



CPM Group

*Commodities Research, Consulting,
Asset Management, and Investment Banking*

Jeffrey M. Christian CFTC Written Testimony

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My name is Jeffrey M. Christian. I am Managing Director and the founder of CPM Group, a commodities research and consulting company in New York. Prior to founding CPM Group I headed the J. Aron Research Department, which became the Commodities Research Group at Goldman, Sachs through a merger in 1981. In 1986 I engineered a management buy-out of the Goldman Sachs Commodities Research Group to create CPM Group, deciding to leave Goldman and create an independent research and consulting company for a variety of reasons. I am an internationally recognized expert on the markets for gold, silver, and platinum group metals in the market. I have provided detailed research, consulting, and management services to major central banks and governments, mine producers, refiners, users, institutional investors, and high net worth individuals related to these metals and other commodities. I also am well versed on base metals, energy, and other commodities markets, having analyzed these markets and worked intensely in them since the 1970s. In 2005 I wrote a book titled **Commodities Rising**, which among other things detailed a number of concerns of mine at that time related to the quality and integrity of commodities markets, some of which unfortunately have been borne out over the past three years.

Let me state that I have long held and publicly espoused the opinion that the Commodity Futures Trading Commission needed more resources and a clarified, strengthened posture vis-a-vis its ability to regulate the commodities markets. Although I was only a student at the time of the original enabling legislation in the middle of the 1970s, studying journalism, international politics and economics, even then my opinion was that the legislation was poorly structured, seemingly purposefully vague, and did not provide the CFTC strong enough authority to effectively regulate these markets. I have expressed concerns that subsequent extensions of the 1974 act seemed to reduce the potential for the CFTC to effectively do its job, and worked with industry groups to try to stop some of the most obviously ill-conceived relaxations of CFTC oversight embodied in the 2000 Commodity Futures Modernization Act. I also have been an outspoken advocate of some regulatory oversight for over the counter derivatives since 1986, when I left Goldman Sachs. I must add, however, that I believe the prospective regulations I have heard proposed by the CFTC and various members of Congress recently seem to me to be inappropriate and ill-conceived, and in my opinion will most likely be ineffective and destructive of legitimate economic value for a broad number of corporations and the U.S. economy as a whole. The current proposals being discussed do not seem likely to me to be able to deliver the stated intended economic and market outcomes.

I put forth this background so that you understand that I have been an advocate of better, and better financed, CFTC regulations of markets for decades. I want to qualify my credentials in this regard so that you may not mis-understand my position on federally, CFTC, mandated and managed position limits on metals, energies, and agricultural commodities.



My Position on the Proposed CFTC Actions Regarding Position Limits

My position is that the proposal is a mistake. Federally managed position limits seem both inappropriate and unnecessary. The proposals at hand most likely would do nothing to improve the efficiency, honesty, integrity, and fairness of metals commodities markets. Instead, I believe they would drive liquidity into less regulated and less transparent overseas and over the counter markets, reducing the efficacy of U.S. regulated derivatives exchanges, skewing the price relationship between U.S. regulated markets and global commodities markets, and costing the United States economy jobs, revenues, and tax receipts.

At present the CFTC has the authority to impose position limits on commodities markets. It has not exercised these powers since its inception in 1975, relying instead on the exchanges to impose and manage position limits. This seems to me to be a more appropriate approach to position limits across commodities markets, including metals, energies, and other commodities. Some arms-length observers may argue that the CFTC ought to be more interactive with the exchanges in monitoring the exchanges' activities in setting and modifying position limits than it has been. From what I can tell, the CFTC already may be adequately engaged in this practice. The idea of allowing the exchanges to set and modify position limits would seem a far better approach to market oversight than to have the CFTC impose and manage position limits. The reason for this is simple: The management of the exchanges ought to be closer to the markets and more familiar with market trends and conditions than are regulators at the CFTC.

There are good reasons for position limits to exist for non-commercial market participants. This always has been true, but it has become more important in the past several years with the rise of mechanically managed, passive, long-only funds that buy and hold commodities. In the precious metals markets the existing exchange traded funds hold physical metals and not futures or options, while in natural gas and other commodities they hold futures or options positions.

