Written Testimony of
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Senate
Permanent Subcommittee on Investigations
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I am Charles P. Carey, vice-chairman of CME Group Inc. Thank you Chairman Levin and Ranking Member Coburn for inviting us to testify today respecting the June 24, 2009, staff report titled, "Excessive Speculation in the Wheat Market." I was the chairman of the Chicago Board of Trade, the home of the soft red winter wheat market, prior to the merger that created CME Group. I trade wheat, corn and other agricultural products and I am the point person on the Board of Directors for dealing with grain markets. I deal with the concerns respecting the impact of index traders on our markets expressed by our members and the agriculture industry and have been directly involved in CBOT's ongoing efforts to modify the wheat contract to assure better convergence.

Initially, I was inclined to give credit to the views of many of our commercial customers that index trading may have been having unwarranted impacts on our wheat market. We responded to these concerns by arranging for an independent analysis of this thesis across grain markets, we also cooperated with others conducting such studies and we analyzed all of the studies of this subject that preceded the report prepared by this Subcommittee.

None of the relevant studies supported the conclusion that index traders or swap dealer participation in our markets was a cause of volatility, high commodity prices or lack of convergence. Indeed, in our corn and soybean markets, there have been no significant convergence issues even though there is substantial participation in those markets by index traders and swap dealers. Despite the clear conclusions of these independent professional studies and our own experience in other grain markets, I remained concerned. I am not a professional statistician or economist and could not ignore the confluence of unexplained price behavior and the large share of open interest held by non-commercial participants. It is difficult to ignore that coincidence and many traders and some of our customers assumed that there was a strong chance that the two were connected.

The professional economists and statisticians explained to us that it was necessary to show causation not just coincidence and that I was committing a very common logical error by attributing cause based on correlation. I had hoped that this Subcommittee's study and report would add new evidence and clarify the relationship between index trading and the lack of convergence or any other unexplained price effect. We are absolutely committed to solving the convergence problem. We would have been pleased if the staff Report has provided a simple explanation and solution. Unfortunately, our economists and the informed critical response to the Report tell us that the Report fails to explain the lack of convergence, despite its assertions to the contrary, and that its proposed solutions are more likely to be harmful to the functioning of our markets than helpful.

You asked us to answer five questions and to discuss the committee's recent staff Report, "Excessive Speculation in the Wheat Market." We have tried to frankly and fully answer your questions, which we set out in full in italics and follow with our answer.

(1) Please describe the recent pricing and convergence problems in the Chicago wheat market; the extent to which these problems have harmed market participants such as farmers, grain elevators, grain merchants, grain processors, and others; and whether these problems need to be addressed to protect the integrity of the CME wheat futures market.

The Report calculates an average daily basis, using information from a wide variety of delivery points that is not derived from actual cash transactions in Chicago or at any other delivery point. According to those calculations the basis sharply diverged from historical levels and levels observed with respect to the Kansas City Wheat Contract, in the second quarter of 2008. We are also concerned that the basis appears to have moved out of line with historical precedents, but do not agree that the calculations included in the report are accurate. It is unclear that any participant in the market was actually harmed, although CBOT believes that its SRW Wheat futures contract cannot fully serve market participants unless divergence from historical basis levels are predictable and explicable on the basis of observable market events.

CBOT has been working to and continues to work to address the convergence issue, which we believe to be the result of divergence over time of commercial practices and contract specifications. Specifically, CBOT has implemented the following changes to the wheat contract: added delivery points, increased the storage fee seasonally and reduced the vomitoxin level (more detail provided in response to question 4. We believe it is important to allow these changes to take effect so that we may fairly assess their impact, and we continue to work with the industry and regulators on additional changes to the contract that might be employed to improve performance, including analysis of a variable

storage rate concept, cash settlement and new wheat products (world wheat index, U.S. milling wheat index, and others)

(2) *Please describe the nature and extent of commodity index trading in the CME wheat futures market over the past five years, including:*

a. *Whether CFTC data is accurate in showing that commodity index trading has increased dramatically in the CME wheat market over the past five years; commodity index traders typically purchased long wheat positions; and from 2006 to 2008, commodity index traders held 35% to 50% of the open long interest on the CME wheat futures exchange;*

