United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

July 16, 2012

VIA EMAIL (rule-comments@sec.gov)

Elizabeth M. Murphy
Secretary
Securities and 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:

The purpose of this comment letter is to express concern about a proposed rule change by the NYSE Arca, Inc. ("NYSE Arca") to list and trade shares of JPM XF Physical Copper Trust ("the Trust"), a commodity-based Exchange Traded Fund ("ETF") linked to copper. There is ample evidence that the proposed ETF will disrupt the market supply of copper by removing from the market a substantial percentage of the copper available for immediate delivery. This supply disruption is likely to affect the cash and futures market for copper, increasing volatility and driving up its price to create a bubble and burst cycle. The proposed ETF is unlike any other metal ETF currently listed on the NYSE and would allow speculators to create a squeeze on the market. 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. This letter respectfully suggests that the proposed rule change should be denied.

Exchange Traded Funds. Exchange Traded Funds enable investors to buy and sell shares in the fund on a stock exchange in the same way that investors can use the stock exchange to buy and sell shares in a corporation. ETFs linked to commodities appeared on U.S. stock exchanges for the first time in 2004, when an ETF linked to gold was offered for sale. Today, retail investors and other market participants can use stock exchanges to buy and sell shares in a wide variety of commodity-based ETFs, some of which track broad commodity indexes, others of which track sub-indexes, and some of which reference a single commodity. By buying and selling these shares, commodity-based ETF traders gain exposure to commodity prices without ever having to transact business on a commodity exchange subject to CFTC oversight.

The particular type of ETF addressed in the NYSE Arca proposal is structured as a trust whose assets are limited to a single physical commodity, copper. The ETF's investment objective is to track the spot price of copper, less trust expenses and fees, and provide its shareholders with exposure to changes in the commodity price. The ETF does not sell or redeem individual shares, but instead sells large blocks or "Creation Units," in units of 2,500 shares each, to broker-dealers or other financial institutions known as Authorized Participants (AP). In return, as a condition of the sale, APs are required to deliver to the ETF a specified amount of the physical commodity to support the value of the ETF shares being issued.

APs then sell the individual ETF shares to investors through the stock exchange. If the commodity price increases, the share values increase, and the investors gain; if the price drops, the share values fall, and investors lose. If the fund attracts more investors, the ETF typically sells more creation units (or blocks of shares) and receives additional physical copper deliveries to support those shares; if investments in the fund decrease, the ETF typically reduces its commodity holdings. The copper underlying the ETF may be purchased in cash markets or in commodity futures markets.

Subcommittee Investigations. The Permanent Subcommittee on Investigations, which I chair, has conducted several in-depth investigations into commodity markets, examining how speculation overwhelms normal supply and demand factors and increases prices at the expense of consumers and American businesses.

In 2006, for example, the Subcommittee released a report which found that billions of dollars in commodity index trading on the crude oil market had pushed up futures prices in 2006, caused a corresponding increase in cash prices, and was responsible for an estimated $20 out of the then $70 cost for a barrel of oil.[1] In 2007, the Subcommittee released a report showing how a single hedge fund named Amaranth made huge, speculative trades on the natural gas market using futures on a regulated futures exchange and swaps on an unregulated electronic energy exchange.[2] These trades pushed up futures prices and increased natural gas prices for consumers and American businesses.

In 2009, the Subcommittee released a bipartisan 260-page staff report and held a hearing examining commodity index trading in the wheat market.[3] One key topic was the impact of commodity index-based ETFs on futures contracts and commodity prices. Essentially, the report found that the purchase of wheat futures contracts to support the commodity index financial instruments, including ETFs, swaps, and exchange traded notes, had created a new demand for those futures contracts; had distorted the prices of those futures contracts by overwhelming normal supply and demand factors; had interfered with the convergence of wheat futures and cash prices; and had hurt American businesses and consumers by causing unreliable wheat prices and hedging failures.

