U.S. COMMODITY FUTURES TRADING COMMISSION
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Division of
Market Oversight

July 26, 2002

Mr. Ted Butler
1620 16th Ct
Jupiter, Florida 33477

Dear Mr. Butler:

I write in response to your recent correspondence in which you allege that the price of silver is being artificially manipulated on the futures market. Let me first assure you that the markets for exchange-traded commodity futures and options are carefully monitored by the Commission in order to detect and prevent any attempted manipulation. The Commodity Exchange Act charges the Commission with ensuring the financial integrity of the clearing and settlement system, with protecting market participants against fraudulent or abusive practices, and with protecting the commodity futures and option markets against manipulation so that these markets may effectively serve their important roles in the economy as mechanisms for risk management and as means of price discovery.

To fulfill this responsibility, the Commission has in place a market surveillance group within the Division of Market Oversight staffed with experienced economists who monitor trading activity to detect and prevent attempted manipulation, to keep the Commissioners informed of market developments, and to ensure compliance with speculative position limits. Their mission includes identifying situations that might pose threats of manipulation and to respond appropriately. Each day, for every active futures or option market, this staff monitors the activities of large traders, key price relationships, and all relevant supply and demand factors in a continuous review for potential market problems.

The Commission's market surveillance group uses many sources of daily market information. Exchanges report to the Commission the daily positions and transactions of each clearing member, showing separately for proprietary and customer accounts the aggregate position and trading volume of each clearing member in each futures and option contract. This information enables market surveillance staff to quickly identify firms that clear the largest buy or sell volumes or hold the biggest positions in a particular market.

The Commission also maintains a large-trader reporting system, under which clearing members, futures commission merchants, and foreign brokers must file daily electronic reports detailing the futures and option positions of individual traders based upon reporting levels set forth in the Commission's regulations.[1] If a reporting firm has a trader with a position at or

[1] The reporting level set for silver is 150 contracts.

above the reporting level in any single futures month or option expiration, it must report that trader's entire position in all futures and option months for that commodity, regardless of size. Since traders may carry positions through more than one intermediary and because a person may control or have an interest in more than one account, the Commission collects information that enables market surveillance staff to aggregate related accounts. The Commission may also issue a "special call" for information to a particular trader or futures commission merchant in order to gain additional information on a market participant's trading and delivery activity, including that trader's positions and transactions in the underlying commodity itself.

Each week, market surveillance economists prepare reports on futures and option contracts nearing their expiration periods. Regional surveillance supervisors immediately review those reports and use them to apprise the Commissioners and senior staff of any potential problems or significant market developments at weekly surveillance meetings. If a problem is detected or suspected, the Commission customarily affords the relevant exchange an opportunity to resolve it; but, if an exchange fails to promptly take appropriate action, the Commission has broad emergency powers under which it can order the exchange to act. The Commission may require the exchange to limit trading by one or more persons to liquidating trades only, impose or tighten position limits, require liquidation, extend a delivery period, or even close a market.

The market surveillance group also monitors compliance with the Commission's and the exchanges' position-limit rules, which help prevent traders from accumulating concentrations of contracts of a size sufficient to possibly disrupt a market. To monitor those limits, market surveillance staff reviews daily large-trader reports for potential violations. Although bona fide hedgers are exempt from speculative limits, staff continues to monitor hedgers' compliance with their exemption levels. Speculative limits in physical-delivery markets are generally set at a lower level during the spot month (the month when the futures contract matures and becomes deliverable). Lower limits in the spot month are important because that is when physical delivery may be required and when the contract may be more vulnerable to price fluctuation caused by abnormally large positions or disorderly trading practices. The Commission requires that spot-month levels for physical-delivery markets be based upon an analysis of deliverable supplies and the history of spot-month liquidations.