While statistical information regarding index participation was not compiled prior to 2006, participation in CME Wheat measured in number of long futures contracts steadily decreased throughout 2008 and has only recently shown a modest increase. In March of 2008 commodity index trading long positions totaled 226,118 contracts. As of July 7, 2009 commodity index trading long positions totaled 182,479 contracts, a decline of 20%. Indeed, earlier in May of 2006 commodity index trading long positions totaled 222,593 – further demonstrating a relatively consistent level of participation for the last few years. During the period of 2006 to the Present, the percentage of long open interest held by commodity index traders fluctuated between 51.8%, reached on January 17, 2006 and 32% reached on October 24, 2006. The most recent data for July 7, 2009 indicates the percentage to be 46.4%.

b. *What types of companies compose the top ten CME wheat commodity index traders, measured by the number of CME wheat futures contracts held by such index traders from 2006 to 2008, including whether these index traders are affiliated with banks,*

broker-dealers, hedge funds, or other types of market participant; and whether they are formed in the United States or in a non-U.S. jurisdiction;

Currently, seven entities are swap dealers who are affiliated with banks; three of these banks are non-U.S. Two of the entities are affiliated with commercial firms and one entity is a registered CPO.

c. *How these top ten CME wheat commodity index traders compare to the top ten commercial wheat traders, measured by the number of CME wheat futures contracts held by such commercial traders versus the index traders and the extent to which they hold spot month or longer-term wheat contracts; and*

Based on information from the CFTC's COT report, during the period from January 2006 to the present, all commercials held an average of 257,214 future equivalent contracts in wheat. During this same period, commodity index traders held an average of 209,475 future equivalent contracts in wheat.

Looking at data as of July 7, 2009 the top 10 commercials held 75,584 futures contracts and the top 10 commodity index trader's held 162,932 future contracts. Commodity index trader's positions were held outside of the spot month. It is important to note that entities with swap exemptions and index exemptions are not allowed to carry positions in excess of speculative limits into the spot month. Commercial traders did carry positions into the spot month but the vast majority of their positions were held in months other than the spot

d. *If any of the top ten commodity index traders are allowed to exceed the CFTC standard 6,500 position limit for wheat contracts , whether they were granted a hedge exemption or waiver by the CFTC to do so, what all-months-combined position limit currently*

applies to each such trader, and whether CME is charged with enforcing compliance with these higher position limits.

Prior to being approved by the CME, all index traders were required to receive prior CFTC approval. The CME did not grant any exemptions to index traders that the CFTC had not already granted. The CME approved the exemptions for the identical quantity that the CFTC had approved. The total exemption quantity approved for index/swap exemptions in wheat is 413,145 contracts of which 19% or 78,586 contracts is currently being utilized. The exemptions only apply to "bona-fide" hedge exposure realized on the respective swap dealer's books or actual fund exposure in the case of the two index funds granted exemptions pursuant to a no-action; the exemptions do not permit speculative trading beyond the entity's actual level of exposure. Seventeen such entities have received exemptions, nine of which are currently being utilized, and the average exemption size across the seventeen entities is 24,303 contracts.

(3) Please provide your views on the report recently released by the Subcommittee entitled, "Excessive Speculation in the Wheat Market," including its findings and recommendations. Please indicate whether commodity index traders, in the aggregate, can significantly affect the price of futures contracts and the performance of the futures market.

The report's findings are based on faulty economic analysis and a misunderstanding of basic market economics. We agree that any large order to buy or sell futures contracts is likely to have temporary market impact. That effect is well understood. We do not agree that the price impact caused by temporary order imbalances have a lasting effect on market price or spreads.

There is no limit to the supply of futures contracts and it has not been shown that there is any limit on the capacity of traders and market makers to absorb new

or unusual capital flows into the market. In our experience, if the underlying contract is well designed, the futures price will revert to the equilibrium dictated by informed traders relatively quickly after index traders or other uninformed traders establish their positions. Once the buying pressure is satisfied, there is nothing to continue to buoy the market. Experienced market makers who sell to the index buyers would be wiped out in short order if this dictum were not correct. It is relevant that index traders do not generally maintain constant upward pressure on the market. They establish their positions in a short time frame, hold those positions, and then sell prior to the delivery period and buy in a subsequent contract month. In sum, the conclusions of the Report are contrary to numerous independent studies, which found there was no causal relationship between index funds' participation and price levels or volatility, and are inconsistent with the behavior of professional futures traders.