In addition to these ETFs, there are indexed funds that have adopted mechanical approaches to investing in futures and options. The structure of these funds and the potential that overwhelming volumes of money will seek to be long via such funds present clear risks to metals and other commodities markets and price stability. The solution to protecting the market and market participants from these risks does not seem to lie in setting government managed position limits, however. Position limits might provide some minor protection against these risks. A more thorough analysis may well suggest that position limits would be insufficient and that a broader regulatory response to the rise of such funds is needed. Any such regulatory moves would have to be tempered by the reality that such funds might continue to exist and merely move to unregulated offshore or domestic markets, continuing to present the risks that they do to markets while doing so in an even less regulated market than the U.S. exchanges. The risk of such migration, or regulatory arbitrage cannot be emphasized enough, especially in metals that already are internationally traded with extremely competitive alternative markets in many countries.

Ill-conceived and poorly managed position limits most likely would drive liquidity from U.S. regulated, relatively transparent markets to more opaque offshore and over the counter markets. They have the capacity to skew the price relationship between domestic, regulated markets and broader physical markets elsewhere, reducing the effectiveness of the price discovery process in U.S. regulated markets. In this way, such position limits would be expected to be economically destructive, causing a loss of revenue to companies engaged in trading on U.S. exchanges, and reducing market transparency and efficiency. The likelihood is that federally managed position limits would have the same basic effects on commodities markets as the well intentioned but poorly structured Sarbanes-Oxley legislation has had on equity



markets: They would do nothing to reduce the potential or actual incidence of market concentration, price distortion, misfeasance, and malfeasance, but they would raise the legal and accounting time and cash costs prohibitively high, and drive liquidity to other markets, depriving the U.S. economy of significant revenue and stature in the international global economy.

It appears to me that the concept of CFTC-set position limits is based on taking a practice that demonstrably has failed in agricultural markets, and applying it to energy and metals markets. The presence of government mandated position limits has done nothing to limit or reduce concentration in the agricultural markets, let alone price volatility and the scope for individual participants in these markets to undertake trading activity with a view to profit from price changes or distortions that might result from their trades. I know of no empirical or theoretical basis for assuming that programs that have failed in the agricultural markets would succeed in the metals and energy markets.

Intended Economic Outcomes

In considering the imposition of federally mandated and managed position limits, one must justify the actions by stating that they would be expected to have beneficial economic outcomes. What the intended economic benefits of these position limits are must be considered, along with the potential that the regulations may or may not achieve such objectives.

The first outcome presumably hoped to be achieved with position limits would be to avoid ‘undue’ concentration of trades. That in and of itself is not a legitimate economic benefit. The rationale must be that avoiding such concentration of trading activity would help avoid or eliminate unfair commodities prices, skewed prices, market manipulation, undue price volatility, or some other economic consequence of market concentration.

The experience in agricultural markets is that concentration has continued to grow despite the existence of position limits imposed by the government. The increased concentration in agricultural markets reflects forces at work in the broader agricultural markets, including the physical markets and the farm industry. These trends are far more fundamental and lie far beyond the scope of position limits in agricultural commodities exchanges. Concentration of trading activity also is occurring, with commercial or bona fide hedgers having the largest positions. The price volatility and price behavior of agricultural commodities meanwhile is in line with those of other commodities that do not have federally managed position limits, suggesting the position limits have had no generalized effect on such economic outcomes.

It should be noted that the price behavior of non-exchange traded commodities also is similar in broad terms to the price behavior of exchange-traded commodities, suggesting that arguments to either effect – that being traded on an exchange increases or decreases price volatility or other price behaviors – do not stand up to statistical scrutiny and are not supported by empirical evidence in the real world. They are beliefs.

Bona Fide Hedger Exemptions

Any position limits must and ought to have exemptions for legitimate hedging activity by merchants, producers, consumers, and other commercial participants of these markets. Evidence in the markets shows that insofar as there are large positions in the markets, they tend to be held by bona fide hedgers, at least up until now and the advent of indexed funds and other passive, long-only institutional investors. Thus, any position limits regime imposed by the federal government would do nothing to reduce concentration of trades among some market participants.



