From: Adrian Douglas <adouglas@marketforceanalysis.com>
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To: secretary <secretary@CFTC.gov>
Subject: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations

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The CFTC Public Hearings on the Precious Metals Markets

By Adrian Douglas

I recently read some of the work of Craig Pirrong who is a recognized expert on commodity markets and manipulation of markets. In an article published in 1994 he discusses some of the major issues of futures market manipulation

Squeezes, Corpses, and the Anti-Manipulation Provisions of the Commodity Exchange Act
http://www.cato.org/pubs/regulation/regv17n4/reg17n4c.html

Despite Pirrong's alleged expertise in commodity markets he considers that manipulation is mainly instigated by the "long" market participants in what is colloquially called a "corner".

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Other speculative activities sometimes called manipulative are far more ephemeral than corners, and are of dubious practical relevance. For example, farm interests and farm state legislators frequently assert that large short sales of futures contracts by speculators are manipulative, and cause prices to fall below their "true" value.

Such "bear raids" are profitable for the raiders only under very restrictive conditions. In order to realize a profit, it is necessary to sell high and buy low, that is, the short seller must eventually buy back his positions at a price which is lower than the price at which he initially sold. Since the number of contracts sold is equal to the number of contracts subsequently bought, this can happen if, and only if, the futures price responds asymmetrically to the speculator's purchases and sales. That is, the price decline caused by the speculator's sales must exceed the price rise caused by his subsequent purchases.

There is no credible evidence that such an asymmetry exists or has existed in futures markets. Moreover, it is even difficult to construct a theoretical model that exhibits this property. As a result, it is highly unlikely that short manipulations of the type that is criticized so vigorously by the opponents of futures markets are a practical concern. Indeed, futures industry experts have been nonplused by the allegations of widespread "downward" manipulation as far back as 1921 when there was no regulation; most recognized the real danger of squeezes and corners, but were deeply skeptical of the possibility of short manipulations.

Nonetheless, the primary impetus behind the regulation of futures markets in the early twenties was the collapse in agricultural prices after the end of World War I. Despite the skepticism of the industry witnesses, the promoters of the legislation regulating futures markets, such as Senator Capper and Representative Tincher, both of Kansas, were convinced that short-selling speculators were largely responsible for this collapse. As a result, Congress was intent upon preventing manipulative short selling. However, since it could not distinguish legitimate short selling for hedging purposes, for instance, from illegitimate short selling, Congress simply proscribed "manipulation" and passed the buck to exchanges by requiring them to prevent what Congress could not define—or face the closure of their markets.
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I find it astonishing that an alleged expert could make such a claim. In the futures market there has to always be a buyer and a seller for every contract; that is to say a “long” for every “short”. This means that there are as many longs as shorts. Whatever model can be proposed for long side manipulation must, by symmetry, be possible for the short side. If one can drive prices up by buying a large amount of contracts one can also drive the market down by selling a lot of contracts.

The prejudice that exists that manipulation can not be effectively carried out on the short side is a fundamental barrier to any intelligent and productive discussion of manipulation of the precious metals markets.

It should be noted that governments favor low commodity prices because this masks their intrinsic tendency to debase the national currency. As the US is a net importer it is particularly advantageous to the US to have cheap commodities. Therefore, there is an inherent conflict of interest in that government regulators police the commodities markets and the principle short sellers are financial institutions that enjoy special privileges such as being “primary dealers” who execute market operations on behalf of the Federal Reserve or the US Government.

Pirrong notes that the law (Commodities Exchange Act) has been largely emasculated to the extent that manipulation is very difficult to prove.

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Unfortunately, courts and regulators in the U.S. have failed to exploit the potential advantages of harm-based penalties for manipulation. In fact, a series of court and CFTC decisions have completely undermined the felony and civil damage provisions of the CEA. As a result of these decisions, it is almost impossible to find a genuine manipulator guilty.

Several features of these decisions are responsible for this state of affairs. In order to prove manipulation under current law, it is necessary to show that:

(1) Market prices were artificial during the alleged manipulation, and

(2) The accused had the power to cause this price artificiality, and

(3) The accused intended to cause the price artificiality.

These are referred to as the "artificial price," "causation," and "intent" tests.

