May 16, 2010
Comments of Matthew Seligman

Before the Commodity Futures Trading Commission

Comment on a Proposal to Exempt, Pursuant to the Authority in Section 4(c) of the Commodity Exchange Act, the Trading and Clearing of Certain Products Related to ETFS Physical Swiss Gold Shares and EFTS Physical Silver Shares

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I. Introduction

I disagree with the Commodity Futures Trading Commission's proposal to exempt certain financial products relating to gold and silver futures from the provisions of the Commodity Exchange Act (CEA), 7 U.S.C. 1 *et seq*.

In particular, I write to caution the Commodities Futures Trading Commission (CFTC) from assuming that "encourag[ing] potential trading of Options and Securities Futures on Gold and Silver Products through modes other than those normally applicable," 75 FR 19621, will enhance market efficiency and competition. An adequate recognition of the dangers of systemic risk may tip the balance as the CFTC "consider[s] the costs and benefits," 7 U.S.C. 19(a), of exempting these financial products from regulations under the CEA.

Financial innovation can serve to greatly benefit the national economy, when there are specific inefficiencies in capital markets that can be remedied. For example, in the late 19th and early 20th Centuries, capital was readily available in the major financial centers on the East Coast but was scarce on the West Coast. This was problematic because the productive capacity of capital was highest in the emerging cities and markets in the west. The introduction of means to transport capital – either physically, or virtually through long-distance contracts – to where it was most useful represented a major advance in the American financial system. Similarly, the introduction of derivatives contracts can help to more efficiently allocate risk – which, in turn, can help to allocate capital itself to where it will be most productive. For example, allowing airline companies to hedge against a rise in the price of jet fuel allows them to direct their resources towards investment in growth.

In the past several years, however, the dangers of financial de-regulation have become painfully apparent. As a result, it is no longer clear that "financial innovation" is always and everywhere beneficial. De-regulation under the guise of "financial innovation" carries with it significant risk. The most obvious example of this risk, of course, is the financial panic triggered by the market in housing mortgage derivatives. While the experience of the financial markets since 2007 should not be used as a pretext to shut down capital markets when they can be productive and safe, regulators should be wary of a strong presumption in favor of de-regulation.

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II. Faults in the CFTC's Cost-Benefit Analysis

This erroneous presumption is manifest in the CFTC's analysis under Section 15(a) of the CEA. That Section requires the CFTC to consider the costs and benefits of the proposed order. Among the factors that the CEA requires the CFTC to consider are:

- "efficiency, competition, and financial integrity of futures markets"[1]
- "sound risk management practices"[2]
- "other public interest considerations"[3]

The CFTC's analysis, as expressed in the Request for Comment, focuses on the benefits of the proposed exemption without addressing the downsides.

First, the analysis under "efficiency, competition, and financial integrity" speculates that the proposed exemption "may" increase market efficiency,[4] without identifying any systematic shortcomings in the allocation of capital that would be remedied by the de-regulation. Simply put, the analysis does not indicate why or how the existing markets are insufficient. The analysis makes cursory reference to the risks in financial integrity, but does so only by stating that the financial products will be cleared by a DCO- and SEC-registered clearing agency, intermediated by SEC-registered broker dealers. This fact alone does not address the risk to financial integrity, because the oversight provided by the SEC has been notably lacking in recent years. While there are legitimate concerns that regulation of the metals markets in the United States would push trading to the London markets,[5] blunt de-regulation in the absence of transatlantic coordination does not address the problems of market manipulation and systemic risk.[6]

Second, the analysis under "sound risk management practices" merely states that the financial products will be subject to "OCC's current risk-management practices including its margining system."[7] This does not address whether those risk-management practices are sufficient – more than a merely hypothetical concern in light of the failure of systemic risk assessment by the SEC and other financial regulators in recent years. This is particularly worrisome given the possibility of large institutional investors taking positions large enough to manipulate prices, a concern recognized by the CFTC in proposing position limits for energy commodity markets including crude oil, gasoline, heating oil, and natural gas.[8]

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[1] 7 U.S.C. 19(a)(2)(B)
[2] 7 U.S.C. 19(a)(2)(D)
[3] 7 U.S.C. 19(a)(2)(E)
[4] 75 FR 19621
[5] *See,* Gregory Mayer, *Dispute Over Curbs on Metal Futures*, FIN. TIMES, Mar. 26, 2010.
[6] *See* Jon Nadler, *Is Market Manipulation Killing Gold, Silver Futures Markets?*, COMMODITY ONLINE, Mar. 26, 2010, *available at* http://www.commodityonline.com/news/Is-manipulation-killing-gold-silver-futures-markets-26909-3-1.html
[7] 75 FR 19622
[8] *See* Gregory Mayer & Javier Blas, *Regulators Cautious On Energy Shake-up*, FIN. TIMES, Jan. 14, 2010.

Last, the analysis under "other public interest considerations" states that the proposed exemption "may encourage development of derivative products through market competition without unnecessary regulatory burden."[9] This impoverished view of the public interest is telling. As stated above, financial innovation can be a huge benefit to the economy by facilitating the allocation of capital in the most productive ways. However, it is essential that the risks of under-regulation be candidly and honestly assessed – the public interest may be served by the proposed exemption, but the CFTC's failure to recognize or consider the weighty public interest considerations counseling caution is deeply troubling.

III. Conclusion and Recommendation

In sum, I recommend that the exemption not be granted pending further evaluation of systemic risk. In the alternative, it is crucial that should the CFTC grant the exemption to these gold and silver financial products that reporting requirements, and ideally position limits, be imposed on large investors.

Respectfully submitted,

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[9] 75 FR 19622