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Division of
Market Oversight

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Dear Silver Investor:

We at the Commodity Futures Trading Commission (CFTC or Commission) normally reply to private correspondence with a private response. We are, therefore, attempting to respond directly to all of you who have written us expressing concern that the price of silver has been artificially depressed due to alleged manipulative activity in the futures market. However, because some of you did not give us return addresses and because of the very large number of letters we have received—over 500 letters and emails—we are taking the additional step of posting this letter on our website.

As I read these letters I was touched by the disappointment expressed by many small investors in the behavior of the silver market and the heartfelt feeling that lower than expected prices were the result of collusion by a handful of big players. I do not mind participating in a competitive arena, as long as I know the competition is fair. It is clear from your letters that most of you feel the same way. Investing and speculation take place in one of the most difficult competitive arenas, because markets are inherently unpredictable. Even though I have spent my entire career around markets—four years in the Federal Reserve System, 18 years at the Chicago Mercantile Exchange, four years as a professor of financial markets, and two years now at the CFTC—I am, if anything, more humble now than ever about my ability to predict where markets are going.

But there is one thing that I am confident in, and that is that in all those years I have rarely seen such a talented, dedicated, and hard-working group of economists as the surveillance team that I found here when I joined the CFTC. The key purpose of this group is to monitor for and prevent manipulation in all the markets we oversee, including the market for silver. They take this responsibility very seriously. And so do I.

Because of the many issues raised in your letters, this response is structured as a series of questions and answers to facilitate the discussion and to focus the arguments. So let's get started.

What are the major points of the allegation of manipulation of the silver market?
The allegations that the CFTC has received can generally be summarized as follows. With silver consumption exceeding new production for many years, it is generally acknowledged that the production deficit has been primarily filled by a drawdown of stocks. Some argue that this decline in silver stocks cannot persist and, since stocks have fallen to low levels, silver prices should have been rising sharply. There is further conjecture that, over the past 20 years, a group of commercial traders (commercials) have held short futures positions that are so large that they cannot serve legitimate hedging purposes because they cannot be backed by real silver. These traders have allegedly used these "naked" short positions to downwardly manipulate the price of silver. Moreover, the argument goes, this alleged 20-year-long manipulation of the silver market

has created the conditions ripe for a huge price spike because stocks have reached dangerously low levels.

What is the CFTC's response to these allegations? [1]

We will respond generally here, and will provide additional detail in response to specific questions below. While there has been a production deficit, there has been no supply deficit. Large silver stocks have existed throughout this period, and have been made available as a source of supply at prevailing prices, presumably by many different and independent holders from around the world. This has had a dampening effect on price. There is no evidence, however, that silver futures prices have been distorted relative to cash silver bullion prices, *i.e*., prices that represent the value of "real" silver.

Moreover, while commercial traders are free to speculate in the futures market, our review indicates that the so-called "naked" shorts are not naked at all, but are for the most part hedging. The allegations imply that these commercials cannot be hedging because their positions exceed immediately deliverable silver stocks. In any futures market, however, the supply of the commodity that is deliverable (*e.g*. silver stocks in NYMEX warehouses) is generally only a small portion of the total stocks or supply of that commodity that can be hedged. Anyone holding the commodity (or having made a commitment to supply or receive that commodity in the future) faces price risk and can hedge that price risk without ever intending to make or take delivery on the futures contract. Most hedgers never do participate in delivery. Having used the futures market to hedge their price risk, they are free to buy or sell the physical commodity through their normal cash market channels.

Nor have we found any evidence that these commercial shorts are a collaborating group, taking positions in concert to drive down silver prices. The commercial short traders have had neither the means nor the motive to manipulate downward the price of silver over the long period alleged. Even if they could have temporarily depressed silver prices, they could not have prevented other traders from coming in to buy silver futures at these "artificially low prices" and either hold the positions until prices corrected upward, or take delivery of this cheap silver. Finally, the allegation fails to provide a coherent motive for manipulation. As in any market, continuous selling at depressed prices is hardly a recipe for long-term financial success. The CFTC has closely monitored the silver market, both in terms of trading activity and price relationships. We have found no evidence of manipulation, and those making the allegation have provided no evidence of manipulation.