Staying on the issue of the role of financial institutions as bona fide hedgers and large commodities market participants for a moment, one must be cognizant that concentration is occurring across almost all areas of banking and finance as a result of market forces – mergers of banks, economies of scale, and the exit from markets by smaller, less profitable and less competitive operators. This is occurring across virtually all financial markets, from mortgage origination to corporate lending, to commodities trading. It is occurring not because of any conscious initiatives on the part of individual entities, but rather because that is the way economic systems work when they are not distorted by regulations, legislation, or other activities that restrict markets from operating efficiently.

Based on documents the CFTC has produced regarding position limits in energy markets, it would seem that the CFTC has an inaccurate concept of the role of what the CFTC calls swap dealers in these markets. I say this because the CFTC appears to be considering swap dealers as not being bona fide hedgers. They are, and any limitations on their ability to effectively hedge their non-exchange traded activities would be devastating to the exchanges' liquidity and price discovery capacity.

Some explanation of the mechanics of the futures markets may be in order, in terms of how industrial or commercial participants in these raw materials markets buy, sell, and hedge their positions. This may be an appropriate time and place to do so. Many producers and industrial users of metals, energy commodities, and agricultural commodities do not trade on the futures markets. I have not seen relevant statistics, and they may not exist, but from my experience it would not be surprising to me if the vast majority of producers, consumers, and physical market intermediaries do not trade directly on the futures and options exchanges. For a variety of reasons, it is easier and more convenient for them to trade in the forward OTC market directly with dealing banks, on a principal-to-principal basis. Their trading counterparts in the forward, OTC, or physical market then use the futures and options markets to hedge their resulting price exposure. Thus, one tends not to see a lot of producers and consumers directly trading on the futures and options markets. One tends to see a reflection of their forward market transactions in the volumes of positions taken on by their trading counterparts. This seemingly obvious aspect of the markets often is overlooked in considerations of these markets, but is critical in terms of understanding the volumes of positions held by banks and other financial service corporations. It also is critical in understanding how easy it would be for the U.S. derivatives exchanges to lose most of their commercial liquidity.

Additionally, the CFTC has floated the concept of dis-allowing trading entities to serve as swap dealers, hedgers, and proprietary traders. This, too, is extremely ill-considered and reveals a lack of understanding as to the efficiencies that are derived by allowing trading companies to have integrated operations. Forcing diversified firms to make seeming, but not, Solomonic decisions as to which part of their babies they should choose to keep would severely damage market intelligence, not only for the diversified trading entities but for the broader markets that benefit from the dissemination of the received wisdom, if in no way other than through the price discovery process. In reality, the market benefits in broader ways than merely having prices reflect real market trends.

Insofar as the speculative position limits the CFTC has said it is considering would remove the capacity of non-hedgers to hold extremely large positions, the first effect of position limits would be to increase the concentration of trades in the hands of the relatively few financial institutions still providing commodities trading services to industry and investors. Insofar as one impetus behind the consideration of instituting position limits may be to limit the concentration of trading in the hands of a few large commodities trading banks and non-banking financial institutions, position limits thus would have the exact opposite effect.



In extending its invitation to provide testimony to the Commission today, the Commission asked that I address a number of additional, related topics.

1. Price Discovery in the Metals Markets

The price discovery mechanism in the metals markets, including gold, silver, platinum, palladium, and copper, is a complex interwoven process involving the prices on U.S. futures exchanges, the U.S. over the counter dealer market, the London-centered international bullion and metals markets, and market trends in Asia and other markets. Market participants have debated to no avail which market is most important or dominant in determining prices. There appear to be no objective, quantifiable methods for resolving this debate.

That said, I have participated in these markets since the 1970s, and have a great deal of personal insights. The short answer is that from my perspective the London dealer market and New York futures exchanges share key importance in the precious metals markets. The price discovery process is bilateral between them. In copper, the London Metals Exchange is the key market for determining prices. U.S. futures contracts key off of the LME market.

