

## **Closing Wall Street's Commodity and Swaps Betting Parlors: Legal Remedies to Combat Needlessly Gambling Up the Price of Crude Oil Beyond What Market Fundamentals Dictate**

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West Texas Intermediate (WTI) is a grade of crude oil that serves as the benchmark for oil pricing in the United States and is the underlying commodity for oil futures contracts on the New York Mercantile Exchange.<sup>1</sup> The price of WTI determines the price of gasoline and other derivative products such as heating oil, and this price has oscillated wildly during the past five years. The WTI spot price (i.e. the price for immediate delivery) was about \$70 per barrel in July 2007, and then it reached a record high of \$145 in July 2008 before falling to a record low of \$30 in December 2008.<sup>2</sup> The price increased to \$75 at the end of July 2009 and reached \$110 in April 2011, decreased to about \$75 in October 2011, and again increased to \$105 in the beginning of April 2012.<sup>3</sup> Even though there was no shutoff of the U.S. supply of foreign oil, the volatility in oil prices between 2007 and today has been exponentially greater than even the oil shocks following the 1973 OPEC oil embargo, the Iranian Revolution, and the Persian Gulf War.<sup>4</sup> Indeed, the Organization of Petroleum Exporting Countries (OPEC) has often increased production over this five-year period to mitigate the wild volatility in crude oil prices.<sup>5</sup> Furthermore, the fundamentals of supply and demand have not only generally remained in equilibrium over these last five years, but the United States has become a net exporter of oil for the first time in more than sixty years.<sup>6</sup>

This volatility in crude oil prices and the attendant rise in gasoline prices threaten the fragile economic recovery in the United States and the rest of the world, raising the specter of a renewed recession with a substantial further increase in unemployment.<sup>7</sup> For example, the increased costs of

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<sup>1</sup> Brent crude oil serves as the benchmark for oil pricing in Europe.

<sup>2</sup> U.S. Energy Information Administration, Cushing, OK WTI Spot Price FOB, <http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RWTC&f=D>.

<sup>3</sup> U.S. Energy Information Administration, *supra* n. 2.

<sup>4</sup> David Frenk et al., Review of Irwin and Sanders 2010 OECD Reports 3 (2010).

<sup>5</sup> See Ali Naimi, *Saudi Arabia will act to lower soaring oil prices*, FIN. TIMES, March 28, 2012, available at <http://www.ft.com/cms/s/0/9e1ccb48-781c-11e1-b237-00144feab49a.html#axzz215C3ltN8>.

<sup>6</sup> Gene Guilford, Statement before the Democratic Steering and Policy Committee of the U.S. House of Representatives, Apr. 4, 2012.

<sup>7</sup> Christine Lagarde, managing director of the International Monetary Fund, has stated that rising energy prices are a greater threat to the worldwide economy than the European sovereign debt crisis. Guy Chazan, *Naimi calls high oil prices 'unjustified'*, FIN. TIMES, March 20, 2012, available at <http://www.ft.com/intl/cms/s/0/f9f8eb00-729e-11e1-9be9-00144feab49a.html#axzz20zrhWHT>. See also Javier Blas, *Soaring crude price threatens recovery*, FIN. TIMES, Feb. 24, 2012, available at <http://www.ft.com/cms/s/0/c198a52a-5f02-11e1-a04d-00144feabdc0.html#axzz209IuO9ej>; *High oil prices threaten global economy, IEA warns*, THE GUARDIAN, Dec. 14, 2011, available at <http://www.guardian.co.uk/business/2011/dec/14/iea-high-oil-prices-global-economy>; Caroline Salas & Steve Matthews, *Fisher, Lockhart Say Rising Oil Prices Threaten U.S. Economic Growth*, BLOOMBERG, Apr. 18, 2011, available at <http://www.bloomberg.com/news/2011-04-18/fed-s-fisher-lockhart-say-rising-oil-prices-threaten-growth.html> (quoting Federal Reserve Bank of Dallas President Richard Fisher: “[Rising oil prices are] a

gasoline, which are a key derivative of crude oil, saps economic demand for consumer goods because consumers spend more on gas and thus have less money to purchase necessities and other consumer items.<sup>8</sup> This, in turn, leads to fewer jobs to produce and distribute such goods, and small businesses will be especially vulnerable to sustained high gas prices because of their limited capital resources.<sup>9</sup>

In short, worldwide changes in crude oil market fundamentals (or perhaps even expectations about threatened disruptions to supply) may be part of the reason for the recent fluctuations in oil prices, but they cannot fully explain the radical oil price oscillations in recent history, especially as global supply has generally met global demand during this time. The recent financialization of crude oil futures and other commodity staples derivatives markets, *i.e.*, rampant betting on the upward direction of these prices, has exacerbated these price swings and has caused the prices of oil and other commodities to remain artificially high. Ending this excessive speculation in commodity futures markets will restore stability to crude oil pricing and facilitate economic growth by allowing commodity producers and consumers to rely on futures markets to hedge their risks effectively.<sup>10</sup> Strong enforcement of rigorous position limits and anti-manipulation rules by the Commodity Futures Trading Commission (CFTC) as directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act and other agencies operating under recent anti-manipulation legislation will curb excessive speculation in the commodities markets. Moreover, efforts by

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double whammy ... as it slows down our economy [and] adds to inflationary pressures.”); Guy Chazan, *Oil’s Rise Threatens Economic Growth*, WALL ST. J., March 1, 2011, available at <http://online.wsj.com/article/SB10001424052748704615504576172071554895928.html>.

See also Mark Cooper, *Excessive Speculation and Oil Price Shock* Recessions: A Case of Wall Street “*Déjà vu* All Over Again” 3-5 (2011); James D. Hamilton, *Historical Oil Shocks* (2011), available at [http://dss.ucsd.edu/~jhamilto/oil\\_history.pdf](http://dss.ucsd.edu/~jhamilto/oil_history.pdf) (detailing the role that oil shocks play as major contributors to recessions).

<sup>8</sup> The estimate in 2011 was that the average household spent \$600 more on gasoline than if excessive speculation had not distorted oil prices. Cooper, *supra* n. 7, at 3-5. In other words, the amount that an American saved from the Congressional payroll tax cut in 2012 goes straight to gas. Gene Guilford, *Connect the dots between Wall Street and the Local Gas Pump* 3 (2012), available at <http://www.scribd.com/doc/94819405/Gene-Guilford-Briefing>.

It is important to note that speculation can drive commodities prices to be too low, which would also be a danger to the worldwide economy. See Robert Rapier, *Cutting Through the Rhetoric on Speculators and Oil Prices*, CONSUMER ENERGY REPORT, Apr. 16, 2012, available at <http://www.consumerenergyreport.com/2012/04/16/cutting-through-the-rhetoric-on-speculators-and-oil-prices/> (“Speculation can drive prices in either direction.”); Gordon Brown & Nicolas Sarkozy, *We Must Address Oil-Market Volatility: Erratic price movements in such an important commodity are cause for alarm*, WALL ST. J., July 8, 2009, available at <http://online.wsj.com/article/SB124699813615707481.html>. (“[W]e as consumers must recognize that abnormally low oil prices, while giving short-term benefits, do long-term damage. They diminish incentives to invest, not only in oil production but also, in our own countries, in energy savings and carbon-free alternatives.”).

<sup>9</sup> Cooper, *supra* n. 7. See also Gene Guilford, Statement before the U.S. House of Representatives Committee on Energy and Commerce Subcommittee for Oversight and Investigations, June 23, 2008 (describing, *inter alia*, the difficulties of consumers and commercial businesses due to excessively high oil prices).

<sup>10</sup> Excessive speculation has also led to volatility in other futures markets, including food staple commodities. See, *e.g.*, PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, *EXCESSIVE SPECULATION IN THE WHEAT MARKET* (June 24, 2009) [hereinafter *WHEAT REPORT*]. The volatility in futures prices for food staples has led to increased hunger and malnutrition throughout the world. See Food and Agricultural Organization of the United Nations, *Experts eye commodities speculation, food price swings*, July 6, 2012, available at <http://www.fao.org/news/story/en/item/150900/icode/> (quoting President Leonel Fernández Reyna of the Dominican Republic: “Financial speculation is exacerbating market fluctuations and this exacerbation is generating uncertainty - this uncontrolled, unregulated exacerbation is provoking a dramatic impact on countries that are net food importers. ... We are not talking about an abstract concept here, we are talking about something that is having a devastating, dramatic and brutal impact on the lives of people.”); Letter from Action Aid USA et al. to President Barack Obama (March 24, 2009), available at <http://www.grassrootsonline.org/news/articles/food-speculation-coalition-letter-president-obama> (letter from 183 human rights and hunger relief organizations regarding the harm of excessive speculation in the food commodities markets on hundreds of millions around the world).

the federal and state governments to ban outright the valueless gambling on crude oil prices may even have a more direct effect on lowering costs in these products to consumers. Decreased excessive speculation will consequently help prevent radically high and wholly unnecessary prices in oil and other commodities and restore those markets to pricing determined by classic market fundamentals. This will in turn help prevent another global recession or worse.

## I. Excessive Speculation Significantly Impacts Oil Prices

The principal functions of commodity futures markets are to serve as a venue for commercial producers and consumers to hedge against price risks and to provide market participants with guidance on fair prices for the immediate delivery of commodities. Because these markets have traditionally operated in accordance with the fundamentals of supply and demand, they serve as “price discovery” mechanisms. That is, the tension between producers and consumers in ensuring fair prices through the futures markets has caused these markets to be determinative of the prices at which the underlying commodities are sold on the spot market. For example, when the producer of oil sells oil, it looks to the futures market price to determine the sale price of the actual commodity. However, as will be shown below, when these markets are overrun by excessive speculation, *i.e.*, too many participants betting on price direction (rather than worrying about fair pricing in commercial sales) without ever taking possession of crude oil, the futures price becomes unmoored from market fundamentals. The unyielding encouragement of betting on price direction in these markets has caused much volatility in the price of oil over the last five years.

### The Role of Futures Markets

Unlike the securities and bond markets, futures markets are not designed to raise capital for or provide lending to business interests. The entire rationale of these markets is to provide vehicles for commercial producers and consumers to ensure against future unpredictable volatility in pricing. Indeed, the classic example of a futures contract begins with the sowing farmer who fears that the prices of his crop will decline by harvest time so that he incurs significant losses. To hedge against that risk, he sells a contract in the futures market that guarantees delivery at a later date for a price that will likely protect the farmer against the feared drop in prices. Likewise, a consumer fears a later rise in prices and purchases a futures contract, which allows the consumer to receive the crop at a later date for a price that will likely protect the consumer against the feared price increase.<sup>11</sup>

The tension between commercial producers ensuring a reasonably high price and consumers trying to achieve a fair low price for the sale and/or purchase of physical commodities through the public transparent hedging process moors these price discovery futures markets to economic fundamentals.<sup>12</sup> This tension thus ensures fair market prices to the ultimate consumers of these commodities. As a result of the tension between consumers and producers seeking fair prices, these markets have provided price discovery in the “spot” (or “cash”) markets.<sup>13</sup> Those selling or buying commodities in the spot markets

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<sup>11</sup> For descriptions and examples of how commercial producers and consumers can hedge against price risk through the commodity futures markets, *see* Commodity Futures Trading Commission, *The Economic Purpose of Futures Markets and How They Work*, <http://www.cftc.gov/ConsumerProtection/EducationCenter/economicpurpose>; NICK BATTLE, *COMMODITY FUTURES & OPTIONS* 5-12 (2d ed. 1995).

<sup>12</sup> *See* 7 U.S.C. § 5(a) (derivatives transactions subject to the Commodity Exchange Act are “affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities.”)

<sup>13</sup> A spot contract is a contract for immediate delivery of a commodity. Commodity Futures Trading Commission, *supra* n. 11.

rely almost exclusively on futures prices to judge amounts to charge or pay for the delivery of a commodity.<sup>14</sup>

Since their creation in the agricultural context many decades ago, it has been widely understood that unless futures markets are properly regulated, they are easily subject to distortion in the economic fundamentals of price discovery (*i.e.* the paying of unnecessarily higher or lower prices) through excessive speculation, *i.e.*, too many participants participating in these markets who do not have any commercial interests and who collectively merely bet on the direction of commodity prices without ever having or taking possession of the underlying commodity.<sup>15</sup> As one disgruntled farmer lamented to the House Agriculture Committee in 1892: “[T]he man who managed or sold or owned those immense wheat fields has not as much to say with the regard to the price of the wheat that some young fellow who stands howling around the Chicago wheat pit could actually sell in a day.”<sup>16</sup>

### The History of Excessive Speculation in the Oil Futures Markets

Speculators have a role to play in the hedging function because they ensure that the futures markets have sufficient liquidity, that is the commodity producer and consumer will always have enough available market participants to close out a contract when needed.<sup>17</sup> In other words, speculators are often needed to ensure that physical hedgers have a ready market where they can find counterparties to buy or sell their futures contracts, even when actual demand for futures contracts among other commercial hedgers is low. However, it is when speculation becomes *excessive* (*i.e.* there is more speculation than necessary to provide commercial hedgers with liquidity) that the market becomes unmoored from the competing tensions between consumers and producers, and it is excessive speculation that the Commodity Exchange Act of 1936<sup>18</sup> banned.