Is the CFTC concerned about the level of prices in the silver market?

The CFTC has absolutely no bias with respect to the level of prices in the silver market or any other market we oversee. Producers of commodities want to see higher prices and complain when they are low. Consumers of commodities want to see lower prices and complain when they are high. We naturally understand these complaints. However, the Commission's responsibility is to ensure that prices are the result of market forces, *i.e*., that prices are the result of the free interaction of supply and demand, and are not the artificial result of manipulative activity.

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[1] Previous responses to the silver analyst quoted in most of the letters we've recently received may be found on our website. Please see letters dated July 26, 2002 and December 9, 2002.

Does the CFTC care about manipulation?
Absolutely. Protecting our markets from manipulation is one of the most important things we do. The Commodity Exchange Act and the Commission's regulations set up a system of standards by which all exchanges, all traders, and all intermediaries must abide. Exchanges must design contracts that are not readily susceptible to manipulation, and they must monitor their own markets to prevent manipulation. Any trader who engages in manipulation is violating the Commodity Exchange Act and is subject to punishment by both the Exchange and the CFTC.

Our Market Surveillance Section has a staff of 48 people, 24 of whom are trained economists whose sole purpose is to monitor all of the markets we oversee in order to detect and deter manipulation. They carefully watch the activity of large traders (and every morning they know the position of every large trader in each futures market) and they carefully watch the behavior of each futures price in relation to other futures prices and related cash prices. They look for any sign of large traders trying to muscle the market out of line with other markets. For a more detailed discussion of how we monitor these markets, please go to http://www.cftc.gov/opa/backgrounder/opasurveill.htm.

If our Division of Enforcement suspects that a manipulation has occurred, it will pursue the perpetrators. The Commission has a long history of vigorously investigating and prosecuting instances of market abuse. Examples include the enforcement action in the Hunt silver manipulation and the 1998 action against Sumitomo Corp. for manipulation of the copper market. Recently, we have pursued numerous cases of both actual and attempted manipulation in the energy markets, resulting in fines collected so far of almost 200 million dollars. (*See also* our website at http://www.cftc.gov/opa/opaenf2004.htm for some of our recent enforcement cases involving fraud, noncompetitive trading, and manipulation or attempted manipulation in exchange-traded and off-exchange markets.)

Has silver consumption exceeded silver production for many years?
The answer is a qualified yes. Based on the best available data, consumption has appeared to exceed production from mines and from recycled silver scrap for many years. GFMS Limited (GFMS), in its 2004 World Silver Survey (Survey), has estimated that this deficit has averaged about 133 million ounces per year in the ten years from 1994 to 2003.[2] The qualification is based on the difficulty of accurately quantifying the many elements that go into the estimates of world production and world consumption of silver. It is our understanding that many analysts view these data with a great deal of caution. Any errors, especially if they are systematic, may distort the data especially when cumulated over many years. (For example, GFMS, in its 2003 Survey, has noted that a mere one percent difference in one's assumptions about cumulative historical mine production can affect the imputed size of current silver bullion stocks by over 400 million ounces.)

Has this production deficit caused a decline in silver stocks?
Yes it has. Any level of consumption in excess of current production must be met by a drawdown of stocks. As a result of the production deficit, both privately held and government owned silver stocks have declined during many recent years. In its most recent annual Survey,

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[2] The GFMS Survey, which is one of the sources for statistics cited in this letter, is published annually based upon various public reports and interviews with a cross-section of miners, refiners, bullion dealers, bankers, and fabricators throughout the world. This year's Survey was just published on May 13. The Survey is underwritten by several of the world's largest mining companies, who would gain no apparent benefit from undervaluing silver.

