July 24, 2013 – Market Dominance

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In the weekly review, I referenced several news stories about JPMorgan. A few hours after publishing that report, another big news story made the scene Â? a comprehensive front page story in Sunday's New York Times concerning the big banks and base metal warehouse shenanigans. In a nutshell, the story alleged that giant financial firms, like Goldman Sachs and JPMorgan, had amassed vast holding of metals warehouses and then engaged in schemes involving artificial metal movements for personal profit (at the expense of the consumer and user communities). http://www.nytimes.com/2013/07/21/business/a-shuffle-of-aluminum-but-to-banks-pure-gold.html?_r=0

This story was followed by news of senate committee hearings yesterday and CFTC interest in the warehousing issue and more commentary about the Federal Reserve having doubts about whether the big banks should be allowed to deal in physical commodities. http://www.nytimes.com/2013/07/24/business/senate-panel-examines-potential-risks-in-big-banks-involvement-in-commodities.html?_r=0 This issue is potentially as important as it gets. And it certainly begs the question I have asked repeatedly – why in the world should big banks be dealing in physical or derivatives on commodities in the first place?

Over the past few years, much has been written and discussed about the Volcker Rule that would outlaw proprietary trading by commercial banks. http://en.wikipedia.org/wiki/Volcker_Rule The main purpose of the proposed rule was to end the risks to the financial system caused by reckless speculation by banks backed by insured deposits that were deemed too big to fail. The idea of the Volcker Rule is to get the big banks out of proprietary trading and eliminate any need for taxpayer bailouts for big bets gone wrong. While the big banks have held the Volcker Rule at bay and prevented its enactment to date, it occurred to me that there is an even more compelling reason why these banks, and especially JPMorgan, should not be allowed to trade commodities for their own accounts. Potential risk is one thing; clear and present damage is another.

Quite apart from the potential risk that taxpayers may have to bail out a big bank on the wrong end of a speculative bet, there is clear proof of a greater actual damage that is occurring today. We are all suffering presently and mightily because of how JPMorgan and others conduct their proprietary trading in commodities. These big banks are not interested in trading commodities like any other market participant; instead their modus operandi is not just to trade in, but to dominate markets. This is my key point Â? JPMorgan's intent and culture is to be the leader, to be number one, in any business activity in which it is involved. Being number one and dominating a particular business space may be fine in activities like investment banking and issuing credit cards, but the problem with this intent in commodity markets is that market dominance equals price control and manipulation.

There is no justification for there to be market dominance in any commodity market. In fact, this is the whole point in having commodity law and a commodity regulator, namely, to prevent dominance by any one entity. I've used the word Â?concentrationÂ? endlessly and that's just another word for dominance. If you allow concentrated holdings and little real competition, you invite price-fixing. This is the problem with the concentrated ownership of metal warehouses, but it is even a bigger problem in our regulated futures markets, where concentration and market dominance are verifiable.

The enactment of legitimate speculative position limits would eliminate and prevent concentration and market dominance (as I've advocated for decades) and it should be no secret that those who hold concentrated and market dominant positions, like JPMorgan, have killed any prospect of legitimate position limits ever coming into existence. If you held a dominant market position that enabled you to control prices and your own profits, wouldn't you fight to keep that control?

Let's face it Â? if I'm going to accuse JPMorgan of concentration and market dominance (and, therefore, of manipulation), I'd better be specific and accurate. In the past, I've pointed out JPMorgan's concentrated short position in COMEX silver futures which had reached over 40% of the total net open interest a few years back. Back then, CFTC Commissioner Bart Chilton verified my findings publicly, but has since retreated from his past statements. So let me update my COMEX silver concentration findings and include specific data on COMEX gold.

In the CFTC's Commitments of Traders (COT) and Bank Participation Reports of February 5, my analysis indicates that JPMorgan held a net short position of 35,000 contracts in COMEX silver futures. Once 50,000 spread positions are removed from the total open interest of 151,512 contracts (to arrive at true net open interest), JPMorgan held 34.5% of the short side of COMEX silver on Feb 5, little real reduction from the 40% that Commissioner Chilton confirmed years before.

