't even be explained away. If the CFTC or the COMEX or the CME or the analytical community could have explained it away persuasively, they would have done so. Instead, we are presented with silence or never ending investigations to specific questions about concentration and the level of silver position limits. Let me state it as simple as I can: if JPMorgan were not short 190 million ounces of COMEX silver futures and other traders were needed to replace them, it would take a hell of a lot higher price. That's always the clearest question to ask in a manipulation: what would the price be if the alleged manipulator's position didn't exist?

So intertwined is the concentrated short position with the future course of the functioning of the exchange, that the possibility that it may cause the demise of the COMEX is something of which I increasingly think. More and more, I have the thought that the situation is so extreme, that the actual closing of the exchange is a real option. At the least, it would get the paper short sellers off the hook in a hurry. (However, it would also open a Pandora's Box of litigation.) And I'm not so sure a closing of the COMEX would be an entirely bad thing. As I have written previously, it certainly wouldn't be detrimental to the price of silver, as one key mechanism behind the manipulation, the ability to short unlimited futures contracts, would be destroyed. But due to my long futures background and my concern about what has been an important institution, I'm not quite ready to actually endorse that. I'd like to think the silver manipulation can be terminated without shutting the COMEX. But maybe I'm hopelessly naïve and optimistic.

I've labeled JPMorgan as the terrorist in my bomb-rigging analogy. My intent is not to defame them, but to end a market manipulation. While JPMorgan has always played a major role in OTC silver derivatives, past Bank Participation Report data does not indicate they played a dominant role in COMEX silver trading prior to 2008. With the financial failure and take-over of Bear Stearns, JPMorgan inherited Bear Stearns concentrated silver (and gold) COMEX short position, along with Bear's giant OTC positions, probably at the government's request. Those were dangerous times for the financial system and I can understand the government not wanting to see silver and gold prices soar in an unrestrained short covering panic. Further, I don't think JPMorgan woke one morning and decided to manipulate the price of silver with an outsized and concentrated short position on the COMEX and OTC markets. I'm inclined to give them the benefit of the doubt and grant that they even may have been acting somewhat patriotically, in ceding to government requests.

But the Bear Stearns' take-over took place more than a year and a half ago. That is too long to qualify as a near-term emergency. We are long past the point at which this should have been resolved. The dramatic increase in JPMorgan's short position in the October Bank Participation Report dispels any notion that they are not controlling the price of silver. Without that short selling, the price would have been much higher. The US is a nation governed by the rule of law. It is perhaps our greatest quality. That means no one is above the law; not JPMorgan, not the COMEX, not the US Government itself. Whoever is responsible for the maintenance of this concentrated short position is undermining the best interests of our country. That makes them terrorists in my book.

That leaves the Bomb Squad. In my mind, the Bomb Squad is composed of one key member, CFTC Chairman Gary Gensler. That's not meant to disparage the other commissioners or staff, just that it will be Gensler who determines how the agency deals with silver problem. Or even if it will be addressed in an open manner. I have been consistent in my praise of him and in my optimism that he will do the right thing in silver, not only in public, but also in my private conversations. I will either be dead right or dead wrong in my assessment of him. I freely admit to the possibility that I may have misjudged him. Since I don't know of anyone who agrees with me, perhaps I should say the "probability" that I will be wrong. Time will tell.

It won't be the end of the world if I have misjudged Chairman Gensler's future actions in silver. The situation in silver is so clear that it is inevitable that it will be resolved with much attention and fanfare regardless of what he, or I, or anyone else may do in the future. The manipulation has lasted for so long that the time for any easy resolution is long gone. Still, there are certain actions that can be taken that are better than others in a city loaded with explosives. In the best interest of our country and markets, let me offer some unsolicited, but well-intended advice to Chairman Gensler.

I know that the CFTC has been negligent for more than 20 years in failing to recognize and terminate the silver manipulation, but Chairman Gensler has been in office for 5 months. He is not responsible for the long-term negligence of the agency. And while the CFTC has been negligent, the agency did not actually manipulate the silver market itself. The actual perpetrators are the concentrated short sellers. These are distinctions that should be kept in mind. Let me explain why.

When the silver market blows up, it won't be the end of the world financially. No one will die, nor will it result in mass unemployment or in the weeping or gnashing of teeth (except among the short sellers). It will be a big deal for me and silver investors, but not for the world as a whole. That's because, fortunately, the silver market is so small. The amount of money that would be lost by the big shorts on a sharp silver price move won't be catastrophic in systemic risk terms. For instance, if JPMorgan closed out its entire short position of 190 million ounces (assuming it wasn't hedged elsewhere) with an average loss of \$20 per ounce, meaning it caused prices to jump to \$50 or more, it would sustain a loss of less than \$4 billion. That's not a small amount of money, but it is also about what JPMorgan earned in the last quarter. Such a loss wouldn't bankrupt them. Neither would the avalanche of lawsuits sure to follow.

My point is that it isn't the financial consequence to the shorts that is the only concern in the inevitable silver market blow-up. A bigger concern to me is what it will do to the perception of the American public of its institutions. And what will a silver scandal do to the image of the US in the world? This is the basis for my advice to Chairman Gensler. In fact, I think he may already appreciate it. If it turns out that the silver market blows up and the CFTC tries to do what government agencies typically do, namely, feebly try to react to the developing crisis by putting out fires, the agency will be heaped with scorn. And, rightly so. That is the worst possible outcome, as more blame will be placed on the CFTC and not on the manipulators, where it belongs. The loss of confidence would be incalculable.

Therefore, my advice to Chairman Gensler is to take the bull by the horns and get ahead of the coming silver scandal. Take preemptive action before the price explosion occurs. Be upfront with the public and explain to them that it was time to deal effectively with a crime in progress, a crime not of your making. Don't apologize for soaring silver prices, as very few would be hurt, and many helped financially. Don't defend the manipulators in the hope of managing the market in an orderly manner. You were not responsible for the manipulation, so don't allow anyone to push you into that role. You are responsible for ending the manipulation. Your responsibility is to the American people and our markets and to uphold the law, not to protect a small number of market bullies. Tell those harmed by the manipulation for years that your agency will help them to recover damages from the manipulators. You didn't set the bombs, but you are responsible for disarming them. Don't allow the silver manipulation to undermine the public's confidence in our regulatory system. By taking forceful and proactive action you will best serve the public.

Silver is a unique situation, both from an investment and regulatory perspective. The short concentration in silver, in terms of the futures market, world production and above ground inventories has no equal. It must be dealt with in a unique regulatory manner. Anything less will prove futile.

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