The Illusion of Owning Gold

May 6, 2020 **By Nick Barisheff**

Gold-backed exchange-traded funds (ETFs) and similar products account for a significant part of the gold market, with institutional and individual investors using them to implement many of their investment strategies without considering the true risk associated with many aspects of holding non-tangible assets. Gold ETFs are units representing physical gold in paper or dematerialized form, which is very different from owning physical gold. According to the World Gold Council, global gold-backed ETFs added 298 tonnes, or US$23 billion, across all regions in the first quarter of 2020[1]. Total ETF holdings amounted to 3,296 tonnes, representing US$179 billion. The largest ETF is SPDR Gold Shares (GLD) with 1,048 tonnes.

Many investors and financial advisors may be surprised to learn that owning shares in a gold ETF is not the same as owning physical gold. As one of the largest ETFs, GLD states in its prospectus: "…designed to track the price of gold." Is it wise to choose convenience over holding physical gold?

Since their introduction in 2003, gold-backed ETFs have transformed the gold investment market into an illusion, diverting attention from ownership of physical gold. This is like a magician that has you focused on a distraction while they perform a trick.

When you buy a physical asset, such as real estate, a car or a boat, a great deal of effort is made to ensure that legal title to the asset is transferred to the buyer. This generally involves a specific description of the asset – the make, model, colour and serial number, in the case of a car. In addition, the seller typically warrants that they have free and clear title, that there are no encumbrances and that they have the legal right to convey title to the buyer.

Surprisingly, when it comes to acquiring gold, investors tend to ignore these basic fundamentals and instead focus on the storage costs and management fees; they don't give a second thought to actual legal ownership. What good is it to save money on the storage costs if you don't have legal title to the gold? Many gold transactions, such as futures contracts, certificates, and ETFs, are nothing more than paper proxies or derivatives of gold. They do not represent legal ownership of gold. These proxies may work as planned during normal market conditions but may fail under stress, when investors need the safe haven of bullion the most. I have always said that if you aren't paying reasonable insured storage fees for allocated bullion, then in all likelihood you don't own any gold at all.

[1] https://www.gold.org/goldhub/data/global-gold-backed-etf-holdings-and-flows

For example, if we were to place a bet on tomorrow's gold price, and we agreed to settle in currency, then we wouldn't need any actual gold as long as each of us had the ability to pay if he/she lost the bet. However, this isn't an investment, and is totally dependent on the credit worthiness of the counterparty. It defeats one of the most important attributes of allocated bullion – **NO COUNTERPARTY RISK.**

ETFs have significant counterparty risk on many levels

In the marketing materials of the GLD ETF, the first thing to note is that it is referred to as a "**Tracking Vehicle**." There is nothing mentioned about owning gold. On the GLD website, it clearly sets out the objective of the Trust. Unlike physical gold, ETFs have counterparty risk, because there's a possibility that the other parties, such as the Authorized Participant (AP), the trustee or others, may default or fail to uphold their part of the agreement.

I have spent many years with lawyers, drafting prospectuses and legal agreements. As everyone can appreciate, lawyers are always careful and precise with the specific language in all legal documents. As a result, it is important for each investor to carefully read all the documents associated with a transaction in order to understand the objectives of the ETF.

Pay strict attention to the wording in the Regulatory Documents

With the recent increased popularity of ETFs, many investors assume they are like open-end mutual funds, but with much lower management fees. They never question why the fees are lower; they simply assume that Wall Street has become generous and wants to provide cost savings to public investors.

In an open-end mutual fund trust, such as the BMG mutual funds, the fund manager receives the investor's contributions and then purchases the appropriate bullion according to the mandate of the fund. Similar to a stock transaction, the Custodian (Scotiabank, in BMG's case) issues a Trade Record Sheet, specifying the bar being transferred to the fund by refiner, serial number, exact weight and purity to three decimal places. Every month, the Custodian provides a list of bars held in custody for each fund by refiner, serial number, exact weight and purity. This monthly document is signed by an officer of the bank and is posted on the BMG Group Inc. website.

The holdings are audited annually by the BMG Funds' independent auditors (RSM Canada LLP).

While open-end funds have to incur a number of expenses, as mandated by regulatory authorities, the investors will benefit from the economies of scale in both purchasing the bullion and storing the bullion on a fully insured basis, as well as the reduced legal and accounting costs.

