The Relationship of Unregulated Excessive Speculation to Oil Market Price Volatility

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This paper presents supplemental views to the Energy Market Volatility portion of the Report by the Expert Group established by the Jeddah and London ad-hoc Energy Meetings (2008) to provide recommendations to the Twelfth International Energy Forum (IEF) Ministerial Meeting in March 2010. Specifically, this paper focuses upon theories articulated in the Report that have been advanced by certain market observers and academics to the effect that changes in crude oil market fundamentals have not been sufficiently dramatic to justify the last two year's extreme worldwide crude oil prices. This view sees the oil market (and even certain predominant expectations about that market) as having been seriously distorted by substantial and volatile passive investments -- not in crude oil itself -- but in deregulated or poorly-regulated crude oil derivatives designed to provide profit only from price changes in the physical market.

In April 2009, Dr. Ahmad R. Jalali-Naini, working under the supervision of Mohammad Alipour-Jeddi, Head of the Petroleum Studies Department for the Organization of the Petroleum Exporting Countries, prepared a seminal report entitled *The Impact of Financial Markets on the Price of Oil and Volatility: Developments since 2007*. Based on his findings therein he concluded, *inter alia*, that speculation in oil futures markets contributes significantly to price volatility and observed that:

> [T]hrough new asset management strategies, financial product innovation, and development of new institutional forms of investing (e.g. index and hedge funds), this 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.[1]

Thus, financial investments in the crude oil market have *substantially moved from capital raising equity and debt investments for production to betting on price direction*. This view pertaining to the influence of

[1] AHMAD R. JALALI-NAINI, PETROLEUM STUDIES DEP'T, OPEC SECRETARIAT, THE IMPACT OF FINANCIAL MARKETS ON THE PRICE OF OIL AND VOLATILITY: DEVELOPMENTS SINCE 2007, at 9 (2009).

the "financialization" by no means represents the entirety of the explanation for the volatility problem. It recognizes that market fundamentals do play a role. It further acknowledges that "expectations" about the future of market fundamentals are also important.

However, as Dr. Jalali-Naini repeatedly warned in his study, too much of the "expectation" factor is not premised on reasoned analysis of the future of market fundamentals, but it is driven instead by marketing of passive investments by derivative dealers based on "exaggerated high price expectations" that are "over-optimistic assessments of the 'super cycle' and 'super spike' prophecies [taking a] rising price scenario to a higher level."[2]

In this regard, one must distinguish between "expectations" that are based on a fundamental and reasoned understanding of the market fundamentals and those "expectations" that have little to do with the fundamentals, but instead are sensitive to efforts at price momentums and self-fulfilling prophecies.

There can be no doubt that an important countermeasure to the adverse impact on crude oil price volatility by financialization, as well as the tamping down of "exaggerated price expectations," is the development of highly refined data about the way in which the energy markets operate. However, in addition to increased and intelligent market data providing transparency, the adverse impact of financialization of these markets requires application of traditional regulatory techniques, particularly speculative position limits, which had managed to insure that market fundamentals drove physical commodity pricing until the deregulation of many of the oil and natural gas derivatives markets at the beginning of this decade.

In this regard, it is interesting to note that those who have been most concerned about regulatory controls on excessive financialization of these markets are the major oil producing and exporting countries, especially at a time when they seemed to be the principal beneficiaries of record high oil prices. For example, in June of 2008, with much of the world economy crippled by soaring crude oil costs, Saudi Arabian King Abdullah convened a meeting in Jeddah with the support, *inter alia*, of the International Energy Forum, to confer with government leaders of many oil producing and consuming countries, as well as industry representatives, to address the crisis. In his opening remarks, King Abdullah emphasized "the frivolity of the speculators in the market for selfish interests," as a critical factor explaining volatility, including what was soon to be the world record high price for crude.[3]

The King's assertion was strongly reinforced by Ali bin Ibrahim Al-Naimi, Minister of Petroleum and Mineral Resources for the Kingdom of Saudi Arabia, who noted:

> "A year ago prices were in the range of $65 a barrel, now, they are almost double that. What has happened during this relatively short period of time? Between the second quarter of 2007 and the second quarter of 2008, global demand rose by an estimated 800,000 to 1.2 million barrels per day, but at the same time global oil supplies rose between 1.4 and 1.6 million barrels per day - substantially more than the increase in

[2] *Id*. at 60, 67.

