THE ALCHEMISTS

By Adrian Douglas

In the Middle-Ages alchemists toiled in vain to transmute lead into gold. One wonders why they used such an expensive starting material, such as lead, when modern alchemists in the gold world have succeeded in transmuting paper into gold. This article reveals the anatomy of a scam that has been perpetrated on investors and goes a long way to explain and tie together developments in the precious metals markets in recent years.

As many readers may know, I have recently been reporting on how delivery notices at the COMEX cannot be reconciled with movements of metals from and into the warehouse. Clearly these are not going to match on a daily basis, just as orders into a factory will not match shipments out on any given day, as there is a time lag. But when averaged over a month, the "flow" of metal inventory should be comparable to the delivery notices issued. This is just basic accounting. But I have observed that reconciliation is almost impossible with the COMEX data. The only explanation I could think of is that settlement of contracts must be bypassing the warehouse. But how could this be possible, as I thought all contracts had to be delivered via a COMEX registered warehouse?

The COMEX states:

"Delivery:

Gold delivered against the futures contract must bear a serial number and identifying stamp of a refiner approved and listed by the Exchange. Delivery must be made from a depository licensed by the Exchange."

This seems unequivocal until you find this exception:

"Exchange of Futures for Physicals (EFP)

The buyer or seller may exchange a futures position for a physical position of equal quantity. EFPs may be used to either initiate or liquidate a futures position."

The COMEX trading rule book clarifies further:

"104.36 Exchange of Futures for, or in Connection with, Product (Physical)

(A) An exchange of futures for, or in connection with, product (EFP) consists of two discrete, but related, transactions; a cash transaction and a futures transaction. At the time such transaction is effected, the buyer and seller of the futures must be the seller and the buyer of a quantity of the physical product covered by this Section. The quantity of physical product must be approximately equivalent to the quantity covered by the futures contract."

So what this means is that contracts can essentially be settled without going through the COMEX warehouse. Futures contracts and a physical commodity equivalent can be exchanged outside of the exchange and an EFP form can be filed to the clearing department at the COMEX. What's more, the physical commodity doesn't have to meet the specification of the COMEX Gold Contract of being 100 troy ounce bar or three 1Kg bars of 995 fineness.

So what can be delivered as the physical gold commodity? This is where it gets very interesting. On February 18, 2005, the NYMEX, parent of the COMEX, issued this announcement:

http://www.cftc.gov/files/submissions/rules/selfcertifications/2005/rul021805nymex001.pdf

"Exchange Rule 104.36, which governs exchange of futures for physicals ("EFP") transactions on the COMEX Division, refers to a "physical commodity" as one of the required components of an EFP transaction but also indicates that the physical commodity need only be substantially the economic equivalent of the futures contract being exchanged.

The purpose of this Notice is to confirm that the Exchange would accept gold-backed exchange-traded Funds ("ETF") shares as the physical commodity component for an EFP transaction involving COMEX gold futures contracts, provided that all elements of a bona fide EFP pursuant to Exchange Rule 104.36 are satisfied.

Thus, acceptable gold-backed and exchange-traded ETF funds include, but are not limited to, the iSharesCOMEX® Gold Trust (ticker: IAU), which began trading on the American Stock Exchange on January 28, 2005.

The trust is an exchange-traded Fund that provides a means of obtaining a level of participation in the gold market through the securities market. The trust shares are intended to constitute a means of making an investment similar to an investment in gold. Each trust share represents a fractional undivided beneficial interest in the trust's net assets which consist primarily of gold held by a custodian on behalf of the trust. The shares of that trust are expected to reflect the price of gold less the trust's expenses and liabilities"

So the gold ETF with the symbol IAU started trading on January 28, 2005, and three short weeks later the shares of IAU became equivalent to real physical gold in the eyes of the COMEX for delivery against futures contracts in an EFP transaction! If that doesn't blow your socks off, I don't know what will.

Also note that the ETF mentioned is a COMEX product! How convenient! Where are the regulators? This ETF is not equivalent to gold. Note the description "Each trust share represents a fractional undivided beneficial interest in the trust's net assets which consist primarily of gold". All that is being guaranteed is that each share is a fraction of the ETF assets. The net assets could be 1 oz of gold while the face value of the total shares sold could be 100 million ozs!