In 2011, the Subcommittee held a hearing on excessive speculation in commodity markets and compliance with the Dodd-Frank Act. We studied the rise of commodity index

[1] "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," U.S. Senate Permanent Subcommittee on Investigations Report, S. Prt. 109-65, June 27, 2006.
[2] "Excessive Speculation in the Natural Gas Market," U.S. Senate Permanent Subcommittee on Investigations Report, S. Hrg. 110-235, June 25 and July 9, 2007.
[3] "Excessive Speculation in the Wheat Market," U.S. Senate Permanent Subcommittee on Investigations Report, S. Hrg. 111-155, July 21, 2009.

funds, commodity-related Exchange Traded Products, and the mutual fund industry.[4] Our investigation discovered that these funds had put billions in speculative money into U.S. commodities markets, causing increased price volatility. The investigation indentified the risk posed to the American economy from unstable prices for materials essential to industry, including copper.[5]

In January of this year, the Subcommittee investigated mutual fund speculation in commodity markets. Through our investigation we learned that IRS private letter rulings had allowed mutual funds to use either wholly-owned offshore corporations or financial instruments called "commodity linked notes" to make unrestricted commodities investments, although the law restricts them from deriving no more than 10% of their income from commodity investments. These investment strategies permitted a flood of billions in new speculative commodity investments.[6]

Copper Market Background. The global copper supply comes either from primary production through the extraction and processing of copper ore or from secondary production through the recycling of copper scrap.[7] The supply of copper is inelastic,[8] in part because extraction from old mines is declining and new mine projects have encountered delays.[9]

Copper is used in vital industries such as the construction, electrical, and electronics industries.[10] It is used to produce cable and wire used in power transmission and generation and in telecommunication, as well as for pipes used in plumbing and heating.[11] Copper demand comes from fabricators and manufacturers who create these products and copper is used as an end product by consumers throughout the world.

The majority of the copper produced annually is sold though long-term supply contracts. While such contracts specify the amount of copper to be delivered, price is typically not fixed until the time of delivery, exposing market participants to price uncertainty.[12] Copper prices tend to experience wide and unpredictable fluctuations.[13] Producers and consumers participate in

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[4] "Excessive Speculation and Compliance with the Dodd-Frank Act," Opening Statement of Senator Carl Levin before the U.S. Senate Permanent Subcommittee on Investigations, November 3, 2011.
[5] *Id.*
[6] "Compliance with Tax Limits on Mutual Fund Commodity Speculation," Opening Statement of Senator Carl Levin before the U.S. Senate Permanent Subcommittee on Investigations, January 26, 2012.
[7] Amendment No. 5 to SEC Form S-1 Registration Statement for JPM XF Physical Copper Trust, July 12, 2011, at p. 32-34 (hereinafter "Registration Statement").
[8] Inelasticity of supply means that an increase in the global demand for copper cannot be met with a short-term increase in supply.
[9] Registration Statement, at p. 32.
[10] *Id.*, at p. 34.
[11] *Id.*, at p. 31.
[12] SEC Notice of Filing of Proposed Rule Change to List and Trade Shares of the JPM XF Physical Copper Trust; Release No. 34-66816; File No. SR-NYSEArca-2012-28, April 16, 2012, at p. 13 (hereinafter "SEC Notice"); available at http://www.sec.gov/rules/sro/nysearca/2012/34-66816.pdf.
[13] Registration Statement, at p. 14.

copper futures exchanges to hedge against this price instability.[14] Speculators also participate in these exchanges, buying price risk in exchange for potential profit.[15]

The London Metal Exchange ("LME") is the largest and most influential copper futures exchange. "As a result of daily trading [of copper futures contracts on the LME], prices are 'discovered' and published by the LME."[16] The LME's prices are then used by producers and commercial end-users around world as the basis for the contract price for the physical purchase or sale of copper.[17] In addition to the base price, copper has an added "locational premia" based on the supply and demand for copper at the location from which it is supplied.[18]

The LME is the main source of information about the physical demand for and supply of copper, because it has traditionally been a "market of last resort" for producers to sell excess stock and consumers to fill short-term needs for copper beyond the amount for which they have contracted.[19] Copper is sold on the LME through "warrants," or "bearer document[s] evidencing the right of the holder to possession of a specified lot of metal at a specified LME warehouse location."[20] Copper sold on the LME must be Grade A and of an "Acceptable Delivery Brand," a brand registered with the LME.[21]

Disrupting Supply. There is ample evidence that if the ETF shares are listed and traded on the NYSE exchange, the Trust will disrupt the global supply of copper. Although the Trust's registration statement cites that in 2008 there was an estimated 2.47 million metric tons of copper stocks in the global copper market, only 390,000 metric tons of this copper was registered with exchanges.[22] The copper registered with exchanges is part of the small percentage of global refined copper stocks that are "liquid stocks" available for immediate delivery.[23] For example, in 2011, total global copper stocks were 3.515 million metric tons while liquid stocks were only 808,000 metric tons.[24]

Of those "liquid stocks," only a small percentage of physical copper is truly available for purchase by third parties. When one removes from the calculation of "liquid stocks" extra copper held by consumers and producers, stocks that are waiting to pass through customs into importing countries, and stocks on the Shanghai Futures Exchange ("SHFE") which are