[3] King Abdullah bin Abdul-Aziz, King of Saudi Arabia, Charge from King Abdullah to the 2008 Jeddah Energy Meeting (June 22, 2008), *available at* http://www.saudi-us-relations.org/articles/2008/ioi/080627-abdullah-remarks.html.

> demand. Accordingly, days of forward cover increased from roughly 52 to 54 days during the last 12 months, and inventory levels are currently well within their normal range."
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> ". . . And yet we have seen this enormous run-up in prices, coupled with wide price swings - as you recall, earlier this month WTI prices spiked nearly 11 dollars in a single trading session, despite the fact there was no major disruption of supplies or one-day spike in demand. Clearly something other than supply-demand fundamentals is at work here, and a simplistic focus on supply expansion is therefore unlikely to tame the current price behavior.. . . ."
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> ". . . I believe that there has been a parting of the ways when it comes to oil supply-demand balances and other industry fundamentals on the one hand, and the price behavior and market volatility on the other. *Industry fundamentals cannot account for today's high prices, nor for the enormous degree of market volatility that we have experienced of late.*"[4]

The Minister then concluded:

> "I would also note that while there is little or no correlation over the past two years between global crude oil inventories and crude oil prices, there has been a strong correlation between the increasing volumes of crude oil futures trade on the NYMEX and rising prices. *According to many observers and analysts, inadequate oversight, regulation and reporting of speculative investments in commodities have further exacerbated this situation*."[5]

The conclusions of Dr. Ahmad R. Jalali-Naini's in his April 2009 seminal report are supported by the findings within several other expert reports below. Dr. Jalali-Naini concluded, *inter alia*, that "oil price movements were at times magnified by speculative pressures and incorrect expectations disseminated by certain investment banks," marketing passive price directional paper investments.[6] He noted that: "Causality tests indicate that changes in speculative positions – resulting from the entry and exit of non-commercials – can generate price volatility. When used in conjunction with a number of other variables, including commercial stocks and product prices to explain variations in the price of oil, *the speculative length in the futures market has a positive and significant coefficient*."[7] Accordingly, Jalali-Naini expressly endorsed "[t]he recent proposals by [the] CFTC to better identify types of traders and *apply the existing regulations on speculative limits [which] are steps in the right direction*."[8]

Similarly, Giacomo Luciani, Director of the Gulf Research Center Foundation, recently found:

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[4] Ali bin Ibrahim Al-Naimi, Minister of Petroleum & Mineral Res., Speech at the2008 Jeddah Energy Meeting (June 22, 2008) (emphasis added), *available at* http://www.saudi-us-relations.org/articles/2008/ioi/080627-naimi-press.html .

[5] *Id.* (emphasis added).

[6] Ahmad R. Jalali-Naini, *Speculation, Volatility and Information*, OPEC BULL., June 2009, at 37, 38.

[7] JALALI-NAINI, *supra* note 1, at 66 (emphasis added).

[8] *Id.* at 68 (emphasis added).

> "The inflow of liquidity, the increasing role played by the futures market (paper barrels) over the spot (wet barrels), and the proliferation of derivatives which encourage betting on price changes rather than on the absolute level of prices all contribute to worsen the situation, amplifying price oscillations."[9]

Mr. Luciani concluded:

> "One can find no justification in supply or demand disequilibrium for the increase of prices from about 50$/b at the beginning of 2007 to triple this level in July 2008, followed by a collapse to less than 40 in December of the same year . . . ."[10]

Princeton Professors Tang and Xiong reached similar conclusions in a September 2009 working paper where they found that, *inter alia*, "the financialization process of commodities precipitated by the rapid growth of index investment to the commodities markets," had "contributed significantly" to the volatility of commodity prices in oil and other non-energy commodities in 2008.[11] Economists at Iowa State University in May 2009 offered similar results and concluded that noncommercial speculation in crude oil futures markets increases price volatility in a "significant manner."[12]