Comments on Findings and Analysis

a. Index Traders Increased Futures Prices Relative to Cash Prices - the finding that index traders increased futures prices relative to cash prices is based on anecdotes not evidence. There is no statistical or economic analysis presented in the report to show causality between trading by index traders and weak basis. Instead, the report relies primarily on graphical presentation of two data series to draw a conclusion of causality: 1) the increasing share of long open interest held by index traders and 2) a trend of weakening basis (cash prices below futures). Several independent studies that employed standard statistical analysis techniques, including Granger Causality and Vector Autoregression, found that changes in positions of index traders did not cause changes in price levels (see *An Evaluation of the Influence of Large Reporting*

Traders on Futures Market Performance; Informa Economics; February 24, 2009; at http://www.informaecon.com/TraderStudy/TraderStudy.htm. Also see "*Comments on Permanent Senate Subcommittee on Investigations Report "Excessive Speculation in the Wheat Market"; Scott Irwin, Darrel L. Good, Philip Garcia, and Eugene L. Kunda; Department of Agricultural and Consumer Economics, University of Illinois, July 6, 2009".*

b. Index Traders Impeded Price Convergence – This statement is made throughout the study and is based on the theory that index traders have created an excess demand for long futures positions which has caused futures prices to move higher in order to attract additional sellers into the market. The fact that the long futures positions of index traders must be offset (sold) prior to the delivery month resulting in futures prices moving lower is never mentioned. While the study notes that index traders roll their positions forward based on the formula stated in the index fund prospectus, it fails to mention that the hedge exemptions and no-action letters granted to index traders specify that positions cannot be carried into the spot (delivery) month, when convergence is expected to take place. Also, in many of the graphical presentations of basis used in the study, the authors chose to use the national average cash price, as represented by the MGEX/DTN Soft Red Winter Wheat Index, as the cash price. Basis is then calculated as the futures price minus the MGEX SRW cash index price. This also demonstrates a gross misunderstanding of delivery market economics where futures price the cheapest to deliver location/grade and not multiple locations throughout the entire U.S.

c. Excessive Speculation led to Unwarranted Price Changes – this statement is also used throughout the study, however, the only evidence given is that soft red winter wheat cash prices were lower than SRW futures prices. Surprisingly, the authors did not interview regulatory staff from any of the exchanges or from CFTC in reaching this conclusion. Also, this finding is inconsistent with data showing that the long term relationship between Chicago and Kansas City wheat futures prices has remained stable. If index trading in the CBOT futures contract had caused unwarranted price changes, you would expect the relationship with KC wheat where there is relatively little index trading to also change.

d. CFTC Waivers Facilitated Excessive Speculation – The report often mentions that CFTC waivers from speculative position limits led to excessive speculation, suggesting that CFTC and the Exchanges simply waived position limits for index traders. This is incorrect as individual index traders were given specific levels of exemptions based on data they provided to exchange and CFTC regulatory staff (the actual level of the exemptions is mentioned once in the report, however, the word "waiver" is used throughout and gives the impression that these firms could establish unlimited positions in the wheat market.) It is also worth noting again that the exemptions permit the index traders to establish positions beyond speculative limits only up to their level of actual exposure, and do not provide for speculative trading beyond the speculative limits.

e. CME Group Wheat Contract Changes – there is only a very brief mention of CME Group contract changes that are designed to address the

convergence issue. In addition, the report states that most of traders and analysts interviewed were skeptical that the contract changes would be sufficient to address the convergence issue. The changes in the wheat contract's delivery specifications are major changes, and they have to be given time to work their way through the market to see if they will achieve the results that we expect them to. With the new delivery locations effective on July 1, seasonal storage rates on July 18 and lower vomitoxin standards on September 1, we anticipate a significant improvement in convergence as early as mid-September and certainly by the end of the year. We also fully expect these changes in contract specifications to continue to provide strong convergence in the future, however, we are ready to implement additional contract changes if necessary.

f. Other Studies – None of the other recent studies that have been conducted on this issue by CFTC, GAO, or Informa were referenced in the PSI study. Instead, the authors included selected comment letters and statements from CFTC's Ag Forum that supported their conclusion that index traders were the major cause of convergence problems in the CBOT Wheat contract. This is another example of the use of unsupported opinion to reach a conclusion instead of empirical economic analysis or statistical analysis based on comprehensive survey data.

