



SENATE REPUBLICAN

POLICY COMMITTEE

## Legislative Notice

No. 67

July 21, 2008

# **S. 3268 – The Stop Excessive Energy Speculation Act of 2008**

Calendar No. 882

*S. 3268 was read twice and placed on the Calendar on July 17, 2008.*

### **Noteworthy**

- On Tuesday, July 22, the Senate will vote on cloture on the motion to proceed to S. 3268, the Stop Excessive Energy Speculation Act of 2008.
- The bill:
  - Sets requirements for the offering of access to electronic trading in the United States by foreign boards of trade, defines legitimate hedge trading to include only transactions by commercial producers and purchasers of actual physical petroleum and energy commodities for future delivery, and generally requires the Commodity Futures Trading Commission (CFTC) to distinguish between hedge trading and trading that is not legitimate (“nonlegitimate”);
  - Requires the CFTC to set position limits on “nonlegitimate” trading;
  - Directs the CFTC to appoint at least 100 new full-time employees;
  - Requires persons owning energy futures or swaps to report the quantity of physical stocks owned and other information regarding the owner’s positions to the Secretary of Energy, subject to such requirements as the Secretary deems necessary; and
  - Permits the CFTC to require certain covered entities to liquidate positions and transactions and comply with position limits if the CFTC determines that a major market disturbance has occurred.
- At press time, there was no Statement of Administration Policy (SAP) for S. 3268.
- At press time, there was no Congressional Budget Office (CBO) score for S. 3268.

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## **Highlights**

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### **Excessive Speculation in Oil Markets:**

S. 3268's stated purpose is to "curb excessive speculation" in oil futures markets. Support for the legislation and similar efforts are based on the assertion that a significant portion of the recent rise in oil prices is due to something other than core global supply and demand imbalances. This assertion is based on the coincidence of both the expansion in the volume of trading on oil futures markets and expansion of investment in commodities by investment funds with recent increases in the price of oil. The association of these two factors is typically coupled with the presentation of the opinions of individual investors and industry participants articulating the notion that the markets are trading at levels inconsistent with physical supplies, inventories, and demand.

Others favor a perspective that analyzes recent oil price increases in light of sustained worldwide growth in GDP led by emerging economies in the Asia-Pacific and the Middle East, coupled with modest to flat growth in supply and shrinking excess oil production capacity. In addition, a weakening dollar and geopolitical risks contribute to volatility and sustained increases in oil prices in several ways. First, depreciation of the currency accentuates any price spike. Against the Euro, for example, the dollar is at or near all-time lows. Because oil is traded in dollars, European purchasers of oil, for example, are currently paying significantly less than U.S. purchasers. Second, a depreciating dollar forces investors in the United States and abroad to seek asset classes that will protect investment value. Purchases of oil and other commodities provide such assets. Finally, geopolitical instability and the possibility of labor unrest in key producing regions including the Middle East, Africa, and South America threaten to suspend or otherwise interrupt an already tight supply and shrinking spare production capacity.

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## **Background**

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### **Trading of Crude Oil in Futures and Commodities Markets:**

There are several physical and financial markets in which crude oil is bought and sold. These include the 'spot' markets, which involve transactions for immediate or short-term delivery of oil and derivative financial contracts like futures. These financial contracts may be traded on organized exchanges such as the New York Mercantile Exchange (NYMEX), on electronic market platforms such as the InterContinental Exchange (ICE), and in other over-the-counter (OTC) transactions that occur between qualified parties. The NYMEX handled more than 350 million futures and options contracts in 2007, accounting for about two-thirds of global volume.<sup>1</sup>

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<sup>1</sup> Congressional Research Service (CRS), *Primer on Energy Derivatives and Their Regulation*, July 15, 2008 p. 3.

## **Futures and Derivatives Background:**

Prices for oil and other energy commodities are set in part by futures and derivatives markets, where producers of commodities, commercial users of those commodities, and financial speculators buy and sell contracts whose value is linked to the price of the underlying commodity. Trading occurs on regulated futures exchanges and between qualified parties in what is referred to as an OTC market. Both forms of trading are global in scope.