The notice does not restrict which gold ETF's are eligible so clearly the infamous GLD is also eligible to be considered as good as physical gold in an EFP transaction.

Right from the inception of the gold ETF's GLD and SLV, the Gold Anti-Trust Action Committee has deduced from studies of the ETF prospectuses that these funds very likely do not hold gold and silver to fully back the issued shares because the prospectuses don't categorically require it [1][2]. In fact, the ETFs may have no gold or silver at all.

What seemed bizarre to GATA at the time was that the two mega-short anti-gold investment banks, JPMorgan and HSBC, would be involved in the launch and operation of precious metal investments that, on the face of it, would create huge investor demand for the very metals in which the banks hold massive and clearly manipulative concentrated short positions.

Now all becomes clear. The system is the ultimate alchemy. If ETF shares are NOT backed by gold but are accepted by the COMEX as equivalent to physical gold... presto! You have turned paper into gold -- and paper is a lot cheaper than lead.

A futures market is supposed to provide price discovery for a commodity. In the gold market this notion has been hijacked because settlement can be made with a derivative instrument, such as an unbacked or partially backed ETF share. If that derivative instrument is not backed by gold on a 1:1 basis the scheme allows an artificial apparent increase in the supply of gold and so distorting price discovery toward lower prices.

Such a scam would be in grave danger of becoming exposed if anyone knew the true inventory condition of the vaults of the ETFs. That problem is easily solved by having HSBC be the custodian of GLD and JPMorgan be the custodian of SLV.

I have not found anywhere that COMEX accepts ETF's as an equivalent to physical silver for an EFP transaction, which probably explains why silver warehouse movements are much larger than those of gold, and perhaps may indicate that physical silver is the Cartel's Achilles heel.

We have all wondered how GLD could have amassed a stunning 1,100 tons of gold in less than five years without the gold price exploding. This represents buying 10 percent of all global gold output each year. What's more, in the last nine months the ETF holdings almost doubled, adding approximately 500 tonnes or 23 percent of annual global production. And this when the signatories to the second Washington Agreement on Gold have reduced their gold sales to a trickle, from 500 tonnes per year. If the GLD shares are unbacked or only partially backed by gold, the alleged 1,100-tonnes gold holding would be easy to achieve with just the use of a printing press for the share certificates.

In looking at COMEX reports the EFP transactions are reported under “Other Volume”. This category is huge compared to delivery notices. For example, on July 8, 2009 the gold price fell by $20. Looking at the relevant COMEX report

http://www.cmegroup.com/trading/energy-metals/files/cmxopint070809.pdf

On page 4 “Other Volume” is 9,540 contracts or 954,000 ozs, while the much more visible delivery notices were only 17 contracts or 1,700 ozs! Looking at many reports the “Other Volume” category is orders of magnitude larger than the delivery notices. What I don't know is how many of these trades are settled with the COMEX-approved gold equivalent ETF’s or even if any are. I have sent an email to the COMEX to ask them. I won't hold my breath for a reply. My guess is that a lot of EFPs are settled this way, which would account in part for the meteoric issue of GLD shares. But the COMEX should be transparent; they should be required to publish exactly what is being traded as “other volume”. In fact if the COMEX wants to be above suspicion it should insist in its rules that EFP’s must be settled with gold that meets exactly the COMEX gold contract specification. The EFP then would facilitate delivery instead of facilitating a change in delivery obligations. Why was it necessary to introduce a mechanism to exchange ETF shares in lieu of physical gold? Where there is smoke there is fire.

Adding credence to this supposition is that GLD have gained wide acceptance with mutual funds, pension funds, and university endowment funds. Many sophisticated investors believe them to be equivalent to investing in bullion. This makes this fiat paper bullion scam easy to perpetrate.

It would appear that the COMEX gold warehouse is merely a window dressing displaying an almost static 2.5 Million ozs of dealer owned gold inventory. But it would appear the vast majority of settlement occurs out of the average investors view AND, therefore, out of the view of the regulators. This means that the COMEX is not what it seems. Delivery for an EFP only needs to be “substantially the economic equivalent” of the deliverable commodity! A default could occur at any time if this sorcery of swapping paper for paper suffered a serious setback.

The members of the Gold Cartel must be very proud of themselves for succeeding where the ancient alchemists failed. In fact, they are so proud they decided they didn't need to limit the scam to the COMEX. They have implemented it on the Tokyo Commodity Exchange too.