Finally, an August 2009 study published by the James A. Baker Institute for Public Policy, corroborates these findings. Kenneth B. Medlock III and Amy Myers Jaffe note that noncommercial players now constitute about "50 percent of those holding outstanding positions in the U.S. oil futures market" and state that the increase is "highly correlated with the run-up in oil prices."[13]

As the President and Chief Operating Officer of Goldman Sachs, the marketer of one of the two largest commodity index swaps funds heavily weighted towards passive investment in crude oil prices has noted in recent testimony before the United States Senate: "So we actually, as a firm, came up with the idea in the early 1990s to create a long only, static investor in the commodity markets."[14] At the height of the oil price bubble, Goldman Sachs analysts were advising: "Commodity indices were designed to be long-only investment vehicles . . . ." However, in January 2010 Goldman Sachs Investment Strategy Group advised Goldman's Private Wealth Management Clients in a highly detailed report that: "We have

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[9] Giacomo Luciani, *From Price Taker to Price Maker? Saudi Arabia and the World Oil Market* 3 (Working Paper, 2009).

[10] *Id*.

[11] Ke Tang & Wei Xiong, *Index Investing and the Financialization of Commodities* 23 (Working Paper, 2009), *available at* http://www.princeton.edu/~wxiong/papers/commodity.pdf.

[12] Xiaodong Du, Cindy L. Yu & Dermot J. Hayes, *Speculation and Volatility Spillover in the Crude Oil and Agricultural Commodity Markets: A Bayesian Analysis* 13 (Center for Agric. & Rural Dev., Iowa State Univ., Working Paper No. 09-WP 491, 2009), *available at* http://www.econ.iastate.edu/research/webpapers/paper_13066.pdf .

[13] KENNETH B. MEDLOCK III & AMY MYERS JAFFE, JAMES A. BAKER III INST. FOR PUB. POLICY, RICE UNIV., WHO IS IN THE OIL FUTURES MARKET AND HOW HAS IT CHANGED? 5 (2009), *available at* http://www.bakerinstitute.org/publications/EF-pub-MedlockJaffeOilFuturesMarket-082609.pdf.

[14] *How We Achieve a More Secure, Reliable, Sustainable and Affordable Energy Future for the American People: Hearing Before the Senate Comm. on Energy and Natural Resources (S. Hrg.110-654)*, 110th Cong. 85 (2008) (statement of Gary Cohn, Chief Operating Officer, Goldman Sachs & Co.), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:45837.pdf.

concluded that there is no consistent and reliable argument for a strategic allocation to a commodity futures index in a well-diversified portfolio."[15]

Within the United States, the view that unchecked excessive financial speculation in "paper" oil has a deleterious impact on extreme volatility of energy prices has been accepted in important quarters, *e.g.*, by the Chairman of the United States House Committee on Agriculture (which has oversight of the U.S. CFTC),[16] the United States House of Representatives which recently passed legislation addressing this issue by granting substantial new powers to the U.S. CFTC to impose aggregate speculative limits over all derivatives markets over which the U.S. has jurisdiction,[17] the Chairman of the United States Senate Committee on Banking,[18] the United States Senate Subcommittee on Permanent Investigations,[19] and such well-respected economists and market observers as Nouriel Roubini,[20] George Soros,[21] and Joseph Stiglitz.[22] There has been a call for strict position limits on excessive speculative activity across physical commodity derivatives markets, including the unregulated over-the counter (OTC) derivatives markets.

Indeed, in the summer and fall of 2008, the United States House of Representatives overwhelmingly passed two bills calling for tighter speculative limits and controls on excessive passive speculation in the crude oil derivatives markets.[23] At the same time, the United States Senate proposed an even stricter regulatory speculative limit framework, which won the support of a majority of the Senate,

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[15] DAVID GREELY & JEFFREY CURRIE, GOLDMAN, SACHS & CO., COMMODITIES: SPECULATORS, INDEX INVESTORS, AND COMMODITY PRICES 4 (2008); GOLDMAN SACHS INV. STRATEGY GROUP, COMMODITIES: A SOLUTION IN SEARCH OF A STRATEGY 7 (2010).

