The Subcommittee on Convergence in Agricultural Commodity Markets had its first meeting in the form of a conference call on June 8, 2009. The following participants were in attendance:

Kyle P. Baltz (Agricultural Retailers Association, Arkansas Farm Bureau, USA Rice Federation);
Matt Bruns (National Grain and Feed Association);
Rick Cole (North American Millers' Association);
James D. Facente (Minneapolis Grain Exchange);
Tom Farley (Intercontinental Exchange);
Jeff Hainline (Missouri Agribusiness Association);
Matthew Jansen (ADM Group, Commodity Markets Council);
Thomas J. Kersting (South Dakota Soybean Processors);
Dave Lehman (CME Group);
Kevin McNew (Montana Grain Growers Association);
Joseph T. Nicosia (American Cotton Shippers Association);
Vince Peterson (US Wheat Associates, Inc.);
Mike Ricks (Cargill);
Michael D. Walter (Commodity Markets Council);
Aaron Wiegand (Bunge);
Steve Wellman (American Soybean Association);
Doug Yoder (Illinois Farm Bureau);

Jeff Harris (CFTC, Chief Economist);
Andrei Kirilenko (CFTC, Office of the Chief Economist);
Nicole Aulerich (CFTC, Office of the Chief Economist);
Pat Fishe (CFTC, Office of the Chief Economist);
Martin White (CFTC, Office of the General Counsel);
Christa Lachenmayr (CFTC, Division of Market Surveillance);
Jason Gizzarelli (CFTC, Office of Commissioner Dunn);
Andrew Morton (CFTC, Office of Commissioner Sommers)

Andrei Kirilenko welcomed everyone to the meeting and set the agenda. The agenda was divided into substantive issues and organizational issues. The organizational issues included how to proceed, how information will become public, and to determine the periodicity and tasks of future meetings. Substantive issues were anchored on solutions to issues the subcommittee was formed to solve.

Jeff Harris noted that the subcommittee will submit reports to the full committee under Commissioner Dunn. Jeff Harris then started the meeting by requesting feedback to the summary of questions on convergence distributed to the members of the subcommittee. The first question presented was "Which agricultural commodities are having a convergence problem?" The overwhelming consensus among others was Soft Red Winter Wheat. Joseph Nicosia noted that the issues are rooted in problems with delivery; the speculative long position versus the size of the crop does not allow for convergence. There was a convergence problem with cotton last March, which has since subsided, while the wheat market problems still subsist. Kyle Baltz noted that there was a problem with convergence in rice a year ago, but it has subsided now.

To clarify Mr. Nicosia's comments, Dave Lehman noted that contract specification changes including moving delivery sites, introducing seasonal storage rates, and reducing vomitoxin levels will be implemented in July and August of this year and are expected to address the convergence issue in CBOT Wheat. Mr. Lehman also wanted to discuss how commodity index traders affect convergence.

Mike Ricks reiterated that the subcommittee needs to find a way to bring futures markets to cash markets, which Mr. Lehman noted is difficult in a full carry market, however, the seasonal storage rates that will be implemented in July should address this issue for wheat. If they do not, a further change to the storage rate mechanism to introduce a variable storage rate that would change more frequently based on a comparison of the nearby futures spread to financial full carry should be considered.

The next question involved the structure of the Soft Red Winter (SRW) Wheat contract. This contract is used as the US wheat contract, however it only accounts for a small percentage of the wheat in the US and a new contract may serve the specifications better. The changes that go into effect in July will move the delivery points for the CBOT Wheat contract into the flow of the cash market. A study conducted by the University of Illinois concluded that delivery should be moved to the Gulf with all classes. Mr. Lehman noted that over half the US crop is used domestically, and this move puts the domestic hedger in a difficult position, raising transportation costs and making the contract less effective. He added that a preferable design would be one that places delivery at the point of the crop's origin, which is centered in Ohio and along the Ohio and mid-Mississippi rivers.

Vince Peterson of the US Wheat Associates, Inc. observed that domestic and export cash SRW values no longer reflect the textbook properties of delivery values for a futures contract plus or minus a basis. Instead, SRW cash values reflect the extent to which SRW competes with wheat coming from the EU and the Black Sea regions in the Mediterranean markets from North Africa to Egypt. Consequently, the US SRW cash value has essentially become similar to the current C&F Egypt competitive world market value - less ocean freight from New Orleans (for FOB NOLA gulf cash values), less barge freight (for interior US domestic values). Thus, as argued in the University of Illinois proposal, a SRW contract with a NOLA Gulf delivery value would be able to better reflect these actual cash market value realities. Then, by applying freight-off delivery differentials to delivery points back up the river systems and even into Chicago and Toledo (all at discounts to the Gulf-based contact), expanded domestic market participants could be provided with additional delivery opportunities and hedging mechanisms that respond to local cash market conditions.

Rick Cole of the North American Millers Association opined that adding delivery points will be ineffective; convergence will only be achieved when those holding long positions feel risk and begin to exit their contracts. Mr. Kirilenko and Mr. Harris affirmed that the CFTC would be interested in opening the door to whatever transparency might help bring convergence, but Mr. Ricks argued that no matter what information is made public, basic fundamentals of the market would remain the same. That is, there will always be sources of money willing to earn the risk-free rate in exchange for zero risk.

Pat Fishe of the CFTC proposed that the problem lies in the contract design; an issue that could be solved by separating the option to defer from the shipping certificate. The concern raised was that the primary contract would be a demand of the delivery mechanism, and would not represent the underlying market. Mr. Fishe responded that would be not a problem because traders would have another choice, to purchase the contract instead of the option.

Joseph Nicosia suggested that the subcommittee apply ideas from other markets, such as coffee and cotton, to the wheat market in order to solve the convergence issue. Mr. Nicosia proposed a discount on shipping certificates over time. In this scenario, high penalty stocks become cheap enough over time compared to the cash value to bring convergence. A member of the subcommittee pointed out, however, that coffee and cotton stocks lose their value much more quickly than those of wheat, making its time value much less significant. Moreover, wheat possesses no linear relationship between its age and its value, which would counteract the goal of adding risk to those holding long positions.

Steve Wellman stated concerns from a farmer's perspective, saying the marketplace is continually getting more difficult for producers to participate, and that moving the delivery point to the Gulf would create a further disconnect from the producers. Further, that a lack of convergence is being driven by inaccurate price discovery driven by the futures market and reflected back in the cash market. The subcommittee assured that their goal was to protect the producer.

Despite its reassurances, Mr. Bruns expressed that the grain and feed industry was forced to use spot prices, and that a swift and secure correction is needed because producers cannot bear large convergence problems another time.

Mr. Cole cautioned that any solution must not crowd out long participation; an equitable solution must be reached.

Mr. Harris requested a full menu of options for the Agriculture Committee, as well as contingency plans. Plan A will consist of the changes that are currently being instituted by the CME Group. Plan B would include a menu of options related to the structural changes in the CME Group's SRW Wheat contract; and various options to adjust the storage rate/delivery specification for grains and oilseeds. Plan B will be recommended for implementation if the changes implemented under Plan A do not fix convergence problems by August-September 2009.

The meeting then moved into organizational issues. The subcommittee will have another conference call in July, shortly after the first changes to the wheat contract become effective.