The process for ETFs is entirely different. The first important distinction is that ETFs are not subject to conventional securities laws. They use a "**Registration Statement**" instead of a "**Prospectus**" and, as a result, are not subject to the same regulations as open-end mutual fund trusts. According to a Solari Special Report by Catherine Austin Fitts, president of Solari, Inc.,

the publisher of The Solari Report and managing member of Solari Investment Advisory Services, LLC, on the GLD and SLV[2], the term "exchange-traded fund" is not a precise legal term defined by statute, as is an "Investment Company," of which mutual funds are a subcategory. Both hedge funds and ETFs, at least under current law, are investment vehicles created for the express purpose of avoiding some or all of the regulation under securities laws that apply to investment companies and traditional stocks. ETF investors have limited voting power, including the ability to remove management. The Trustee's and Custodian's limited responsibilities are set out at the creation of the trust and execution of the custodial agreement, with no mechanism to change those responsibilities in the event of change, and no direct accountability to investors.

CUSTODIANS OF THE GOLD AND SILVER IN AN ETF

Concerns have been raised by numerous analysts over the Custodians in the GLD and SLV ETFs – HSBC Bank (HSBC) and JPMorgan Chase (JPM). Both HSBC and JPM, while holding 1,080 tonnes in gold and almost 9,500 tonnes in silver (December 2009), held significant over-the-counter derivatives in both gold and silver, and significant short positions in both gold and silver, on the COMEX. According to the Commitment of Traders Report (CFTC), between them, HSBC and JPM are short more than 30% of the entire COMEX silver market on a net basis, with JPM holding the vast majority of these short positions. Moreover, both banks have been fined by regulators and have class action lawsuits pending against them for manipulating the gold and silver markets, bond rigging, LIBOR rigging, rigging commodity markets and mortgage securities fraud[3].

Both banks have been fined various times by multiple institutions such as the Federal Trade Commission (FTC) for manipulating these markets, for fraud, for money laundering, and for helping Americans evade taxes. (HSBC 's Rising Legal Liability and JPMorgan Faces Potential Class Action Lawsuit)

In addition to the ethical concerns about the Custodians for the GLD and SLV ETFs, neither the Trustee, Manager or Custodian assumes any responsibility for the quality of gold and silver delivered to the ETF in question. There is no requirement for the sub-custodians to be London Bullion Market Association (LBMA) members. There is no assurance that the bullion is legally mined and meets Responsible Investment Association (RIA) standards. The importance of this is that gold normally held by LBMA members in LBMA member- vaults will maintain its Chain of Integrity. This means that every Good Delivery bar is tracked from the mine, the transportation company, the refiner and the vault. If gold is removed from this chain of integrity, there can be no assurance that it is pure gold or that it meets Good Delivery Standards. In the past, investors have been swindled into buying gold-plated tungsten bars when no chain of integrity was in place.

Elemental Gold was initially rated as an LBMA-qualified refiner but lost that status when a money-laundering investigation was launched by the Financial Crimes Enforcement Network

[2]https://home.solari.com/wp-content/uploads/2010/Disclosure_in_the_Precious_Metals_Puzzle_Palace.pdf
[3] https://www.forbes.com/sites/francescoppola/2016/02/28/hsbcs-catalog-of-lawsuits/#1151570657fc

(FinCEN). Elemental Gold was accused of selling illegally mined gold that did not meet LBMA standards[4].

Instead of "**Buying**" or "**Acquiring**" assets, ETFs use Authorized Participants to "**contribute**" "**baskets**" of securities, as defined in the Registration Statement. Authorized Participants are typically the largest brokerage houses and must be members of the Depository Trust Corporation (DTC). As a result, even institutions or pension funds cannot redeem in physical if they are ETF shareholders unless they are also members of the DTC and have entered into an Authorized Participant Agreement. According to the prospectus, APs **"assemble"** the securities to form the baskets.

Why do they use the word "assemble" instead of "purchase" or "acquire"?

How do they "assemble" the baskets?

According to Catherine Austin Fitts, *"**Underlying documents may permit Authorized Participants to contribute (or at least not expressly prohibit them from contributing) to the ETFs' gold and silver leased from central banks instead of precious metals to which Authorized Participants hold absolute legal title.**"*

In addition, a report written by Deloitte & Touche LLP entitled *"Exchange Traded Funds – Challenging the Dominance of Mutual Funds"* described how baskets are created and redeemed.

