Responses of Members of the Subcommittee on Convergence to Preparatory Questions

Background

On March 9, 2009, the Commodity Futures Trading Commission (CFTC) posted a Federal Register Notice to announce that it is seeking nominations to the Subcommittee on Convergence in Agricultural Commodity Markets, a Subcommittee of the CFTC's Agricultural Advisory Committee. The Subcommittee on Convergence will work to identify the causes of poor cash-futures convergence in select agricultural commodity markets and advise on actions to remedy the situation.

On April 24, 2009, the CFTC has announced that it has selected the members of the Subcommittee on Convergence in Agricultural Commodity Markets. Of the 36 nominees, the CFTC Nominating Committee selected 18 members representing a broad and diverse spectrum of agricultural markets and interests.

In preparation for the agenda of the Subcommittee, those who were nominated (irrespective of whether they were subsequently selected as members or not) were asked to submit written answers to the following three questions:

1. In your opinion, which agricultural commodity (or commodities) has experienced the most pronounced convergence problem and why?
2. What are possible remedies to the convergence problem(s) that you identified in Question 1?
3. What are the pros and cons of adopting the remedies that you suggested in Question 2 and for whom?

Twenty responses were received. A summary of responses is below.

A summary of answers to the preparatory questions

<u>Answers to Question 1: Which agricultural commodity (or commodities) has experienced the most pronounced convergence problem and why?</u>

With one exception, there was a general consensus that the CBOT Soft Red Wheat (SRW) contract exhibited the greatest problems with convergence characterized by the duration, depth and volatility of the lack of convergence.

Soybean and corn futures contracts were described as having convergence problems to a lesser extent than the SRW contract. Rice, Soybean Oil and Cotton were mentioned as well.

Respondents attributed the lack of convergence to many different factors, including:

- For the SRW contract, most respondents gave at least one structural or contract design flaw such as too few delivery locations or locations that were out of position, making the shipping certificates more costly to obtain. Others discussed physical issues with storage such as the fact that more SRW is held by commercials instead of in on-farm storage, and that the corn and soybean crops follow SRW so that storage is at a higher premium or elevators are less likely to want to take SRW. Another mentioned that the 4ppm vomitoxin permitted in the SRW contract reduces the utility to the long side of the market.

- Several respondents discussed market issues such as the contract volume and position limits vis-à-vis crop size and the dominance of non-commercials to hedgers. Several also made mention of the run-up in commodity prices, attributing that phenomenon to index funds.

- In terms of the delivery process, several noted the industry concentration of those able to issue shipping certificates and were concerned that larger crops could cause congestion at the delivery locations and prevent broad access to the delivery mechanism. Others noted an unregulated cash market.

- Several respondents cited the University of Illinois study on the relationship of convergence to full carry.

<u>Answers to Question 2: What are possible remedies to the convergence problem(s)?</u>

There was a degree of consensus on the potential remedies for lack of convergence, although preference for any given solution appeared to be dependent on the industry segment in which a respondent participates. Those remedies can be divided into three groups:

- Fix the structural issue for the SRW contract by changing the waterway delivery system. Many respondents suggested the addition of delivery locations/facilities to replicate the commercial flow of grain through the Gulf.

- Address the carrying charge issue by either increasing contract storage rates or instituting a variable storage charges based on market carry.

- Address the decoupling of cash and futures markets directly via:
    - Cash settlement or a cash-settled index;
    - Forced load out, introduction of demand certificates, penalty for redelivery, or mandatory expiration of shipping certificates;
    - A limit on the speculative ownership of certificates, a mandatory reduction in position limits or increased regulation.

Answers to Question 3: What are the pros and cons of adopting the remedies that you suggested in Question 2 and for whom?

On fixing the structural issue of the SRW contract by changing the waterway delivery system or adding delivery locations to the existing system, some respondents noted that creating a Gulf delivery system would add transportation complexity to the longs, while questioned whether just adding delivery locations to the current delivery system would be sufficient.

Increasing contract storage rates or instituting a variable storage charges based on market carry seems to appeal to both long and short sides of the market. Some respondents mentioned that a potential downside of an across-the-board increase in storage rates is finding the appropriate rate. Similarly, some respondents argued that the downside of a variable rate is coming up with an acceptable formula. There was also a concern that this remedy might not be sufficient to achieve convergence.

On addressing the convergence directly through cash settlement or an introduction of a cash-settled index, many respondents suggested that this might be an appropriate remedy and noted that, by definition, convergence would be achieved. However, there was a general concern about the susceptibility to manipulation of an index contract. In addition, some respondents noted that the design of such a contract would be an issue as there currently exists is a cash-settled index that has failed to attract the interest of the market.

On addressing the convergence directly through forced load out/demand certificates, penalty for redelivery, or expiration of shipping certificates, there is a general consensus that this would very likely solve convergence, but at the expense of possibly large risks on the long side of the market.

On addressing the convergence directly by imposing a limit on the speculative ownership of certificates, a mandatory reduction in position limits or increased regulation, several respondents noted that posing additional regulation may not be supported by the data (on index funds as the cause of a lack of convergence) and that it could have the effect of hampering or driving important participants out of the market.