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PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Homeland Security and Governmental Affairs

Carl Levin, Chairman
Tom Coburn, Acting Ranking Minority Member

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Investigations Subcommittee Releases Levin-Coburn Report On Excessive Speculation in the Wheat Market

Report Calls for Clampdown on Index Traders Buying Wheat Futures

WASHINGTON – Today, Senator Carl Levin (D-Mich.), Chairman of the U.S. Senate Permanent Subcommittee on Investigations, and Sen. Tom Coburn (R-Okla.), Acting Ranking Minority Member, released a 247-page report entitled, ***Excessive Speculation in the Wheat Market***, examining how commodity index traders, in the aggregate, have made such large purchases on the Chicago wheat futures market that they have pushed up futures prices, disrupted the normal relationship between futures prices and cash prices for wheat, and caused farmers, grain elevators, grain processors, consumers, and others to experience significant unwarranted costs and price risks.

"In the last three years, speculators have spent billions of dollars on commodity indexes, and the financial firms selling those index instruments have purchased billions of dollars in commodity futures to offset their financial risks, creating price disruptions for producers and consumers," said Levin. "In the case of wheat, we found that index traders purchased huge numbers of wheat contracts on the Chicago exchange, increased futures prices relative to cash prices, and created unwarranted costs and risks for wheat farmers, grain merchants, grain processors, and consumers. It is another case of speculative money overwhelming a market, and federal regulators failing to take the steps needed to protect the market. In fact, the CFTC has allowed some index traders to exceed normal trading limits for wheat." Levin added, "It is time for the CFTC to change course, rein in commodity index traders, and clamp down on excessive speculation that is disrupting commodity prices."

A one-year bipartisan Subcommittee investigation examined millions of trading records from the Chicago Mercantile Exchange, Kansas City Exchange, Minneapolis Grain Exchange, the Commodity Futures Trading Commission (CFTC), and others to track and analyze wheat prices. The data showed that commodity index traders – traders who are not producers or consumers of wheat, but buy wheat futures to help offset their financial exposure from selling commodity index instruments to third parties -- injected billions of dollars, in the aggregate, into the wheat futures market over the last six years. Commodity index traders increased their holdings from a total of about 30,000 wheat contracts in 2004, up to 220,000 contracts in 2008. That sevenfold increase dramatically enlarged the market share of commodity index trading so that, in each year since 2006, commodity index traders held between 35% and 50% of all outstanding wheat futures contracts on the Chicago exchange.

The Subcommittee investigation uncovered substantial and persuasive evidence that, by purchasing so many futures contracts, commodity index traders, in the aggregate, pushed up futures prices, created an unprecedented, large, and persistent gap between futures and cash wheat prices in the Chicago market, and impeded the two prices from converging at contract expiration. For example, the average gap between futures and cash prices on the expiration of futures contracts on the Chicago exchange, called the "basis," grew from about from 13 cents per bushel in 2005, to 34 cents in 2006, to 60 cents in 2007, to $1.53 in 2008, a tenfold increase in four years.

The investigation determined that these unwarranted price changes imposed an undue burden on wheat farmers, grain elevators, grain merchants, grain processors, consumers, and others by making it difficult to use the futures market to protect against price changes and by generating significant unanticipated costs. Those costs included higher margin calls due to higher futures prices; failed hedges; and disruption of normal pricing patterns and relationships. The investigation found that a major reason for each of these problems is index trading that, as a whole, constituted excessive speculation in the wheat futures market.

"The bottom line," said Levin, "is that excessive speculation in commodity indexes has created losers throughout the wheat industry, from wheat farmers to grain elevators, grain merchants, grain processors, and grain users like bakeries and cereal companies. Those groups can't manage their price risks through hedging, and are socked with unwarranted costs from higher margin calls and failed hedges. When those costs are passed onto consumers, the result is higher food prices."

The Commodity Exchange Act requires the key federal commodities regulator, the CFTC, to prevent excessive speculation by imposing position limits on commodity traders. But in the wheat market, instead of restricting traders to no more than 6,500 wheat contracts at a time, its standard position limit for wheat, the CFTC has allowed some commodity index traders to hold up to 10,000, 26,000, even 53,000 contracts at a time. Six commodity index traders are currently authorized to hold a total of up to 130,000 wheat contracts at a time, instead of up to 39,000 contracts, or one-third less if standard position limits were applied.

To stop the excessive speculation, the Levin-Coburn report recommends that the CFTC apply the standard 6,500 wheat position limit to all commodity index traders in the wheat market. If that does not cure the pricing problems on the Chicago exchange, the report recommends lowering the position limit further, such as to the 5,000 contract limit that applied to wheat traders until 2005. In addition, the report recommends that the CFTC analyze the impact of commodity index trading on other commodities, including crude oil, to determine if excessive speculation is distorting prices.