The reasoning in several cases makes it virtually impossible to meet any of these three

standards, let alone all three simultaneously. The CFTC decisions in the In re Indiana Farm Bureau (1982) and In re Cox (1983) cases make it difficult, if not impossible, to show that any price is artificial even if there is pronounced evidence of manipulative distortions. In each case, price relations differed dramatically from past experience. Moreover, price patterns were clearly symptomatic of a market power manipulation. The evidence in Indiana Farm Bureau is particularly striking. The price of corn rose 30 percent on the last day of trading of the July 1973 corn futures contract; immediately after the end of trading, corn cash prices were 30 percent lower than the closing futures price. Nonetheless, the commissioners considered this evidence unpersuasive. In Indiana Farm Bureau, the majority decision stated that, instead of focusing on prices alone, "One must look at aggregate forces of demand and supply and search for those factors that are extraneous to the pricing system." In Cox, the majority asserted that the "prospective behavior of a ‘normal’ market is not bounded by the market’s historical experiences." In dissent, Commissioner Fowler West argued that this interpretation severely compromises the ability of adjudicators to rely upon any data in manipulation cases. These precedents make it nearly impossible to prove price artificiality.
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Currently the CFTC is asking for public comment on the imposition of position limits on the precious metals markets.

The CFTC has been investigating the gold and silver markets for potential manipulation for almost a year and a half. Why is the CFTC looking to impose limits? Is this because manipulation is tacitly acknowledged?

The imposition of limits will be largely impotent at stopping manipulation because as it is occurring on the short side the commercial traders will no doubt be afforded exemptions to the limits as they have been in the recent limits imposed on the energy markets.

But we should not be discussing the merits or otherwise of the imposition of position limits. We should instead be addressing the fundamental issues that plague the futures markets. Gradualism is the major enemy of accurate problem diagnosis. When changes happen rapidly we can immediately associate the change with the problem. When changes happen slowly an entirely incorrect diagnosis can be made. When we look at ourselves in the mirror each day we never notice that we have aged. It is only when we see a photograph of ourselves from our younger days that it becomes obvious how we have changed. And so it is with the futures markets.

The futures markets were conceived to allow commodity producers to reduce risk by being able to contract to sell their yet to be produced commodity at some time in the future. By the same token, it allowed commodity users to reduce risk by being able to contract to buy a yet to be produced commodity in the future. The futures markets also served to perform the function of price discovery by matching future demand with future supply at a market clearing price.

However, gradualism has resulted in the futures markets morphing into giant casinos where less than 5% of contracts get settled with a physical commodity delivery. The futures markets are now totally divorced from their intended function. The futures markets have become such a farce that the delivery of physical commodities has become an inconvenience that hinders speculation and market manipulation.

The ultimate poster child for the ridiculous state of affairs of the futures markets is the Nymex Uranium futures contract. It is a “non deliverable” contract! This means that traders pretend to

sell uranium and buyers pretend to buy uranium and without a single gram of uranium ever changing hands the price of uranium is "discovered"! It is difficult to keep a straight face. I have wondered why a non deliverable heroin contract is not introduced in this way we could have the opportunity to make a fortune trading virtual heroin and never have to worry about being arrested by the DEA because not a gram of heroin would ever be involved!

Craig Pirrong testified before the House Committee on Agriculture in November 2008 and identified what should be the central target of regulation:

http://www.ftc.gov/os/comments/marketmanipulation2/538416-00018.pdf

QUOTE
In particular, the Proposed Rule completely ignores the most important form of market manipulation. In its focus on fraud and deceit, the Proposed Rule overlooks the kind of manipulative conduct that has bedeviled commodity markets from time immemorial, and which is a serious concern today—the exercise of market power by traders holding positions in derivatives contracts. Indeed, in my opinion, market power manipulation is the most important form of manipulation of petroleum markets, and should be the focus of the Commission's scrutiny. Instead, it is completely absent from the Proposed Rule. There are some forms of conduct that distort markets that (a) are properly considered "manipulation", and (b) result from fraud or deceit. For instance, making false price reports to industry publications is fraudulent, deceitful, and manipulative, and can distort prices and the allocation of resources. Similarly, the spreading of false rumors is manipulative conduct that relies on deceit. But the most important form of manipulation in commodity markets in general, and petroleum markets in particular, is related to the exercise of market power intended to enhance the profitability of derivatives positions.
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Currently JPMorgan Chase holds $80 Billion in gold OTC derivatives out of a total of $102 Billion. The third quarter 2009 OCC report on derivatives held by US banks does not list HSBC's position separately.