In order to achieve the intended effect of the speculative position limits, the Commission and the exchanges treat multiple positions that are subject to common ownership or control as if they were a single trader. Accounts are considered to be under common ownership if there is a ten percent or greater financial interest. The rules are applied in a manner calculated to aggregate related accounts. For example, each participant with a ten percent or greater interest in a partnership account must aggregate the entire position of the partnership—not just their fractional share—together with whatever positions they may hold separately from the partnership. Likewise, a pool comprised of many traders is allowed only to hold positions as if it were a single trader. The Commission also treats accounts that are not otherwise related, but are acting pursuant to an expressed or implied agreement, as a single aggregated position for purposes of applying the limits.

The Commission's efforts generally, and particularly those of its market surveillance group and its enforcement team, have been effective in detecting and preventing attempts at market manipulation. When indications of attempted manipulation are found, they are referred to the Division of Enforcement, where experienced attorneys investigate and prosecute alleged violations of the Commodity Exchange Act or the Commission's regulations.

The Commission can utilize a variety of administrative sanctions against wrongdoers, including revocations or suspensions of registrations, prohibitions on trading, cease and desist orders, civil monetary penalties, and restitution orders. The Commission can also obtain Federal court injunctions, restraining orders, asset freezes, receiver appointments, and disgorgement orders. When evidence of criminal activity is found, matters may be referred to the Justice Department for prosecution of violations of other federal criminal statutes, such as mail fraud, wire fraud, and conspiracy. The Commission has successfully brought enforcement cases against firms and traders for attempting to manipulate prices, including, for examples, the well-publicized cases against Sumitomo Corporation for manipulation of the copper market and against the Hunt brothers for manipulation of the silver market.

With specific reference to your concerns about the silver futures market, it should be noted first that unrestricted access to the market by many knowledgeable and well-capitalized traders, and the ability of long-position holders to demand delivery at futures contract expiration, are the best safeguards against artificially low futures prices. These conditions are present in the Comex silver futures marketplace, and we have found no indications of artificially low Comex futures prices. The Commission has not observed futures prices on Comex that are low relative to cash prices, either domestic or international, or that are low relative to other forward silver market prices, in the U.S. or elsewhere.

If a short position holder or group of short position holders were somehow to be successful in artificially depressing Comex prices relative to other silver prices, then silver users, investors, dealers, and other knowledgeable silver traders would be free to buy Comex futures and demand delivery. Any trader that was convinced that Comex prices were too low, could buy at that too-low price, demand delivery, sell into the world market, and profit by the difference. There is no reason to believe that large short positions in a futures market must necessarily result in too-low prices. In fact, for every short position there is a long position, and long position holders may demand delivery against every single contract they hold. In other words, any short that "oversold" and caused low futures prices would ultimately be forced to either buy silver on the cash market to satisfy his or her delivery obligation or to buy offsetting long futures positions. Either action would tend to raise market prices and rectify any alleged "oversold" condition. Of course, a short may already own silver and merely deliver it, without entering the market to buy physicals or offsetting futures. But that would mean the trader held both short futures positions and long inventory to begin with, thus exerting no net influence on the market. Again, we have seen no such signs: no unexplained price differences, no unusually large demand for delivery, nor any other signals of artificially low prices on the Comex.

The Commission is aware that you have for many years alleged that large short futures positions have artificially depressed the world price of silver. However, this would require conspiracy across multiple markets and would be incredibly difficult to sustain. To artificially depress the global price of a widely-traded commodity would require an aggressive and visible cartel of historic proportions, involving all physical channels and all markets. Our surveillance efforts have uncovered absolutely no evidence that large silver futures traders are acting in collusion. Any attempt to hold prices at artificially-low levels would require visible, systematic, and comprehensive efforts to block the ability of users, investors, and dealers to take advantage of too-low prices. It could not be accomplished solely by continuous or periodic selling in futures markets or maintaining large short futures positions, because the demand for delivery would rectify any too-low price, as explained above.