The volumes of copper that trade on the London Metals Exchange far exceed the volumes trading on the New York Comex, a division of the CME Group.

For precious metals, trading volume and turnover data are not reported, nor even collected it seems, for the volumes of precious metals trading in the London OTC dealer markets for gold, silver, platinum, and palladium. Clearing volumes have been published on a monthly basis for gold and silver since the fourth quarter of 1996 for London trading, but it is generally assumed that trading volumes far exceed clearing volumes. The market's major participants profess on a non-quantified basis that more gold and silver trade through the London-based OTC market than on the Comex, and that appears to be true.

In terms of price determining effects, it has been my experience that trading in London and New York are both extremely important in price discovery. Debating which is more important is not a useful employment of effort and time. It is sufficient in my view to agree that these two markets are the key markets in which gold and silver prices are determined. Trading in the London market clearly is important on a global basis, and clearly influences trading in both the New York futures markets and the U.S. OTC markets. It also is clearly true that price developments on the New York futures markets have a major influence in the London OTC market. Trading grows thin in London prior to the New York opening most mornings, often called the "New York pre-market," and then resumes if not rises as the New York exchanges begin trading. Companies seeking to execute large trades wait until New York opens, finding the market more liquid and pricing more competitive. Conversely, there are times when companies enter the market with large trades during the New York pre-market, apparently with the intention of moving prices in their favor by placing a large order or orders before the liquidity is there to accommodate such trades. Within the North American or New York market, trading on the Comex is the most transparent and apparent, and appears to have a major effect on the OTC market.

Trading trends in the Asian markets, including Tokyo, Singapore, Hong Kong, Sydney, and increasingly Shanghai, also have an effect, but the influence of these markets appears less domineering than either London or New York. In copper, Shanghai has become an increasingly important market, with London-Shanghai trading now an important part of the volumes in the London market.



The bottom line is that the precious metals and copper markets are integrated, futures and exchange-traded options with forwards and OTC options in the ‘physical’ or dealer market. The price discovery process moves around the world with the sun. Trading volumes on both the OTC and futures markets are intertwined, as is trading in the United States with trading in London and other geographically dispersed markets.

This is important for the issue at hand for at least a couple of reasons. For one thing, the ability to trade in other markets, should the U.S. regulated markets become burdened with regulatory obstacles that distort their price discovery capacity, is easy and can quickly be executed. Any move that distorts the price making mechanisms on the futures exchanges, for example by limiting the size of trades that participants may execute and the size of positions they may hold, would skew the futures prices relative to the rest of the global metals markets. That would instantly reduce the interest in trading on the U.S. futures exchanges, which would be perceived as inefficient compared to other markets. The resulting loss of liquidity as investors, commercial participants, and others shifted their trading to other venues would lead to a spiral effect of reduced the relevance of the U.S. markets.

2. The Role of Passive Funds

The Commission has asked about the role of passive, long-only positions such as those associated with index funds or exchange-traded funds.

CPM Group’s view has been that passive, long-only funds, indexed funds, and exchange-traded funds present risks to the underlying commodities markets. This is most true in markets where a fund is investing using futures and options. In the precious metals markets, however, the existing exchange traded funds are investing in physical metals at present. Other funds, such as indexed funds, are investing in futures and options, and present risks for market and price stability if they grow too large relative to the markets in which they invest. Limiting their holdings, creating what in essence would be closed-end funds, may not be a suitable solution to these problems.

The fact that precious metals ETFs do not participate in exchange traded futures and options removes them from this issue, but it does not reduce the potential risk that individual index funds could build too large of positions in a futures or options contract.

There are other issues related to exchange traded funds that hold physical metal, including in the case of silver, platinum, and palladium the risks that these funds will build positions so large that sudden changes in their holdings would greatly affect metals prices. These are probably beyond the scope of today’s discussion.

3. The application of speculative position limits

The Commission has asked for opinions related to whether speculative position limits could or should be applied consistently across all metals derivatives markets and participants.