## **Price Discovery and Hedging Opportunities:**

Futures markets are intended to provide price discovery and hedging opportunities to mitigate business risk. The futures exchanges essentially function as fora where all available information about supply and demand for the underlying commodity is assembled and incorporated into the price. Participants incorporate current data, including inventories and consumption, expectations about long-term supply and demand trends, macroeconomic conditions, and geopolitical risk factors that could disrupt supply, and trade accordingly. Hedgers, on the other hand, seek to avoid the risk that the price of an underlying commodity will fluctuate to their detriment. A corn producer might hedge against a drop in corn prices by locking in a contract to deliver corn at a certain price. In many cases, a speculator will be the contracting party in such a contract, agreeing to buy corn from the producer.<sup>2</sup> Without a willing party to take the other side of the contract, hedgers are unable to mitigate risk.

## **Oil Futures and Derivatives Transactions:**

An **oil futures contract** typically represents 1,000 barrels of oil. Like other futures contracts, neither party to the contract need ever possess the physical commodity. One party simply agrees to buy oil at a future date from another party. In this type of contract, the party agreeing to buy oil at some point in the future is referred to as the “**long**” (or the “long” position), and the counterpart agreeing to sell the commodity is called the “**short**” (or the “short” position). Contracts are available with different maturities, designated by expiration in months, and can require **margins**, a deposit paid by both parties to a contract that ensures that if the market moves against that party the clearinghouse can make payment to the other party.

Assume, for example, the agreed price of oil under a futures contract is \$135 per barrel. This means simply that the long trader is committed to buy at that price, and the short trader is obligated to sell at that price, both at some future date. If at some point before delivery is due, the price of oil goes up to \$145/barrel (bbl), the motivations of the two traders might begin to change. The long trader now has an unrealized gain: he “owns” a contract to buy oil for \$135, but the oil is now worth \$10 more than that. The short position has lost a corresponding amount: the owner is obliged to sell oil that may be worth \$145/bbl for less than that, namely \$135, the agreed price under the futures contract.

If the price continues to go up, or if the short position believes the price will continue to go up, the holder of the short position may choose to exit the market. The owner can do this by securing a contract to buy oil at a set price, say \$146/bbl, provided he/she is able to find such a

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<sup>2</sup> CRS, *Primer on Energy Derivatives and Their Regulation*, July 15, 2008, pp. 1-2.

contract. If the short position is able to do so, he/she is in effect purchasing a long contract with the same expiration date. The obligation is now to sell oil at the initial price (\$135/bbl) and to buy oil at the second price of \$146/bbl. The difference between the two contracted prices represents the loss the short trader has realized, in the addition to transaction costs. What results is that the short position has “**hedged**” against any additional loss by securing the second contract, or more generally, made an additional investment taken out specifically to reduce or cancel out the risk in the initial investment.

### **Hedging Activity:**

Other parties may wish to hedge against some sort of business risk other than that generated solely by participating in the futures market. A commodity consumer, like an airline, for example, might wish to hedge in the context of a predictable future need of jet fuel. If an airline purchases fuel on the spot market, it can be exposed to short-term fluctuations in prices, making business planning difficult. Alternatively, an airline can contract for longer-term acquisition of fuel for its operations. In either case, the airline, like any other high volume consumer of petroleum products, faces a certain type of price risk that can be in part managed by the use of hedging tools. Because there are no futures contracts for jet fuel, such hedging is typically done through a swap transaction (a customized tool developed for hedging needs beyond those contracts available on an exchange). If for example, current prices are relatively low, the airline can lock-in current prices by purchasing a contract that gives them the right to purchase fuel (or some other commodity whose price changes in tandem with the price of fuel) in the future at the current price. In this case a swap dealer is the seller entering into the contract with an airline. The swap dealer may actually sell individual components of this customized contract to a **speculator** if the speculator needed that contract to offset some other risk, or if the speculator thought that oil for future delivery would be available at some price less than the current price.