GFMS estimated that the implied net reduction of privately held silver stocks during the ten years from 1994 to 2003 was 687 million ounces – about 69 million ounces per year, on average. Most of that reduction took place during the earlier years of the period. Since 2001, there has been a slight build of about six million ounces in privately-held stocks. Over the same ten-year period, GFMS estimates that net government sales have totaled about 504 million ounces, with most of that total occurring since 1999. The Chinese government has been a significant seller of silver in recent years. For example, GFMS estimated that Chinese government sold 57 million ounces in 2003, which represented 69 percent of all net government sales for that year. GFMS estimated that world identifiable bullion stocks amounted to 671 million ounces at the end of 2003. In its 2003 Survey, GFMS noted that world identifiable bullion stocks had fallen by around half from their level a decade earlier. However, this decline accounted for only about 56 percent of the total implied decline in bullion stocks. The remaining 44 percent came from unrecorded private or government holdings.

Why hasn't this production deficit caused silver prices to rise?
This is because, in spite of the production deficit, there has not been a supply deficit. Prices have not risen higher because there has been no shortage of silver to meet consumption demand at prevailing prices. The drawdown of existing silver stocks has, for many years, bridged the gap between production and consumption. Holders of stocks have made silver available for consumption at prevailing prices, without any evidence of coercion or manipulation. It is interesting to note that the implied net reduction of privately held silver stocks during this period suggests that stocks were very large when the allegation of manipulation of the silver market was first made 20 years ago and were, in fact, considerable larger than estimated at that time. It is likely that these large stocks, rather than manipulation, explain why silver prices have remained low. Had these stocks not been available, silver prices surely would have risen higher.

Have silver stocks fallen to unusually low levels compared to other commodity markets?
No, compared to other commodities, including other industrial metals, silver stocks are not at unusually low levels. As noted above, GFMS estimated identifiable world silver stocks at the end of 2003 at 671 million troy ounces, equivalent to 39.6 weeks of consumption. Non-government silver stocks were equivalent to 27.5 weeks of consumption. The table below compares these silver stocks with stocks of other industrial metals, in terms of equivalent weeks of consumption. These comparisons are all based on stock levels at the end of 2003. The estimates of stocks for these metals, other than silver, come from Metal Bulletin Research.

Metal	Private Stocks As Number Of Weeks of Consumption
Silver	27.5
Zinc	8.9
Tin	8.4
Aluminum	8.2
Copper	6.0
Nickel	5.3
Lead	3.8

As illustrated, in terms of weeks of consumption, silver stocks were more than triple those of zinc, the metal with the next largest stocks, and were seven times as large as lead stocks. Silver

stocks were more than four times as large as copper stocks, another industrial metal for which there is a very active futures market in the United States.

Is there evidence that NYMEX silver futures prices are artificially low?

No. We routinely examine NYMEX silver futures prices in comparison to prices for silver traded in other markets. If silver prices were being kept artificially low by futures trading on the NYMEX, a distortion relative to other silver prices would be likely, especially prices for physical silver. The table below shows the annual average prices for silver traded on the NYMEX, on the London Bullion Market (LBMA), and in the U.S. cash market (Bloomberg composite price).

Year	NYMEX	LBMA	U.S. Cash
2000	4.969	4.951	4.955
2001	4.359	4.370	4.379
2002	4.600	4.599	4.606
2003	4.896	4.879	4.892
2004 (through 5/13)	6.748	6.686	6.718

The LBMA is the world's largest market for trading physical silver. It is a very liquid market, backed with large silver bullion stocks. Its price is considered to be the benchmark price for trading of physical silver. Since at least 2000, the prices of NYMEX silver futures have tracked very closely cash prices for silver on the LBMA and in the U.S. cash market. We believe that an examination of these relationships for earlier periods would show the same thing.