This report is the fifth in a series released by the Subcommittee on commodity pricing since 2003. The first four focused on energy prices, including for gasoline, crude oil, and natural gas. Two have focused on how excessive speculation can distort commodity prices.

A 2006 report found, for example, that billions of dollars in commodity index trading on the crude oil market had increased futures prices in 2006, and were responsible for an estimated $20 out of the then $70 cost for a barrel of oil. A 2007 report showed how a single hedge fund named Amaranth made huge trades on the natural gas market, pushed up futures prices, and increased natural gas prices for consumers. This report, the first by the Subcommittee to examine agricultural prices, uses wheat as a case history due to the availability of detailed commodity index trading data, the large proportion of commodity index trading on the Chicago exchange, and the dramatic pricing problems affecting wheat traded on the Chicago exchange.

In July, the Subcommittee will hold a hearing on excessive speculation in the wheat market. The report's findings and recommendations are as follows.

FINDINGS AND RECOMMENDATIONS

A. FINDINGS

(1) **Excessive Speculation in Wheat.** The large number of wheat futures contracts purchased and held by commodity index traders on the Chicago futures exchange over the last five years constituted excessive speculation.

(a) **Index Traders Increased Futures Prices Relative to Cash Prices.** The large number of wheat futures contracts purchased by index traders on the Chicago exchange created additional demand for those contracts and was a major contributing factor in the increasing difference between wheat futures prices and cash prices from 2006 to 2008.

(b) **Index Traders Impeded Price Convergence.** Over the past few years, the large number of Chicago wheat futures contracts purchased by index investors has been a major cause of the frequent failure of wheat futures and cash prices to converge upon contract expiration.

(c) **Unwarranted Price Changes.** The additional demand for Chicago wheat futures contracts attributable to commodity index traders contributed to "unreasonable fluctuations or unwarranted changes" in wheat futures prices, resulting in an abnormally large and persistent gap between wheat futures and cash prices (the basis). Largely as a result of index trading, the average difference between the cash and futures price at contract expiration rose from 13 cents per bushel in 2005, to 34 cents in 2006, to 60 cents in 2007, to $1.53 in 2008, a tenfold increase in four years.

(d) **Undue Burden on Commerce.** The unwarranted changes in wheat prices resulting from the large amount of index trading in the Chicago wheat futures market created an undue burden on interstate commerce. This undue burden was imposed on farmers, grain elevators, grain merchants, grain processors, and others by impeding useful hedging strategies, imposing significant unanticipated costs, and providing inaccurate indications of expected prices in the wheat markets.

(2) **CFTC Waivers Facilitated Excessive Speculation.** CFTC actions to waive position limits for commodity index traders facilitated excessive speculation in the Chicago wheat futures market. Waiving position limits for these index traders is inconsistent with the CFTC's statutory mandate to maintain position limits to prevent excessive speculation.

(3) **Inflated Futures Prices Affect Crop Insurance.** Because federal crop insurance, which is backed with taxpayer dollars, uses futures prices in its calculations, inflated futures prices can inflate insurance premiums, whose cost is shared by farmers and taxpayers, and impair the accuracy of the formulas used to determine the payouts to farmers, resulting in either overpayments or underpayments.

(4) **Poor Data Impedes Analysis.** There is a lack of adequate data on the number of futures contracts purchased by commodity index traders for non-agricultural commodities like crude oil. Improved data is essential to analyze the extent to which index traders may be contributing to higher futures prices and excessive speculation in crude oil and other markets.

B. RECOMMENDATIONS

(1) **Phase Out Existing Wheat Waivers for Index Traders.** The CFTC should phase out existing waivers, granted through exemptions or no-action letters, which permit commodity index traders to exceed the standard limit of 6,500 wheat contracts per trader at any one time, and re-apply the standard position limit designed to prevent excessive speculation in the wheat market.

(2) **Take Further Action If Necessary.** If pricing problems in the Chicago exchange persist after the phase-out of index trader waivers and after implementation of other actions being taken by the Chicago exchange, the CFTC should consider imposing additional restrictions on commodity index traders to reduce excessive speculation, such as by imposing a position limit of 5,000 wheat contracts per index trader.

(3) **Analyze Other Agricultural Commodities.** The CFTC should undertake an analysis of other agricultural commodities to determine whether commodity index traders have increased futures prices compared to cash prices or caused price convergence problems, and whether position limit waivers for index traders should be phased out to eliminate excessive speculation.

(4) **Strengthen Data Collection for Non-Agricultural Commodities.** The CFTC should develop reliable data on the extent to which commodity index traders purchase non-agricultural commodity futures contracts, especially crude oil and other energy commodities. Once this data is collected, the CFTC should evaluate the impact of index trading in these markets, and whether position limits for index traders should be phased out to eliminate excessive speculation.

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