**Options** on futures are also available, adding a layer of complexity to the trading of derivatives. The holder or owner may choose to enter into a long or short futures contract on which the option is based. Naturally, the option will only be exercised if price movements are favorable to the buyer.<sup>3</sup>

### **The Commodity Futures Trading Commission (CFTC):**

In 1974, Congress created the CFTC to oversee trading in derivative financial instruments involving commodities.<sup>4</sup> The mission of the CFTC is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets. Futures contracts for agricultural commodities have been traded in the U.S. for more than 150 years and have been under federal regulation since the 1920s. In recent years, trading in futures contracts has expanded rapidly beyond traditional physical and agricultural commodities into a vast array of financial instruments, including foreign currencies, U.S. and foreign government securities, and U.S. and foreign stock indices. Through oversight, the CFTC assures the

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<sup>3</sup> CRS, *Primer on Energy Derivatives and Their Regulation*, July 15, 2008, “Appendix. A Futures Contract.”

<sup>4</sup> Derivatives are financial contracts whose value depends on the value of an underlying security or physical asset. Futures, options, warrants, and convertible bonds are all examples of a derivative. Derivatives exist as both exchange-traded contracts and privately negotiated contracts.

economic utility of the futures markets by encouraging their competitiveness and efficiency, ensuring their integrity, protecting market participants and others from manipulation, preventing abusive trading practices and fraud, and ensuring the financial integrity of the clearing process.<sup>5</sup> The CFTC has a statutory duty to prevent excessive speculation whereby sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity exist (as determined by the Commission), and is authorized to limit the amount of trading in the market if such circumstances exist.<sup>6</sup>

### **The Commodity Exchange Act and the Farm Bill:**

The Commodity Exchange Act (CEA) provides the basis for federal regulation of commodity futures trading through the CFTC. In 2000, the Commodity Futures Modernization Act (CFMA) enacted significant amendments to the CEA.<sup>7</sup> The farm bill ([P.L. 110-234](#)) built on these changes and gave the CFTC authority over electronic trading facilities like the InterContinental Exchange, where certain contracts had come to play a significant role in price discovery. Trading on this type of exchange had not been directly regulated by the CFTC. If the CFTC determines that an energy contract traded on an over-the-counter (OTC) electronic trading facility plays a significant role in setting prices (that is, if prices generated there are linked to, or used as reference points by, other markets), the OTC market is required to register with the CFTC and comply with several regulatory core principles aimed at curbing manipulation and improving the monitoring of speculation activities, including the establishment and enforcement of position limits. The OTC market is required to publish and/or report to the CFTC information relating to prices, trading volume, and the size of positions held by speculators and hedgers.

### **CFTC Treatment of Foreign Boards of Trade:**

Foreign boards of trade (FBOTs) wishing to offer trading opportunities to U.S. entities must either become a registered entity under the CEA (become a “designated contract market”), or obtain a letter or memorandum from the CFTC noting the conditions under which the FBOT will be permitted to have direct access to U.S. traders. The CFTC typically takes such action in order to maximize trading opportunities for U.S. entities if it believes that the exchange is regulated adequately in its home jurisdiction and if the foreign exchange or foreign regulator agrees to provide necessary data to the CFTC to ensure that activities on the foreign exchange can be properly monitored. Additional requirements are typically required by the CFTC depending on the exchange, their regulator and the contract which they would like to directly offer to U.S. traders.<sup>8</sup>

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<sup>5</sup> CFTC Website, viewed July 15, 2008. [www.cftc.gov](http://www.cftc.gov).

<sup>6</sup> See 7 U.S.C. 6a.

<sup>7</sup> For more information on the CFMA, see Congressional Research Service, *The Commodity Futures Modernization Act of 2000: Derivatives Regulations Reconsidered*, January 29, 2003.

<sup>8</sup> See Congressional Research Service, *Speculation and Energy Prices: Legislative Responses*, July 18, 2008, pp. 5-6.

## Bill Provisions

### **Section 2. Energy Commodity.**

Defines “energy commodity” as a petroleum product or natural gas.