Is a long-term manipulation of the type alleged possible? What would be the mechanism that could cause it? What would be the motive?

As we discuss in response to other questions, we do not think that there is any factual basis for the manipulation allegation. But beyond that, we believe that the allegation lacks a coherent explanation of how such a manipulation could occur, or a plausible explanation for a motive. Even if the commercial short positions were not hedge positions, and even if their selling did cause the silver price to decline, any artificially low prices could not persist for long. Because there is unrestricted access to the market, many knowledgeable and well-capitalized traders would readily buy any silver offered at artificially low prices. The buying by these traders – buying that the alleged manipulators would have no way of preventing – would quickly cause the price to rise to its appropriate level. (*See* my July 26, 2002 letter for a more detailed discussion of this point.)

The allegation of a long-standing manipulation also fails to offer a plausible motive. The purpose of any manipulation is to make a profit. The allegation is that, over a long period, the commercial shorts have continued to sell at what they know to be artificially low prices. This defies rational explanation. Sellers in a short manipulation could make manipulative profits only if they later bought back their positions at prices lower than those at which they sold them, and yet the allegation is that for 20 years the commercial shorts have continued to sell at artificially low prices without ever taking profits. Further, by knowingly selling something for less than it was worth, they would put themselves at grave risk since they could never know when the market price might correct.

A recent CFTC Commitment of Traders (COT) report shows that the large commercial shorts held open futures positions equivalent to about 470 million ounces of silver, while there were only about 122 million ounces of silver in NYMEX warehouses. Does this mean that most of these commercial short positions are not true hedge positions?
No. Commercial traders in NYMEX silver futures are not limited to hedging only NYMEX warehouse stocks. They can hedge any silver price exposure they may have, including NYMEX bullion stocks, bullion stocks held outside NYMEX warehouses, silver held in non-bullion form, new silver production, and derivative and forward positions in other silver markets. GFMS has estimated that, at a minimum, world stocks at the end of 2003 were 671 million ounces. The amount of silver that is in non-bullion form is not known, but is almost certainly very large. New mine production was about 596 million ounces in 2003. Production from old silver scrap was an additional 192 million ounces. Combining world stocks at the end of 2003 and annual world silver production would amount to almost 1.5 billion ounces of silver price exposure. While this is only a rough approximation of the magnitude of the silver price exposure that could be hedged, it is clear that this magnitude far exceeds the commercial short positions on NYMEX.

Is there anything else unusual about these short silver futures positions?
In many ways these positions are very much like short positions in other markets. For example, the share of open positions held by the largest short traders in silver futures is about average compared to other markets. Of the 60 markets for which the Commission published COT data in 2003, silver on average ranked 30th in terms of the percentage of open contracts held by the four largest *gross* short positions, and ranked 25th in terms of percentage of open contracts held by the four largest *net* short positions.[3] (These COT rankings were virtually identical for both the futures-only and futures-and-options-combined data.)

The silver market is also not remarkable in the fact that the total open futures contracts held by large commercial short traders often exceeds the ability of those traders to make actual physical delivery against their futures contracts. I have already noted in my answer to a previous question that, in NYMEX silver contracts, total open contracts held recently by large commercial short traders was a little under four times larger than the total NYMEX silver warehouse stocks, *i.e.*, about 470 million ounces to 122 million ounces. Compare that to, for example, NYMEX gold futures, where total open contracts held recently by large commercial short traders was over six times larger than the NYMEX gold warehouse stocks. And in soybeans, total futures open contracts held recently by large commercial short traders was more than 11 times larger than the total futures delivery capacity for soybeans (as measured by the maximum number of soybean certificates that could be issued by every exchange-approved delivery facility).

