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Speculators Get a Break in New Rule

By GRETCHEN MORGENSON

A LOAF of whole wheat. A gallon of gasoline. A pair of Levi's. Americans are paying more for many basic items this year, making tough economic times even tougher.

But these hardships for consumers provide another reason to check in on Dodd-Frank, that package of financial reforms that Congress passed in 2010. Here's why:

Congress told federal regulators to write rules that would ensure that Dodd-Frank does what it's supposed to do, which includes protecting consumers. But the [Commodity Futures Trading Commission](#) has proposed rules that critics say might actually encourage speculation in the commodities markets, rather than reduce it.

Senator Bill Nelson, a Florida Democrat, says that as things stand, the C.F.T.C.'s plan could cost ordinary Americans.

"Despite a clear directive from Congress to rein in excessive speculation, regulators still are listening too much to Wall Street and not acting quickly enough to protect American consumers," Mr. Nelson said last week.

Granted, prices of various commodities, including [heating oil](#) and gasoline, fell last week amid all the

economic gloom. But that's no reason to give speculators a pass.

There are those who reject the notion that financial speculation has made commodity prices more volatile and even driven up prices in recent years. Some of them work for the C.F.T.C.

But Michael Greenberger, a professor at the University of Maryland Law School, says that a majority of academic studies on this issue — from Texas A&M, Rice and Stanford — demonstrate the ill effects of speculation on energy and [food prices](#).

Indeed, a bipartisan report by the Senate Permanent Subcommittee on Investigations in 2009 concluded that there was “significant and persuasive evidence” that skyrocketing wheat prices reflected high levels of speculation in that market.

That report highlighted trading linked to commodities indexes and other financial instruments, a field that's exploded with the growth of commodity index [investment funds](#).

“Dodd-Frank was intended to include these commodity index swaps with strict limitations on the participation of speculators in the commodities staples futures markets,” [Mr. Greenberger says](#). But the response from the C.F.T.C. “is a horrifically weak rule.”

At the center of the debate are rules that would place a cap on how many financial contracts traders can accumulate for any given commodity. The idea is to prevent a small group from dominating an entire market.

The C.F.T.C. has proposed a limit of 25 percent of the deliverable supply of the underlying commodity. Mr. Nelson last week proposed a bill that would put that position limit at 5 percent of the deliverable supply. He says the C.F.T.C.'s limit is so high that it would encourage speculation and make markets more volatile.

The C.F.T.C. declined to comment, as the rule is still being considered.

Commodity index funds are big business. Such funds have attracted as much as \$350 billion from

investors in recent years. As such players have grown, the influence of commercial traders, like food producers and airlines that use the **commodities markets to hedge** against price swings, has declined. Hedging has gotten more expensive, and those higher costs have been passed on to consumers. Dodd-Frank determined that position limits were a solution to excessive speculation.

Mr. Nelson's bill, the Anti-Excessive Speculation Act of 2011, sets limits in energy contracts that would apply to speculators as a class of traders, aiming to cap the overall level of speculation in the market at its historic 25-year average. In the **oil** markets, speculative trading accounts for about half of all trading. He says his plan would reduce that figure to about 20 percent. He cited research showing that speculators may add \$21 to \$27 — or about 25 percent at current prices — to the price of a barrel of oil.

“This legislation aims to ensure that prices at the pump better reflect the true supply and demand for oil — and not the activities of speculators,” he says.

The C.F.T.C. proposal has drawn other criticism as well. It also would allow for greater position limits for commodities contracts that are settled for cash, rather than by physical delivery of the underlying goods. Most of these financial contracts trade on unregulated exchanges.

The proposal would let traders in cash-settled contracts hold five times the amount of contracts allowed for traders of physically settled versions in the final days of trading, or the so-called spot month. Traders employing this higher limit cannot participate in the market for the physically settled contracts.

That's a bad idea, according to the Commodity Markets Oversight Coalition, a group of commodities end-users including smallish heating oil companies in Vermont, New Mexico and Maine. In a comment letter to the C.F.T.C., the group said that because the spot month is when futures prices converge with the spot price of an underlying commodity, allowing five times the leverage in cash contracts at that time would probably increase volatility and costs for end users who are hedging.

“The adoption of the current proposed rulemaking will increase the threat of price manipulation,

especially in the final days of trading,” the group wrote, adding that Congress didn’t intend to allow position limits to give favorable treatment to unregulated exchanges at the expense of regulated markets.

Interestingly, a recent enforcement action filed by the C.F.T.C. against several crude oil speculators seems to confirm the possibility for manipulation using outsize amounts of cash-settled contracts.

Outlining the case filed last May against Parnon Energy, based in California, and its affiliate Arcadia Petroleum, which is based in London, the C.F.T.C. accused the companies of manipulating the market for crude oil in early 2008 using a combination of physically settled and financially settled contracts.

At the time the C.F.T.C. contended that the manipulation took place, there were market-imposed limits on the number of physically settled contracts a trader could hold but no caps on the cash-settled version. The scheme generated \$35 million in improper profits, the C.F.T.C. said.

Parnon denied the C.F.T.C.’s accusations and is contesting them in federal court.

According to the Federal Energy Regulatory Commission, the collapse of the \$10 billion Amaranth Advisors hedge fund in 2006 also involved manipulation conducted through a combination of cash-settled and physically delivered contracts, in that case, for natural gas. Once again, there were limits on the physical contracts but none on those settled for cash. The Energy Regulatory Commission [settled with Amaranth Advisors](#) in 2009 for \$7.5 million.

The C.F.T.C. might still change its proposal. The commission is expected to vote by mid-October. Stay tuned.



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