COMMODITY FUTURES TRADING COMMISSION

EXAMINATION OF FUTURES AND OPTIONS TRADING IN THE METALS MARKETS

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Chairman Gensler, members of the Commission, on behalf of the HSBC Group ("HSBC"), I want to thank you for inviting us to participate in this hearing as the Commission examines futures and options trading in the metals markets. My name is Jeremy Charles and I am Global Head of HSBC's precious metals business. Until last year, I was also a member of the management committee of the London Bullion Market Association ("LBMA"), where I served as its Chairman for three years. The LBMA is a London-based trade association that represents the wholesale over-the-counter market for gold and silver in London.

Headquartered in London, HSBC is one of the largest banking and financial services organizations in the world. HSBC's international network comprises around 8,000 offices in 88 countries and territories in Europe, the Asia-Pacific region, the Americas, the Middle East and Africa.

HSBC is a significant participant in the global markets for precious metals, providing a full range of products and services to a broad client base, which includes industrial users, central banks, producers, fabricators, refiners, jewellers, and institutional investors. We also engage in market making activities with respect to these products.

HSBC Bank USA, N.A. is the key metals risk management arm of HSBC, with trading desks in New York, Hong Kong and London.

We understand that the primary focus of the Commission's examination and, more specifically, today's hearing is the potential application of federal speculative position limits to the metals markets. HSBC believes that the adoption of speculative position limits for precious metals is not necessary. Such limits are unnecessary "to diminish, eliminate, or prevent" excessive speculation that may cause "sudden or unreasonable fluctuations or unwarranted changes" in the prices of these products and, as explained below, could be counterproductive. (Commodity Exchange Act, section 4a(a))

To better understand our position, it may be useful first to identify some of the key characteristics of the global precious metals industry and describe HSBC's role in this dynamic market. (As indicated above, HSBC deals in precious metals, and our comments for purposes of this hearing are limited to precious metals. Our comments do not address the markets for base metals.)

Precious Metals Are Fundamentally Different From Other Commodities

In calling today's hearing, Chairman Gensler indicated that, like agricultural commodities and energy products, the supply of metals, including precious metals, may be finite. That may be, but it is important to distinguish between "finite supply" and "limited supply." Essentially all products traded on US designated contract markets have a finite supply at any given time, even foreign currencies. However, not all products have a limited supply, such that the prices of these products may be subject to "sudden or unreasonable fluctuations or unwarranted changes." Gold and silver are such products.

In particular, unlike agricultural commodities and energy products, the vast majority of precious metals are not produced to be consumed and, once consumed, disappear from the economy. Further, unlike agricultural commodities and certain energy products, such as electricity, precious metals are not wasting assets which, if not consumed within a fixed period of time, lose all value. To the contrary, the vast bulk of all the bullion that has been produced since the beginning of time is held in one form or another by central banks, industry consumers, commercial institutions, exchanges and the public. In the event of a shortage of gold or silver, supply can be mobilized on relatively short notice. The buoyant scrap market, which has grown significantly during the current rally and is credited by many analysts with helping to moderate price appreciation, is an example of the rapid mobilization of existing supply.

Moreover, although these metals are important and necessary components in certain industrial and scientific processes, a considerable portion of the production is used for jewelry. In the case of gold, for example, jewelry accounts for approximately two-thirds of production. In the face of high prices, the consumer can choose to reduce his or her consumption of precious metals in favor of other competing luxury items. The decline in jewelry sales in the past 24 months in reaction to high prices within and outside the United States is evidence of this. Therefore, a threatened disruption in the supply chain for these metals will not have the same economic and social consequences as shortages in food or energy supplies.

Finally, in contrast to other products, precious metals are a form of currency, as well as a commodity. This dual function is at the very essence of the bullion market and illustrates its unique status. Most economists agree that gold, in particular, performs a valuable economic function:

- It is a reliable store of wealth over the long term.
- It is a safe haven in times of economic, financial, or geopolitical stress.
- It is an efficient portfolio diversifier, lowering overall risk and performing best when the financial markets become dysfunctional

- It performs the function of a supra-national currency (it was mobilized recently by the government of South Korea as a tool to help stabilize the Korean won).
- It remains a vital and significant component of central bank reserves around the world, including the US.
- It is the only form of currency that is not subject to any government's monetary and fiscal policy.
- It is the only reliable hard asset that is both deeply liquid – gold trades virtually 24 hours a day – and that is not anyone else's liability.

