



Americans for Financial Reform
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October 23, 2012

Ms. Elizabeth M. Murray
Secretary
Securities Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Proposed Rule Change to List and Trade Shares of the JPM XF Physical Copper Trust Pursuant to NYSE Arca Equities Rule 8.201; Release No. 34-67075; File No. SR-NYSEArca-2012-28.

Dear Ms. Murphy:

Americans for Financial Reform (“AFR”) appreciates this opportunity to comment on the above-referenced notice of proposed rule change (the “Proposed Rule Change”) by the Securities Exchange Commission (the “Commission”) to list and trade shares of JPM Xr: Physical Copper Trust (“the Trust”), a commodity-based Exchange Traded Fund (“ETF”) linked to copper. The proposed rule change is inconsistent with Section 6(b)(5) of the Securities Exchange Act of 1934 (“Act”), which requires that rules be designed to prevent manipulative acts and protect investors and the public interest. AFR respectfully suggests that the proposed rule change should be denied.

AFR is a coalition of over 250 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups along with prominent independent experts.

The AFL-CIO is the country’s largest labor federation and represents 12.2 million union members. Union-sponsored pension and employee benefit plans hold more than \$480 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in pension plans sponsored by corporate or public sector employers.

Introduction

Exchange traded funds enable investors to trade shares of an entity that are valued in relation to asset prices on a stock exchange. They are touted as transforming physical assets into financial instruments. Unfortunately, the financialization of physical assets through the alchemy of

structured finance can have profound unintended consequences. Financialization also opens the door to serious *intended* consequences through manipulation of price distortions for gain by sponsors who benefit from asymmetrical information regarding market forces. This intent can be present at the inception of the new financialization or can develop over time as the sponsor observes the effect of the ETF on the markets.

The proposed ETF represents a qualitative departure from prior market practices, which poses a clear and inescapable threat to the public interest. It will affect the pricing mechanism for an essential commodity and distort the relationship between supply and demand and prices. It will open the door for manipulation of prices through futures and swaps markets and through corners and squeezes of the underlying physical copper markets.

The proposed ETF is particularly insidious because the shares will be backed by physical assets that, unlike precious metals, have value based on consumption rather than intrinsic value. Precious metals share many attributes of financial instruments. They are commonly held as investments. Copper and similar commodities are valuable based on their use in processes. (“Consumable Commodities”) A physical copper ETF will introduce an entirely new valuation element into the copper market. Its very purpose is to transform copper into an investment asset.

This is exceedingly dangerous, on its face and as a precedent. As prices increase, the shares of an ETF will become more attractive triggering inflows into the fund. Such inflows will require the acquisition of more physical copper, removing supply from the market. Increasing prices should instead trigger an increase in the supply, which will moderate price increases and cyclically reduce the fundamental value of the asset. The same process should occur in reverse in a falling price environment. The ETF will constitute an accelerant of upward and downward price cycles, causing booms and busts.

This increased medium-term volatility constitutes a disruptive force that must be compensated for in fundamental pricing mechanisms. If market participants have to contend with volatility and the uncertainty that it causes, they will require a premium in forward prices. This is a market signal that prices will be rising and will increase spot prices as supply to the market slows if forward prices are high (there is an added incentive to slow deliveries to the market). It also opens the door to manipulation by market participants, such as the sponsors of the funds, who have superior information regarding inflows and outflows and enjoy great proficiency in commodity trading markets.

AFR fully supports the letter (the “Levin Letter”) sent to you by Senator Carl Levin regarding the proposed ETF.¹ The contents of that letter are incorporated herein as if copied in full. Allowing physical copper ETFs will render commodities markets even less transparent and reliable than they already are.

The Proposed ETF

¹ Letter from Senator Carl Levin to Elizabeth Murray, Secretary, Securities and Exchange Committee, dated July 16, 2012.

The proposed ETF would be structured as a trust whose assets are limited to physical copper. New investment in the Trust would be *via* sales of “Creation Units” of 2500 shares each to broker-dealers or other financial institutions constituting “authorized participants” (“APs”). The APs would deliver physical copper to the Trust corresponding to the number of Creation Units.

The APs distribute the shares that comprise the Creation Units on stock exchanges. There, they are traded like shares in an operating company.

To date, financialization of Consumable Commodities has been accomplished using Commodity Index Funds (“CIFs”). Investors on CIFs generally receive total return swaps instead of shares. These swaps replicate ownership, similar to shares. However, there are two major differences between the proposed ETF and CIFs:

- CIF total return swaps are valued based on indices comprised of a market basket of commodity futures prices, rather than referencing a single commodity. Therefore, the price movement of a single commodity is more weakly connected to fund inflows and outflows.
- The sponsors of CIFs are counterparties to the total return swaps. Therefore, they must hedge the price risk embedded in the total return swaps. The best hedge is a portfolio of the same futures that comprise the market basket reflected in the index. Physical holdings are an imperfect hedge. While physical holdings are sometimes used by the sponsors, futures contracts are far more prevalent as hedges. Therefore, on a dollar-for-dollar basis, CIFs represent far less physical holdings.