CPM Group’s opinion is that speculative position limits on non-commercial entities should be applied consistently to all non-commercial market participants. The levels and structures of such position limits should be based on the particular characteristics of each market, however. There are critical differences between gold and silver, gold and copper, gold and platinum, for example. There are differences between Comex copper and LME copper. There are critical differences among markets. The nature, structure, and



levels of position limits should reflect the structure of each market. They also should change with market conditions.

As stated in my introductory comments, my personal opinion is that the exchanges are better suited to manage such position limits, with the input and oversight of the CFTC, than is the CFTC itself.

The Commission additionally asked if indexed funds and ETFs should be included in such position limits. They should. Again, however, as I stated in my introductory comments, it appears to me that the risks presented markets, including commodities, of index funds and other passive, long-only funds, may be greater than can be managed by position limits, and may warrant a more comprehensive regulatory approach beyond the scope of today's discussions.

4. *Would such limits enhance market integrity and efficiency?*

I do not believe that CFTC managed position limits would enhance market integrity and efficiency. As I stated early on, I would be extremely concerned that such position limits would reduce market integrity and efficiency, driving liquidity and trading activity to less regulated OTC and offshore markets.

5. *The Commission asked several questions related to the implementation of position limits on metals.*

- a. What formulation should be used for establishing and modifying position limits. The CFTC is aware of this, having reviewed the concept that some mixture of percentages of open interest be used in determining market position limits, while the size of positions relative to 'deliverable supply' be used for other position limit calculations. This seems reasonable.

The exchanges presently employ position limits that are set at the number of contracts. The numbers used for such position limits reflect market liquidity in a given contract at any given time. A hard and fast rule for numbers of contracts or percentages of open interest in given contract months and contracts would not be expected to work effectively, given the small levels of open interest in many forward contracts and out of the money options. Position limits need to be established, managed, and modified by people who are intimately involved in the markets, are monitoring the markets closely on a continual basis, and are adept at adjusting position limits to balance the need to accommodate all legitimate commercial activity while protecting the total market from inappropriate concentration.

Within this context, the Commission has been discussing using percentages of deliverable supply as the methodology for setting position limits in the energy markets. Setting aside issues related to defining and delineating 'deliverable supply' in an accurate and meaningful manner, this probably is an inappropriate measure to use, at least if it is the only one to be employed. A percentage of open interest in a given contract month can be more important in forestalling performance problems. I believe that much of the problems related to the Amaranth trading crisis a few years ago did not relate to the percentage of 'deliverable supply' represented by Amaranth's open interest of contracts, but rather than there was insufficient liquidity in some of the contract months from counterparties which effectively disallowed Amaranth from liquidating positions in a timing and effective manner. This one example speaks to the need for the application of a spectrum of metrics to be considered and deployed in setting and maintaining position limits, even if one accepts the statistically unsupported premise that position limits would prevent future problems in these markets.



Additionally, it appears to me that the position limit metrics the CFTC is suggesting it would employ are larger in many respects than the position limits now used in many markets. Again, accepting for the moment that federally managed position limits were an effective instrument for the CFTC to control the commodities markets and that such control were an acceptable regulatory goal, one would expect that such high levels as have been proposed would be ineffectual. It begs the wag to question whether the Commission would next suggest that the exchanges raise their much lower position limits now in existence or remove them entirely, trusting in the higher CFTC-mandated position limits to protect the markets from undue concentration's presumed price consequences. The CFTC has suggested that it would not do this, regarding energy market positions limits. One must necessarily ask why the CFTC would expect to have its own higher limits provide any sort of protection not already afforded the markets by the lower, ostensibly more effective and restrictive, exchange-managed position limits.