http://www.occ.treas.gov/ftp/release/2009-161a.pdf

From the first quarter 2009 report where the HSBC gold derivatives position is listed as $19 billion, and HSBC & JPM are shown to hold together 96% of all the gold derivatives, it can be inferred that HSBC now holds approximately $18 Billion

http://www.occ.treas.gov/ftp/release/2009-72a.pdf

The entire open interest of the gold market on the COMEX represents notionally 52 Billion dollars of gold. The two largest shorts on the COMEX are almost without any doubt JPM and HSBC. These two banks control upwards of 60% of the commercial net short position in gold on the COMEX at any time. Bucket shops were outlawed in the 1920's, yet the massive unregulated derivatives market that has a nominal value of more than 600 Trillion dollars is nothing more than a monumental bucket shop. But the fraud is much more sophisticated than it was in the 1920's because by manipulating the tiny futures market the profitability of the massive bucket shop of a derivatives market is guaranteed.

This fraud has the effect of suppressing commodity prices, and in particular gold and silver. Because the outcome of this fraud is in the best interests of the US government and the

Federal Reserve in masking inflation, keeping a strong dollar (in spite of promiscuous money creation), and maintaining low interest rates, the US government only ever toys with the idea of introducing regulation that would in any way impede or halt this perpetual distortion of free markets. In fact every measure is taken to handicap the participants on the long side of the market.

I urge the CFTC to take a close look at the absurdity of the markets it supposedly regulates. We are beyond the stage where cosmetic changes will suffice. The CFTC needs to wake up and acknowledge that gradualism has allowed free markets to be hijacked from under their noses. They are no longer markets for the future exchange of physical commodities between producers and users and mechanisms to provide price discovery. They are nothing more than casinos where players can place a bet on future prices and where those future prices are rigged with impunity by the house.

The CFTC may choose, as it has so frequently done before, to simply look the other way. However, if it refuses to properly regulate the markets under its jurisdiction the market will eventually impose its own will. The distortion of commodity markets by price suppression abnormally reduces production and abnormally increases demand leading to shortages and sudden price dislocations. There are already signs of acute shortages of precious metals, as evidenced by, among other things, the rationing of the US Governments own minting of gold and silver eagles. Central banks have become net buyers of gold and sovereign states are ever more eager to diversify out of US dollars into gold as demonstrated by the Indian purchase of 200 mt of IMF gold. Meanwhile global gold production has peaked and is in terminal decline. The CFTC has the option of attempting to make the transition of gold to a free market price to be somewhat orderly through appropriate regulatory change or having the market impose a disorderly readjustment. There are no other options as the burgeoning demand in the physical market is soon to denude the fraudulent fractional reserve banking extensively employed in gold and silver trading.

Adrian Douglas
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Adrian Douglas was born in 1957 in England. He graduated from Cambridge University in 1980 in Natural Sciences. He worked for 20 years in the Oil & Gas Industry with Schlumberger where he reached senior management positions in Marketing and Sales.

Adrian established a highly successful consultancy business specializing in pricing and marketing called InnovoMark - Innovative Marketing. He developed unique methodologies related to pricing and marketing which have been incorporated into proprietary training programs. He has consulted for the world's largest oilfield service companies such as Halliburton, Schlumberger, and Weatherford.

The study of commercial enterprise pricing led to a deep interest into the market pricing mechanisms of financial assets. Following several years of research Adrian developed a unique algorithm and methodology for analyzing financial futures markets, and in particular identifying appropriate entry and exit points. The technique has been named "Market Force Analysis" (MFA) and two patents are pending. The service has been commercialized through web-based subscription (www.marektforceanalysis.com). A new development has recently been introduced which is Equilibrium Regressional Analysis (ERA). The Market Force Analysis techniques have an established track record of accurately determining buy and sell points for trading and investment purposes.

Adrian has been interviewed for various internet radio stations and for TV as well as making presentations at investment conferences. Adrian has made almost a daily contribution to the website "Le Metropole Cafe" commenting on precious metals and the financial markets in general.

Adrian is also a Director of the Gold Anti-Trust Action Committee (GATA); a non-profit organization that is an

advocate for a freely traded gold market.

Adrian is also a member of the Advisory Board of SAMEX, a junior mining company exploring for gold/silver and copper in Chile and Bolivia.