On October 29, 2008, the TOCOM made the following announcement:

"Based on the Memorandum of Understanding signed in January this year, The Tokyo Commodity Exchange (TOCOM) and Tokyo Stock Exchange (TSE) have launched 'Inter-market Cooperation Workshop' in efforts to improve convenience for participants of both markets, and studied to reinforce cooperation between the commodity market and the stock market.

In light of the study at the workshop, TOCOM has added a 'physically backed commodity ETF' as a possible physical for EFP (Exchange of Futures for Physicals) transactions at the exchange, which allows seller and the buyer, who holds agreement for physical transactions, to conclude the contracts in the commodity futures market without continuous trading of physicals.

Therefore, the SPDR® Gold Shares, physically backed commodity ETF listed on the TSE, which has a correlation with the gold spot price, can now be used as a physical for EFP transaction on TOCOM's gold market.

Thanks to this new arrangement, it is expected that the link between TSE's SPDR® Gold Shares market and the TOCOM gold market will be strengthened and that the price reliability, as well as the liquidity of both markets, will be enhanced.

For inquiries about this news release, please contact:

Planning Department,
The Tokyo Commodity Exchange"
http://www.tocom.or.jp/news/2008/20081105-1.html

Notice the comment that the "liquidity of both markets will be enhanced." There can be little doubt about that! They can print as many ETF shares as they want and they can then settle as many EFPs as they want ... and guess what happens to the price of gold with such an apparent increase in liquidity. Yes, it will be suppressed. As they said in the release, "the price reliability will be enhanced."

Now that reminds me of Alan Greenspan, who said, "Central Banks stand ready to lease gold in increasing quantities should the price rise." But why get the central banks to lease the real stuff when an ETF can print up an IOU that the unsuspecting investor will accept to be as good as gold?

Does this mean that the Alchemists of the Gold Cartel have discovered the Elixir of Life for their gold suppression scheme so that it will go on forever? No, absolutely not. Faith in anything paper is going out of fashion. California is shortly going to discover that people don't like IOUs. Central banks outside of the G7 countries are buying gold, and I am sure they know about this alchemy. I doubt that the Chinese will accept GLD shares for settlement of futures contracts.

If you want an investment in bullion, then make sure you have an investment in bullion. In my opinion what I have presented here, and what other analysts have written, indicate that GLD and SLV are not investments in bullion. They are IOUs in bullion. Take physical delivery of gold and silver from the COMEX. They have only 2.5 million ounces of the real stuff in the gold inventory. That is a paltry $2.3 billion at today's price.

The Gold Cartel is desperate to suppress gold and keep the dream of a "strong dollar" alive along with maintaining low interest rates by using a mechanism described by Professors Summers and Barsky in their research paper "Gibson's Paradox and the Gold Standard." The London Gold Pool used real gold to try to suppress the gold market, and it failed. The paper IOU is going to be even less successful. Imagine what will happen to the gold price when the holders of the paper IOUs go looking for physical gold instead. The Gold Cartel has built a dam on the river of physical gold demand, thinking that it is clever enough to defy the laws of supply and demand. Wait until the dam bursts to experience gold fever such has never been seen before.

Buy real gold and silver before the dam bursts!

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www.marketforceanalysis.com

References

[1] THE PAPER GAME by James Turk
http://www.financialsense.com/editorials/turk/2007/0305.html

[2] Unanswered Questions about the Silver ETF by James Turk
http://goldismoney.info/forums/showthread.php?t=125607

Adrian Douglas, Market Analyst and CEO of Market Force Analysis. Adrian graduated in 1980 from Cambridge University, England, in Natural Sciences. He worked for 20 years in the oil and gas industry where he held senior management positions in marketing and sales. He now runs his own consultancy and has been contracted by the largest companies in the oilfield services sector.

His study of enterprise pricing and commercial markets led to his interest in the market pricing mechanisms of financial assets. As a result he developed a unique algorithm and methodology for analyzing financial futures markets and in particular for identifying appropriate entry and exit points. The technique has been named "Market Force Analysis" and two patents have been filed on his techniques. He runs the subscription website service for investors of the same name (www.MarketForceAnalysis.com). Adrian has a particular interest in the Precious Metals markets and also serves on the Board of Directors of the Gold Anti-Trust Action Committee (GATA).