> ***'The "creation of units" is the daily operational process that is utilized by APs to create ETF units. A portfolio composition file, created by the sponsor, lists the composition and weights of the underlying securities or commodities that mirror the target index. APs then buy or borrow relatively large amounts of the underlying stocks from the capital markets that would mirror the index. If the proposed ETF tracks a commodity, it buys or borrows certificates of ownership of that commodity. The basket of securities is delivered to the custodian who verifies that it is an approximate mirror of the index. The AP (if they are the sponsor) then subsequently receives a "creation unit" delivered to their account at the Depository Trust Corporation. The creation unit is broken up into ETF shares, which represent a fraction of the creation unit. The number of ETF shares depends on the NAV of the creation unit — a function of the weights assigned to the underlying securities. In the case of commodities, the sponsor will usually have a formula to calculate the NAV. Because this is "in-kind" barter and no cash changes hands, there are no tax implications.'***

But what is in it for the Authorized Participants?

Investors who think that a major brokerage firm actually buys gold at the prevailing spot price, contributes it to an ETF at Net Asset Value (NAV), is issued Creation Units at NAV and then

[4] https://www.silverdoctors.com/gold/gold-news/what-does-the-elemetal-gold-scandal-say-about-gold-prices/

sells those units to the public at NAV are incredibly naive in their understanding of how Wall Street works.

The APs borrow the assets, contribute them to the ETF, and are issued Creation Units, which they sell to the public. They keep 100% of the money.

In order to understand the inner workings of an ETF, you must consider history and analyze how the first ETFs were established to track an index such as the DOW or the S&P 500. Authorized Participants could always borrow the assets from their clients' margin accounts, and also from hedge fund accounts, where they acted as prime broker. They would then contribute the borrowed assets to the ETF.

Then the APs would be issued Origination Units of the ETF in exchange for the basket of securities. The APs would then sell the ETF units to other clients and **KEEP ALL OF THE MONEY**. They would have an equivalent liability but it would never be called, and most clients wouldn't know that they held broker IOUs in their margin accounts instead of the securities itemized on their statement.

In addition to keeping all of the money from the issuance of new ETF shares, the APs make money every day acting as market makers. They make the arbitrage spread between the NAV and the market price of the ETF units. Only APs have access to both the market data and the NAV, allowing them to make an arbitrage spread during normal market conditions.

Authorized Participants have no specific obligation to purchase and redeem ETF shares in order to minimize the fluctuations in market prices. Under normal conditions, it is profitable to make the arbitrage spread between the market price and the NAV of the ETF shares; however, in a major market decline, bearing in mind that APs are essentially "short" the asset, it is in their best interest to let it decline as much as possible before redeeming, so that covering their short position is the least expensive. That is when ETFs will underperform the market for the underlying assets.

If a client wanted to sell a security that was lent to an ETF, the broker would simply deposit the cash proceeds of the theoretical sale into the client's account. In the meantime, they would have had an interest-free loan of the securities from their client. The client wouldn't be aware that this had happened in his or her brokerage margin account.

What happens if the AP becomes insolvent? The lawyers get rich arguing about who is the true owner of the assets.

It is obviously much more lucrative to get 100% of the investment proceeds than to earn 1.5% in management fees.

Apart from the leased gold and the resulting suppressed gold price, most of the information is disclosed in the GLD documents. In addition to the Registration Statement, the Authorized Participant Agreement must be reviewed to fully understand the operation of the GLD. However, the Authorized Participant Agreement can no longer be found with the GLD documents on EDGAR or the streetTRACKS website. Most surprisingly, the original Registration Statements

filed in August 2005 were 108 pages long; the current Registration Statement is only 34 pages long[5].

If BMG filed a prospectus that was over 70% shorter than the last version filed with the regulators, the chances of approval would be very slim. Moreover, prospectus offerings have strict regulatory guidelines that do not apply to ETFs. Both the original Registration Statement and the Authorized Participant Agreement[6] can be reviewed in the footnotes.