Overall, the Committee's recommendations to phase out existing exemptions and possibly lower existing speculative position limits would reduce liquidity in the wheat futures contract which would lead to increased hedging costs and an overall reduction in market efficiency. CME Group does not believe, and has not found evidence to convince otherwise, that index traders, in the aggregate, affect

price or market performance. Indeed, a number of studies have revealed the same conclusion (CFTC, Informa, University of Illinois, GAO) – none of which are referenced in the Subcommittee's report. In addition to not contemplating the statistical evidence found in these reports, the Subcommittee only briefly mentions other fundamentals that could be affecting convergence and poor performance of the wheat contract – many cited by these others.

In particular, the Subcommittee does not address the basic nature of the contract itself. The CBOT wheat contract is in many respects a world contract in that it is used to trade wheat generically; however, as the fundamentals affecting world wheat and soft red winter wheat can differ, there is a potential for poor basis performance. The changes employed by CME Group to the contract attempt to address these contract imperfections, however, it must be recognized that users of the contract have expressed very different opinions about how to address this issue. Also, the Commodity Exchange Act dictates that material changes in contract specifications for enumerated commodities can only be implemented for months without open interest, which can inject a significant lead time into the implementation schedule for material changes since open interest in the wheat contract is present through July 2011.

(4) *Please describe the actions recently taken by CME Group to modify its wheat futures contract, what steps CME will take to determine whether these modification are curing the pricing and convergence problems in the Chicago wheat market, and how long CME anticipates it will take to complete this evaluation.*

On December 4, 2008 the CFTC approved amendments to the CBOT's wheat futures contract submitted to the Commission by CME Group on September

4, 2008. The amendments, which added three new delivery locations, increased the storage rate fee, and reduced the vomitoxin level, are the most significant changes ever made to the contract. Specifically, the changes do the following:

- Add three new delivery locations, including a 12-county area in northwest Ohio at a discount of 20 cents per bushel; a territory along the Ohio River from Cincinnati to Mississippi River at par; and another along the Mississippi River from St. Louis to Memphis at a 20 cents per bushel premium.
- Increase the storage fee to eight cents per bushel from five cents for the period from July 18 through December 17.
- Reduce the vomitoxin level for par delivery to three parts per million on September 1, 2009 and to two parts per million on September 1, 2011. In addition, a discount schedule for wheat with three and four parts per million at rates of 12 and 24 cents per bushel, respectively will be implemented.

The first two of these changes – additional delivery points and higher storage fees – were implemented on July 1 and July 18, respectively, and the vomitoxin changes will be implemented gradually over the next two years due to the material impact they will have on contract pricing. It is possible that we will see some significant improvement in contract performance by mid-September and certainly by the end of the year (basis has already strengthened from nearly $2 under futures one year ago to approximately $0.60 under futures at the new delivery locations on the Ohio River).

CME Group believes these changes will have a significant impact on the performance of the wheat contract. That said, we continue to maintain a dialogue and consult with the CFTC and market users to weigh other possible changes to the

contract to better its performance. Additionally, we are participants in the CFTC's convergence subcommittee – a subset of Commissioner Dunn's Agriculture Advisory Committee – that was established after approval of the amendments to the CBOT wheat contract and is tasked with examining the convergence issue and future performance of the contract, and making recommendations for any additional changes.