### **Section 3. Speculative Limits.**

Amends the Commodity Exchange Act (CEA) such that Foreign Boards of Trade (FBOTs) may not offer access to electronic trading to U.S. participants unless:

- The FBOT makes public daily trading information comparable to what domestic boards of trade make public; and
- The FBOT gives notice to the CFTC of changes in what the FBOT will make public, changes in its position or speculation limits, and any position reductions required to prevent manipulation; and
- The FBOT adopts position limits, speculation limits, and accountability provisions for speculators adopted by the board of trade against which the contract settles; and
- Possesses the authority to require or direct market participants to liquidate provisions the FBOT determines is necessary to reduce or prevent the threat of price manipulation, excessive speculation, price distortion, or disruption of delivery or the cash settlement process; and
- Provides information to the CFTC regarding legitimate and non-legitimate hedge trading comparable to information the CFTC deems necessary to publish its Commitments of Traders report for the domestic entity.

For FBOTs with existing agreements with the CFTC, the provision becomes effective six months after enactment.

### **Section 4. CFTC Authority.**

Permits the CFTC to require any person located in the United States who enters a trade directly in the trade matching system of a foreign board of trade to maintain records and “books.”

Makes illegal the violation by a U.S. person of any bylaw, rule, regulation, or “resolution” of any FBOT or foreign futures authority establishing limits on the amount of trading or position limits, or options on futures.

Requires the CFTC to consult with the appropriate foreign entity taking related actions.

### **Section 5. International Working Group.**

Requires the CFTC within 90 days to convene a “working group of international regulators” to develop international reporting and regulatory standards to protect futures markets from “nonlegitimate hedge trading, excessive speculation, manipulation, location shopping, and lowest common denominator regulation.”

### **Section 6. Manipulation and Excessive Speculation.**

Limits hedge trading to commercial producers and purchasers of physical petroleum and energy commodities and direct counter-parties of transactions by those parties. Subsequent trades by an

intermediary are deemed legitimate hedge trading if they are “done proximate to the initial trade” and are “economically the same in size and substance as the initial trade.”

Requires the CFTC to modify all definitions, classifications, and data collections as are necessary to identify and classify direct and indirect parties as engaging in either legitimate hedge trading or other trading. Requires the CFTC to review in their entirety its regulations, rules, letters, orders, and other actions taken on behalf of the CFTC regarding all energy futures market participants or market activity to ensure that legitimate hedge trading is protected and promoted and that excessive speculation is eliminated.

Requires the CFTC to review and modify or revoke any prior action it has taken unless it can affirmatively determine that such actions “will protect and promote legitimate hedge trading and does not permit or encourage excessive speculation.”

Requires the CFTC to establish, within 30 days, speculative position limits on trading that is not legitimate hedge trading in energy commodities. Further requires the CFTC to convene an advisory group comprised of commercial producers and purchasers that will advise the CFTC in their final rulemaking authority regarding speculative position limits. The final rulemaking shall be issued within 18 months.

Requires the CFTC to develop methodology to determine and set aggregate speculation limits for nonlegitimate traders of energy commodities. Speculative position limits are to be set at a maximum level practicable to ensure market liquidity for legitimate hedging activities, ensure that price discovery is not disrupted, protect and promote legitimate hedge trading, minimize nonlegitimate hedge trading, and eliminate excess speculation.

#### **Section 7. Over-the-Counter Transactions.**

Requires the CFTC to identify each large over-the-counter (OTC) transaction or class of transactions the reporting of information concerning which the CFTC determines would be “appropriate to assist” the Commission in detection and prevention of price manipulation or excessive speculation. Entities involved in these transactions would be required to submit reports describing “large” positions involving substantial quantities of commodities, substantial positions, investments, or contracts relating to the commodity, and “any other information” the CFTC determines to be necessary.

Permits the CFTC to require any covered entity to liquidate positions and transactions and comply with a position limit if the CFTC determines that a major market disturbance has occurred. Compliance with a position limit may be required even if the limit was established after the entity entered into the contract.

#### **Section 8. Index Traders and Swap Dealers.**

Requires the CFTC to obtain detailed reporting from index traders and swap dealers, distinguish between index traders and swap dealers for purposes of regulatory treatment, review the trading practices of index traders to ensure that index trading does not adversely impact the price discovery process, and ensure that reports submitted by dealers and traders distinguish between legitimate and nonlegitimate hedge trading.