The CEA, enacted in 1936 in a format whose template survives today, authorizes federal commodity regulators to ban excessive speculation in these markets. As a report from the House Agriculture Committee commented in 1935: “The fundamental purpose of [the Commodity Exchange Act] is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which *too often demoralize the markets to the injury of producers and consumers and the exchanges themselves.*”<sup>19</sup> Thus, a chief aim of the CEA was to protect farmers and other futures market participants from the harm that ensues from the excessive speculative activity that leads to unreasonable market prices for commodities.

When President Roosevelt introduced in 1934 what became the CEA, he said: “[I]t should be our national policy to restrict, as far as possible, the use of these exchanges for *purely speculative*

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<sup>14</sup> See Platts, Platts Oil Pricing and MOC Methodology Explained 3 (June 2010), available at <http://russia.platts.com/IM.Platts.Content/InsightAnalysis/IndustrySolutionPapers/moc.pdf>.

<sup>15</sup> Some go as far as to say that excessive speculation not only distorts but destroys the price discovery function of the market. Michael W. Masters, Statement before the Commodity Futures Trading Commission, March 25, 2010.

<sup>16</sup> Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States, 1875-1905*, 111 AM. HISTORICAL REV. 307 (2006) (quoting U.S. House Comm. on Agric., *Fictitious Dealings in Agricultural Products*, 52nd Cong., 3rd sess. (1892)).

<sup>17</sup> See 1 PHILLIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION, § 1.03[4] (2005) [hereinafter DERIVATIVES REGULATION] (differentiating among speculating, investing, and hedging), § 1.03[6] (“Yet it is highly unlikely that the commercial world’s need for futures contracts at any given time will be exactly balanced between long and short contracts. Commodity investors are admitted access to these markets in order to fill the demand for futures contracts even when no commercial firm has an interest in doing so[.]”). See also B.P.N. Am. Petroleum v. Solar ST, 250 F.3d 307, 311 n. 3 (5th Cir. 2001) (defining speculators and hedgers).

<sup>18</sup> 7 U.S.C. §§ 1-27 [hereinafter “CEA”].

<sup>19</sup> H.R. REP. NO. 421, 74th Cong., 1st Sess. 1 (1935) (emphasis added).

operations.”<sup>20</sup> Accordingly, § 4a(a) of the CEA grants the CFTC the authority to set maximum position limits:

*Excessive speculation in any commodity ... causing sudden or unreasonable fluctuations or unwarranted changes in the prices of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, the Commission shall ... fix such limits on the amounts of trading which may be done [relating to] such commodity ... as the Commission finds ... necessary to diminish ... such burden.*<sup>21</sup>

To bolster the language of the statute unequivocally, the House Agriculture Committee stated that the CEA “authorizes the Commission...to fix limitations upon purely speculative trades...”<sup>22</sup> These position limits were historically designed to ensure enough speculation to maintain liquidity in the commodities futures markets but prevent unmooring of market fundamentals due to *excessive* speculation.

The Commodity Exchange Act allows exemptions from position limits for businesses to “hedge their legitimate anticipated business needs.”<sup>23</sup> In other words, businesses are exempted from position limits if they need to enter the futures market in order to protect themselves against adverse movement in prices of commodities that they need to buy or sell. Examples include farmers who need to hedge against a future fall in prices for their crops or airlines that need to hedge against future increases in the price of fuel.

However, the CFTC authorized in 1991 a “bona fide hedging” exemption to the swap dealer, J. Aron and Company, which was owned by the Goldman Sachs Group, Inc. and which had for purposes of the proposed exemption no physical commodity exposure and therefore no legitimate anticipated business need.<sup>24</sup> Nevertheless, this swaps dealer received a bona fide hedging exemption, presumably on the theory that in order to lay off risks from swaps bets that it afforded its customers, *i.e.*, selling to its customers the ability to bet (but not take possession of commodities) on commodity price direction, the swap dealer as the operator of a de facto “casino” has a “commercial” need to buy as many futures contracts as it could to offset its exposure to losses on those bets. In the absence of the exemption, it would have had to limit its customers’ bets to the restrictions of the position limits.

Since 1991, fifteen different investment banks had been granted these staff exemptions,<sup>25</sup> even though the swaps dealer “casinos” had no legitimate anticipated commercial or business need as was anticipated by President Roosevelt and Congress in 1936. The argument for this exemption was that these large institutions needed to hedge their bets in what was until 2010 the unregulated swaps market by investing in futures contracts, and they were secretly and without public notice classified by CFTC staff as commercial traders.<sup>26</sup>

The resulting “swaps loophole” has led swaps dealers, essentially large financial institutions, to take positions in the oil futures (and other commodity staples) markets that are larger than if they had

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<sup>20</sup> Franklin D. Roosevelt, Message to Congress Recommending a Securities Exchange Commission, Feb. 9, 1934, available at <http://www.presidency.ucsb.edu/ws/index.php?pid=14805>.

<sup>21</sup> Pub. L. No. 74-675, ch. 545 at § 5, 49 Stat. 1491, 1492, codified at 7 U.S.C. § 6a(a)(1) (emphasis added). For a discussion regarding the CFTC’s enforcement of position limits in other agricultural commodities and the process of such enforcement, see 1 DERIVATIVES REGULATION, *supra* n. 17 § 2.04[9].

<sup>22</sup> H.R. REP. NO. 421, *supra* n. 19.

<sup>23</sup> Commodity Exchange Act § 4a(c) (codified at 7 U.S.C. 6a(c)).

<sup>24</sup> Bart Stupak, Testimony before the Commodity Futures Trading Commission 5, July 28, 2009, available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing072809\\_stupak.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing072809_stupak.pdf).

<sup>25</sup> *Id.*

<sup>26</sup> Kevin G. Hall & Robert A. Rankin, *Speculation explains more about oil prices than anything else*, MCCLATCHY NEWSPAPERS, May 13, 2011, available at <http://www.mcclatchydc.com/2011/05/13/114190/speculation-explains-more-about.html>

merely bought or sold futures contracts, which would have been subject to speculative position limits.<sup>27</sup> These larger positions lay off the betting risk assumed by large financial institutions through sales to their wealthy customers of commodity index swaps,<sup>28</sup> exchange traded funds,<sup>29</sup> and exchange traded notes,<sup>30</sup> all of which allow investors to bet passively on the direction of a synthetic “basket” of energy and food commodities that are heavily weighted toward crude oil.<sup>31</sup> To make these bets, the customers do not have to own (and most often do not own) the underlying commodities on which they bet.<sup>32</sup> Recognizing the destructive social impact that they have on needlessly raising the price of commodity staples, many swaps dealers have abandoned all or some of these bets.<sup>33</sup>

Passive investors include not only banks but also other institutional investors such as pension funds, endowment funds, and sovereign wealth funds as well as wealthy individual speculators, who in the aggregate account for the largest share of outstanding commodities futures contracts.<sup>34</sup> As swaps

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<sup>27</sup> See Kenneth B. Medlock III & Amy M. Jaffe, *Who Is in the Oil Futures Market and How Has It Changed?* 9 (2009).

<sup>28</sup> A commodity index swap is a “swap whose cash flows are intended to replicate a commodity index.” Commodity Futures Trading Commission, CFTC Glossary: A Guide to the Language of the Futures Industry, <http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm>. In other words, the returns of a commodity index swap are “based upon the performance of a specific index. ... If the value of the commodity index increases, the value of the swap to the purchaser will increase by a corresponding amount.” WHEAT REPORT, *supra* n. 10, at 83.

<sup>29</sup> An exchange traded fund is an investment vehicle holding a commodity or other asset that issues shares that are traded like a stock on a securities exchange. Commodity Futures Trading Commission, *supra* n. 28. These shares hold the various futures contracts whose values are used to compute the index value. WHEAT REPORT, *supra* n. 10, at 86.

<sup>30</sup> An exchange traded note is “designed and sold by banks and other financial institutions to permit retail investors to purchase shares of a debt security whose price is linked to that of a commodity index. Upon maturation of the note, the issuer of the ETN promises to pay the holder of each share of the note the value of [the] commodity index.” *Id.*

<sup>31</sup> See Ke Tang & Wei Xiong, *Index Investment and Financialization of Commodities* (2011), available at <http://www.princeton.edu/~wxiong/papers/commodity.pdf> (“As a result of the financialization process, the price of an individual commodity is no longer simply determined by its supply and demand. Instead, prices are also determined by the aggregate risk appetite for financial assets and investment behavior of diversified commodity index investors.”). See also Cyrus Sanati, *Congress girds for a fight on oil trading*, CNN MONEY, March 26, 2012, available at <http://finance.fortune.cnn.com/2012/03/26/congress-oil-trading/> (“A lot of the speculative money comes from passive investment vehicles, like ETFs and ETNs run by investment management firms like PIMCO. Since those passive funds have a long bias, they tend to skew the market by dampening downswings in the market while augmenting run-ups.”); Michael W. Masters, Statement before the Commodity Futures Trading Commission, Aug. 5, 2009 (describing how investment banks had created commodity investment vehicles that only allowed investors to take long positions).

<sup>32</sup> See, e.g., Altavest Worldwide Trading, Inc., *Futures and Options 101*, <http://www.altavest.com/education/default.aspx> (“When trading futures, you never actually buy or sell anything tangible; you are just contracting to do so at a future date. You are merely taking a buying or selling position as a speculator, expecting to profit from rising or falling prices. You have no intention of making or taking delivery of the commodity you are trading, your only goal is to buy low and sell high, or vice-versa.”).

<sup>33</sup> Javier Blas, *Banks withdraw food commodity funds*, FIN. Times, Aug. 14, 2012, available at <http://www.ft.com/cms/s/0/17a816f4-e62f-11e1-ac5f-00144feab49a.html#axzz23oxFzBVk>. See also *supra* n. 10.

<sup>34</sup> DANIEL YERGIN, *THE QUEST: ENERGY, SECURITY, AND THE REMAKING OF THE MODERN WORLD* c. 8 (2011) (referring to the investment in commodities by the “massive passives”); WHEAT REPORT, *supra* n. 10 at 37 (investments in commodity indexes are “purchased mainly by financial institutions, insurance companies, pension funds, foundations, hedge funds and wealthy individuals[.]”); George Soros, Statement before the US Senate Commerce Committee, June 3, 2008 (explaining the role of institutional investors in inflating the oil price bubble); Michael W. Masters, Statement before the US Senate Committee on Homeland Security and Governmental Affairs, May 20, 2008, available at <http://www.hsgac.senate.gov/imo/media/doc/052008Masters.pdf?attempt=2>.

Leading up to the record high oil prices in 2008, CalPERS (the main public-employee pension fund in California) had invested \$1 billion in commodity index funds believing that “in the coming decades natural

vehicles and offsetting bets made by the “casinos” are now informally recognized as its own class of assets for investment portfolios,<sup>35</sup> the weight of their record volume of long investments in the oil futures markets<sup>36</sup> helps explain the world record price of crude oil of \$147 in July 2008 despite the fact that in 2008, the available supply of crude oil in the United States was at a 20-year high while the demand for crude oil was at a 10-year low.<sup>37</sup>

Again, it must be emphasized that those institutions and wealthy investors speculating through these passive bets are not required to own any commodities<sup>38</sup> and therefore by placing the bets do not otherwise put money into energy or agricultural production. As a report from the OPEC Petroleum Studies Department stated:

[N]ew asset management strategies, financial product innovation, and development of new institutional forms of investing (e.g. index and hedge funds) ... paved the way for greater financialization of the oil industry ... [This has] resulted in greater ... depth in the paper-oil market. These developments ... have given rise to new investment assets that get their reward from price performance of oil futures and derivatives rather than the old-fashioned form of market reward through capital investment into oil exploration and extraction, and the resulting higher production.<sup>39</sup>

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resources are going to be where the action is.” Steven Mufson, *Oil Price Defies Easy Calculation*, WASH. POST., Apr. 11, 2008, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/04/10/AR2008041003778.html>. In 2012, the amount that CalPERS has invested in such assets has increased to \$3.6 billion. John Kemp, *CalPERS fails to make money in commodities*, REUTERS, July 23, 2012, available at <http://www.reuters.com/article/2012/07/23/column-kemp-commodities-pensions-idUSL6E8IN6IK20120723>.

<sup>35</sup> See Robert Pollin & James Heintz, *How Wall Street Speculation is Driving Up Gasoline Prices Today 3* (2011) (describing “energy futures contracts as an alternative to holding stocks, bonds, or other types of derivatives assets, such as mortgage-backed securities”); DANIEL O’SULLIVAN, *PETROMANIA: BLACK GOLD, PAPER BARRELS AND OIL PRICE BUBBLES* (2011) (explaining the process by which oil futures became investment vehicles and the effect of this price on increasing oil prices); Gary Gorton & K. Geert Rouwenhorst, *Facts and Fantasies about Commodity Futures*, 62 FIN. ANALYSTS J. 47 (2006) (“Commodity futures returns have been especially effective in providing diversification of both stock and bond portfolios.”). See also Giulio Cifarelli & Giovanna Paladino, *Oil price dynamics and speculation: A multivariate financial approach*, 32 ENERGY ECONOMICS 363 (2010) (discussing investment strategies that involve purchasing commodities to diversify a portfolio when a trader is bearish on stocks).