[16] 155 CONG. REC. H14705 (daily ed. Dec. 10, 2009) (statement of Rep. Peterson).

[17] Kevin Drawbaugh, *House Approves Sweeping Financial Reforms*, REUTERS, Dec. 11, 2009, *available at* http://www.reuters.com/article/idUSTRE5B90CY20091211; Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. §3113 (2009); *see, e.g.*, Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795, 111th Cong. (2009) (sponsored by Congressman Frank) (discussing the various approaches taken by the House Financial Services and Agriculture Committees to address these issues).

[18] Restoring American Financial Stability Act of 2009, Discussion Draft, 111th Cong. (2009) (sponsored by Senator Dodd), *available at* http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

[19] *See* STAFF OF SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, EXCESSIVE SPECULATION IN THE WHEAT MARKET 4 (2009) [hereinafter WHEAT REPORT]; STAFF OF SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET 51–75 (2007) [hereinafter NATURAL GAS REPORT].

[20] *See* Lara Crigger, *Nouriel Roubini: The Coming Commodities Correction*, HARDASSETSINVESTOR.COM, Nov. 6, 2009, http://www.hardassetsinvestor.com/features-and-interviews/1846-nouriel-roubini-the-coming-commodities-correction.html.

[21] *See* Edmund Conway, *George Soros: Rocketing Oil Price Is a Bubble*, DAILY TELEGRAPH (U.K.), May 26, 2008, *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2790539/George-Soros-rocketingoil-price-is-a-bubble.html (quoting Soros, a highly successful speculator, as stating "[s]peculation . . . is increasingly affecting the price" of energy).

[22] *See* especially *infra* notes 29-31, 44 for full citations to the conclusions of those mentioned within this paragraph without citation here.

[23] David Cho, *House Passes Bill Bolstering Oil Trade Regulator*, WASH. POST, June 27, 2008, at D8; Commodity Markets Transparency and Accountability Act of 2008, H.R. 6604, 110th Cong. (2008).

but fell short of the super-majority of 60 Senators required for passage to overcome a threatened filibuster at that time.[24]

The impetus for this near-consensus within the United States was the destabilizing affect dizzying crude oil price volatility has had on the American economy. Although the price of crude oil was only 10% higher in June 2009 than in June 2007, crude oil endured extreme volatility in the period between those benchmarks.

In June 2007, the price of WTI crude oil was $65 per barrel, but by July 2008, this price rose over 126% to $147. Despite predictions in mid-July by prominent swaps dealers that crude oil would rise to $200/b by year's end, the price then sank to the low $30s by winter 2008/2009; but, in the absence of any final regulatory legislation, it rose back to $75 in 2009, stabilizing in the $65-75 range until just a few weeks ago when the price broke through the $80 level on reports (which turned out to be unfounded) that the CFTC Chairman did not have support for a strict position limit regime.

During the first six month 2009 run-up from the $30s to $75, gasoline prices in the United States rose for a record 54 days in a row.[25] The price for crude oil futures contracts on NYMEX expiring in 2017, while thinly traded, has hovered at $100 with Goldman Sachs recently predicting its commodity swaps index fund heavily weighted in crude oil will increase at 17.5 % pace for the near future.[26]

While the recent increase in prices has persuaded some to believe that fundamental principles of supply/demand are now alone driving the market, respected experts have concluded that this recent rise in commodity prices is simply another bubble.[27] Professor Nouriel Roubini describes the 2009 commodity spike as "money chasing commodities" and states that "[t]here is a risk that oil can rise to $80, $90 or $100 because of speculative demand."[28]

Dr. Roubini therefore is "*in favor of position limits*, because I think this volatility in oil prices is severely damaging the global economy. When oil goes to $145, we have a global recession. When oil goes to $30, nobody invests in new capacity. And these swings in boom and bust in oil prices are

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[24] See 154 CONG. REC. S5409-10 (daily ed. June 10, 2008) for Consumer-First Energy Act of 2008, S. 3044, 110th Cong. (2008) (Record Vote Number: 146, Cloture motion rejected – 51 Yeas, 43 Nays, 6 Not voting).

