The Persistent Power of Finance

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In a move that went contrary to what is expected of regulators, the Securities and Exchange Commission of the US approved in mid-December a controversial JP Morgan-created exchange-traded fund (ETF) backed by physical supplies of copper. The fund will use investor money to buy and hold copper, presumably to earn a profit when prices rise. According to a NASDAQ analysis the investment vehicle will register 6.18 million shares backed by 61,800 metric tonnes of copper in physical form stored in warehouses approved by the London Metal Exchange or located in the Netherlands, Singapore, South Korea, China and the US, and not approved by the LME. With this decision of the SEC, copper joins metals such as gold, silver, platinum, and palladium that are already traded through ETFs. If the JP Morgan proposal goes through so would another ETF proposed by Blackrock titled iShares Copper Trust, which awaits SEC approval.

Copper is a metal much in demand for electricity wiring and various industrial uses that are growth areas in many emerging markets. The result is that copper has been trading in rather tight markets. According to the International Copper Study Group, apparent global usage of copper rose by grew by 5.2 per cent during the the first nine months of 2012 as compared with the corresponding period of 2011, driven largely by a 19 per cent increase in China's apparent usage. China accounted for 43 per cent of world usage over this period. As a result the refined copper balance for the first nine months of 2012 points to a deficit of 594,000 tonnes, which was more than a third of refined copper production with capacity utilised to the extent of 80 per cent. While slowing growth in China may have led to accumulation of inventories, the market is indeed tight. According to the Economist Intelligence Unit, copper will be the strongest performer among metals in 2013, with prices rising by 12 per cent thanks to the supply-demand balance.

Given this context, the SEC's decision has been mired in controversy though taken after a delay of more than two years since JP Morgan first proposed the fund. The fundamental issue is whether the process of buying and holding claims on physical stocks of copper would keep supplies out of a tight market and drive up prices to deliver speculative gains to financial investors. Copper traders and users argue it would. The JP Morgan and Blackrock ETF's together would, in their view, reduce copper available for immediate delivery by about 34 per cent and "wreak havoc" as a result of a "substantial artificially induced rise in near-term copper prices." Complainants include companies such as Southwire, Encore Wire, Luvata and AmRod and a trading house, Red Kite.

The SEC on the other hand has held that since copper held by the fund can be redeemed in three business days against a share purchase, there would be no "meaningful change" in availability. Rather, in its view this provides another route to purchasing copper and thereby increases competition in the market. This argument makes little sense since creating a financial instrument against physical copper is essentially a way of offering one more alternative asset to financial investors interested in profiting from speculation in the copper market. At a time when restrictions on futures trading in commodities have been recommended by the Dodd-

Frank Wall Street Reform and Consumer Protection Act, inducing additional elements of speculation into the market is hardly defensible.

Moreover, the SEC's argument, which suggests that it has bought into JP Morgan's reasoning, flies in the face of facts. Thus, according to the Financial Times, since the launch of physical gold ETFs in the US in 2004, they have collectively acquired $140 billion worth of gold (which is more than what most central banks hold), in the aftermath of which gold prices have risen by 282 per cent. Similarly, a new palladium ETF launched in 2010 acquired 505,000 ounces in two months, which was equivalent to 42 per cent of mine production over the period. The result was that prices rose to a two-year high, forcing even JP Morgan to admit that ETF buying had "crowded out" the market.

Stuart Burns, writing on Seeking Alpha, refers to similar evidence from the aluminium market. According to him: "Financial involvement has distorted the aluminium market so badly that there are officially some 5 million tons and potentially twice that sitting isolated from the market in park-and-ride finance deals. The resulting competition for metal has created premiums for primary ingot over and above the LME price."

In sum, the SEC was not short of evidence to reject JP Morgan's proposal. That it has instead decided to back it points to the influence that finance capital exerts. At the time of the 2008 financial crisis there was enough evidence that it was not because of regulatory failure but in part because of regulatory capture and collusion that matters took the turn they did. The post-crisis debate had raised expectations that this would be corrected. The SEC's decision, along with developments in other markets, is strong evidence that those expectations have been belied.

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