Interestingly, there are researchers who have identified commodities such as oil to be speculative instruments based on comparisons to gold. Gold is widely known as a highly speculative commodity with a price that is driven by factors other than demand, and the relationship between the prices of gold and oil were surprisingly close for decades before oil prices started growing at a much higher rate than gold prices in 2002. See Khan, *infra* n. 44; Bennett et al, *infra* n. 100. See also John Baffes & Tassos Haniotis, *Placing the 2006/2008 Commodity Price Boom in Perspective* 28 (2010), available at [http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2010/07/21/000158349\\_20100721110120/Rendered/PDF/WPS5371.pdf](http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2010/07/21/000158349_20100721110120/Rendered/PDF/WPS5371.pdf) (explaining that the financialization of commodities was a role “typically reserved for gold” in the past).

<sup>36</sup> Silla Brush, *Hedge Fund Energy Speculation Highest on Record, CFTC’s Bart Chilton Says*, BLOOMBERG, March 15, 2011, available at <http://www.bloomberg.com/news/2011-03-15/hedge-fund-energy-speculation-highest-on-record-cftc-s-bart-chilton-says.html> (“Hedge funds and other speculators have increased their positions in energy markets by 64% since June 2008 to the highest level on record.”). See also Pollin & Heintz, *supra* n. 35 at 3 (“These traders entered the market with enormous financial resources, enabling them to influence the ups and downs of market prices to an unprecedented degree. To a large extent, these traders are affiliated with major investment banks, such as Goldman Sachs and UBS.”).

<sup>37</sup> Michael Masters, Statement before the U.S. Senate Comm. on Agriculture, Nutrition, and Forestry, June 4, 2009.

<sup>38</sup> See *supra* n. 32.

<sup>39</sup> Ahmad R. Jalali-Naini, *The Impact of Financial Markets on the Price of Oil and Volatility: Developments Since 2007* 9 (2009).

Wall Street banks that issue these investment vehicles hedge against the passive investors' bets by buying long in the corresponding futures markets. Paper contracts are thereby created that call for the making or taking of delivery of commodities that are far in excess of the world inventory of those products. The betting on the upward price direction and the hedging of those bets in the real commercial-oriented futures market by Wall Street banks and large financial institutions sends continuous false "demand" signals to the markets, causing commodity prices to rise and pull spot prices upward as well despite an equilibrium between supply and demand.

The ratio between commercial hedgers and speculators in a futures market is ideally 70:30.<sup>40</sup> Prior to 2002, the average composition of noncommercial speculators in the US oil futures market was 20%, but it rose to about 50% in 2009.<sup>41</sup> Some estimates now place the percentage of these speculators between 70%<sup>42</sup> and 80%<sup>43</sup>. The resulting amount of excessive speculation is reflected by the fact that while about 1 billion barrels are traded in the synthetic oil futures markets per day, only about 85 million barrels of oil are produced in actuality per day.<sup>44</sup> In other words, less than 10 percent of what is traded in the oil futures markets consists of actual oil.

In response to the 2008 financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>45</sup> to improve and protect the nation's financial system. Section 737 of the Act was written with a clear goal of returning to the kind of hard position limits for non-commercial financial institutions originally required by the CEA before the granting of stealth CFTC staff exemptions from them. Section 737 also strengthened position limits to cover not just classic futures markets, but all derivatives markets, including swaps: "[the Commission] shall by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions that may be held by any person[.]"<sup>46</sup>

During the hearings that led to the passage of Dodd-Frank, Senator Dianne Feinstein (D-Calif.) stated that "position limits provide an important restriction on market manipulation and the amount of risk that can build up in any one participant" and that the CFTC would "be able to prevent speculators from assembling massive positions in a particular commodity, such as oil, by assembling large positions in multiple contracts."<sup>47</sup> Furthermore, Rep. Collin Peterson (D-Minn.), then Chairman of the House Committee on Agriculture, stated: "We all remember when we had \$147 oil ... This conference report includes the tools we authorized and the direction to the CFTC to mitigate outrageous price spikes we saw two years ago."<sup>48</sup>

### Observations on the Effect of Excessive Speculation on Oil Prices

While some have debated and denied it, the great weight of independent and reasoned authority find that outsized excessive speculation within the physical derivatives markets has caused unnecessary price volatility in crude oil prices since 2008, which has led to unnecessary and substantial price increases

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<sup>40</sup> See Masters, *supra* n.31, at 5 ("I believe that speculators should ideally be in the range of 25%-35% of open interest."); Dennis Kelleher, *Speculators are driving up gas prices*, CNN MONEY, Mar. 21, 2012, available at <http://money.cnn.com/2012/03/21/markets/oil-gas-prices-speculators/index.htm>.

<sup>41</sup> Medlock & Jaffe, *supra* n. 27, at 5.

<sup>42</sup> Guilford, *supra* n. 8; Joseph P. Kennedy III, Op-Ed., *The High Cost of Gambling Oil*, N.Y. TIMES, Apr. 10, 2012, available at <http://www.nytimes.com/2012/04/11/opinion/ban-pure-speculators-of-oil-futures.html>; Hall & Rankin, *supra* n. 26. Between 1998 and 2008, "[t]he positions of bona fide physical hedgers doubled ... while the positions of speculators rose by 1200%." Masters, *supra* n. 15.

<sup>43</sup> Michael Greenberger, Statement Before House Democratic Steering and Policy Committee 7, Apr. 4, 2012.

<sup>44</sup> Kennedy, *supra* n. 42; Mohsin Khan, *The 2008 Oil Price "Bubble"* 4 (2009).

<sup>45</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010) (hereinafter "Dodd-Frank").

<sup>46</sup> *Id.* at § 737 (emphasis added).

<sup>47</sup> 156 Cong. Rec. S. 2699 (daily ed. Apr. 27, 2010).

<sup>48</sup> 156 Cong. Rec. H. 5245 (daily ed. June 30, 2010).



that consumers pay for everyday crude oil and derivative products, such as gasoline as well as many other energy and food staples.

### *Market Participants*

In March 2011, when the price of crude oil in the spot market was more than \$100 per barrel,<sup>49</sup> the CEO of ExxonMobil testified to the United States Senate Finance Committee that market fundamentals only justified a price of \$60-\$70 per barrel.<sup>50</sup> Around the same time, the chief counsel of Delta Air Lines stated that the marginal cost of oil production on March 22, 2011 was \$60 to \$70, which veered drastically from the WTI price at that time.<sup>51</sup> By October 2011, the \$100-per-barrel bubble in the oil markets had burst, and the price did in fact drop close to the \$70 range.<sup>52</sup>

These appeals from airline and oil companies were not new. In an “open letter to all customers” in 2008, the CEOs of twelve American airline companies wrote that “normal market forces are being dangerously amplified by poorly regulated market speculation.”<sup>53</sup> The CEO of Virgin America, Inc. further labeled the volatile fuel prices “out of control” and “a kind of silent killer.”<sup>54</sup> Many other market participants have stated likewise,<sup>55</sup> including many industry associations.<sup>56</sup> The decreased ability of airlines to use futures markets for price risk management has led some to advise the airline industry to abandon hedging outright and to handle volatile fuel prices with passenger ticket surcharges.<sup>57</sup>

Gene Guilford, the executive director of the Independent Connecticut Petroleum Institute, speaking on behalf of the New England Fuel Institute stated that “we are no longer confident that the markets are doing their job of providing our industry and consumers with a benchmark for pricing product that is based on economic dynamics of supply and demand, and they no longer function as a risk management tool. They have become completely disconnected from reality.”<sup>58</sup> When the price of crude oil reached \$139 in June 2008, he noted that the amount of crude oil traded in the markets that day was 53

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<sup>49</sup> U.S. Energy Information Administration, *supra* n. 2.

<sup>50</sup> Robert Lenzner, *ExxonMobil CEO Says Oil Price Should Be \$60 To \$70 A Barrel*, FORBES, May 14, 2011, <http://www.forbes.com/sites/robertlenzner/2011/05/14/exxon-mobil-ceo-says-oil-price-should-be-60-70-a-barrel/>. Executives from Royal Dutch Shell, Marathon Oil, and the Inland Oil Company also testified that speculation was to blame for rising oil prices in 2008. 154 Cong. Rec. S. 7102 (daily ed. July 23, 2008).

<sup>51</sup> Jim Spencer & Dee DePass, *As we pay more at the pump, oil trading curbs still on hold*, STAR TRIBUNE, March 20, 2011, available at <http://www.startribune.com/business/118268059.html?refer=y> (quoting Ben Hirst, Chief Counsel, Delta Air Lines: “[S]peculators try to anticipate what other speculators are going to do, and the market overreacts. It’s not as though there’s a shortage of product that caused the price to move up. It’s a casino process with financial players betting on where the price is going to go. But it has an effect on prices.”).

<sup>52</sup> U.S. Energy Information Administration, *supra* n. 2.

<sup>53</sup> *An Open Letter to All Airline Customers*, CNBC, July 9, 2008, available at <http://www.cnbc.com/id/25613293/An-Open-Letter-to-All-Airline-Customers>; David Goldman, *Airlines: Curb oil speculation*, CNN MONEY, July 9, 2008, available at [http://money.cnn.com/2008/07/09/news/companies/airlines\\_speculation\\_letter/](http://money.cnn.com/2008/07/09/news/companies/airlines_speculation_letter/).

<sup>54</sup> Mary Jane Credeur et al., *United, Delta Profit At Risk On ‘Silent Killer’ Hedges*, BLOOMBERG, Jan. 31, 2011, available at <http://www.bloomberg.com/news/2011-01-31/united-delta-profit-at-risk-from-silent-killer-in-fuel-hedges.html>.

<sup>55</sup> Roger Diwan, Statement before the U.S. House Committee on Energy and Commerce Subcommittee on Oversight and Investigations, June 23, 2008 (stating that if regulatory changes are adopted, “it’s clear that prices will reflect closer to the marginal cost of producing oil”); Edward Krapels, Statement before the U.S. House Committee on Energy and Commerce Subcommittee on Oversight and Investigations, June 23, 2008 (“I think the amount of speculation is really substantial [within the crude oil market.]”).

<sup>56</sup> Joint Letter from Airlines for America et al. to Gary Gensler, Chairman of the Commodity Futures Trading Commission, March 19, 2012, available at [http://images.politico.com/global/2012/03/120320\\_eemac.html](http://images.politico.com/global/2012/03/120320_eemac.html).

<sup>57</sup> Credeur, *supra* n. 54.

<sup>58</sup> Guilford, *supra* n. 9.

times daily US consumption.<sup>59</sup> During the wild swings in crude oil prices since that time, there was continuous ample supply to meet the demand for oil.<sup>60</sup> Guilford later presented the situation in heating oil during the winter of 2011-2012 to describe plainly the effects of excessive speculation in a commodities market: during a most unseasonably warm winter when the volume of heating oil sold by retailers was about one-thirds less than normal, the commodity cost of heating oil was \$3.22 per gallon,<sup>61</sup> which was close to the record high of \$3.71 per gallon.<sup>62</sup> Furthermore, the price for a barrel of heating oil was \$135 while a barrel of crude oil was \$104.<sup>63</sup> For a commodity that was in such little demand to the point that “you can’t give away heating oil” during seventy-degree days in February,<sup>64</sup> there was nothing but the market being overwhelmed by speculators betting the price up through, *e.g.*, commodity index swaps, which required swaps dealers to lay off their risk by buying huge amounts of long crude oil futures unencumbered by any meaningful position limits.

### *Bankers and Investors*

Goldman Sachs stated in an internal report in February 2012 when the price of crude reached \$109 per gallon<sup>65</sup> that each barrel of oil costs about \$23 more than it would without the excessive speculation in the markets today.<sup>66</sup> Similarly, the chief global investment officer of JP Morgan stated during the summer of 2008 that “an enormous amount of speculation ran up the price” and “140 dollars in July [2008] was ridiculous.”<sup>67</sup>

Hedge fund investor George Soros has maintained that the volatility in the price of oil (and other commodities) is a result of excessive speculation, stating in 2008 that the oil futures market was experiencing a bubble fed by too much speculation.<sup>68</sup> He entered a massive short position in crude oil at \$137 per barrel during the summer of 2008 when oil prices reached record highs and profited when they fell precipitously on their way down to \$30 in December 2008.<sup>69</sup>

Michael Masters, a hedge fund manager, has repeatedly testified that passive investments from institutional investors have upset the price discovery mechanisms of crude oil and other commodities futures markets:

[P]assive speculators drain liquidity by buying and holding large quantities of futures contracts – basically acting as consumers who never actually take delivery of goods.

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<sup>59</sup> Id. Furthermore, the amount of heating oil traded during that summer day was half of US consumption for an entire year. Id.

<sup>60</sup> Id.

<sup>61</sup> Guilford, *supra* n. 6.