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[14] SEC Notice, at p. 14
[15] *Id.*
[16] Registration Statement, at p. 40.
[17] *Id.*
[18] SEC Notice, at p. 25
[19] Registration Statement, at p. 41.
[20] *Id.*, at p. 40-41.
[21] *Id.*, at p. 42.
[22] *Id.*, at p. 20.
[23] *Report on Refined Copper Inventories on the Global Market*, Table 3: "Refined Copper Balance Detail," Bloomsbury Minerals Economics Ltd, October 12, 2011 (hereinafter "BME Report"). Available at http://www.sec.gov/comments/sr-nysearca-2012-28/nysearca201228-5.pdf as Exhibit A of Submitted Comment from Robert B. Bernstein, Vandenberg & Feliu LLC, July 13, 2012, p. 15. Bloomsbury Minerals Economics is a specialized consultancy engaged in base metals market and price analysis, focusing in particular on copper.
[24] BME report, Table 3.

unavailable outside of China, it appears that most of the remaining copper stocks available for immediate delivery are on the LME and Commodity Exchange, Inc. ("COMEX").[25]

Additionally, the proposed EFT will accept and hold only Grade A copper of an "Acceptable Delivery Brand," exactly the type of copper on the LME.[26] Thus, even though the copper held by the Trust will not be held through LME warrants,[27] the set-up of the Trust makes it extremely likely that its copper will be acquired from LME warehouses.

In August 2011, the LME reported that it possessed approximately 464,000 metric tons of copper stocks and the COMEX had about 81,000 short tons (or about 73,500 metric tons), giving them combined approximately 537,500 metric tons of copper stocks.[28] As discussed above, copper supply is inelastic, so even with advance warning about an increase in the demand for copper, supply on these exchanges is not likely to increase. According to the Trust's registration statement, the Trust will acquire 61,800 metric tons of copper to back its initial shares.[29] In addition, on June 22, 2012, NYSE Arca filed a rule proposal to list another copper trust, iShares® Copper Trust, sponsored by BlackRock Asset Management International, Inc., which would also significantly increase the demand for physical copper.[30] If BlackRocks's copper ETF is also approved, it will acquire an initial 121,200 metric tons of copper.[31] Together these Trusts would hold approximately 34% of the stocks of copper available for immediate delivery.[32]

Effecting Price. Removing one third of the available copper stocks undoubtedly will affect and increase the price of copper. If the supply of copper available for immediate delivery drops by about 34%, it naturally follows that the price of copper will rise. As the price of copper in the market rises, demand for shares of the Trust will likely increase as well, leading the Trust to create more shares, removing even more copper from the market and further decreasing the liquid supply. This artificial supply and demand pattern is likely to create a boom and bust cycle, as speculators enter and leave the market.

The Trust itself warns that "[b]ecause there is no limit on the amount of copper that the Trust may acquire, the Trust, as it grows, may have an impact on supply and demand for copper that ultimately may affect the price of the shares in a manner unrelated to other factors affecting the global markets for copper."[33]

Moreover, according to the Trust's registration statement, "[p]urchasing activity in the copper market associated with the purchase of Creation Units from the Trust or selling activity

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[25] *Id.* The Commodity Exchange, Inc., or COMEX, is a division of the New York Mercantile Exchange.
[26] Registration Statement, at p. 44.
[27] Registration Statement, at p. 43.
[28] LME Stock Report, J.P.Morgan, 9:07 AM, August 10, 2011.
[29] Jack Farchy, *JPMorgan copper ETF plan would 'wreck havoc,'* Financial Times, May 24, 2012.
[30] SEC Notice of Filing of Proposed Rule Change to List and Trade Shares of IShares Copper Trust; Release No. 34–67237; File No. SR–NYSEArca–2012–66, June 22, 2012.
[31] Jack Farchy, *JPMorgan copper ETF plan would 'wreck havoc,'* Financial Times, May 24, 2012.
[32] *See* LME Stock Report, J.P.Morgan, 9:07 AM, August 10, 2011; and Jack Farchy, *JPMorgan copper ETF plan would 'wreck havoc,'* Financial Times, May 24, 2012.
[33] Registration Statement, at p. 20.

following the redemption of Creation Units may affect the price of copper . . ."[34] There is nothing to prevent high investor demand from causing an increase in copper prices or a quick drop in demand from driving down copper prices. The risk of a bubble in the copper market creates a corresponding risk that the bubble will eventually burst. When it bursts, investors may dump thousands of metric tons of copper back onto the market, swamping the market and depressing the price, and again impacting the world economy at large.