- b. The quantitative measures to be used would include numbers of contracts and percentages of open interest. I have addressed the issue of whether using a percentage of deliverable supply is a reasonable metric in 'a' above.
- c. As in 'a' and 'b' above.
- d. Position limits most likely make sense across all contract months, on a net and gross basis, in individual months, and in the nearby and actively deliverable contracts. All of these are important.
- e. Spread trades should be incorporated into such calculations. Net and gross positions both are important.
- f. The Commission asked if it should limit the aggregate amount of positions held by one trader across different markets. The answer is no. The question is worrisome, however, for it perhaps suggests a view that the purpose of establishing position limits managed by the CFTC has less to do with efforts to assure the integrity, honesty, and efficiency of individual commodities markets, and more to do with targeting individual corporations, institutional investors, or others not for their role in any given market, but for their broader role in commodities markets. The CFTC should not be in a position where it is responsible for deciding who is allowed to trade commodities, who is a legitimate market participant and at what size, and which trading entity may be too large to be allowed to continue undertaking what may be legitimate economic activities.
- g. The Commission asked what metals commodities should be covered. I do not think any metals should be covered by CFTC mandated and managed position limits.
- h. Finally, the Commission asked my opinion on whether speculative position limits would be effective in metals markets where the preponderance of trading activity and positions may involve cash market activity or trading overseas. This of course means, all metal markets.

I do not think that CFTC managed position limits would be effective in such markets, in any metal market. As I discussed earlier, the Commission risks implementing rules that would achieve no economic benefits, would not enhance the price discovery efficacy or integrity of derivatives exchanges, and would stand a dangerously high probability of spawning only



negative economic consequences by driving liquidity into less regulated or unregulated markets overseas or over the counter. The scope for the CFTC to seriously damage the integrity and international reputation of U.S. exchange traded derivatives is enormous, and seems likely to far outweigh the potential real economic benefits that might be achieved. The CFTC should take a medical approach to the application of its authority, and start with the proposition that first and foremost it should do no harm.

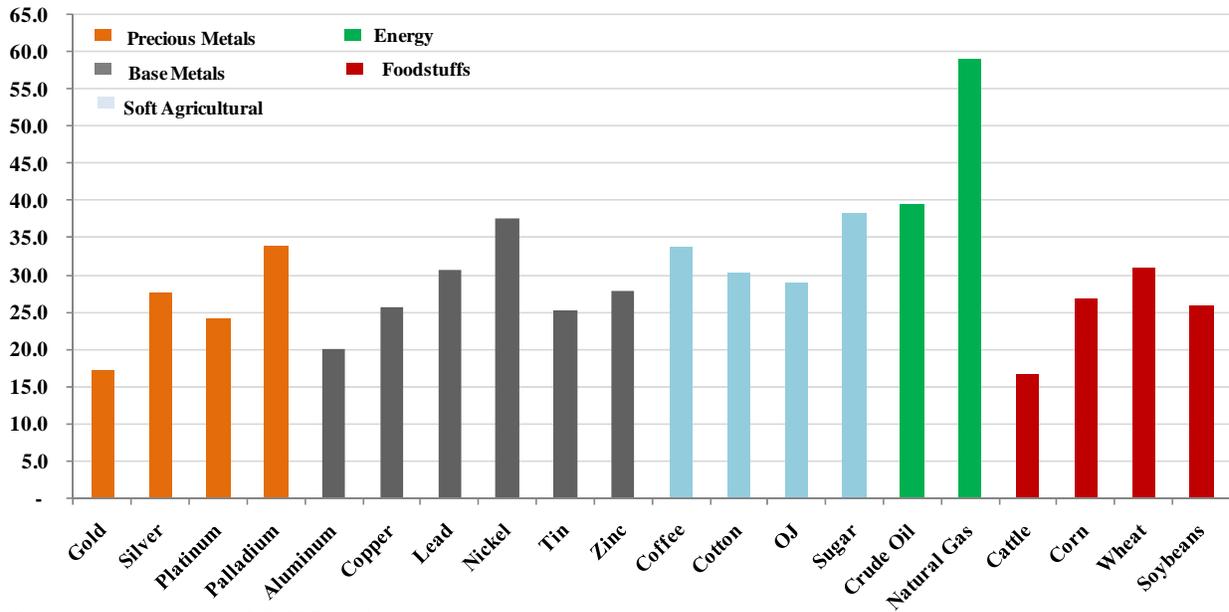
Thank you.



Average Monthly Historical Price Volatilities

Jan. 2000 - Dec. 2009

Percent



Note: Annualization factor of 260, 30-Day volatility
Source: Bloomberg, CPM Group