<sup>62</sup> See James Walsh, *Home-heating oil prices near record high*, TIMES HERALD-RECORD, Dec. 11, 2011, available at <http://www.recordonline.com/apps/pbcs.dll/article?AID=/20111211/NEWS/112110323>.

<sup>63</sup> Guilford, *supra* n. 6.

<sup>64</sup> Id.

<sup>65</sup> Energy Information Administration, *supra* n. 2.

<sup>66</sup> Robert Lenzner, *Speculation In Crude Oil Adds \$23.39 To The Price Per Barrel*, FORBES, Feb. 27, 2012, available at <http://www.forbes.com/sites/robertlenzner/2012/02/27/speculation-in-crude-oil-adds-23-39-to-the-price-per-barrel/>. See also Alain Sherter, *When Goldman Sachs Warns That Speculation Drive Oil Prices, Listen Up*, CBS MONEY WATCH, Apr. 13, 2011, available at [http://www.cbsnews.com/8301-505123\\_162-43552722/when-goldman-sachs-warns-that-speculation-drives-oil-prices-listen-up/](http://www.cbsnews.com/8301-505123_162-43552722/when-goldman-sachs-warns-that-speculation-drives-oil-prices-listen-up/).

<sup>67</sup> *Did Speculation Fuel Oil Price Swings?*, CBS NEWS, Apr. 14, 2009, available at [http://www.cbsnews.com/2100-18560\\_162-4707770.html?pageNum=2&tag=contentMain;contentBody](http://www.cbsnews.com/2100-18560_162-4707770.html?pageNum=2&tag=contentMain;contentBody)

<sup>68</sup> Edmund Conway, *George Soros: rocketing oil price is a bubble*, THE TELEGRAPH, May 26, 2008, available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2790539/George-Soros-rocketing-oil-price-is-a-bubble.html> (quoting Soros: “The price has this parabolic shape which is characteristic of bubbles”). See also Soros, *supra* n. 34.

<sup>69</sup> Lenzner, *supra* n. 66. See also Energy Information Administration, *supra* n. 2.

Passive speculators “invest” in a commodity or basket of commodities (such as an index), and continuously roll their position, as part of a long-term portfolio diversification strategy. This strategy is completely blind to the supply and demand realities in the market. As such, passive speculators not only undermine, but actually destroy the price discovery function of the market and make way for the formation of speculative bubbles.<sup>70</sup>

### *Financial Analysts*

Financial analysts have also discovered increased speculation in the oil futures markets. An energy analyst at Citi Futures Perspective, has stated: “With the latest push to the upside, we see the crude oil market becoming even more completely divorced from any connection to fundamental factors and becoming even more obsessed with the simple question, ‘How high can it go?’”<sup>71</sup> Furthermore, Evans has explained that more than supply-demand fundamentals, the feelings and whims of investors are what move the price of oil.<sup>72</sup> Another Citigroup oil analyst referred to the oil price outlook as being “more subjective than ever and hence leaves any long-term oil price assertion equally subjective and somewhat irrespective of traditional ‘fundamental’ analysis.”<sup>73</sup> Similarly, a study published by Deutsche Bank Research concludes that speculators’ dispersion of beliefs (*i.e.* the willingness of speculators to engage in trading activity even when there is a large gap between market prices and fundamentally justified prices) has a significant impact on oil prices.<sup>74</sup>

Other financial analysts have been more forceful about the need to address speculation in the oil markets, including the former chair of the Petroleum Marketers Association of America, who has called excessive speculation the fuel that has driven the “runaway train” in crude oil prices.<sup>75</sup> Likewise, economist Mike Norman has repeatedly argued about the role of speculation on volatile oil prices: “Oil prices are high because of speculation, pure and simple. That’s not an assertion, that’s a fact. Yet rather than attack the speculation and rid ourselves of the problem, we flail away at the symptoms.”<sup>76</sup>

In the same way, Fadel Gheit, a managing director and senior analyst covering the oil and gas sector for Oppenheimer & Co. Inc., implores regulators to address the root of this issue: “It is not Exxon or BP or Shell that moves the oil markets. It is the financial players. It is the Goldman Sachs, the Morgan Stanley, or the other guys. It is a shame on the government that allows them to get away with that.”<sup>77</sup>

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<sup>70</sup> Masters, *supra* n. 15.

<sup>71</sup> Tim Evans, *PM Energy News & Views*, CITI FUTURES PERSPECTIVE, July 3, 2008 at 2.

<sup>72</sup> David Sheppard, *Oil boasts fourth-biggest daily price gain ever*, GLOBE AND MAIL, June 29, 2012, available at <http://m.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/oil-boasts-fourth-biggest-daily-price-gain-ever/article4381474/?service=mobile> (quoting Evans: “What has changed today is the market sentiment, the fundamentals may evolve at a more glacial pace.”).

<sup>73</sup> Mufson, *supra* n. 34.

<sup>74</sup> Jochen Möbert, *Dispersion in beliefs among speculators as a determinant of crude oil prices* (2009). The fact that it is the dispersion of beliefs, not speculators themselves, that leads to excessively oil prices demonstrates the need for some speculation to maintain liquidity in the futures markets. *See supra* n. 17. *See also* Jalali-Naini, *supra* n. 39 (commenting on the effects of “exaggerated high price expectations” that are “over-optimistic assessments”).

<sup>75</sup> Jonathan Davis, *Speculators ‘not to blame’ for oil prices*, UPSTREAM, April 4, 2008, available at <http://www.upstreamonline.com/live/article151805.ece> (quoting Sean Cota).

<sup>76</sup> Mike Norman, *The Danger of Speculation*, FOX NEWS, Aug. 19, 2005, available at <http://www.foxnews.com/story/0,2933,166038,00.html>. *See also* Brenda Buttner, *Main Street feeling price pinch*, FOX NEWS, Feb. 25, 2012, available at <http://www.foxnews.com/on-air/cost-of-freedom/2012/02/27/main-street-feeling-price-pinch> (quoting Mike Norman: “That is outside any of the normal rules of economics. In my opinion, there’s only one reason for it and that is speculation rearing its ugly head just as it did in 2008. I don’t even know why we have to have this discussion as to whether or not it’s contributing. It’s absolutely contributing because every economic factor tells you that gas should be coming down, not up.”).

<sup>77</sup> Ed Wallace, *Has the US Turned Against Consumers?*, BLOOMBERG BUSINESSWEEK, July 6, 2011, available at <http://www.businessweek.com/top-news/has-the-us-turned-against-consumers-07062011.html>. *See also* Kevin G.

## *International Leaders*

The minister of petroleum and mineral resources in Saudi Arabia, Ali Naimi, has decried volatile oil prices on numerous occasions, including in March 2012 when the price for a barrel of oil had reached \$128.<sup>78</sup> He declared: “I think high prices are unjustified today [on] a supply-demand basis,” noting that global supply was exceeding demand by 1 million to 2 million barrels per day.<sup>79</sup> Regardless, the oil minister offered that his nation would increase its output of oil by as much as 25 percent if necessary,<sup>80</sup> and he has forcefully argued that there has never been a shortage of oil to justify higher prices:

We want to correct the myth that there is, or could be, a shortage. It is an irrational fear, a fear without basis. Saudi Arabia’s current capacity is 12.5m barrels per day, way beyond current levels demanded, and a reliable buffer against any temporary loss of production. Saudi Arabia has invested a great deal to sustain its capacity, and it will use spare production capacity to supply the oil market with any additional required volumes.<sup>81</sup>

With full worldwide reserves of oil and increased oil production among members of the Organization of Petroleum Exporting Countries (OPEC) and many other nations, “there is no rational reason why oil prices are continuing to remain at these high levels.”<sup>82</sup>

The secretary general of OPEC, Abdalla Salem El-Badri, has gone a step further by blaming excessive speculation for the unjustified prices in crude oil. Stating that “[a]nything that will reduce this speculation activity...is a step in the right direction”,<sup>83</sup> he has urged and praised efforts to implement position limits by the CFTC.<sup>84</sup> This stance from OPEC was not new. The former acting secretary general Adnan Shihab-Eldin as early as 2005 said: “Today, and especially with non-fundamental factors – such as speculation in oil futures markets – playing such a critical role in oil price determination, we feel that leaving such a sensitive trading environment as the oil market to its own devices would surely be a recipe for disaster, both for producers and consumers.”<sup>85</sup>

President Obama has on at least four occasions attributed the repeated and extreme spikes in crude oil and gasoline prices to speculative activity by large financial players in the oil market: June 22,

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Hall, *Speculators blamed for rising oil, gas prices*, SEATTLE TIMES, Feb. 23, 2012, available at <http://seattletimes.nwsources.com/text/2017563277.html> (quoting Gheit: “Speculation is now part of the DNA of oil prices. You cannot separate the two anymore. There is no demarcation.”); Alejandro Lazo, *Energy Stocks Haven’t Caught Up With Oil Prices*, WASH. POST, Mar. 23, 2008, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/03/21/AR2008032103825.html> (quoting Gheit: “The largest speculators are the largest financial companies.”);

<sup>78</sup> Chazan, *supra* n. 7.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* In fact, Saudi Arabia was already pumping oil at 30-year highs. *Id.*

<sup>81</sup> Naimi, *supra* n. 5.

<sup>82</sup> *Id.* Saudi Arabia has increased oil production during many crucial emergencies around the world in the past, *id.*, but the persistent fear and uncertainty about oil supply has been prime fuel for promoting excessive speculation. See Sornette et al., *infra* n. 113.

<sup>83</sup> *Opec against ‘excessive’ oil speculation*, OIL & GAS NEWS, Feb. 8, 2010, available at <http://www.oilandgasnewsonline.com/pages/article.aspx?aid=28267>.

<sup>84</sup> Maher Chmaytelli, *OPEC Calls for Curbing Oil Speculation, Blames Funds*, BLOOMBERG, Jan. 28, 2009, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVRKbFhcfKdKM>.

<sup>85</sup> Adnan Shihab-Eldin, Speech to the Cosmopolitan Club Vienna: The Role of OPEC: A historical perspective and outlook to the future, Mar. 24, 2005, available at [http://www.opec.org/opec\\_web/en/press\\_room/894.htm](http://www.opec.org/opec_web/en/press_room/894.htm). See also Kenneth N. Gilpin, *OPEC Agrees to Increase Output in July to Ease Oil Prices*, N.Y. TIMES, June 3, 2004, available at <http://www.nytimes.com/2004/06/03/business/03CND-OIL.html?pagewanted=all> (quoting Shihab-Eldin: “There is not a crude shortage, which is why OPEC was so reluctant to raise production. But prices got so high that they had to increase production to quell the speculation and fear that is in the market”).

2008 (during his presidential campaign when crude oil was approaching its world-record high of \$147 per barrel);<sup>86</sup> April 20, 2011 (when crude oil reached \$110 per barrel);<sup>87</sup> March 8, 2012 (when oil prices spiked to \$106);<sup>88</sup> and on April 17, 2012 (as gasoline prices approached \$4 per gallon).<sup>89</sup> As he did in April 2011, the President once again convened in March 2012 an inter-agency task force led by the Department of Justice to investigate illegal manipulation of crude oil prices.<sup>90</sup> Meanwhile, many Congressional investigations (often bi-partisan in nature) have uncovered excessive speculation in the oil markets.<sup>91</sup>

Other international leaders have also expressed similar statements. Observing the volatile oil prices despite the lack of serious interruption in supply, former British Prime Minister Gordon Brown and former French President Nicolas Sarkozy jointly called for renewed investigations into the effect of trading activity on amplified erratic price movements.<sup>92</sup> Likewise, former Chinese President Jiang Zemin noted that “the rapid growth of global capital market, virtual economy, financial derivatives and the overflow of speculation funds have great impacts on ... oil.”<sup>93</sup>

### *Academics and Economists*

Nobel Prize-winning economist Paul Krugman, who originally remained steadfast in his belief that crude oil prices were dictated by market fundamentals, ultimately embraced the argument that excessive speculative activity is driving up the price of oil. As Krugman observed: “Last year I was skeptical about claims that speculation was central to the price rise ... [T]his time there’s no question: speculation has been driving prices up.”<sup>94</sup>

Many quantitative studies have demonstrated statistically significant effects of excessive speculation activity on oil prices. Researchers from the Federal Reserve Bank of St. Louis demonstrate in a working paper the effects of speculation shocks along with oil supply, global demand, and oil inventory demand on the price of oil.<sup>95</sup> The researchers define speculation shock as arising from a “shift in the

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<sup>86</sup> Caren Bohan, *Obama Vows to Crack Down on Oil Speculation*, REUTERS, June 22, 2008, available at <http://www.reuters.com/article/2008/06/22/us-usa-politics-obama-energy-idUSN2243134220080622>.

<sup>87</sup> Jason Mason, *Obama Blames Speculators for Rising U.S. Fuel Prices*, REUTERS, April 20, 2011, available at <http://www.reuters.com/article/2011/04/20/us-usa-energy-obama-speculators-idUSTRE73J1NN20110420>.

<sup>88</sup> Kevin Hall & Lesley Clark, *Back to Work for Gas Price Unit*, MCCLATCHY NEWSPAPERS, March 9, 2012, available at [http://www.stltoday.com/news/national/back-to-work-for-gas-price-unit/article\\_212a4a50-32f3-5375-973e-74a3beb26924.html](http://www.stltoday.com/news/national/back-to-work-for-gas-price-unit/article_212a4a50-32f3-5375-973e-74a3beb26924.html).