U.S. Impact. The impact on copper supply and price will be strongest in the United States because it is likely that the ETF's copper will come from LME warehouses in the United States. The Trust will likely acquire its initial copper holdings from the location with the lowest locational premia. In addition, of the countries where the Trust has "initially permitted warehouse locations,"[35] the United States is the country with the lowest locational premia.

Moreover, because of the difficulty and expense of transporting copper,[36] it is likely the Trust will acquire its copper in the same location as where it plans to store the copper. The Trust's registration statement says that "under most circumstances, the Trust will hold most of its copper in the warehouse . . . that is in the cheapest-to-deliver location [with the lowest locational premium]. Therefore, that Trust's storage of copper may ultimately be concentrated in only a few warehouse locations or even a single warehouse location."[37] As discussed above, the United States is likely to be that "cheapest-to-deliver location." Also, most of the copper in LME warehouses in the United States is stored by the Henry Bath Group, a J.P. Morgan affiliate, which has been designated the warehouse keeper for the Trust.[38] The Trust could acquire the copper currently stored by Henry Bath for the LME and have it already located in a Trust-permitted warehouse location without any transportation costs.

As of August 2011, there were only about 257,000 metric tons of copper in LME warehouses in the United States and only about 73,500 metric tons in COMEX warehouses, for a total of about 330,500 metric tons of copper stocks available on exchanges in the United States.[39] The Trust's initial 61,800 metric tons alone would remove about 19% of the U.S. supply of copper available for immediate delivery. If BlackRock's 121,200 metric tons are included, these ETFs would remove over 55% of available U.S. copper stocks from the market.

Unlike Existing ETFs. While the SEC permits U.S. exchange sales of commodity-backed ETFs for gold, silver, platinum, and palladium, these metals and their markets are substantially different than copper. These four permitted metals are the only precious metals that are currently treated as world currencies. For this reason, they are commonly held for investment purposes. As a result there are substantial existing supplies of these metals which could be acquired to back an ETF without affecting the world market price in these metals.

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[34] *Id.*, at p. 28.
[35] SEC Notice, at p. 26.
[36] *Id.*, at p. 11.
[37] Registration Statement, at p. 20.
[38] *Id.*, at p. 2.
[39] LME Stock Report, J.P.Morgan, 9:07 AM, August 10, 2011.

Conversely, copper is not currently held for investment purposes because it is, relative to precious metals, very expensive to store and difficult to transport.[40] Because copper has not been held for investment, there is not the same existing supply of copper for the Trust to acquire to back its ETF. Holding copper for investment purposes will have a significantly greater impact on the copper market than ETFs holding palladium, platinum, silver, or gold had on their respective markets and the broader economy.

Squeezing the Market. If the proposed rule change is approved, it will make the copper market more susceptible to squeezes and corners by speculators. Creating this market condition is inconsistent with Section 6(b)(5)'s requirement that exchange rules be designed to prevent manipulative practices. A squeeze on the copper market is when a lack of supply and excess demand forces the price upward, and a corner is when one party acquires enough copper to be able to manipulate its price. A squeeze on the copper market already purportedly occurred this year in April when one entity took control of up to 90% of the cash contracts and inventory on the LME.[41] The ETF will make the market more susceptible to squeezes, because it could be used by market participants to remove copper from the available supply in order to purposefully artificially inflate the price. Moreover, their activities would go undetected by the LME, which conducts surveillance for dominant market participants, because ETFs are not currently subject to any form of commodity regulations. By holding physical copper rather than LME warrants, the Trust can control more of the available supply of copper without triggering LME reporting or rules.

Section 6(b)(5) requires that NYSE rules be designed to prevent manipulative acts and protect investors and the public interest. The proposed rule change is not designed to prevent manipulative acts. To the contrary, it may encourage such acts. This ETF may allow speculators to squeeze or corner the market in copper. If approved, the ETF is likely to distort the global price of copper, leading to a boom and bust pricing cycle which will hurt manufacturers who rely on this essential industrial product and will ultimately hurt consumers and the larger economy. It is not in the public interest for a new investment instrument to disrupt the delicate balance of supply and demand that sets the price for an essential commodity. The proposed rule change will benefit speculators at the expense of consumers and American businesses. The proposed rule change should be denied.

Thank you for this opportunity to comment on the proposed rule.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations

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[40] Registration Statement, at p. 36-37.

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