Please allow me to state the obvious Â? JPMorgan held a manipulative share of the silver market on Feb 5 and that controlling and dominant market share was primarily responsible for the fall in silver prices from $32 on that date to a recent low of $18 and change. For those keeping score, JPMorgan's historic rigging of the silver price lower enabled the bank to reduce its share on the short side to less than 15% of total current COMEX net open interest. Certainly if I am misstating anything, I call on the CFTC or JPMorgan (or anyone else) to correct the record.

I've been writing a lot about JPMorgan's COMEX gold position recently and I thought it might be instructive to talk about the bank's concentrated and dominant market share of that market. On February 5, JPMorgan was net short around 50,000 COMEX gold contracts, with the price of gold at $1670. After removing approximately 70,000 spread positions from total gold open interest of 423,982 contracts on that date, there was a true net open interest on Feb 5 of 354,000 contracts. Therefore, JPMorgan short position of 50,000 contracts (or more) made up 14% of the entire short side of COMEX gold futures on a true net basis on Feb 5.

A 14% share of a market may not sound like much after I just stated that JPMorgan had held a 34.5% share of the silver market on Feb 5, but silver is very special when it comes to being manipulated in both level of degree and longevity. It would be a mistake to underemphasize the significance of a 14% net market share in any regulated futures market, especially one as large as COMEX gold futures with a total notional value of more than $50 billion. Let me return to the significance of such large percentages of concentration and market share dominance in a moment. First, let's look at JPMorgan's current long COMEX gold position.

Based upon the most recent COT report, as of July 16, I estimate JPMorgan's net long position in COMEX gold futures to be 75,000 contracts. After subtracting 77,000 spread positions from total open interest of 440,283 contracts, true net open interest in COMEX gold futures is just over 363,000 contracts. Therefore, JPMorgan's 75,000 contract net long position represents more than 20% of the entire COMEX gold futures market on the long side. First, JPMorgan had a 14% market share on the short side and now they flipped that into a 20% share of the long side, as a result of JPMorgan manipulating the price of gold nearly $500 lower. These are extraordinary and dominant market shares and unprecedented price rigs to the downside. To not see them as cause and effect is to miss the obvious.

To get a perspective of market shares of 34.5%, 14% and 20%, you must measure them against some objective barometer. I would suggest using the CFTC's own formula for position limits as the barometer. The formula (10% of the first 25,000 of open interest, plus 2.5% of the remaining open interest) would call for a position limit in silver of around 5200 contracts in silver, and not the 35,000 contracts held by JPM on Feb 5 or the 14,000 contracts that JPMorgan holds net short now in silver. In gold, the CFTC's formula would call for a position limit of 12,875 contracts and not the 75,000 that JPMorgan holds long now. Expressed in percentage terms, the CFTC's formula in gold would call for any one trader to hold not more than 2.9% of the COMEX gold futures market, yet JPMorgan currently holds 20% on the long side.

If you can remember back three years ago, I was bitterly disappointed when the CFTC devised their formula for position limits. Many thousands of public comments were sent to the Commission at my urging asking that 1500 contracts or 1% (of the entire COMEX market or of total world production) be the proper formula in silver. http://www.investmentrarities.com/ted_butler_comentary09-14-10.shtml Not only was the base rate of the formula two and a half times greater than the proper 1%, adding the much larger 10% provision on the first 25,000 contracts of open interest, artificially raised the effective rate to 5% for smaller open interest markets like silver. By the way, this provision was provided by the CME Group and was readily accepted by the CFTC.

As it turned out, I should have saved my disappointment for the eventuality that even the much larger 5% position limit in silver was too restrictive for the CME and JPMorgan. As it turned out, the enactment of position limits approved by the CFTC in conjunction with the Dodd-Frank Act was disallowed after legal action sponsored by JPMorgan. Now you know why we don't have position limits Â? because it would limit JPMorgan's manipulative hold on the market.