<sup>89</sup> Helene Cooper, *As Gas Prices Cast Cloud, Obama Calls for Scrutiny on Market*, N.Y. TIMES, (Apr. 17, 2012), available at <http://www.nytimes.com/2012/04/18/us/politics/obama-urges-oil-market-scrutiny-as-gas-prices-cast-cloud.html>.

<sup>90</sup> Id.

<sup>91</sup> See, e.g., Staff of Permanent Subcommittee on Investigations, US Senate Committee on Homeland Security and Governmental Affairs, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat* (2006) (concluding that the large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil to be delivered in the future in the same manner that additional demand for the immediate delivery of a physical barrel of oil drives up the price on the spot market.). Cf. WHEAT REPORT, *supra* n. 10 (concluding that there is significant and persuasive evidence that one of the major reasons for the recent market problems is the unusually high level of speculation in the Chicago wheat futures market due to purchases of futures contracts by index traders offsetting sales of commodity index instruments.); Staff of Permanent Subcommittee on Investigations, US Senate Committee on Homeland Security and Governmental Affairs, *Excessive Speculation in the Natural Gas Market* (2007).

<sup>92</sup> Brown & Sarkozy, *supra* n. 8.

<sup>93</sup> Jiang Zemin, *Reflections on energy issues in China*, 13 J. OF SHANGHAI JIAOTONG UNIV. 257, 261 (2008).

<sup>94</sup> Paul Krugman, *Oil speculation*, N.Y. TIMES, July 8, 2009, available at <http://krugman.blogs.nytimes.com/2009/07/08/oil-speculation/?scp=2&sq=speculative%20trading%20in%20oil&st=cse>.

<sup>95</sup> Luciana Juvenal & Ivan Petrella, *Speculation in the Oil Market* (Federal Reserve Bank of St. Louis, Working Paper 2011-027E, 2011), available at <http://research.stlouisfed.org/wp/2011/2011-027.pdf>.

expected future spot price” that can be unrelated to market fundamentals due to “an increase in oil prices driven by trading activity in the oil futures market.”<sup>96</sup> Using a statistical model, they conclude that speculation shocks are the second most important driver of movements in the price of oil behind global demand.<sup>97</sup>

Researchers from the European Central Bank have also found that “destabilizing financial activity,” which primarily involves passive investment in oil futures through such vehicles as commodity index funds, significantly impact oil price swings in the short run along with variations in supply and demand.<sup>98</sup> They further conclude through their statistical model that this inefficient financial activity divorced from fundamentals in the oil futures market caused oil prices to be 15% above the level justified by oil fundamentals alone between 2000 and 2008.<sup>99</sup> Likewise, country desk economists and mission chiefs from the International Monetary Fund have concluded: “In summary, it appears that speculation has played a significant role in the run-up in oil prices as the U.S. dollar has weakened and investors have looked for a hedge in oil futures[.]”<sup>100</sup>

Kenneth J. Singleton of Stanford University found that growing positions of commodity index investors had significant effects on oil futures market returns during the 2008 boom and bust.<sup>101</sup> He further criticized studies concluding otherwise because the contradicting studies measure the effects of investor flows in futures markets over short horizons (i.e. a few days) rather than weeks or months, as did his investigations.<sup>102</sup> Similarly, another study shows that the hedging trades of the issuers of commodity linked notes in the futures markets significantly raise the underlying futures prices.<sup>103</sup>

The researchers mentioned above are joined by many other academics and economists in finding that excessive speculation in commodity markets has a significant impact in oil prices.<sup>104</sup>

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<sup>96</sup> Id. at 4.

<sup>97</sup> Id. The researchers find that their speculation shocks variable “pick[ed] up the effects of financialization driven by the rapid growth of commodity index investment[.]” Id. at 4. *See also supra* nn. 27-37 (discussion of commodity index funds).

<sup>98</sup> Marco J. Lombardi & Ine Van Robays, *Do Financial Investors Destabilize the Oil Price?* 21 (2011).

<sup>99</sup> Id. at 15.

<sup>100</sup> Adam Bennett et al., *Regional Economic Outlook: Middle East and Central Asia* (2008), *available at* <http://www.imf.org/external/pubs/ft/reo/2008/MCD/eng/mreo0508.pdf>.

<sup>101</sup> Kenneth J. Singleton, *Investor Flows and the 2008 Boom/Bust in Oil Prices* (2011).

<sup>102</sup> Id. at 25.

<sup>103</sup> Brian J. Anderson, Neil D. Pearson & Li Wang, *New Evidence on the Financialization of Commodity Markets* (2012) (“The issuers’ initial hedging trades for issues with proceeds greater than or equal to \$2 million, \$5 million, and \$10 million raise the underlying commodity futures prices by an average of 37, 40, and 51 basis points, respectively, around the pricing dates of the [commodity linked notes].”).

<sup>104</sup> Robert F. Kaufman, *The role of market fundamentals and speculation in recent price changes for crude oil*, 39 ENERGY POLICY 105 (2011); Tang/Xiong, *supra* n. 31 (from Princeton University and Renmin University of China); Alan S. Blinder, *The Two Issues to Watch on Financial Reform*, WALL ST. J. (April 22, 2010), *available at* <http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html>; Cifarelli & Paladino, *supra* n. 35 (“large daily upward and downward shifts in oil prices do not fit a fundamental-driven market”); Michael Greenberger, *The Relationship of Unregulated Excessive Speculation to Oil Market Price Volatility* (2010), *available at* <http://www.michaelgreenberger.com/files/IEF-Greenberger-AppendixVII.pdf>; Machiko Nissanke, *Commodity Markets and Excess Volatility: Sources and Strategies to Reduce Adverse Development Impacts* (Revised 2011) (from the University of London School of Oriental and African Studies) *available at* [http://commonfund.org/uploads/tx\\_cfc/CFC\\_report\\_Nissanke\\_Volatility\\_Development\\_Impact\\_2010\\_02.pdf](http://commonfund.org/uploads/tx_cfc/CFC_report_Nissanke_Volatility_Development_Impact_2010_02.pdf); James D. Hamilton, *Causes and Consequences of the Oil Shock of 2007-2008*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, Spring 2009, at 215-261, *available at* [http://www.brookings.edu/~media/Files/Programs/ES/BPEA/2009\\_spring\\_bpea\\_papers/2009a\\_bpea\\_hamilton.pdf](http://www.brookings.edu/~media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009a_bpea_hamilton.pdf) (“With hindsight, it is hard to deny that the price of oil rose too high in July 2008 and that this miscalculation was influenced in part by the flow of investment dollars into commodity futures contracts.”); Medlock & Jaffe, *supra* n. 41; Nouriel Roubini, *The risk of a double-dip recession is rising*, FIN. TIMES, Aug. 23, 2009, *available at* <http://www.ft.com/cms/s/0/90227fdc-900d-11de-bc59-00144feabdc0.html#axzz1hwna8cxk>; David P. Anderson, *The Effects of Ethanol on Texas Food and Feed* (2008), *available at* <http://www.afpc.tamu.edu/pubs/2/515/RR-08-01.pdf> (from the Texas A&M University Agricultural &

## Rebuttal to Fundamentalist Arguments

Despite the weight of evidence demonstrating that excessive speculation in commodity futures markets leads to deleterious volatility in the movement of oil prices, there are still those who continue to argue that the market fundamentals of supply and demand are the sole contributing factor to that volatility.<sup>105</sup> The basic argument among these market fundamentalists is that there have been oil price spikes because the increasing worldwide demand for oil (especially from China and other developing nations) surpasses the worldwide supply. This imbalance in supply and demand, as encapsulated by Robert Samuelson, is the classical cause of rising prices that lead to equilibrium in the market.<sup>106</sup>

Although it is true that the absolute demand for oil has grown, what these studies or analyses blaming market fundamentals overlook is that the rate of growth in global demand for oil fell from 2004 to the price spikes in 2008 (despite China's large growth in demand) while production had kept pace.<sup>107</sup> This means that under supply and demand principles, the price of oil should have dropped given that the worldwide supply of oil gained ground on meeting any increase in demand. Furthermore, Saudi Arabia has consistently adjusted its oil production not only to cover drop-offs in oil production elsewhere in the world but also to meet unusually high increases in demand so that supply for oil meets demand.<sup>108</sup> Saudi Arabia increased oil production following the invasion of Iraq in 2001, a workers' strike in Venezuela in 2002, Hurricane Katrina in 2005, and the tumult from Arab Spring in 2011.<sup>109</sup> Saudi Arabia also boosted

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Food Policy Center: speculative fund activities in futures markets have led to more money in the markets and more volatility while increased price volatility has encouraged wider trading limits, resulting in the loss of the ability to use futures markets for price risk management due to the inability to finance margin requirements); R.S. Eckaus, *The Oil Price Really Is A Speculative Bubble* (2008) (from the Massachusetts Institute of Technology Center for Energy and Environmental Policy Research) available at <http://web.mit.edu/ceepr/www/publications/workingpapers/2008-007.pdf>; L. Randall Wray, *The commodities market bubble: money manager capitalism and the financialization of commodities* (2008) (from the University of London School of Oriental and African Studies), available at [http://www.levyinstitute.org/pubs/ppb\\_96.pdf](http://www.levyinstitute.org/pubs/ppb_96.pdf); Akira Yanagisawa, *Decomposition Analysis of the Soaring Crude Oil Prices* (2008), available at <http://eneken.ieej.or.jp/en/data/pdf/421.pdf> (from the Institute of Energy Economics in Japan: "oil prices are quite different from the fundamental prices."). See also James K. Galbraith, Statement before the Financial Crisis Inquiry Commission, June 30, 2010, available at <http://www.newdeal20.org/wp-content/uploads/2010/06/deficitcommissionrv.pdf>; Joseph E. Stiglitz, Statement before the Congressional Oversight Panel, Jan. 14, 2009, available at <http://cybercemetery.unt.edu/archive/cop/20110402024657/http://cop.senate.gov/documents/testimony-011409-stiglitz.pdf> (arguing that only standardized and regulated products used for hedging against risk, but not gambling, should be permitted).

<sup>105</sup> Many "fundamentalists" rely on statistical models based on Granger causality tests, which attempt to predict whether the past histories (or time series data) of variable X and variable Y assist in predicting variable Y. See *In re Amaranth Natural Gas Commodities Litigation*, 269 F.R.D. 366, 384 (S.D.N.Y. 2010) (explaining a Granger causality test). However, it has been shown that Granger tests cannot handle data that are characterized by high volatility such as oil prices. David Frenk et al., *supra* n. 4, at 6-7 (2010); Richard Branson, Michael Masters & David Frenk, *Letter to the Editor: Swaps, Spots and Bubbles*, THE ECONOMIST, July 29, 2010, available at [http://www.economist.com/node/16690679?story\\_id=16690679&cfid=162683712&cftoken=35576411](http://www.economist.com/node/16690679?story_id=16690679&cfid=162683712&cftoken=35576411).

<sup>106</sup> See, e.g., Robert J. Samuelson, *The fallacy of blaming oil 'speculators'*, WASH. POST, May 2, 2012, available at [http://www.washingtonpost.com/opinions/the-fallacy-of-oil-speculation/2012/05/02/gIQAk7bkwT\\_story.html](http://www.washingtonpost.com/opinions/the-fallacy-of-oil-speculation/2012/05/02/gIQAk7bkwT_story.html).

<sup>107</sup> Kaufman, *supra* n. 104; Eckaus, *supra* n. 104; Frenk et al, *supra* n. 4; Pollin & Heintz, *supra* n. 35. See also Staff of Rony Wyden, *The Fallacy of Blaming the Market as the Sole Cause of High Gas Prices*, <http://www.wyden.senate.gov/news/blog/post/the-fallacy-of-blaming-the-market-as-the-sole-cause-of-high-gas-prices> (countering Samuelson, *supra* n. 106, by revealing that supply had exceeded demand and that there was greater spare capacity in the beginning 2012, but the price of oil counterintuitively rose by more than 20% in the first quarter).

<sup>108</sup> Ali Naimi, *supra* n. 5.

<sup>109</sup> Id.

oil production to meet an unusually steep increase in demand due to China's surging economy in 2004.<sup>110</sup> In the future, the kingdom has promised to boost its production by as much as 25% if necessary due to sanctions on Iranian crude.<sup>111</sup>

Others have argued that uncertainty in world affairs creates a fear and expectation of reduced oil supplies in the future, which drives the price of oil upward. Such uncertainty does indeed affect the oil markets, but it does not explain the great volatility in oil prices of recent years. In order to explain the very large oil price spikes in 2004 and 2008 under this theory, there must have been a most dramatic change in world conditions (especially during the record peak in 2008), but there was no great jolt to international stability during those points in history.<sup>112</sup> Indeed, there is evidence showing that uncertainty is the "fertilizer of speculation," driving the actions of speculators so that oil prices are "increasingly decoupled from fundamental valuation (the hallmark of a bubble)".<sup>113</sup>

Most recently, there have been further arguments that the uncertainty in world affairs has caused price spikes in oil, including expectations of disruptions in oil due to the events of the Arab Spring and Iran's threat to close the Strait of Hormuz. However, Saudi Arabia had promised in both instances to make up any oil differential,<sup>114</sup> and the United States is now a net exporter of refined petroleum products.<sup>115</sup> The claim that the price of oil is volatile due to uncertainty in conditions relating to supply and demand is without merit.