Whether a price is artificial or uneconomic is usually assessed by comparing it to prices in other relevant markets. Price differences that cannot be explained by quality differences, temporal differences (*i.e.*, immediate values versus deferred values), locational differences, carrying cost differences (*i.e.*, storage and interest rates), or other pertinent economic parameters might indicate artificial prices. However, we do not see any such uneconomic differences with respect to silver market prices and the evidence does not support an allegation that any trader or group of traders has or could deceive these large global markets into accepting artificially low silver prices.

Your correspondence implies that a market price persistently below the cost of silver production means that the market price has been manipulated. This theory is flawed in several respects. First, there is no universal cost of production. Different firms and different production facilities have very different cost structures, and U.S. producers face some of the highest cost structures. Because the mining and refining of metals are processes that require large capital investments and long production horizon, low market prices may not halt or slow production if variable costs and even a portion of fixed costs are recovered by continuing production. Moreover, in the particular case of silver, approximately 75% of new production is a byproduct of mining for other metals. Recovering residual silver mined in this fashion is relatively cheap compared to the cost of mining silver as the primary product. Silver will continue to be recovered as a secondary product as long as the primary mining activity makes economic sense. Thus, the size and cost of new silver production do not correlate well with the market price of silver, even over long periods of time.

Although the silver market has long been characterized by large shortfalls between annual production and annual demand, silver has been mined for centuries and has accumulated worldwide in public and unofficial private stores as bullion, sterling, jewelry, bulk coins, silverware, ornaments, and scrap. These "old," above-ground supplies cannot be accurately tallied or monitored. Moreover, the motivations of owners of such old silver supplies to hold or sell do not necessarily have a strong connection with the mining and refining costs of new production. Some such supplies, such as electronic and photographic scrap, are routinely and continuously recycled at well below the cost of mining. This, along with sales of "old" silver, bridges the gap between new production and demand.

We are aware of some misconceptions about the CFTC's *Commitments of Traders* (COT) report, which summarizes the week-to-week position changes of reportable traders on regulated U.S. futures markets. The COT data for Comex silver is <u>not</u> a summary of the global silver positions of any trader, and the reportable long and short aggregate positions in Comex silver futures (or futures plus options on futures) revealed in the COT are <u>not</u> necessarily naked exposures. Short futures positions are often offset by inventory, by positions in the London bullion market (a well-established, over-the-counter market used by commercials and dealers), and in other over-the-counter derivative markets in the U.S. or overseas. It would be erroneous to infer from COT data anything about the overall position or net exposure of any trader or group of traders in a market that is intrinsically global. Moreover, the concentration ratios of the four and eight largest longs and shorts in silver futures, though large, are not unusual. So far in the year 2002, for example, 16 of the nearly 50 active regulated markets, on average, have a higher relative concentration (*i.e.*, the difference between the gross long and gross short concentration ratios) than does silver, and eight other markets (including platinum and copper) show higher gross short-side concentration ratios than does silver.

Finally, you appear to have compared certain traders' positions and the total open interest in silver futures and options to a narrow definition of silver supply and concluded thereby that futures traders can control that market. First, no provision of the Commodity Exchange Act nor any exchange rule prohibits aggregate silver futures positions (or open interest) from exceeding visible or deliverable stocks. Since most futures contracts are offset by trades rather than settled by physical delivery, open interest can and often does exceed immediately-available deliverable supplies in many markets, including silver. Secondly, the size of the global supply of silver is the subject of debate and we have seen highly-regarded trade and published estimates that available supplies amount to several hundred million ounces, which is larger than the size of the entire Comex open interest in silver futures.

In closing, the CFTC has received numerous letters on this same issue, the vast majority of which appear to have been inspired by your allegations. We have carefully examined these allegations and found them to be not credible and not supported by facts. Nonetheless, we take very seriously our responsibility for regulating the commodity futures and option markets and will remain vigilant with respect to every such market.

I hope this information is helpful to you.

Sincerely,

Michael Gorham
Director

cc: James Newsome
Chairman