A section of the Registration Statement that is particularly important to review is **Risk Factors** (page seven of the 2005 Original Registration Statement). There are a total of 24 itemized Risk Factors that every prospective investor should study carefully. The noteworthy risk factors are set out below:

> ***"Shareholders do not have the protection associated with ownership in an investment company registered under the Investment Company Act of 1940, or the protections afforded by the Commodity Exchange Act of 1936."*** *Page 9, paragraph 5*
>
> **"Shareholders do not have the rights enjoyed by investors in certain other vehicles (including, for example, the right to bring "oppression" or "derivative" actions)."** In addition, the shares have limited voting and distribution rights; for example, shareholders do not have the right to elect directors and will not receive dividends. *Page 10, paragraphs 6 and 7*
>
> ***"The Trust's gold may be subject to loss, damage, theft or restriction on access."***
>
> ***"The Trust may not have adequate sources of recovery if its gold is lost, damaged, stolen or destroyed and recovery may be limited, even in the event of fraud, to the market value of the gold at the time the fraud is discovered."***
>
> ***"The Trust will not insure its gold."***
>
> ***"In addition, the Custodian and Trustee will not require any direct or indirect subcustodians to be insured or bonded with respect to their custodial activities or in respect of the gold held by them on behalf of the Trust."***
>
> ***"The Custodian is only liable for losses that are the direct result of its own negligence, fraud or willful default in the performance of its duties."*** *Page 11, paragraphs 4, 6, 7, 8*
>
> ***"The Custodian is not liable for acts or omissions of its subcustodians unless the selection of such subcustodians was made negligently or in bad faith."***

[5] https://www.spdrgoldshares.com/media/GLD/file/SPDRGoldTrustProspectus2012.pdf
[6] https://documentcloud.adobe.com/link/review/?uri=urn%3Aaaid%3Ascds%3AUS%3A1323b588-c911-4005-9170-662847735576&pageNum=1

> ***"There are expected to be no written contractual arrangements between subcustodians that hold the Trust's gold and the Trustee or the Custodian."***
>
> ***"Gold Bullion allocated to the Trust in connection with the creation of a basket may not meet London Good Delivery Standards and if a basket is issued against such gold the Trust may suffer a loss."***
>
> ***"If the Trust's gold is lost, damaged, stolen or destroyed under circumstances rendering a party liable to the Trust, the responsible party may not have sufficient resources sufficient to satisfy the Trust's claim."*** *Page 12, paragraphs 2, 3, 4, 12*
>
> "***Because neither the Trustee nor the Custodian oversees or monitors the activities of subcustodians who may hold the Trust's gold, failure by the subcustodians to exercise due care in the safekeeping of the Trust's gold could result in a loss to the trust.***"
>
> "***The Trustee may have no right to visit the premises of any subcustodian for the purposes of examining the Trust's gold or any records maintained by the subcustodian, and no subcustodian will be obliged to cooperate in any review the trustee may wish to conduct of the facilities, procedures, records or creditworthiness of such subcustodian.***"
>
> ***"The ability of the Trustee to take legal action against subcustodians may be limited, which increases the possibility that the Trust may suffer a loss if a subcustodian does not use due care in the safekeeping of the Trust's gold."*** *Page 13, paragraphs 2, 3, 4*
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> ***"The Custodian may not have the right to, and does not have the obligation to, seek recovery of the gold from any subcustodian appointed by a subcustodian."*** *Page 44, paragraph 6*

In the current 2020 Registration Statement for the GLD, some additional Risk Factors were added:

> ***"The liquidity of the Shares may be affected by the withdrawal of Authorized Participants. In the event that one or more Authorized Participants which has substantial interests in the Shares withdraws from participation, the liquidity of the Shares will likely decrease, which could adversely affect the market price of the Shares."*** *Page 9*

How does the withdrawal of an Authorized Participant affect the value of the shares if ownership of the gold was transferred to the ETF?

In contrast, the BMG Funds require that:

- the Custodian, Scotiabank, maintains insurance for all risks except for war, nuclear incident or governmental confiscation;
- Scotiabank cannot appoint subcustodians without prior written approval for the appointment of any subcustodians;

- subcustodians have to comply with National Instrument 81-102 for Canadian Mutual Fund custodians that essentially limits custodians to major chartered banks;
- Scotiabank must exercise a high standard of care in the custody of the Funds' bullion – "at least the same degree as it exercises with respect to its own property of a similar kind";
- Scotiabank delivers to BMG Management Services Inc. (the Fund Manager) a list of bars held in custody for the BMG Funds listing the name of the refiner, the exact weight and the serial number; and
- The Funds' auditors and the Fund Manager are allowed to inspect the holdings upon reasonable notice and verify the physical bars to the bar lists delivered by Scotiabank at the time of purchase.