## II. The Enforcement of Strong Position Limits and Anti-Manipulation Rules Contemplated by Dodd-Frank Will Dampen Excessive Speculation

Recent history has shown that even the threat of action by the federal government has had significant impacts in curbing excessive speculation. With an array of regulations at its disposal as authorized by Dodd-Frank, the CFTC along with other regulatory agencies will be able to decrease the excessive speculation that so significantly affects the oil futures markets.

### The Effect of Enforcement (or Threatened Enforcement) Tamping Down Excessive Speculation Has Forced Down Prices

Congressional Democrats have repeatedly and successfully intervened to highlight and blunt the adverse impact of excessive speculation on the crude oil markets. On June 26, 2008, as oil prices were reaching their world-record high, the House Democratic leadership and then Chairman of the House Agriculture Committee, Collin Peterson, introduced legislation<sup>116</sup> that passed the House that same day by a bipartisan vote of 402-19. The bill required the CFTC to act pursuant to its authority under the

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<sup>110</sup> Id.

<sup>111</sup> Chazan, *supra* n. 7.

<sup>112</sup> Eckaus, *supra* n. 104. ("Short of a virtually complete shutdown of Middle East oil production, no plausible price elasticity of demand would justify the quadrupling of prices.")

<sup>113</sup> Didier Sornette, Ryan Woodard & Wei-Xing Zhou, *The 2006-2008 oil bubble: Evidence of speculation, and prediction*, 388 PHYSICA A 1571, 1576 (2009); Yergin, *supra* n. 34 at 170-171 ("With [economic growth and financialization] came more volatility, more fluctuations in the price, which was drawing in the traders."). See also F. William Engdahl, *Perhaps 60% of Today's Oil Price is Pure Speculation* (2008), available at [http://www.engdahl.oilgeopolitics.net/Financial\\_Tsunami/Oil\\_Speculation/oil\\_speculation.HTM](http://www.engdahl.oilgeopolitics.net/Financial_Tsunami/Oil_Speculation/oil_speculation.HTM) ("Speculators trade on rumor, not fact.")

<sup>114</sup> See Naimi, *supra* n. 5.

<sup>115</sup> Guilford, *supra* n. 6.

<sup>116</sup> H.R. 6377, 110th Cong. (2008).



Commodity Exchange Act of 1936 and declare an “emergency” in the oil market, thereby triggering CFTC authority to impose special limits on excessive speculative activity in crude oil futures markets.<sup>117</sup>

On July 15, 2008, Senate Majority Leader Harry Reid sponsored legislation<sup>118</sup> that would have imposed tough congressionally driven limits on excessive speculative activity in the crude oil futures markets.<sup>119</sup> On July 25, 2008, that bill received 51 votes in favor with 93 Senators present, a majority of the Senate, but not enough to invoke cloture.<sup>120</sup> Despite the bill’s defeat, certain Republican senators voted for cloture and others indicated that they might support the legislation in the future.

On September 28, 2008, then Chairman Peterson again brought to the House floor a bill<sup>121</sup> that would impose tough speculative position limits. The bill passed the House 283-133.<sup>122</sup> Also, on July 31, 2008, Senators Wyden (D-Oregon) and Grassley (R-Iowa) circulated a widely publicized discussion draft bill that would have taxed profits from passive speculative crude oil futures as ordinary income.<sup>123</sup>

The combination of all of these Congressional efforts led speculators to fear that Congress would take immediate action to limit speculation in commodities markets and so they abandoned these markets in droves. The mass exodus of passive bettors from the crude oil market precipitated a radical drop in the price of a barrel of crude oil: the price dropped from its July 2008 world-record high of \$147 a barrel to \$30 a barrel by December of that year.

In the winter of 2009 when financial institutions realized that Congress would not pass legislation stopping excessive speculation into law, the price of oil once again spiked. Gas prices rose 54 days in a row in the spring of 2009, and by July 2009, the price of a barrel of crude oil reached \$75.<sup>124</sup> During this period of high oil and gas prices, the legislation that later became the Dodd-Frank Act began making its way through Congress. President Obama and Democratic leaders made clear that the legislation aimed to impose tough new limits on excessive speculation in commodity derivatives markets and to strengthen the hand of the CFTC by allowing the agency to pursue market manipulation cases more easily. Indeed, by the time Dodd-Frank was signed into law, crude oil prices had stabilized for almost 18 months; prices fluctuated between \$75 and \$85 a barrel. However, as will be shown below, the CFTC in January 2011 could barely muster enough votes to report out a very weak proposed position limit rule, and recognizing that Dodd-Frank would not be properly implemented, the price of crude immediately soared to \$95 per barrel by February 2011.<sup>125</sup> Similarly as shown below, when the CFTC promulgated its final weak position limit rule in October 2011, the price of crude oil shot back up from \$75 to more than \$100 in November.<sup>126</sup>

On April 21, 2011, President Obama stated that the price spike in oil in February and April 2011 was not the result of market fundamentals but crude oil market manipulation by non-commercial speculators. He subsequently convened an inter-agency task force led by the Department of Justice to

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<sup>117</sup> *Id.* See also *House Passes Legislation Requiring CFTC to Curb Oil Market Speculation*, WISCONSIN AG CONNECTION, June 27, 2008, available at <http://www.wisconsinagconnection.com/story-national.php?Id=1516&yr=2008>.

<sup>118</sup> S. 3268, 110th Cong. (2008).

<sup>119</sup> *Id.* See *ATA applauds Senator Reid and other sponsors of S. 3268*, THOMASNET NEWS, July 21, 2008, available at <http://news.thomasnet.com/companystory/ATA-applauds-Senator-Reid-and-other-sponsors-of-S-3268-547049>.

<sup>120</sup> Govtrack.us, On the Cloture Motion S. 3268, <http://www.govtrack.us/congress/votes/110-2008/s184>.

<sup>121</sup> H.R. 6604, 110th Cong (2008).

<sup>122</sup> House Committee on Agriculture, House of Representatives Approves Bill to Strengthen Oversight of Futures Markets, <http://agriculture.house.gov/press-release/house-representatives-approves-bill-strengthen-oversight-futures-markets>.

<sup>123</sup> Press Release, Sen. Ron Wyden, Wyden-Grassley Staff Proposes Level Playing Field for Oil Trade (July 31, 2008), available at <http://www.wyden.senate.gov/news/press-releases/wyden-grassley-staff-proposes-level-playing-field-for-oil-trade>.

<sup>124</sup> See *supra* n. 3.

<sup>125</sup> Energy Information Administration, *supra* n. 2.

<sup>126</sup> *Id.*

investigate manipulation in the crude oil market. As a result of the threatened prosecutions for market manipulation, the price of crude oil was, by October 2011, back down to around \$75—a price that accurately reflected market fundamentals according to statements made by the CEO of ExxonMobil in April 2011.<sup>127</sup> Yet, when the CFTC promulgated its final weak position limit rule in October 2011, the price of crude oil shot back up from \$75 to more than \$100 in November, leading the President once again to convene the inter-agency task force in March 2012.<sup>128</sup>

## Legal Weapons against Excessive Speculation

### *Position Limits*

As required by Dodd-Frank,<sup>129</sup> the CFTC approved by a 3-2 vote its final rule for position limits on futures and swaps on October 18, 2011.<sup>130</sup> The rule establishes speculative position limits for 28 commodity futures contracts (including NYMEX WTI Light Sweet Crude Oil)<sup>131</sup> and establishes that no trader may hold or own a position in a “referenced contract” in the same commodity if the position exceeds a spot-month position limit of 25% of the estimated spot-month deliverable supply.<sup>132</sup> Furthermore, the non-spot month position limits rule establishes that no trader may hold or control positions that exceed 10% of the first 25,000 contracts and 2.5% thereafter in all contract months combined (including the spot month) or in a single month.<sup>133</sup>

Unfortunately, substantial questions have been raised by certain market observers, academics, and commercial users of commodity staples futures and swaps markets as to whether these position limits implementing Dodd-Frank are strong enough to satisfy the Dodd-Frank position limits mandate. In particular, many believe that the 25% spot-month deliverable supply limit per speculator is far too high.<sup>134</sup> Recognizing this, Sen. Maria Cantwell has likened the “broad rule” to “setting the speed limit at 125 miles per hour” and further expressed her disappointment that the rule “is simply too weak to meaningfully protect consumers.”<sup>135</sup>

According to the general counsel at Delta Air Lines, the CFTC’s currently proposed limit on speculative position (i.e. 25 percent of available supply) is far too high, and “[the CFTC is] not proposing to adopt rules that will have any effect on speculation ... They are only making sure no one can corner the market.”<sup>136</sup> In other words, while the proposed levels may be effective to prevent extreme forms of

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<sup>127</sup> See *supra* n. 50.

<sup>128</sup> See *supra* n. 89, *infra* n. Hall, n. 175.

<sup>129</sup> See CEA § 4a(a)(2), codified at 7 U.S.C. § 6a(a)(2).

<sup>130</sup> Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011) (codified at 17 C.F.R. §§ 1, 150, 151).

<sup>131</sup> See Position Limits for Futures and Swaps, *supra* n. 130 at 71686 (codified at 17 C.F.R. §151.2). The position limits rule also applies to futures and swaps that are economically equivalent to those contracts. 17 C.F.R. §§151.1

<sup>132</sup> 17 C.F.R. § 151.4(a). This rule becomes effective for oil futures contracts on “January 1st of the second calendar year after the term ‘swap’ is further defined.” 17 C.F.R. § 151.4(d)(2).

<sup>133</sup> 17 C.F.R. § 151.4(b). This rule becomes effective for oil futures contracts after twelve months of collection of “swap positional data.” 17 C.F.R. § 151.4(d)(3).

<sup>134</sup> See, e.g., Sanati, *supra* n. 31 (“Wall Street could swallow a 25% limit on the prompt month given the immense volume on that contract”).

<sup>135</sup> Press Release, Sen. Maria Cantwell, Cantwell: Weak Wall Street Speculation Rule is “Like Setting Speed Limit at 125 MPH” (Oct. 18, 2011), available at <http://www.cantwell.senate.gov/news/record.cfm?id=334518>. Likewise, Sen. Bernie Sanders has specifically labeled the 25% spot-month deliverable supply rule as being “not enough.” Ben Geman, *Regulators impose limits on oil speculation*, THE HILL, Oct. 18, 2011, available at <http://thehill.com/blogs/e2-wire/e2-wire/188239-market-regulators-impose-oil-speculation-curbs>.

<sup>136</sup> Spencer & DePass, *supra* n. 51 (quoting Ben Hirst).

market manipulation, they are insufficient to prevent the wholly separate statutory objective of stopping excessive speculation, which requires no showing of intent but in the aggregate constrains market fundamentals, and reducing speculative participation in these markets down from 70 to 80% to around 30%, which had been the norm prior to the staff stealth exemptions referred to above.

For example, in order to corner the market, one might need to control the majority of the available supply for that commodity. However, one would not need to control the majority of available supply to engage in excessive speculation. As has been shown in detail above, aggregate betting on the price direction of commodities by many speculators composing a majority of a market in their entirety can, without any intent, destabilize market fundamentals. The CEA defines “excessive speculation” as any commodity under contracts of sale “causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity.”<sup>137</sup> Therefore, speculative betting that exceeds the need to create liquidity for commercial handlers causes price changes that defy market fundamentals of supply and demand and has been historically banned as excessive speculation. Since the relevant crude oil futures market now has 80% speculative participation (with no one speculator likely to control more than 25% of the market), the expectation is that the new position limits (rather than restore the market to 70:30 in favor of commercial entities) will merely preserve the market as one for speculators rather than for commercial users.

It must therefore be remembered that manipulation of markets that evidences intent of wrongdoing is completely different from excessive speculation, which can occur by flooding of the market by thousands of passive price directional bettors who destroy the market without necessarily having any adverse intent to do so. To prevent this, there had been calls for the CFTC to set the position levels at five (5) percent of open interest up to the first 25,000 contracts, and 2.5 percent thereafter across all markets. For example, Michael Masters has suggested: “No single non-commercial entity should ever be allowed to represent more than 5% of a market’s total open interest under any circumstances.”<sup>138</sup>

Yet, there is still some hope that the position limits (even in their lax present form) may be strong enough to dampen speculation to bring down commodity and therefore crude oil prices. This hope is perhaps most evident in the reaction to the CFTC’s new position limits rules by the big bank speculators themselves. On December 2, 2011, Wall Street-dominated trade associations challenged the CFTC’s final position limits rule in federal district court.<sup>139</sup> The plaintiffs argued that the Commission had not conducted the required cost-benefit analysis before enacting the position limits, which they believe would show that the position limits will decrease liquidity and increase volatility.<sup>140</sup> The plaintiffs further remarked that the final position limits rule passed by a mere 3-2 vote, with Commissioner Dunn voting in favor of the rule but stating on the record that he thought the rule would do more harm than good.<sup>141</sup> On February 27, 2012, the district court heard Wall Street’s motion to enjoin the final rule on an interlocutory basis and observers widely read the district court as indicating that the motion to enter a preliminary injunction would be granted.