Futures positions are taken in order to manage or assume risk. Futures traders do not generally plan to make or take delivery of the physical product. They get out of their positions by offsetting them (*i.e.*, by buying to cancel a sell position and selling to cancel a buy position). The purpose of delivery in a futures market is to ensure that, at expiration, the futures price converges with the cash price. The CFTC's market surveillance staff closely monitors the

[3] The COT report shows the percents of open interest held by the largest four and eight reportable traders. The concentration ratios are shown with trader positions computed on a gross long and gross short basis and on a net long or net short basis. The "Net Position" ratios are computed after offsetting each trader's equal long and short positions. Thus a reportable trader with relatively large, balanced long and short positions in a single market may be among the four and eight largest traders in both the gross long and gross short categories, but will probably not be included among the four and eight largest traders on a net basis.

expiration of futures contracts, analyzing in particular whether there is proper convergence between cash and futures prices. We have seen excellent convergence between NYMEX silver futures prices and silver cash prices.

Would it be a violation of CFTC rules for commercial firms to hold positions that are not for hedging purposes?
No, commercial firms may legally hold futures positions for hedging or speculative purposes. The mere holding of speculative positions by either commercials or non-commercials is neither a violation of CFTC or NYMEX rules, nor evidence of manipulation.

Is there any evidence of collusion among the large short traders in the market?
No, we have from time to time looked for relationships among the largest traders and have found no evidence that short traders are colluding to downwardly manipulate the price of silver, nor has any such evidence been provided to us by those making these allegations. Yet, some hypothesize that collusion is somehow implied by the size of the aggregate positions of the largest commercial traders taken from the COT report. In fact, the composition of the largest short traders has changed many times during the many years that these allegations have been made. The idea that a rotating cartel of short traders could sustain a manipulation over many years is not plausible. It is simply not credible that, with all the personnel hirings and firings, all the company mergers and acquisitions, and all the business failures and start ups, a conspiracy of a changing group of short futures traders has controlled and depressed silver prices for 20 years. To date, not one single person has come forward, nor has any evidence surfaced, to corroborate those allegations.

What has been the relationship between commercial selling of silver futures and silver prices over time?
Since at least 1990, the largest commercial short positions have been held during periods when the price of silver has been relatively strong, and the smallest commercial short positions have been held when silver prices have been low. This is the complete opposite of the situation assumed in the allegations at issue. Since 1990, the average price for silver has been about $4.83 per ounce. During periods when the price has been above that average, reportable commercials (a reportable position in silver is currently 150 contracts) have held significantly larger short positions than during periods when the price has been below that average. Just two examples of this recurring pattern: (1) the smallest commercial short positions (equivalent to around 110 million ounces) were held during the second and third quarters of 2001, when silver prices were in the low $4 range; (2) in March 2004, when silver prices were well above $7.50, commercial short positions were close to the highest level since 1990. Silver is not unusual in this regard. This is a pattern that we have seen in many markets. During periods of rising prices, speculative buying interest increases, and that is matched with commercial selling, especially by producers, who lock in what they believe are attractive prices. During periods of falling prices, speculative selling interest increases, while commercial selling interest declines.

Does the CFTC have information that shows that the largest commercial short positions are not "naked" short positions?
Yes. The CFTC has substantially more information than it is permitted under the Commodity Exchange Act to make public. The Commission routinely obtains detailed information on large silver futures positions – long and short. Both the CFTC and the NYMEX have had discussions with the largest traders in the market and, in some instances, have looked beyond their NYMEX silver positions to obtain written documentation of their positions in various other silver markets

and silver derivatives. We have used this information to evaluate the overall exposure, market power, and trading incentives that a trader's complete "book" of positions would present. Based on the information that we have, we are satisfied that what may appear to be large net short futures exposures are often offset by other market positions, including physical silver inventories, forward positions, positions in other derivative products, and positions in non-U.S. markets. We believe that the characterization of the largest commercial short positions as "naked" short positions is simply not correct.