[25] U.S. Energy Info. Admin., Cushing, OK WTI Spot Price FOB (Dollars per Barrel), http://tonto.eia.doe.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=rwtc&f=d (last visited Jan. 14, 2010). *See also* Senator Bernard Sanders, Testimony Before the Commodity Futures Trading Commission on Energy Position Limits and Hedge Exemptions 28 (July 28, 2009), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript072809.pdf.

[26] *See* Izabella Kaminska, *Goldman Still Bullish on Commodities: Oil, Corn, Copper to Rise*, FT.COM/ALPHAVILLE, Nov. 10, 2009, http://ftalphaville.ft.com/blog/2009/11/10/82451/goldman-still-bullish-on-commodities-oil-corn-copper-to-rise/.

[27] *See* Anabela Reis & Mark Deen, *Roubini Sees Asset-Bubble as Money Chases Commodities*, BLOOMBERG.COM, Nov. 20, 2009, http://www.bloomberg.com/apps/news?pid=20601207&sid=agzqkJ2EQR3M; Izabella Kaminska, *Why Refinery Shutdowns Matter,* FT.COM/ALPHAVILLE, Nov. 23, 2009, http://ftalphaville.ft.com/blog/2009/11/23/84711/why-refinery-shutdowns-matter/. It is also worth nothing that floating storage is also helping to complicate these issues. *Id*.

[28] *See* Reis & Deen, *supra* note 27.

extremely damaging to economic growth. It's time to control it. *If we don't control it, these booms and busts are going to become more severe, more damaging and more risky.*"[29]

The use of speculative position limits has been an historical feature of U.S. regulated futures markets and is consistent with the fundamental purposes of those markets, which have always been to support sound price discovery mechanisms based on commercial hedgers (usually commercial handlers of a physical commodity) using futures markets for those markets' intended purpose: to shift price risk.[30]

In a smooth-functioning futures market, prices are determined by the healthy tension between commercial consumers, who want prices to be as low as possible, and commercial producers, who want them to be as high as possible.[31] Speculators are needed in the futures market to create sufficient liquidity for commercial users,[32] but excessive speculation, *i.e.*, speculation that overwhelms the dynamics of supplier/consumer hedging, completely dislodges the market from economic fundamentals.[33]

In contrast, speculators have no stake in discovering the fair price of a commodity; instead, they hope to profit from price directional bets. Thus, they want prices to move, as dramatically as possible, in the direction of the bet.[34] As a result, when speculators make up too large a share of the futures market, they have the potential to upset the healthy tension between consumers and producers and resulting adherence of prices to market fundamentals.[35] The resulting volatility makes it more difficult for commercial consumers and producers to successfully hedge risk, because prices do not reflect market fundamentals, and so they abandon the futures market and risk shifting—thereby further destabilizing the price discovery influence of these markets.[36] For example, the NYMEX crude oil WTI open interest