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<sup>137</sup> CEA § 4a(a) (codified at 7 U.S.C. § 6a(a)).

<sup>138</sup> Masters, *supra* n. 31.

<sup>139</sup> International Swaps and Derivatives Ass’n v. Commodity Futures Trading Comm’n, No. 1:11-cv-02146 (D.D.C. filed Dec. 2, 2011).

<sup>140</sup> See Christopher Doering, *Wall St. sues CFTC over commodity trading crackdown*, REUTERS, Dec. 2, 2011, available at [www.reuters.com/article/2011/12/02/us-financial-limits-lawsuit-idUSTRE7B11XJ20111202](http://www.reuters.com/article/2011/12/02/us-financial-limits-lawsuit-idUSTRE7B11XJ20111202).

<sup>141</sup> See COMMODITY FUTURES TRADING COMMISSION, OPEN MEETING ON TWO FINAL RULE PROPOSALS UNDER THE DODD-FRANK ACT: HEARING BEFORE THE COMMODITY FUTURES TRADING COMMISSION 12 (Oct. 18, 2011), available at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7\\_101811-trans.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_101811-trans.pdf). See also Asjylyn Loder & Silla Brush, *CFTC Votes 3-2 to Approve Limits on Commodity Speculation*, BLOOMBERG, Oct. 18, 2011, available at <http://www.businessweek.com/news/2011-10-18/cftc-votes-3-2-to-approve-limits-on-commodity-speculation.html>; Brian Scheid, *A position limits rule no one likes, partisan fighting, and a song*, PLATTS, Oct. 20, 2011, available at [http://www.platts.com/weblog/oilblog/2011/10/20/a\\_position\\_limi.html](http://www.platts.com/weblog/oilblog/2011/10/20/a_position_limi.html).

### *Legislative Ban on Commodity Investment Vehicles*

As the CFTC encounters difficulty in enforcing Congress' intent in substantially limiting excessive speculation under Section 737 of Dodd-Frank, Congress should immediately and on an emergency basis enact legislation that bans the use of the two most damaging investment vehicles for speculation in commodity staples derivatives markets: commodity index swaps and exchange traded funds that are premised on synthetic bets on commodity futures price directions.

In this respect, H.R. 5186, the Halt Index Trading of Energy Commodities Act<sup>142</sup> (HITEC), introduced by Representative Ed Markey on April 27, 2012, and co-sponsored by Representatives Barney Frank and Rosa DeLauro, represents a bold and important first step toward ending excessive speculation in commodities markets. The bill would prevent commodity index funds that trade in crude oil, natural gas, or derivatives thereof, from engaging in transactions with investors who are not bona fide hedgers.<sup>143</sup> Importantly, HITEC identifies commodity index funds as the main cause of speculative activity in staple commodities markets<sup>144</sup> and asserts that speculative activity has added nearly \$1.00 to the per gallon price of gasoline.<sup>145</sup> The bill's impact on speculative activity already appears to have been significant: oil prices dropped from \$105 to \$98 a barrel in the week after the legislation was introduced and within weeks dropped to about \$80.<sup>146</sup> This decline mimics the drop from a world record high of \$147 per barrel of crude oil in July 2008 to \$30 per barrel in December 2008 in the wake of strong legislative efforts to curb excessive speculation during the fall of 2008 that were mentioned above.

The effect of a comprehensive legislative ban on commodity index swaps and exchange traded funds would be only to stop the passive betting on the upward direction of commodity staples, including oil futures. In fact, persons who wish to place price directional bets will have other less deleterious investment avenues to pursue: they can buy or short stocks in companies that produce the commodities; they can buy the actual commodities; or they can buy long or short contracts in the futures markets. Of course, these alternative and traditional avenues of investment require financial sophistication—they do not comport with the ease of walking up to the commodity staples betting window and placing a bet with a big Wall Street bank that a basket of synthetic commodities will rise in value.

As commodity index vehicles and exchange traded funds allow for passive betting on commodity staples, individual states may now employ their gaming and bucket-shop laws to regulate these vehicles. The Commodity Futures Modernization Act of 2000 (CFMA)<sup>147</sup> had expressly preempted state gaming and anti-bucket shop laws from regulating commodity-based swaps.<sup>148</sup> Therefore, the betting on commodity staples prices through commodity index vehicles could not be stopped by the states through their gaming laws. However, Dodd-Frank eliminated this preemption of state gaming and bucket-shop laws for swaps that are not based on securities.<sup>149</sup> This would allow state regulators to act under these gaming and anti-bucket-shop laws for the first time in many years to regulate or terminate betting on commodity staples prices and thus serve as another regulatory check on highly speculative and systemically risky “bets” by large U.S. financial institutions.

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<sup>142</sup> Halt Index Trading of Energy Commodities Act of 2012, H.R. 5186, 112th Cong. (2012).

<sup>143</sup> Press Release, Natural Resources Committee (Democrats), Markey, Frank, Delauro Go After Wall Street Oil Investment Products, (April 30, 2012), available at <http://democrats.naturalresources.house.gov/press-release/markey-frank-delauro-go-after-wall-street-oil-investment-products>.

<sup>144</sup> Halt Index Trading of Energy Commodities Act, *supra* n. 142 (“Almost all of this increase in speculation has been caused by a surge in trading commodity index funds.”).

<sup>145</sup> *Id.*

<sup>146</sup> Energy Information Administration, *supra* n. 2.

<sup>147</sup> Pub. L. No. 106-554, 114 Stat. 2763.

<sup>148</sup> Commodity Futures Modernization Act of 2000 § 408(c)(2). See also 1 DERIVATIVES REGULATION, *supra* n. 17, at 975.

<sup>149</sup> Dodd-Frank, *supra* n. 45, § 725(g) (removing preemption against “covered swap agreements” by amending the CEA, codified at 7 U.S.C. 27f), § 767 (preempting state and local regulations and prohibitions regarding gaming and bucket shops by amending the Securities Exchange Act of 1934, codified at 15 U.S.C. 78bb(a)).

## *Anti-Manipulation Rules*

Anti-manipulation remedies may also in light of weak CFTC position limit rules be a better route to dampen excessive speculation in the futures markets. Section 753 of Dodd-Frank<sup>150</sup> directs the CFTC to enact regulations that prohibit market participants from using or employing “any manipulative or deceptive device or contrivance” to affect commodities prices.<sup>151</sup> Also known as the “Cantwell Amendment,” section 753 enhances the CFTC’s anti-manipulation authority by lowering the standard of proof that the CFTC must satisfy in order to prove market manipulation.<sup>152</sup> Prior to the passage of the amendment, the CFTC had to prove market manipulation by establishing that, inter alia, the accused acted with the specific intent to create an artificial price.<sup>153</sup> The difficulty of pursuing actions under this old anti-manipulation rule was reflected by the fact that the Commission was able to win only one anti-manipulation case in 35 years.<sup>154</sup>

Under Dodd-Frank, the CFTC may prove manipulation by establishing that the accused recklessly employed a manipulative scheme to affect commodity prices.<sup>155</sup> As a former CFTC general counsel explained: “It won’t be a defence to say that you didn’t specifically intend to manipulate the market, if the actions you took were reckless in having that impact or effect.”<sup>156</sup> In this respect, the anti-manipulation authority provided by Section 753 offers “a strong and clear legal standard that allows regulators to successfully go after reckless and manipulative behavior.”<sup>157</sup>

The CFTC published its final market manipulation rule on July 14, 2011.<sup>158</sup> The rule prohibits the use of “fraud and fraud-based manipulative devices and contrivances employed intentionally or recklessly, regardless of whether the conduct in question was intended to create or did create an artificial price.”<sup>159</sup> The CFTC’s newfound ability to pursue manipulation cases based on recklessness is in line

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<sup>150</sup> *Supra* n. 45.

<sup>151</sup> *Id.* § 753(a), amending CEA §6(c).

<sup>152</sup> Press Release, Sen. Maria Cantwell, Senate Passes Cantwell Anti-Manipulation Amendment (May 6, 2010), available at <http://cantwell.senate.gov/news/record.cfm?id=324761> (observing that Section 753 “strengthen[s] the CFTC’s] enforcement powers over commodity and derivatives trading” and provides the agency with “a more effective legal tool to enforce prohibitions on market manipulation in futures and derivatives markets”).

<sup>153</sup> See Gary Gensler, Chairman Gensler’s Statements of Support on Five Dodd-Frank Final Rules, July 7, 2011, available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement070711b> (explaining that “[i]n the past, the CFTC . . . had to prove the specific intent of the accused to create an artificial price”). The Commission previously was required to prove: “(1) that the accused had the ability to influence market prices; (2) that the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) that artificial prices existed; and (4) that the accused caused the artificial prices.” OFFICE OF PUBLIC AFFAIRS, COMMODITY FUTURES TRADING COMMISSION, Q & A – ANTI-MANIPULATION AND ANTI-FRAUD FINAL RULES 1, available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/amaf\\_qa\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/amaf_qa_final.pdf).

<sup>154</sup> Jamila Trindle, *CFTC Expands Its Power to Pursue Fraud, Manipulation*, WALL ST. J., July 8, 2011, available at <http://online.wsj.com/article/SB10001424052702303544604576431814190513164.html>.

<sup>155</sup> See Gensler, *supra* n. 153. (“Under the new law and one of the rules before us today, the Commission’s anti-manipulation reach is extended to prohibit the reckless use of fraud-based manipulative schemes. This closes a significant gap, as it will broaden the types of cases we can pursue and improve the chances of prevailing over wrongdoers.”).

<sup>156</sup> Alexander Osipovich, *Will CFTC’s new powers lead to more market manipulation case?*, RISK, June 7, 2012, available at <http://www.risk.net/energy-risk/feature/2182658/cftcs-powers-lead-market-manipulation>.

<sup>157</sup> Press Release, Sen. Maria Cantwell, Federal Regulators Finalize Tough New Market Manipulation Rule Required by Cantwell (July 7, 2011), available at <http://cantwell.senate.gov/news/record.cfm?id=333423>.

<sup>158</sup> Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398 (July 14, 2011) (codified at 17 C.F.R. § 180). See also Trindle, *supra* n. 154.

<sup>159</sup> Commodity Futures Trading Commission, Q & A – Anti-Manipulation and Anti-Fraud Final Rules, available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/amaf\\_qa\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/amaf_qa_final.pdf).

with the scienter requirement of other regulatory agencies to find manipulation in other markets, including the Securities and Exchange Commission (SEC),<sup>160</sup> the Federal Energy Regulatory Commission (FERC),<sup>161</sup> and the Federal Trade Commission (FTC).<sup>162</sup> The CFTC thus defines “recklessness” as “an act or omission that departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.”<sup>163</sup> Furthermore, proof of knowledge is not required.<sup>164</sup>

The effect of anti-manipulation enforcement on excessive speculation has been evident in the natural gas market. The pricing crisis in natural gas led the Republican-controlled Congress to pass the Energy Policy Act of 2005.<sup>165</sup> Since the passage of that Act, FERC has made stopping market fraud and manipulation in the natural gas markets “an enforcement priority.”<sup>166</sup> It has passed regulations that ensure market transparency<sup>167</sup> and sought considerable fines from traders who allegedly manipulated natural gas prices. In 2006, FERC sought penalties and disgorged profits of over \$290 million in connection with the alleged manipulation of natural gas markets by traders at Amaranth Advisors LLC.<sup>168</sup> FERC settled with Amaranth but continued proceedings against Brian Hunter, a former Amaranth trader, and eventually fined him \$30 million for his involvement in the manipulation scheme.<sup>169</sup> In 2011, FERC brought manipulation cases against Atmos Energy (for attempting to avoid FERC’s posting and bidding

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<sup>160</sup> Recklessness is sufficient for the Securities Exchange Commission to pursue market manipulation cases under SEC Rule 10b-5, codified at 17 C.F.R. 240.10b-5. *See, e.g.*, *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998); *Graham v. SEC*, 222 F.3d 994 (D.C. Cir. 2000). *Cf. Osipovich, supra* n. 156 (quoting former FERC economist who draws parallels behind more stringent insider trading laws in the 1980s and the new anti-manipulation rules for futures markets).

<sup>161</sup> Energy Policy Act of 2005, Public Law 109-58, §§315, 1283, 119 Stat. 594 (2005) (amending 15 U.S.C. § 717c-1, 16 U.S.C. § 824v).

<sup>162</sup> Energy Independence and Security Act of 2007, Public Law 110-140, §§811, 812, 121 Stat. 1492 (2007) (amending 42 U.S.C. 17301, 17302).

<sup>163</sup> 76 Fed. Reg., *supra* n. 158 at 41404 (internal quotations and citations omitted).