(5) *If the CFTC were to phase out existing hedge exemptions and waivers for commodity index traders and require them to comply with the standard 6,500 position limit for wheat contracts, please describe how you believe the CME and CME wheat futures market would be affected.*

As previously noted, in general, a change to the exemption process/allowance would impact market liquidity and therefore increase hedging costs in general. It is worth noting again that the exemptions from the limits does not apply to the spot month. Finally, removing these exemptions implies that the use of commodity futures by investors for financial hedging, portfolio diversification and as an inflation hedge is not a legitimate/bona fide hedge. Such a policy is bad for investors, bad for the economy and contrary to Congressional efforts to control systemic risk through intelligent regulatory reform.

We absolutely agree with the Subcommittee's concern that the lack of convergence impairs the value of our market and needs to be corrected. We share the concern of knowledgeable economists who have examined this market and who have carefully reviewed the Subcommittee's report that the evidence adduced in support of the conclusion that index traders are the principle cause of the lack of convergence and persistent contango has not been validated by any of the statistical measures that are accepted by experts in the field. We are concerned that

the Report's focus of blame on index traders and speculators directs attention away from appropriate efforts to identify any structural problems with the contract specifications and impairs our ongoing efforts to cure the problem by fixing those terms.

We have implemented very significant changes to the delivery specifications of the SRW wheat contract. We have acted in accordance with our obligations under the CEA respecting the timing of changes to enumerated futures contracts with open interest and have attempted to take account of the suggestions of all segments of the industry to whom this contract is important. We have also attempted to implement the changes in an orderly fashion so that we will have time to judge their effectiveness and so that we do not overshoot the market and risk damaging the liquidity that users of this market depend on.

We have authorized a wide ranging addition of delivery points and facilities. We added 58 new locations for delivery and that will provide an additional 90 million bushels of capacity on the Ohio and Mississippi rivers and in a 12-county area of Northwest Ohio. We expect that this will relieve any congestion issues that prevented arbitrage from driving the convergence within historic ranges and better align our delivery locations with the primary flow of soft red winter wheat in the domestic cash market and to the New Orleans Gulf for export. Similar changes made to the corn and soybean contracts in 2000 greatly enhanced the performance of these contracts and we expect similar results from these changes in the wheat contract.

We have also implemented seasonal storage rate adjustments that are intended to incent shorts who own deliverable wheat or who can acquire deliverable wheat to make delivery when the basis moves to unjustifiable

differentials. The higher futures storage rate during the July-December period reflects higher seasonal storage rates in the cash market when wheat that has just been harvested competes with the upcoming corn and soybean harvests for storage space and will allow wider carrying charges if needed throughout the country elevator system and for producers with on-farm storage. The higher futures storage charges will also encourage buyers who stand for delivery and must pay the storage rate to the seller, to either load out or re-deliver the wheat, both of which will enhance convergence.

On September 1, the reduced level of allowable vomitoxin will be implemented, which will convert the contract from a feed grade wheat contract to a human consumption grade. We expect that this change will have a positive impact on convergence for the following reasons: (1) the estimated cash market discount for wheat with 4 parts per million of vomitoxin is 12 cents per bushel, and that differential will be applied to 4 ppm wheat delivered against futures contracts. Par delivery will require no more than 3 ppm of vomitoxin, which is expected to improve the cash/futures relationship by 12 cents per bushel; and (2) the industry standard for vomitoxin in the domestic milling and export markets is 2 ppm, and we will implement this level in delivery specifications for the futures contract in September 2011, with 3 ppm remaining deliverable at a 12 cent discount and 4 ppm at a 24 cent discount. This final change in the quality specifications for the wheat contract will align our par quality specifications with industry standards while providing the flexibility to deliver lower quality wheat at significant discounts when higher quality is not available.

We hope for a significant improvement in convergence as early as mid-September and, anticipate, with a higher degree of confidence, greater improvement by the end of the year. If the results fail to meet our expectations, we

have additional modifications at the ready and are prepared to continue to modify the contract or to introduce a new contract to provide a safe and effective environment to permit producers and users to hedge their needs and to provide effective price discovery to the remainder of the market.

We are committed to dealing effectively with the lack of convergence by attacking the structural problems regarding specifications and delivery. In this regard we are aligned with the staff's recommendations. We do not, however, believe that restrictions on index traders, beyond those that we already impose, are anything but a distraction from our efforts.