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[29] Crigger, *supra* note 20 (emphasis added).
[30] *See* WHEAT REPORT, *supra* note 19, at 4; NATURAL GAS REPORT, *supra* note 19, at 51–75; NICK BATTLEY, AN INTRODUCTION TO COMMODITY FUTURES AND OPTIONS 1 (2d ed. 1995); *Regulatory Reform Hearing Before the Cong. Oversight Panel*, 111th Cong. (2009) (testimony of Joseph E. Stiglitz) (arguing that only standardized and regulated products used for hedging against risk, but not "gambling," should be permitted), *available at* http://cop.senate.gov/documents/testimony-011409-stiglitz.pdf; Commodity Futures Trading Comm'n (CFTC), The Economic Purpose of Futures Markets and How They Work, http://www.cftc.gov/educationcenter/economicpurpose.html (last visited Jan. 14, 2010).
[31] *See* NATURAL GAS REPORT, *supra* note 19, at 29; WHEAT REPORT, *supra* note 19, at 152–57; BATTLEY, *supra* note 30, at 101.
[32] *See* Al-Naimi, *supra* note 4; NATURAL GAS REPORT, *supra* note 19, at 29; BATTLEY, *supra* note 30, at 44.
[33] *See* PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, THE ROLE OF MARKET SPECULATION IN RISING OIL AND GAS PRICES: A NEED TO PUT THE COP BACK ON THE BEAT 11-12 (2006) [hereinafter MARKET SPECULATION]; Jonathon Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States, 1875–1905*, AM. HIST. REV. 307, 307 (2006) ("'[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'" (quoting *Fictitious Dealings in Agriculture Products: Hearing on H.R. 392, H.R. 2699 and H.R. 3870 Before the H. Comm. on Agriculture*, 52d Cong. (1892) (testimony of Charles Pillsbury))).
[34] *See* WHEAT REPORT, *supra* note 19, at 152–57; BATTLEY, *supra* note 30, at 101–02; Tang & Xiong, *supra* note 11, at 2.
[35] *See* WHEAT REPORT, *supra* note 19, at 152–57; BATTLEY, *supra* note 30, at 101–02; Tang & Xiong, *supra* note 11, at 2.
[36] *See, e.g.*, NATURAL GAS REPORT, *supra* note 19, at 73–74; Congressman Bart Stupak, Testimony Before the Commodity Futures Trading Commission on Energy Position Limits and Hedge Exemptions 3 (July 28, 2009),

moved from approximately 70% commercial/30% non-commercial in 2001 to virtually the exact opposite by the summer of 2008.[37]

In just one example, the dominance of a single speculative hedge fund, Amaranth, in the natural gas futures market drove up energy prices so much that upon its failure, the futures price between July and September of 2006 dropped by 43%. In response to the Amaranth debacle, the United States Congress required the CFTC to examine unregulated energy markets within its jurisdiction, which by virtue of the Commodity Futures Modernization Act of 2000, were exempt from regulation and therefore position limits, to determine whether they should be reregulated.[38] The CFTC has already reregulated several of those markets with the imposition of attendant position limits and is exploring the reregulation of several others. The CFTC has also required Foreign Boards of Trade doing business in the U.S., but regulated directly by their home oversight agencies, to, nevertheless impose position limits applied by U.S. exchanges as a condition of continuing their operations within the U.S. when they conduct trading relating to, or affecting, U.S.-based commodity contracts.[39]

Historically, regulatory position limits draw a line between that speculation necessary for liquidity and excessive speculation that has been recognized to cause markets to become distorted. Thus, position limits are a major regulatory tool designed to maximize the influence of market fundamentals on pricing.

Position limits reign in speculation by limiting the number of derivatives contracts that individual investors can hold, thus controlling their share of a market and subsequent impact on it.[40] Position limits may encompass three main types of controls: spot month limits (applying only to contracts held in the month a contract expires); single month limits (applying to monthly contracts other than those in the spot month); and all-months combined limits (a limit on the total number of contracts across all contract months).[41]

Currently, the CFTC has the capacity on markets over which it has regulatory authority to set all three types of position limits.[42] However, it has historically only applied hard limits to the spot month; even then, it has provided significant and opaque exemptions for speculators if they can demonstrate that they are hedging financial risk, such as laying off risk from exposure to their unregulated OTC energy

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available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing072809_stupak.pdf (reporting that according to congressional investigation, the oil futures market had been "taken over by swap dealers and speculators").

[37] *See* Stupak, *supra* note 36, at 3.

[38] *See* MARKET SPECULATION, *supra* note 33, at 1-7.

[39] *See*, *e.g.*, 71 Fed. Reg. 64,443, 64,445 n.23 (Nov. 2, 2006) ("In the absence of no-action relief, a board of trade, exchange or market that permits direct access by U.S. persons might be subject to Commission action for violation of, among other provisions, section 4(a) of the CEA, if it were not found to qualify for the exclusion from the DCM designation or DTEF registration requirement.").