<sup>164</sup> *Id.*

<sup>165</sup> Pub. L. No. 109-58, 119 Stat. 594 (2005). When Representative Graves co-sponsored another bill with Rep. Barrow in July 2007 to require traders who hold large positions in the natural gas market to report these positions to the CFTC, he stated that natural gas prices were “being driven by speculation and manipulation of the markets” and that Congress needed to act to prevent consumers from paying more for natural gas. *See Lawmakers see need to put limits on U.S. electronic energy markets*, PUBLIC POWER Weekly, July 3, 2008, at 5.

<sup>166</sup> Federal Energy Regulatory Commission, Prohibition of Energy Market Manipulation, Apr. 21, 2011, available at <http://www.ferc.gov/enforcement/market-manipulation.asp>. *See also* Scott DiSavino & Jonathan Leff, *Insight: Energy regulators in new push to quash manipulation*, Reuters, Apr. 12, 2012, available at <http://www.reuters.com/article/2012/04/12/us-regulations-energy-us-idUSBRE83B06Z20120412>.

<sup>167</sup> CLEARY GOTTLEB, FERC’S NEW FOCUS ON TRANSPARENCY AND PROTECTING AGAINST MANIPULATION OF GAS MARKETS, Jan. 17, 2008, available at <http://www.cgsh.com/files/News/c30a1328-e321-4d45-a060-5d6a0bf6c3c6/Presentation/NewsAttachment/2c55bc4e-18c3-4e6e-a3db-6061618857c8/10-2008%20Natural%20Gas%20Alert%2020080117.pdf> (commenting that FERC regulations require a broad range of market participants to report annually specified information related to their natural gas trades, such as the total volume of transactions for the previous year and the volume of transactions that were priced according to a particular pricing mechanism); *see also* PHILLIP MOELLER, TRANSPARENCY PROVISIONS OF SECTION 23 OF THE NATURAL GAS ACT (April 19, 2007), available at <http://www.ferc.gov/media/statements-speeches/moeller/2007/04-19-07-moeller-M-1.pdf> (“I am confident that the proposed daily postings by the intrastate carrier will allow the Commission and other market observe[r]s to identify and remedy potentially manipulativ[e] activity more actively by tracking price movements.”).

<sup>168</sup> CLEARY GOTTLEB, *supra* n. 167, at 2. *See also* John R. Morris, *FERC Changes Its Approach in Two Price Manipulation Cases*, ECONOMISTS INK, Dec. 2009, at 2, available at <http://www.ei.com/vieweconink.php?id=238>.

<sup>169</sup> *See* Federal Energy Regulatory Commission, *FERC Orders \$30 Million Fine Against Former Amaranth Trader* (April 21, 2011), available at <http://www.ferc.gov/media/newsreleases/2011/2011-2/04-21-11-G-1.asp> (explaining that traders at Amaranth allegedly amassed large amounts of NG Futures Contracts, which they then sold at one time in order to increase the value of the significantly larger short positions maintained by Amaranth in natural gas swaps).

requirements in order to create a long-term, noncompetitive discounted rate release)<sup>170</sup> and BP (for fraudulently trading physical natural gas and for trading points in order to increase the value of its financial positions).<sup>171</sup> FERC's aggressive stance against manipulation in the natural gas market has helped bring natural gas prices from record highs around \$15 per million BTU in December 2005 to ten-year lows around \$1.70 per million BTU in April 2012.<sup>172</sup>

This experience in the natural gas market reflects the effectiveness of a regulatory authority's enforcement of anti-manipulation rules in bringing market prices under control. In the same way, the CFTC can expect to decrease volatility and bring prices under control in the commodity futures markets. Furthermore, FERC's anti-manipulation enforcement experience in the natural gas markets suggests that in the quite related crude oil markets, there are similar instances of manipulation and that it is worth investigating the presence of manipulation in the oil futures market as well.

In contrast, the Federal Trade Commission has exercised very little its authority to enforce the prohibition against manipulation of crude oil gasoline or petroleum distillates at wholesale, which was granted by Congress through the Energy Independence and Security Act of 2007.<sup>173</sup> In response, the FTC launched a probe in June 2011 to investigate whether oil companies and refineries have engaged in price fixing,<sup>174</sup> but nothing has emerged from this effort.<sup>175</sup>

Unlike the FTC's lack of action, the CFTC has recently aggressively pursued manipulation cases in the crude oil futures markets under its own anti-manipulation rules. In April 2012, the Commission reached a settlement and received \$13 million in penalties and \$1 million in disgorged profits from Optiver Holding BV, whose subsidiaries and traders had allegedly manipulated crude oil, gasoline, and heating oil prices.<sup>176</sup>

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<sup>170</sup> See Federal Energy Regulatory Commission, *Staff Notice of Alleged Violations* (Aug. 12, 2011), available at <http://www.ferc.gov/enforcement/alleged-violation/notices/atmos.pdf>.

<sup>171</sup> See Federal Energy Regulatory Commission, *Staff Notice of Alleged Violations* (July 28, 2011), available at <http://www.ferc.gov/enforcement/alleged-violation/notices/bp-america.pdf>.

<sup>172</sup> Dan Strumpf, *Natural Gas Slides to 10-Year Low*, WALL ST. J., March 29, 2012, available at <http://online.wsj.com/article/SB10001424052702303816504577311911947295928.html>; Steve Hargreaves, *Big Oil sees energy bonanza ahead*, CNN MONEY, Dec. 6, 2011, available at [http://money.cnn.com/2011/12/06/news/economy/oil\\_gas\\_supply/index.htm](http://money.cnn.com/2011/12/06/news/economy/oil_gas_supply/index.htm). See also Ken Silverstein, *Oil and Natural Gas Part Ways*, FORBES, May 14, 2012, available at <http://www.forbes.com/sites/kensilverstein/2012/05/14/oil-and-natural-gas-part-ways/> (quoting Valerie Woods, the president of an energy consulting firm: "I think prices have reached an interim low and therefore some of the speculators are willing to come back into natural gas[.]"); Rapier, *supra* n. 9.

<sup>173</sup> Pub. L. 110-140, §§ 811-815.

<sup>174</sup> See Ayesha Rascoe & Roberta Rampton, *FTC probes possible oil market manipulation*, REUTERS, June 20, 2011, available at <http://www.reuters.com/article/2011/06/20/us-oil-ftc-probe-idUSTRE75J6J020110620>; Ben Geman, *FTC probes possible oil market manipulation*, THE HILL, June 20, 2011, available at <http://thehill.com/blogs/e2-wire/e2-wire/167411-federal-trade-commission-opens-probe-of-possible-oil-market-manipulation>.

<sup>175</sup> See Kevin G. Hall, *Whatever happened to task force on oil speculation?*, MCCLATCHY NEWSPAPERS, Aug. 6, 2012, available at <http://www.mcclatchydc.com/2012/03/01/v-print/140564/whatever-happened-to-task-force.html>; Roberta Rampton, *Democrat senator urges FTC to wrap up gasoline probe*, REUTERS, Mar. 1, 2012 available at <http://www.reuters.com/article/2012/03/01/usa-oil-ftc-idUSL2E8E188W20120301>.

<sup>176</sup> See David Sheppard & Jonathan Stempel, *High-frequency trader Optiver pays \$14 mln in oil manipulation case*, REUTERS, Apr. 19, 2012, available at <http://www.reuters.com/article/2012/04/20/optiver-settlement-idUSL2E8FJIP820120420>. The defendants had allegedly been involved in a manipulative tactic called "banging the close," which involves "acquiring a substantial position leading up to the closing period, followed by taking offsetting positions in a manner intended to push prices in the manipulator's favor." Press Release, Commodity Futures Trading Commission, *Federal Court Orders \$14 Million in Fines and Disgorgement Stemming from CFTC Charges against Optiver and Others for Manipulation of NYMEX Crude Oil, Heating Oil, and Gasoline Futures Contracts and Making False Statements* (Apr. 19, 2012) available at <http://www.cftc.gov/PressRoom/PressReleases/pr6239-12>.

In May 2011, the Commission charged Parnon Energy and its affiliates with profiting \$50 million from an oil manipulation scheme in 2008.<sup>177</sup> Two traders from the company had allegedly amassed very large positions in the Cushing, Oklahoma physical market in order to create the impression of a shortage and pushing up the price of WTI futures on the New York Mercantile Exchange.<sup>178</sup> The traders had profited by purchasing futures that would profit from such a rise in price.<sup>179</sup> The judge in the federal case has denied a motion to dismiss.<sup>180</sup>

Notably, the CFTC has pursued its actions against Optiver and Parnon Energy under the old manipulation rules requiring a showing of defendants' intent. With the new anti-manipulation rules that provide the Commission with more potent weapons, it will be able to curb speculative malpractices in the crude oil futures markets by demonstrating that speculators have acted with recklessness in causing prices to be unmoored from market fundamentals.

The Commission has demonstrated through these cases (along with its widely publicized anti-manipulation investigations of LIBOR interest rates)<sup>181</sup> that it is more than willing to combat manipulation in commodity staples markets, including crude oil. However, because of Wall Street and Republican opposition to its mission, the CFTC has found difficulty in exercising its authority because of a tremendous lack of resources consistent with its mission to oversee the \$300 trillion notional value futures and swaps markets now under its jurisdiction after the passage of Dodd-Frank.<sup>182</sup> In this light, President Obama's strategy of deploying an inter-agency task force led by the Department of Justice presents the best chance to address manipulation in the crude oil futures markets.<sup>183</sup> This inter-agency task force combines the expertise of the understaffed CFTC along with the vast investigatory resources of the Department of Justice. Just as FERC uncovered manipulation in the natural gas markets, this combination of the CFTC and the Department of Justice if pursued aggressively should uncover and turn back manipulation in the crude oil futures markets, thereby driving down the price of crude oil in a manner that is consistent with market fundamentals.

## CONCLUSION

A wide range of experts, observers, and market participants make it clear that there is speculation in the oil futures markets that exceed what is required for proper liquidity, and that this excessive speculation has led to overwhelming volatility in oil prices, often driving the price of a barrel of crude oil \$25 to \$30 dollars above what market fundamentals dictate. It is widely understood that increasing

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<sup>177</sup> Jack Farchy & Javier Blas, *CFTC charges traders over oil price*, FIN. TIMES, May 25, 2011, available at <http://www.ft.com/cms/s/0/dc5136aa-8633-11e0-9e2c-00144feabdc0.html#axzz20uXre5vi>.

<sup>178</sup> Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under the Commodity Exchange Act, *Commodity Futures Trading Comm'n v. Parnon Energy, Inc.*, No. 1:11-cv-3543 (S.D.N.Y. May 24, 2011), available at <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfparnoncomplaint052411.pdf>. See also Farchy & Blas, *supra* n. 177; Ayesha Rascoe & Christopher Doering, *CFTC charges Arcadia, oil traders with manipulation*, REUTERS, May 24, 2011, available at <http://www.reuters.com/article/2011/05/24/us-cftc-oil-manipulation-idUSTRE74N6S720110524>.

<sup>179</sup> Complaint, *supra* n. 178.

<sup>180</sup> Bob Van Voris, *Parnon, Arcadia Loses Bid Dismiss Oil Manipulation Case*, BUSINESS WEEK, Apr. 26, 2012, available at <http://www.businessweek.com/news/2012-04-26/parnon-arcadia-loses-bid-dismiss-oil-manipulation-case>.

<sup>181</sup> See, e.g., Press Release, CFTC Orders Barclays to pay \$200 Million Penalty for Attempted Manipulation of and False Reporting concerning LIBOR and Euribor Benchmark Interest Rates (June 27, 2012).

<sup>182</sup> See Michael Greenberger, Statement before the U.S. House of Representatives Democratic Steering and Policy Committee, Apr. 4, 2012; Bruce Edwards, *Taking aim at speculators*, RUTLAND HERALD, March 11, 2012, available at <http://www.rutlandherald.com/article/20120311/BUSINESS03/703119968/0/OPINION03>; COMMODITY FUTURES TRADING COMMISSION, STRATEGIC PLAN FY 2011-2015 (2011).

<sup>183</sup> See *supra*, nn. 87-90. But see Hall, *supra* n. 175.



volatility makes it more expensive for producers and consumers to use futures as a hedge. If commercial interests cannot hedge in a fair and orderly market, they and their ultimate consumers (i.e. the public at large) are left to the mercy of volatile markets that undercut the hedging function.

Position limits and other enforcement mechanisms are necessary in commodities of finite supply to curb excessive speculation. The current CFTC position limit rules should therefore be strengthened and strictly enforced, and the CFTC must take advantage of the new anti-manipulation rules that empower it to pursue more strongly those futures market speculators who cause the price of oil (and other commodities) to become unmoored from economic fundamentals.

The enforcement of strong position limits and other rules that limit excessive speculation has no meaningful adverse affect on the real economy. Position limits are designed to permit sufficient speculation to afford liquidity to commercial users of derivatives markets. They also limit the scope of gambling – for gambling’s sake – on upward price directional bets on energy and food staples worldwide. Stopping *excessive* gambling will not undercut production of commodities one whit, for the passive betting does not provide any assistance to the production of those commodities. The cost benefit analysis here is quite simple. By stopping unproductive gambling by passive wealthy investors and institutions that exceeds the provision of liquidity, consumers here and worldwide will pay fair, lower and market driven prices for their everyday needs.