Testimony before the CFTC

Public Meeting to Examine Futures and Options Trading in the Metals Markets

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Chairman Gensler, Commissioners, fellow panelists, my name is Mark Epstein, and I am an individual trader in the futures markets. Thank you for the opportunity to participate in this panel discussion. I trade nearly every business day in all of the active futures markets listed on the CME (including metals, energies, interest rates, agricultural products, currencies and equity indices). And, I am a member of the CME, CBOT, NYMEX, and COMEX.

I received a bachelor's degree in Mathematics and a master's degree in Computer Science from The University of Chicago, and I have been involved in the futures and options markets for nearly 25 years. Initially I worked as a technical analyst, researcher, and computer programmer, but for the past 10 years or more, I've also been the trader. Currently, I trade for my own individual account.

In all of the futures markets that I participate, I am a market maker, a liquidity provider, and I make two-sided markets nearly all day long. Using computers, I am able to quickly adjust my markets in real-time to respond to changing conditions and to manage the risks that I am taking. I am short-term speculator responding to the ebbs and flows of the prices, buying and selling, and I go home each night with either more or less money than I started with at the beginning of the day. I tend to close out my positions, so I rarely have overnight risk.

Each futures market has its own individual personality, they all behave differently, and I know a lot about the personality of each of the markets that I trade. I place orders to buy and sell, working to make profits while avoiding danger. Second-by-second (or even millisecond-by-millisecond), I have decisions to make and orders to place. To me the markets are a complex puzzle of moving numbers. But, behind the scenes, the markets are actually real people, real products, and real activities. Especially in commodities markets of finite-supply.

Today, I am here to speak about the metals. I make markets in COMEX gold and silver futures, and I typically trade between 1,000 and 2,000 futures contracts in the metals every day. I can tell you all kinds of statistics about the markets and the prices, but let's take a quick look at 10:15 am on Feb 4, 2010. Somebody seems to have been in a rush to sell gold, and in less than a quarter-of-a-second, they sold about 2,000 futures contracts driving the price down instantly a hundred ticks. This represents 200,000 ounces of gold, or about $215 million dollars worth of gold at that time. That was a very big trade, and it took place in the blink-of-an-eye. There aren't many players in the gold market capable of playing that big, and I'm not sure what motivated them to decide to overwhelm the price of gold instantly (rather than selling more slowly), but this kind of thing happens in the metals markets. Not even India's move to buy $6.7 billion worth of gold from the IMF on Nov 3, 2009 created this big of a disruption to the gold futures markets.

Today, I'd like to primarily speak about the COMEX silver market. I've traded silver futures for a few years, but I only became particularly interested when I started to buy physical silver, back in May 2008. At the time, silver was trading at about the same price it is now, around $17 per ounce. But, in between then and now, silver took a journey down to near $8.25 per ounce, and visited as high as about $19.50 per ounce.

The futures markets for commodities of finite-supply are very interesting, and to maintain their integrity, there must be a tight relationship between the futures prices and the physical prices. This attracts speculators to participate and develops an effective marketplace for price discovery, which assists bona fide producers and consumers of physical commodities to hedge the price risks in their businesses.

I follow the prices of COMEX silver futures and the prices in the physical silver market. Near the end of 2008, there appeared to be a divergence between the price of the COMEX silver futures and the price of physical silver. So, I bought some silver futures, took physical delivery of 1,000 ounce bars, melted them into 100 ounce bars, and sold them in the retail marketplace. This price divergence lasted for a couple of months, and I wasn't the only one who noticed. The warehouse stocks of physical silver at COMEX dropped about 20 million ounces as people realized the cheapest way to get physical silver was by draining the inventory from the COMEX. Currently the COMEX silver warehouse stocks are down to about 115 million ounces.

The accountability limits in COMEX Silver are 6,000 contracts (or 30 million ounces), with the delivery month limited to 1,500 contracts (or 7.5 million ounces). I believe this is too high. Additionally, the current open interest is about 114,000 contracts (or 570 million ounces), almost a year's worth of mine production.

From the Commitment of Traders and Bank Participation Reports, it appears that the largest single position is held by a bank on the short side, and the size of that position is about 30,000 contracts (or 150 million ounces), which is about 120 million ounces larger than the current accountability limit! Presumably, they must have been granted an exemption to the position limits, but this seems wrong to me. Exemptions should only be granted to bona fide hedgers.

In studying the micro-price movement personality of the COMEX silver market, I can tell you that it behaves like no other market. The typical available liquidity in the deck is tiny, yet we have average daily volume in excess of 40,000 contracts. And as a result, there is significant price volatility for the market to absorb large orders. The existence of oversized market participants has a chilling effect on market makers, which results in even less liquidity as market makers widen their prices to compensate for the increased risks they are taking. Consequently, the large orders wind up setting prices, rather than the proper function of the futures markets to discover prices.

The size of the open interest in COMEX silver is irresponsibly large, given the reality of world inventories and production. Additionally, there is a significant imbalance between the largest long positions and the largest short positions, with the shorts being heavily concentrated. In a physically delivered futures contract for a commodity of finite-supply, this also exposes the marketplace to an unnecessary risk of failure-to-deliver. Such an event could destroy the COMEX silver market.

I am encouraged with the CFTC's stated intention to implement a consistent policy for position limits in all commodity markets of finite-supply. For COMEX silver, I think the position limit should be reduced to 2,000 contracts, with delivery month limited to 1,000 contracts. And, most importantly, exemptions should only be granted to bona fide hedgers.