[40] *Cf.* 7 U.S.C. § 6a(a) (2006) ("Excessive speculation [in the futures markets for a 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 or positions which may be held by any person . . . ."); WHEAT REPORT, *supra* note 19, at 70–72.

[41] 17 C.F.R. § 150.1(a)-(c) (2009).

[42] *Id*.

swap book concerning price directional betting.[43] These exemptions, most of which have been granted through opaque procedures by CFTC staff (rather than by the Commissioners themselves), have recently and conclusively been shown by a prominent Senate Permanent Subcommittee on Invertigations to have resulted in significant volatility in agricultural commodities such as wheat.[44] The Chairman of the CFTC, Gary Gensler, has stated that "[t]hough there are certainly many causes of the [current economic] crisis, I think most would agree that the unregulated OTC derivatives marketplace played a central role."[45] It is for this reason that the CFTC itself has recently proposed setting all three types of position limits on the important natural gas and crude oil futures contracts over which it has jurisdiction.[46]

Position limits in the United States are now set on an exchange-by-exchange basis, but they are more effective if they are set on an aggregate basis, so that a corporate entity is assigned limits applying to the entire corporate structure on futures trading for each physical derivatives market whether regulated or traded in the presently unregulated OTC markets.[47] Again, both the full U.S. House and Senate on a bipartisan basis have passed different forms of legislation to this end and important Congressional Committees on a bipartisan basis have recently gone on record supporting and giving authority to CFTC Chairman Gensler to carry out his proposed strict imposition of position limits on an aggregated basis on regulated and OTC markets over which the U.S. has jurisdiction.[48]

On December 11, 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009, which among other things, permits the CFTC to establish position limits on commodity-based derivatives.[49] This bill "would impose regulation for the first time on the $450 trillion over-the-counter derivatives market."[50] Under this legislation, the CFTC would have the power to set aggregate position limits across regulated U.S. futures markets, contracts traded on foreign boards of trade that provide access to members or participants located in the United States for U.S.-commodity based contracts, and over-the-counter derivatives in physical commodities in which U.S. citizens or companies are counterparties or which are executed in the U.S.[51]

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[43] *See* WHEAT REPORT, *supra* note 19, at 105–06.
[44] *Id*.
[45] *Hearing Before the House Comm. on Energy and Commerce, Subcomm. on Energy and the Environment*, 111th Cong. 1 (2009) (testimony of Gary Gensler, CFTC Chairman), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-21.pdf.
[46] Notice of Proposed Rulemaking for Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (Jan. 14, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/proposedpositionlimitsrule.pdf (not yet published in the Federal Register, affecting 17 C.F.R. pts. 1, 20, 151).
[47] *See* Paul N. Cicio, Indus. Energy Consumers of Am., Testimony Before the Commodity Futures Trading Commission on Energy Position Limits and Hedge Exemptions 4 (Aug. 5, 2009), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing080509_cicio.pdf ("Without aggregate position limits and transparency across all exchanges and players, position limits will not work effectively. Without aggregate position limits, players will move their transactions to dark markets.").
[48] *See supra* notes 17-21, 26-28, and 45-47 and accompanying text.
[49] Kevin Drawbaugh, *supra* note 17.
[50] *Id*.
[51] Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. §3113 (2009).

The Chairman of the U.S. House Agriculture Committee, who drafted the new CFTC position limit authority, strongly endorsed the need for strong position limits to control price volatility in the energy markets. He said on the floor of the U.S. House:

> It began with the price volatility we saw in energy futures markets, first with natural gas, then for crude oil. We examined in our committee the influx of new kinds of traders in these markets, like hedge funds and index funds. We looked at the relationship between what was occurring on the regulated markets and the even larger unregulated, over-the counter market. More aptly, this probably should have been called the under-the-counter market because trillions of dollars in transactions affecting commodity prices were being conducted out of sight and out of reach of market regulators. . . . The [bill] strengthens confidence in trader position limits on physically deliverable commodities as a way to prevent excessive speculation. And it will call for international harmonization by requiring foreign boards of trade to share trading data and adopt speculative position limits on contracts that trade U.S. commodities similar to U.S.-regulated exchanges.[52]

Just as Dr. Jalali-Naini in his report cited above notes, the "financialization" of the crude oil derivatives markets represents an investor shift toward price directional bets and away from "[i]nvestor involvement in the oil sector . . . mainly through equity positions in oil companies."[53] It can therefore be reasonably assumed that once speculation is subject to position limits, there would be a shift back by a good portion of non-commercial funds toward capital investment in production, exploration, and technology in the energy or alternative fuels sector.