The proposed ETF is also fundamentally different from precious metals ETFs. Precious metals are intrinsically financial assets. Unlike copper, their value is not a function of their consumption in a commercial process. Financialization of precious metals does not introduce a financial element to the pricing function. The proposed ETF does, as described below.

Effect on Prices

A single commodity, physical asset-backed ETF will have a direct and significant impact on prices of the subject commodity. The ETF will buy and hold the commodity, removing physical supply from the market. It is the equivalent of hoarding.

Furthermore, as prices for the physical commodity rise, incremental investment will be attracted to the ETF. More physical assets will be accumulated increasing the hoarding effect. This will accelerate the upward price move by offsetting increased production in response to the rising price. The supply and demand pricing mechanism will be disrupted as “hoarding” activity generated by the ETF will increase with price rises.

The opposite effect will be triggered in a downward price environment.

The result will be a physical market for copper characterized by volatile boom and bust cycles. This medium term volatility will increase the price risk for producers and consumers of copper,

or, if they hedge the price risk with futures or swaps, the cost of hedging. Volatility increases the cost by increasing the initial margin for the futures or swaps and/or the risk borne by counterparties.

This is not mere conjecture. The price effects of CIFs have been studied extensively. One such study examines the hedging activity of sponsors using futures as hedges for the total return swaps.² Futures expire monthly. In order to maintain a continuous hedge, the sponsor must reverse the expiring futures contracts and replace them with later-maturing futures contracts on a continuous basis (a process referred to in the market as the “roll”). The study examined the five-day period roll period for CIS hedges of the Goldman Sachs Commodity Futures Index over a multi-year period. It found an extremely strong and significant correlation between the roll period in each month with a movement in the forward price curve toward higher prices in the future. Importantly, this bias did not exist for any period in the trading months studied other than the roll.

The forward price curve signals the market that prices will be increasing, decreasing or staying the same. Therefore, the study identifies based price signals that prices will be higher in the future than otherwise would be the case related to the roll. The relatively higher price signal induces changes to the supply of the commodity that are similar to hoarding as suppliers hold onto more of the commodity to take advantage of the apparent rising prices, though no fundamental forces have caused this perception.

The effect of the proposed ETF is far more direct than the effect of the CIF roll. The CIF roll affects prices because it sends a false signal that prices are on the rise relative to fundamentally justified future prices. This induces hoarding behavior and increases in spot prices (as higher prices are required to attract supply that otherwise could be hoarded). The proposed ETF will result in actual withdrawal of supply from rising-price markets, and flooding of supply in decreasing-price markets. It is not a false price signal that has a diminishing effect as prices trend further from legitimate fundamental values. It is an actual change in supply and demand relationships.

Potential for Manipulation

It is very likely that sponsors of Consumable Commodity ETFs and others already have anticipated the price effects of these programs. Even if they have not, they will observe them over time. The sponsors will likely be participants in the futures and swaps markets for the subject commodities. For example, JP Morgan has an extensive commodities trading operation.³ JP Morgan also owns copper warehousing capacity in the United States giving it access to physical supply. If a sponsor knows information regarding ETF inflows and outflows and understands the volatility consequences of changes in the holdings of the ETF, it can trade accordingly. This asymmetrical information will be a potential source of disruption to the markets.

² Frenk, D. and Turbeville, W., “Commodity Index Traders and the Boom Bust Cycle in Commodities Prices,” October 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1945570

³ See <http://www.jpmorgan.com/pages/jpmorgan/investbk/solutions/commodities>.

Furthermore, as pointed out in the Levin Letter, supply in the physical market for copper is exceedingly tight. It has been reported that a squeeze of the market occurred in April of this year as a market participant acquired a large percentage of the supply.⁴ The collective action of investors in the ETF can create a squeeze even without the specific intent to do so. As described in the Levin Letter, this would occur without the knowledge of the major copper exchanges

Conclusion

AFR urges the Commission to deny the proposed rule change related to the proposed Trust.

We hope that the comments set forth above are helpful to the Commission in considering the proposed rule change.

Sincerely,

Americans for Financial Reform

⁴ Eric Onstad, *Copper market expects squeeze, big holding appears*. Reuters, July 2, 2012.

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services

- Home Defender's League
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group

- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Affiliates

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY

- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG

- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET

