A Broken Price Process <?xml:namespace prefix = o ns = "urn:schemas-microsoft-com:office:office" />

There are two big developments this week to report on; the CFTC's vote yesterday to offer a further definition of □swap□ and the unexpected scandal at a mid-sized commodity brokerage, Peregrine Financial Group (PFG). I'll review both briefly and try to relate them to an issue I raised in the weekly review concerning the functioning of the silver and gold markets.

The Commission voted 4-1 to approve the swap definition provision, with Commissioner Bart Chilton dissenting on grounds it may have left a loophole that might be exploited in time. I'm sure if the measure were in jeopardy of not passing, Chilton would have voted otherwise. That's because this swap vote was the necessary step on the way to position limits, a matter Chilton has always advanced (much to his credit). I doubt he would have undermined the advancement of position limits on his loophole concerns. Then again, I don't speak for Chilton and if he has changed his mind on the need for position limits I'm sure he will let us know.

As I think you know, I have greatly toned down my expectations on how the Commission will actually end up enacting position limits for silver. Upfront, I hope I have this all wrong and I will relish the agency proving me wrong. I've

pushed for legitimate speculative position limits for silver for more than 20 years because I know with them in place and administered intelligently, concentration and manipulation would be impossible. The two keys to position limits are determining the proper level of the number of contracts any one trader may hold and making sure that the level will not be evaded by exempting any speculative trader falsely claiming to be hedging. Both keys are necessary for position limits to function as intended.

I've tried hard to make the case that 1500 contracts or the equivalent of 7.5 million ounces was the proper level for a silver position limit for a wide variety of reasons. Many thousands of readers, on multiple occasions, have submitted official public comments to the agency asking for 1500 contracts to be the level for silver position limits. Unfortunately, the Commission ignored those public comments, without any discussion, and settled instead on a formula that at current total open interest levels in COMEX silver (125,000 contracts) would amount to 5000 contracts. That was my first big disappointment with the agency.

Still, the concentration on the short side of COMEX silver is so extreme that even a position limit more than three times the 1500 contract level would still promise to end the manipulation, if it were administered correctly. The extreme level of concentration on the short side of silver is visible in the latest COT report. Even though the concentrated net short position of the four largest

traders is down more than 50% from peak historical levels, that position is still more than 29,000 contracts. This is more than 9,000 contracts over the mathematically-maximum number of 20,000 contracts (if each of the 4 traders held no more than 5,000 contracts). Incidentally, the concentrated position of the four largest long COMEX traders is a bit over 14,000 contracts or well below the 20,000 contract theoretical limit.

However, it's not that all four of the big COMEX silver shorts are over the pending 5000 contract limit. My analysis indicates that only one of those traders, JPMorgan, is substantially over the proposed position limit, with a 15,000 contract net short position. This brings in the second key to position limits, namely, what exemptions are granted by the regulators to permit bona fide hedgers to hold more than the 5000 contract speculative limit. Of course, JPMorgan has and will claim that its short silver position is not speculative, but is strictly for hedging purposes for clients. That's what they always claim, no matter the actual circumstances. I know JPMorgan is lying, but it's not up to me; it's up to the regulators to decide if JPM is lying. That's why I am not inclined to great enthusiasm about the prospects for position limits ending the silver manipulation forthwith. The CFTC has indicated no zeal to butt heads with JPMorgan (or the CME) on any issue. Maybe it's because of the Working Group connection I've recently written about, but whatever the reason, the Commission hasn't stood up to JPMorgan like they should. As I said, I hope I'm wrong and the agency does the right thing in cracking down on JPM, but given

developments to date, I'm not holding my breath.

The scandal at PFG is another black-eye for the futures industry and, worse, appears to have resulted in more than $200 million in losses to innocent customers of the company. Although I have a background in the futures world going back 40 years and I write about the COMEX and other futures related matters regularly, hopefully readers know that I strongly oppose the use of margin in silver investing. This basically precludes trading in silver futures. In perusing the PFG web site, however, I did see that the company also offered the purchase and storage of precious metals, in addition to futures trading. This prompts me to remind you that you should never, ever, have your metal stored at the dealer you purchased it from. A cardinal rule is to make sure whoever is storing your metals is separate from the dealer you bought from. No exceptions.

Many have been quick to blame the CFTC for the apparent theft and fraud at PFG, even though the Designated Self Regulatory Organization (DSRO) with direct responsibility for auditing PFG was the National Futures Association (NFA). In any scandal where innocent bystanders are suddenly out hundreds of millions of dollars, there is plenty of blame to go around. Ironically, it appears the fraud and theft at PFG was precipitated by regulatory demands for electronic third party verification of customer funds. Why such demands weren't made years earlier is a legitimate question, but no body of law or regulation can completely eliminate criminal behavior. I wish it were different. Still, there are

things we can reflect on as a result of the latest scandal.

Clearly, there is much room for improvement in rooting out financial wrongdoing, even if we recognize that we will never live in a world devoid of fraud and manipulation. I believe one of the keys to beneficial change is doing what we can do where possible, as opposed to concluding it is futile to instigate for change. For me, that means pointing out what's really wrong with the price of silver being manipulated. That's why I persist in labeling JPMorgan as the big silver manipulator and the CME as a criminal enterprise. There's nothing personal about this and I don't wish either organization any harm; it's just a case that they are orchestrating a crime in progress. Since all I can do is explain why that is the case, let me continue to do so.