Critics of position limits often state that such a regulatory approach will not be successful because those trading derivatives will simply take their trading from U.S.-based exchanges or foreign exchanges doing trading in the U.S. to those located in other counties (usually in Europe). Recent developments indicate that this is not as plausible as some might think. In a recent report, the Commission of the European Communities documented the types of regulatory changes that the European Union should adopt with regard to derivatives. This committee (buttressed by strong July 2009 statements of British Prime Minister Brown and French President Sarkozy) indicated that it was going to propose rules that would allow regulators to adopt position limits, in order to combat price volatility.[54] It has also been indicated that due to agreements reached through the G20,foreign derivatives activity would have to be

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[52] 155 CONG. REC. H14705 (daily ed. Dec. 10, 2009) (statement of Rep. Peterson).

[53] JALALI-NAINI, *supra* note 1, at 9.

[54] *See* COMM'N OF THE EUROPEAN CMTYS., COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN CENTRAL BANK, ENSURING EFFICIENT, SAFE AND SOUND DERIVATIVES MARKETS: FUTURE POLICY ACTIONS 9 (2009); *see*, *e.g.,* Gordon Brown & Nicolas Sarkozy, *Oil Prices Need Government Supervision*, WALL ST. J., July 8, 2009, at A15; Press Release, European Comm'n, Financial Services: Commission Sets Out Future Actions to Strengthen the Safety of Derivatives Markets (Oct. 20, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1546&format=HTML&aged=0&language=EN&guiLanguage=en; Joel Clark & Duncan Wood, *Industry Faces Basel Capital Hikes for OTC Derivatives*, RISK.NET, Dec. 11, 2009, http://www.risk.net/risk-magazine/news/1565832/industry-basel-capital-hikes-otc-derivatives (discussing the Basel Committee on Banking Supervision's efforts to increase OTC derivative regulation).

aligned with U.S. regulations.[55] These recent changes make it unlikely that participants involved with derivatives trading will be able to "shop" for the least-regulated market; and they also reflect global endorsement of speculative position limits.

Finally, arguments have been advanced that establishing position limits is an inexact science or that there is not enough competent market data upon which such limits can be based. From 1936, when the United States Congress followed President Roosevelt's request that commodity markets be regulated to control speculative activity (which at that time was undercutting farm prices), through the deregulation of energy markets sponsored by Enron in December 2000, position limits have been deployed effectively by either the CFTC (or its predecessor agencies) or the U.S. futures exchanges themselves with little criticism of the limits and without any complaints about the kind of excessive speculative activity undermining market fundamentals that we find today. Only after deregulation and after broad-based position limit exemptions were granted to speculators in regulated future markets has there been the outcry about the lack of those limits by the broad-based worldwide constituency cited above.

There can be no gainsaying that the establishment of positions limits is more properly described as an art rather than an exact science. However, the U.S. regulatory history has shown that that there are many regulators and commercial users of the markets that are quite experienced in that art. Doubtless with the kind of improved market data the Expert Group recommendations call for, regulators and exchanges will establish limits with greater precision. In that regard, position limits can be regularly and quickly readjusted if they are shown to cause a lack of liquidity.

The damage price volatility causes the economy by needlessly inflating energy and food prices worldwide far outweighs the concerns about the precise application of what for over 70 years has been the historic regulatory technique for controlling excessive speculation in risk-shifting derivative markets. In this regard, Voltaire had it right when he said that the "perfect should not be the enemy of the good."

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[55] *See* COMM'N OF THE EUROPEAN CMTYS., *supra* note 54, at 9.