But by being specific and clear, I am hopeful that the current scrutiny being placed upon the big banks for their dealings in commodities might focus on the real issue Â? market dominance. This is the key issue and it has gone unstated until now. According to the CFTC's own proposed formula, no one trader should hold more than 3% in COMEX gold futures, yet JPMorgan holds 20% currently. Why is that allowed? Years ago, the CFTC was successful in alleging manipulation in the copper market by a trader from Sumitomo called Â?Mr. 5%Â? for his share of the market. What should we call JPMorgan – Â?Sir 20%Â? or Â?Your Highness 34.5%Â??

The important point is that my analysis is based upon publicly available data from the CFTC. That data indicate that JPMorgan holds an unnaturally large and dominant share of the gold and silver markets based upon any objective measure. Of course, a 20% or larger market share is not unnatural from JPMorgan's perspective or culture and, quite frankly, that is the problem. JPMorgan is only doing in the commodities market what it does in its other lines of business. But what it does elsewhere is manipulation in the commodities market.

Some may question whether I should even raise the issue of JPMorgan holding such a large concentrated and dominant long position in COMEX gold for fear its forced disposal might pressure gold prices. I understand those concerns, but as an analyst it would be dishonest for me to remain silent in the face of such compelling evidence of wrongdoing by this crooked bank. Besides, the chances of any immediate action by the CFTC are remote. Still, it would be far better to remove JPMorgan as the dominant participant in the commodities market and eliminate their incentive for continued commodity manipulation. Certainly, I shouldn't have to be the one to urge the CFTC to do the job they swore to do, particularly when the proof of market dominance and control is contained in their own publications.

Finally, there continues to be an outburst of what I feel are misleading reports from within the precious metals Internet community. Some of the reports, from declining gold inventories on the COMEX, to stories about lease rates and backwardation in gold, to predictions of COMEX default or sudden changes in contract delivery terms, have my head spinning. Look, I'm bullish about the price prospects for gold and silver based upon the market structure and the fact that the silver cost of production is above current prices, but that's no excuse for spreading false information. The level of COMEX inventories has little to do with a contract default. What would matter more would be short contract holders refusing to buy back or roll over positions in the spot delivery month.

A delivery default would kill the COMEX and it would be a self-inflicted fatality. The CME knows better than anyone what the consequences of a delivery default would be and they would take any measure necessary to prevent it, especially now that JPMorgan is massively long COMEX gold. The same goes for suggestions that the exchange would suddenly and unilaterally alter basic contract delivery requirements or institute a cash settlement. The term, futures contract, means there are rigid contractual requirements which can't be suddenly abrogated without that being considered a legal default.

I suppose the CME could introduce new futures contracts voiding the physical delivery obligations of the current contracts, but that would take years and no one would deal in such phony contracts anyway. The one thing that gives COMEX metal contracts legitimacy is the ability to convert futures contracts into actual metal via delivery. The chance of the CME initiating a contract default in gold or silver, regardless of what warehouse inventories may be, are about as good as me stepping ahead of the new royal baby in future UK succession plans for the throne. And I have to add that I don't understand any of the current discussion of gold lease rates (and I am very familiar with metals leasing), for the simple reason that none of them make any sense. Let me be the first to say it Â? for a wide variety of reasons, GOFO is goofy.

Instead, as I indicated on Saturday, one market participant, JPMorgan, determines what will happen price-wise in gold and silver (and other commodities). This is a crooked bank that has no business controlling the gold and silver markets by its easy to document dominant market position. It's encouraging that there is wide discussion on the unnatural control that big banks have on LME metal warehouses and that the Fed is reconsidering the wisdom of allowing banks to deal in physical commodities. But the most obvious danger of all is allowing JPMorgan to hold dominant market shares in regulated futures markets.

Ted Butler

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Silver – $20.05

Gold – $1318

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