Every day (even every minute), I never know what to expect in silver. I have strong expectations about the long term prospects for silver, but day to day I don't have a clue. I don't think anyone else does either (except for the manipulators), but I can only speak for myself. While the short term is always uncertain, there are some new factors in place that make short term prognosis more difficult than ever. Mainly, it has to do with a radical change in the price discovery process in silver.

Price discovery is just a fancy economic term for how prices are determined. For

a world commodity, like silver, it is assumed that the price is determined by the sum total of all the producers and other sellers of silver interacting with all the consumers and other buyers in a free market environment. This is at the heart of the law of supply and demand. I think this is still largely true in many world commodities, but I think there has been a radical change in the price discovery process in silver. In essence, the real producers and consumers of silver are no longer determining the price; someone and something else has replaced the real silver producers and consumers in determining the price.

Big trading entities (like JPMorgan) and corrupt trading practices (like High Frequency Trading) on the COMEX have completely superseded the role of real producers and consumers in determining the price of silver. This is what is behind the basically incomprehensible price changes of late in silver and many other commodities. The basic pricing mechanism has been radically altered. No longer does real supply and demand matter to the silver price in the short run; it's all about paper trading on the COMEX. In the past, I have used the analogy that this is like the tail being able to wag the dog. It's simply preposterous and it has turned the pricing of silver on its head.

I wouldn't think of making this statement without substantiation. As usual, we need look no further than recent government data on COMEX silver trading as reported in the COTs. In the previous COT report (for the week ended June 26), the speculators sold and the commercials bought roughly 25 million net ounces

on sharply lower prices. In the current COT (for the week ended July 3), the speculators bought and the commercials sold 27 million oz on sharply higher prices. The coming COT report for positions as of yesterday will undoubtedly again show the speculators selling and the commercials buying on the sharply lower prices thru yesterday. 25 million paper ounces of silver is truly an enormous amount to have changed hands during a week; certainly it is much more than the actual amount of real silver produced and consumed in a week throughout the world (no more than 17.5 million oz).

The first point I would make is that a bigger market will have more impact on price than a smaller market. In silver, the biggest market for the past few weeks was the COMEX, as opposed to the total real world market. I'm not talking about daily trading volumes on the COMEX which were much higher than the COT changes I quoted. I'm talking about the net change in positions between one group of traders (called speculators) and another group called commercials (but who are also speculators) exceeding the quantity of all the silver in the world produced and consumed in that same time. That's so beyond crazy, that I don't have the proper words to fully describe it.

The second point is that because of the quantities of paper silver that changed ownership (as opposed to all trading volume), it is impossible for this to be considered legitimate hedging. Many assume that the commercials are basically hedgers, in contrast to the technical funds and other speculative traders who

are just trying to make a profit in their trading. But the actual COT data show that this can't possibly be considered legitimate hedging. Most of the COMEX commercial positioning in silver over the past few weeks occurred because prices rose or fell a dollar or so. It is impossible for the quantities that were positioned and repositioned to be hedging because real hedgers don't move such large quantities of silver on such relatively small price changes.

This commercial positioning must be identified for what it truly is, namely, part of a speculative paper trading scheme designed to extract as much money from the speculative traders as is possible. Normally, that shouldn't concern anyone aside from the parties involved. But due to the incredible size of the paper quantities involved, this paper trading scheme has morphed into the price determinant for all the real silver produced and consumed in the world. This COMEX paper trading scam has ascended to become the price discovery process in silver. That concerns us all, not just the private club of paper traders involved in the scheme.

The wonder is where the heck the CFTC is while all this is going on? It shouldn't be up to me to point this out; it should be the Commission. Instead of just reporting the data that documents that the futures market tail is wagging the real market dog, it should be that the CFTC would move to end the scam. It would appear that the agency might be side-stepping a critical regulatory responsibility for the reason I have recently concluded illegal allegiance to the

Working Group and not to the public that the Commission has sworn to serve. It's hard to be optimistic about the prospects for legitimate position limit enforcement while the Commission refuses to end the phony paper trading scheme in COMEX silver that is clearly setting prices.

I do intend to continue to expose the corrupt pricing mechanism in COMEX silver, despite my lack of expectation that the CFTC will do anything about it. But there is an intended method to this apparent madness. My intent concerns the perspective of the real silver investor. I think it is better to know what is going on, as opposed to being in the dark. Yes, the crooks at JPMorgan and the CME have the upper hand in the manipulative short term pricing of silver. Yes, the CFTC appears powerless or unwilling to address the manipulation or the perversion of the price discovery process in silver. But all is not lost.

No one controls the long term price of silver indefinitely. If they did, we would never have climbed 12-fold at the price peak. That price is now extremely undervalued as a result of the manipulation and the perverted price discovery process. As has been the case for the past ten years or so, in addition to all of this having created an extremely attractive investment opportunity for silver, I think my allegations of the perverted price discovery process in silver will have to be addressed by the Commission in time. I say that having been amazed at how JPMorgan and the CME have remained so mute in the face of private and public allegations that they are breaking the law in silver. I wouldn't have

expected that in a million years.

Ted Butler

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Silver – $27

Gold – $1572