The merits of gold and silver as safe haven in times of stress is clear in the nearly unprecedented demand for precious metals by ordinary investors worldwide during the recent crisis in the financial markets. Inhibiting trading by market participants that are in a position to respond to that demand would not be in the best interests of ordinary investors.

As further evidence of its importance as a form of currency, it should be noted that gold has traded inversely to the US dollar since 1971, when the US "de-linked" the dollar from the price of gold. When the US economy and the US dollar are strong, the price of gold may weaken. When, as is currently the case, the US economy and the US dollar are perceived as weak, the price of gold may rise as it is a hard asset whose inherent value is recognized world-wide.

The Precious Metals Markets Are Broad and Deep

The US futures markets are an important component of the global precious metals trade. They are used by commercial institutions, including HSBC, to hedge client flows and to manage our global business. In addition, they are used by a broad range of participants, including mining and consumer companies, as well as exchange-traded funds ("ETFs"), index funds, hedge funds and other institutional investors, and retail clients that may not have easy access to the wholesale physical market.

A key advantage of trading on the futures markets, of course, is that all transactions are cleared through a derivatives clearing organization, which acts as a central counterparty. In light of the recent credit crisis and the greater awareness of counterparty risk, the availability of a central counterparty, in markets such as these, has taken on greater importance.

Nonetheless, the US futures markets are but one component of a worldwide precious metals market. In addition to the major markets in London and New York, gold and silver are traded on markets and exchanges around the world, including those in Switzerland, China, India, Vietnam, Singapore, Thailand, Australia, Japan, Hong Kong, Turkey, Dubai and Brazil.

Moreover, although the US futures markets serve a vital hedging and risk management function, they are not the sole source of price discovery. The cash market in London sets the par value price for gold and silver, with prices elsewhere trading at a premium or discount to London's prices. Hedging and arbitrage assure that these prices do not diverge significantly for any extended period of time. Without the ability to hedge and arbitrage, gold and silver prices in each of these individual markets have the potential to swing dramatically in response to local supply and demand. It is the connection between the global markets that provides the safety valve, which is vital for these markets to function efficiently and effectively. Traders should not be prevented arbitrarily from entering into such hedge and arbitrage transactions.

HSBC's Use of the Futures Markets

As a dealer in precious metals, HSBC maintains a significant presence locally and, in particular, in the London cash market. As noted earlier and consistent with the activities of other active precious metals dealers, HSBC is continually entering into cash, forward and options transactions with its clients and other market participants. In this connection, HSBC also frequently maintains large open positions on US futures markets. HSBC currently maintains short futures positions, hedging its long cash positions. These positions fluctuate on a daily basis and can be rolled forward, when and as appropriate.

HSBC is also an important source of market liquidity. As discussed above, futures markets participants include mining and consumer companies, approved participants of ETFs, index funds, hedge funds and other institutional clients. More often than not, these participants are "natural longs" that infrequently take delivery and instead simply roll their futures positions forward on a periodic basis. Were it not for the active participation of commercial traders that take the other side of those trades, the spread between the price at which the current contract is liquidated and a new contract is entered into could widen dramatically, to the detriment of all participants.

Federal Speculative Position Limits Are Unnecessary

In light of the unique characteristics of precious metals, the global and interconnected nature of the precious metals markets, and the critical role that large commercial institutions play in maintaining liquidity, we respectfully submit that the Commission has no practical reason for considering the adoption of federal speculative position limits for precious metals. Further, without evidence of excessive speculation in precious metals that may cause "sudden or unreasonable fluctuations or unwarranted changes" in the prices of these products, we submit that the Commission lacks the statutory basis for considering the adoption of federal speculative limits with respect to these products. The market surveillance activities undertaken by the futures exchange, including the existing large trader reporting requirements and position accountability rules, have proven to be more than adequate to govern appropriate behavior on the part of all market participants, promote market integrity and otherwise protect the public interest.

Moreover, given the global nature of the precious metals markets, unilateral action on the part of the Commission could simply cause large market participants to shift business to other markets. Such a result could adversely affect liquidity and, consequently, prices on US markets, to the detriment of precious metals market participants.

If, notwithstanding the foregoing, the Commission elects to go forward with speculative position limits for precious metals, we ask the Commission to consider the following:

- Bona fide hedge and risk management exemptions should take account of the nature of these markets. In particular, any limits should provide an exemption for hedged transactions.

- Bona fide hedge and risk management exemptions should be clearly defined.

- Market participants that take advantage of bona fide hedge or risk management exemptions should not necessarily be prohibited from entering into transactions for their own account.

On behalf of HSBC, I want to thank you again for opportunity to appear before you. I would be pleased to answer any questions you may have.