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CFTC investigates cattle case

Futures manipulations appear to have forced a price cap below Corn Belt feeders' breakeven level.

The Commodity Futures Trading Commission (CFTC) is presently investigating the activities of a grouping of 32 large traders suspected of manipulating the Chicago Mercantile Exchange's live-cattle futures market. The traders—officers and principals of interlocked brokerage firms, large commercial feedlots, grain companies and packing houses—were identified in a study conducted by the staff of the House Committee on Small Business under the direction of Neal Smith (D-Iowa). Representative Smith made the findings public in late February.

Smith reported that a scheme to predict live cattle futures price changes with 100 percent accuracy had been discovered, and that the fail-safe scheme was being used by 32 interlocked traders to reap huge profits and squeeze out Corn Belt cattle feeders.

The evidence was presented in detail in a report, prepared for Smith, "On the Systematic Downward Bias in Live Cattle Futures." The study, coordinated by staff economist John Helmuth, shows that the live-cattle futures market "is operating with a consistent, systematic, perfectly predictable downward price bias."

The trading scheme, charted by Helmuth and his staff from January 1978 through October 1980, is straightforward. It is based on publicly available information.

Live cattle futures prices are routinely reported by USDA, and are costs incurred by the more than 68,000 smaller farmer feedlots in the Corn Belt (as opposed to the lower costs incurred by the 422 large feedlots that handle more than half of all fed cattle in the country). When these live-cattle futures prices reach a level that covers Corn Belt cattle feeders' costs, plus an interior Iowa-Southern Minnesota basis adjustment, the price will *drop every time!*

Using this technique over the past three years, a trader could have netted anywhere from $10,500 to $4,700,000 virtually risk-free. And that's what these traders did, says Smith.

The CFTC has agreed to look into this prima facie case of manipulation and irregularities.

But the commission so far refuses to address what both Smith and Helmuth believe to be the more fundamental issue raised by the study—whether the live-cattle futures contract is serving a justifiable economic purpose inasmuch as its effect is to give the advantage to the large concentrated feeders over and against the small farmer-feeder.

A series of investigations and studies conducted by Helmuth over the past 18 months has put together the picture of a deliberately skewed market. Unlike the grain or other futures markets, the live-cattle market is characterized by a volume of short hedging, or selling, four times greater than long hedging. It was also found that, contrary to expectation, most packers did not take long or buyers' positions, but short-hedged along with the grain companies and commercial feedlots.

What happens is that the packers, grain companies and commercial feedlots—who all have lower costs than farmer-feeders, *or can shift them from one level to another*—start selling when the price gets over their costs, at a level that is still below where most Corn Belt feeders could hedge against a loss. When brokers and others jump on the bandwagon the price drop is unstoppable.

The net result is a cap placed on prices below the Corn Belt feeders' breakeven level.

The apparently coordinated activity on the part of the 32 traders in this context, in Smith's view, was just further exacerbating the problem.

In making the study public, Smith stated his hope that exposure of the trading scheme would itself help to render it ineffective. He made a number of recommendations, including enforcement of speculative limits on the Commodity Mercantile Exchange, more effective monitoring of the speculator-hedger distinction, and a call for CFTC action on the matter.

Smith has also reintroduced his bill, H.R. 631, which sharply circumscribes the activity on and off the futures markets of large packers, such as Iowa Beef, found in this and earlier studies to be exerting concentrated market power to the detriment of the livestock industry as a whole.

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