What are the implications of this with regard to the allegation of manipulation?
The allegation that naked short positions are the means through which silver prices have been kept artificially low is the linchpin in the allegation of manipulation. As we have said above, we do not think that it would necessarily be evidence of manipulation even if these positions were held for speculative purposes. However, it is clear that if this characterization is not correct – if, as we believe, these commercial short positions in silver futures are not "naked" shorts – then the allegation of manipulation has no merit. Traders with offsetting long and short exposures have neither the market power nor the incentive to manipulate the price of silver either up or down.

Should speculative position limits be placed on all silver futures months?
Many of the letters we have received suggest that a speculative position limit of 1500 contracts should be placed on all NYMEX silver futures positions, rather than just applied during the spot month as is now the case. The NYMEX's current speculative position limits for silver futures are well within Commission rules and guidance[4] and are consistent with limits that the Exchange has set for the other precious and industrial metal futures contracts. The Commission's guidance on speculative position limits focuses primarily on the spot month because, in our experience, physical delivery futures markets, such as silver, are most susceptible to threats of manipulation during the spot month. That is when the requirements for making or taking futures delivery are most pressing, liquidity is diminished because the numbers of open contracts and volume are generally declining, and time is running out to decide how to settle an open position – liquidate it outright, roll it forward with a spread trade, or be involved in actual delivery of the physical commodity. The letters provide no evidence for, nor do our analyses demonstrate, the need to impose position limits in silver futures outside of the spot month.

Should shorts be required to post warehouse receipts by first notice day?
Many of the letters also suggest that, in order to avoid delivery defaults, by first notice-of-delivery day (which is the last business day of the month before the delivery month), shorts in the spot month should be required to deposit NYMEX warehouse receipts equal to the size of their positions and, at the same time, longs would post the full cash value for their positions. We believe that the effect of such a requirement would, in most respects, simply choke off trading activity during the spot month. Spot month liquidity would dry up, open interest would fall, and the last trading day would for all practical purposes simply move from the end of the month, where it is now, to the beginning of the month.

This is a solution without a problem. If the purpose is to limit the size of individual positions, the NYMEX already has a spot month limit that goes into effect two business days before the

[4] See Commission rules "Appendix B to Part 38 – Guidance on, and Acceptable Practices in, Compliance with Core Principles," specifically with respect to Core Principle 5: Position Limitations or Accountability.

start of the delivery month. If the purpose is to avoid delivery defaults, we note that there has never been a delivery default in the history of silver trading on the NYMEX market.

Bottom Line

The CFTC does not forecast prices. We leave that to market participants and analysts. Our major focus is to monitor for and prevent manipulation in the markets we oversee. We have taken the unusual step of sharing with you our own analysis of the market to explain why we believe the allegations of manipulation in silver futures made by one analyst for so many years are based on false assumptions and faulty analysis. The detailed large trader data to which we have access and the various prices we monitor give us no reason to believe that there has been a manipulation of silver prices, either up or down.

Despite the fact that we find this particular analysis to be off the mark, we do value thoughtful independent analysis of our markets. And in particular, we value tips. Concrete, specific tips from market participants regarding potential manipulation have in the past helped us to take action against market abusers. We welcome such tips.

One final note on listening to analysts. Please consider two things. First, good, clever writing can carry half-truths and total falsehoods as easily as it can carry accurate information. Think about all the advertising to which we are all subjected every day. So, we must all carefully evaluate any analysis on which we plan to base financial decisions. Second, always try to evaluate the motives of the analyst and those who are bringing the analysis to you. Read the disclaimers that come with the analysis. If the purpose is to sell you an investment, you should ask whether the analyst is looking after your interests or the interests of the salespersons who want you to buy a product. It is, after all, your money that is being put at risk.

Finally, I want to thank you all for taking the time to share your thoughts with us. We do take our charge to protect our markets from manipulation very seriously. We hope that the information we have provided has been useful to you in making up your own minds regarding both the behavior of this market and our role in it.

Sincerely,

Michael Gorham
Director