Under General Investment Risks, the BMG Prospectus sets out the following:

> ***"BMG BullionFund invests only in the purchase of unencumbered physical gold, silver and platinum bullion that is held on an allocated basis. BMG Silver BullionFund invests only in the purchase of unencumbered physical silver bullion that is held on an allocated basis. Each of the BMG Funds has the objective of providing a secure, convenient alternative for investors seeking to hold the physical bullion for capital preservation and long-term appreciation. As a result, the following risk factors are applicable for each BMG Fund."***

In addition, the BMG website states:

> ***"BMG Mutual Funds are all open-end mutual fund trusts that provide a cost-effective and convenient method of owning precious metals bullion without compromising any of the fundamental attributes of bullion, which are: absolute liquidity, no counterparty risk and no reliance on management skills. No derivatives, futures contracts, options or certificates are used in BMG Mutual Funds. BMG Mutual Funds are an ideal way to balance your portfolio with physical gold, silver and platinum bullion."***

In contrast, the important sections of the GLD's Authorized Participant Agreement that one has to pay close attention to have to do with redeeming of ETF units and contributing gold bullion.

When redeeming ETF units, the Authorized Participant Agreement states that it:

> ***"...owns outright or has full legal authority and legal and beneficial right to tender for redemption the Baskets to be redeemed and to receive the entire proceeds of the redemption, and (ii) such Baskets have not been loaned or pledged to another party and are not the subject of a repurchase agreement, securities lending agreement or any other arrangement which would preclude the delivery of such Baskets to the Trustee the third Business Day following the Redemption Order Date."***

The warranties above are what one expects for the transfer of hard assets.

However, when APs contribute bullion, the expected warranties are missing. The Authorized Participant Agreement states that:

> ***"The Authorized Participant represents and warrants on behalf of itself and any party for which it acts that upon delivery of a Creation Basket Deposit to the Trustee in accordance with the terms of the Trust Indenture and this Agreement, the Trust will acquire good and unencumbered title to the Gold which is the subject of such Creation Basket Deposit, free and clear of all pledges, security interests, liens, charges, taxes, a ssessments, encumbrances, equities, claims, options or limitations of any kind or nature, fixed or contingent, and not subject to any adverse claims, including any restriction upon the sale or transfer of all or any part of such Gold which is imposed by any agreement or arrangement entered into by the Authorized Participant or any party for which it is acting in connection with a Purchase Order."***

How can the purchaser warrant to the seller that it will have good title? I can assure you that lawyers charging $1,000 an hour did not simply make a drafting error.

But what are the risks to the investors?

Just as in my earlier example of the bet, ETF investors don't own any bullion. As long as the APs are solvent, the system works. However, if an AP became insolvent, the lawyers would get rich arguing whether the ETF or the actual beneficial owners would be deemed to be the rightful owners. Although we came close to the ETF market blowing up in 2008 when Lehman Brothers, an AP, defaulted, the system and Lehman was bailed out.

While this poses as a serious problem with traditional securities ETFs, it is a much bigger problem when it comes to bullion. In the case of precious metals, as would be the case with the GLD and SLV ETFs, the bullion is leased from central banks by bullion banks acting as APs. The potential problem here is much larger, as with any lease transaction. Title to the asset remains the property of the lessor. The lessee only has a limited right to use the asset and must re-convey it to the lessor[7]. As a result, when a central bank leases gold, it still shows the asset on its balance sheet, even though it has been leased to a bullion bank, and it no longer has physical possession of the bullion.

Again, everything works relatively smoothly during normal market conditions. However, if a bullion bank becomes insolvent, the central bank lessor would demand the return of its bullion from the ETF.

The result could be a total loss for the ETF investors at a time when they would need the wealth preservation attributes of bullion the most. For the sake of saving about 1% on annual management fees, they risk a 100% loss of their capital.