**Section 9. Disaggregation of Index Funds and Other Data in Energy Markets.**

Requires that the CFTC disaggregate index funds and requires them to make public monthly: (1) the number of positions and total value of index funds and other passive, long-only (a position that requires a buyer of a contract to purchase the commodity for a set price at a future date) positions in energy markets; and (2) data on speculative positions relative to bona fide physical hedgers in those markets.

**Section 10. Additional Commodity Futures Trading Commission Employees for Improved Enforcement.**

Requires that the CFTC appoint at least 100 full-time employees.

**Section 11. Working Group on Energy Markets.**

Establishes a Working Group on Energy Markets that is composed of the Secretary of Energy, the Secretary of the Treasury, the Chairman of the Federal Energy Regulatory Commission, the Chairman of the Federal Trade Commission, the Chairman of the Securities and Exchange Commission, the Chairman of the CFTC, and the Administrator of the Energy Information Administration. The Secretary of Energy shall be the initial chairperson for a one-year period and thereafter the chairmanship shall rotate each year in the order to which the members are listed above. For example, in year two, the Chairman will be the Secretary of the Treasury.

**Section 12. Study of Regulatory Framework for Energy Markets.**

The Working Group created in Section 11 above will conduct a study. That study should include an examination of price formation with respect to crude oil and refined petroleum products, an examination of relevant international regulatory regimes, and an examination of the degree to which changes in energy market transparency, liquidity, and structure have influenced or driven abuse, manipulation, excessive speculation, or inefficient price formation.

The Working Group will submit the report to Congress within one year of the date of enactment. In addition, necessary appropriations are authorized to carry out the study (no exact amount is listed).

**Section 13. Collection and Analysis of Information on Energy Commodities.**

Gives authority to the Administrator of the Energy Information Administration to collect on a weekly basis information identifying the ownership of all commercially held oil and natural gas inventories in the United States. The information should include company-specific data related to volumes of product under ownership, ownership storage, and transportation capacity. Requires that any person holding or controlling energy futures contracts or energy commodity swaps report on a monthly basis, with respect to the energy commodities, and the byproducts of the energy commodities, several things: (1) the quantity of physical stocks owned; (2) the quantity of fixed price purchase commitments open; (3) the quantity of fixed price sales commitments open; (4) the physical storage capacity owned or leased; and (5) additional information that the Secretary deems necessary.

**Section 14. National Natural Gas Market Investigation.**

Not later than 30 days after enactment of this bill, the Federal Energy Regulatory Commission (“Commission”) shall begin an investigation into the role of financial institutions in natural gas markets.



Not later than 270 days after enactment of this bill, the Commission shall submit a report on its investigation to the Committee on Energy and Natural Resources of the Senate and the Committee on Energy and Commerce of the House of Representatives.

**Section 15. Studies; Reports.**

The Comptroller General of the United States shall conduct a study of the international regime for regulating the trading of energy commodity futures and derivatives. No later than one year after enactment of this bill, the Comptroller General shall submit a report to Congress on the findings.

The Comptroller General shall also conduct a study of the effects of noncommercial speculators on energy futures markets and energy prices. No later than two years after enactment of this bill, the Comptroller General shall submit a report to Congress on the findings.

No later than 60 days after enactment of this bill, the CFTC shall submit to Congress a report that describes in detail the actions the Commission has taken, is taking, or intends to take to carry out this section. The report shall be updated every 45 days thereafter. In addition, the Commission should also submit a report on the number of additional employees it needs within 60 days after enactment of this bill.

**Section 16. Expedited Procedures.**

The CFTC shall use emergency and expedited procedures to carry out this Act. If the CFTC decides not to use emergency and expedited procedures, then they must submit no later than 30 days after the date of the decision a detailed report to Congress that describes in each instance the reasons for not using emergency and expedited procedures.

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**Administration Position**

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At press time, there was no Statement of Administration (SAP) for S. 3268.

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**Cost**

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At press time, there was no CBO score for S. 3268.

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**Possible Amendments**

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At press time, there was no agreement in place for consideration of amendments.