[7] https://www.bis.org/bcbs/cp3/leaseuro.pdf

A similar situation occurred in 2011 with MF Global. Investors were interested in acquiring bullion through commodities futures due to the attractive leverage. Instead of making leveraged profits, most of the investors lost all of their money when MF Global declared bankruptcy in 2011[8].

The conclusion is clear. The public has been misled about the merits and risks of investing in gold and silver using ETFs. GLD has 1,048 tonnes of gold bullion but as a result of its structure, the supply/demand of gold is not affected since the GLD gold is borrowed. In the supply/demand statistics of both GFMS and CPM (reputable precious metals publications), there is no line item that corresponds to the amount of gold that is supposedly held by the GLD. This is because the gold is leased instead of purchased.

This structure has been detrimental to retail investors, institutions and pension funds, as well as to the mining industry. It has only been a lucrative cash flow opportunity for the large brokerage firms who act as Authorized Participants. If an open-end mutual fund held that much gold, or if the gold was held directly, then the price today would be many multiples of the current number.

The supply/demand statistics compiled by both GFMS and CPM were questioned as far back as 1998, when I started the first open-end BMG BullionFund. Frank Veneroso wrote an extensive analytical report called “The 1998 Gold Book Annual.” In it, he meticulously compiled statistics to demonstrate that the amount of leased gold was grossly understated. Accordingly, Veneroso and the Gold Anti-Trust Action Committee (GATA) identified that central banks could report owning over 30,000 tonnes of gold without having to store it in their vaults. The IMF requests that central banks do not exclude leased gold from their reserve assets, which results in no party knowing how much gold in the vaults is leased[9]. As a result, Veneroso concluded that central bank gold leasing had artificially suppressed the full extent of gold demand to the tune of approximately 1,600 tonnes per year, when annual supply was 4,000 tonnes. Central banks were officially on record as owning over 30,000 tonnes, and it is estimated that **at least** 5,000 of the 30,000 tonnes of central bank gold was most likely leased out. His 2003 updates and projections stated that total leased gold was most likely in the range of 10,000 – 16,000 tonnes[10].

The controversy over the amount of total leased gold continues today. Many observers question whether the US has any gold left in Fort Knox. In addition, many question whether China has only 1,600 tonnes when many analysts believe they have in excess of 6,000 tonnes, and their stated objective is to have more than the 8,000 tonnes purportedly held by the US. When China is satisfied that they have enough gold to move away from the US dollar as the reserve currency and announce their true gold holdings, many analysts will wonder where they got the gold, since it has not been accounted for by GFMS or CPM. The only place it could have come from is central banks, including the Federal Reserve, that have leased their gold. The speculation is

[8] https://en.wikipedia.org/wiki/MF_Global
https://fortune.com/2013/11/15/how-mf-globals-missing-1-5-billion-was-lost-and-found/
[9] https://www.gold-eagle.com/article/gold-gata
[10] http://bmg-group.com/doc_bin/manipuation-in-gold-market-and-related-opportunity.pdf

that APs sold gold to China: They redeemed 400-ounce bars from the ETFs and re-assayed them into kilo bars in Switzerland before selling the kilo bars to China.

Despite my criticism, there is a good use for ETFs in investment portfolios. Unlike open-end mutual funds, ETFs offer put and call options. The best use of ETFs is to hedge a portfolio of assets that you have legal title to and own outright by using ETF options. When it comes to bullion, you could acquire ETF puts to hedge your physical precious metal holdings. In addition, you could buy calls to enhance the performance of your bullion holdings.

Finally, let me reiterate: Do not assume that you actually own any bullion or have any legal claim to any bullion when you invest in bullion ETFs.

> ***"Do not invest in something that you do not understand. If you cannot explain the investment opportunity in a few words and in an understandable way, you may need to reconsider the potential investment."*** SEC investor bulletin – August 2012.

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Widely recognized as international bullion expert, Nick has written numerous articles on bullion and current market trends that have been published on various news and business websites. Nick has appeared on BNN, CBC, CNBC and Sun Media, and has been interviewed for countless articles by leading business publications across North America, Europe and Asia. His first book, $10,000 Gold: Why Gold's Inevitable Rise Is the Investor's Safe Haven, was published in the spring of 2013. Every investor who seeks the safety of sound money will benefit from Nick's insights into the portfolio-preserving power of gold.

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