Dairy Farmers of America

October 28, 2010

***VIA ELECTRONIC SUBMISSION***

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

**Re: Agricultural Swaps ANPRM;**
**Agricultural Commodity Definition (RIN 3038–AD21)**

Dear Mr. Stawick:

Dairy Farmers of America, Inc. ("DFA") respectfully submits these comments in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") September 28, 2010 Advanced Notice of Proposed Rulemaking and Request for Comment (the "Advanced Notice")[1] regarding the agricultural swap provisions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), as well as the CFTC's Notice of Proposed Rulemaking regarding the definition of "agricultural commodity" under the Dodd-Frank Act.[2] DFA also repeats, and incorporates herein, its comments filed with the CFTC on September 20, 2010.

DFA appreciates the CFTC's request for comment and the opportunity to address the appropriate conditions, restrictions, or protections to be included in any rule, regulation, or order governing the trading of agricultural swaps.

## I. DESCRIPTION OF DFA AND ITS INTEREST IN THE PROPOSED RULE

### A. DFA Hedges the Commercial Risk Associated with the Milk it Markets for More than 17,000 Dairy Farmer Member-Owners

DFA is a farmer-owned dairy marketing cooperative. DFA's core business is marketing the milk of its more than 17,000 member-owners. DFA has a diverse membership spanning the continental United States. DFA's member-owners include small traditional farms (such as a 50-cow member-owner in Pennsylvania), mid-size farms (such as a 350-cow member-owner in

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1 75 Fed. Reg. 59666 (Sept 28, 2010).

2 Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act in 7 U.S.C. ch. 1; 75 Fed. Reg. 65586 (Oct. 26, 2010).

Wisconsin) and larger farms with 1,000 or more cows. This diversity in member-owners requires DFA to offer a broad range of tools to meet their risk management needs. DFA is passionately committed to providing marketing programs and business services to ensure the success of its members-owners' businesses. In doing so, DFA provides important risk management services to help members mitigate the commercial risk associated with the high volatility in milk and input prices. Much of this volatility is fairly new to the dairy industry and has increased more recently with the advent of a growing and substantial global dairy market emanating from reduced trade barriers and increased feed price volatility emanating from Federal ethanol policies. DFA offers to its members a forward contracting program as a primary means of mitigating commercial risk. As one alternative under the forward contracting program, DFA offers its member-owners a fixed price for their milk with some ability to adjust the price of their milk in the event that the price of the feed for their livestock changes. DFA does this through the use of a "milk-over-feed margin contract," which allows a farmer to lock in a margin between the Class III milk price and the price of feed.

DFA uses the futures markets, and to a smaller extent, over-the-counter ("OTC") swaps to enable it to provide fixed-price certainty to its members through its forward contracting program. These risk mitigation tools are critical for DFA's farmers. For example, a 50-cow farm that purchases one third of its feed each month typically may need to hedge about 300 bushels of corn and 2.5 tons of soybean meal per month. This farmer would not be able to use the futures markets to hedge its input risk because of the larger volumes underlying the relevant futures contracts and because the corn and soybean contracts do not trade on a monthly basis.[3] However, through DFA's forward contracting program, DFA can offer a more customized solution for its farmer member-owners. Yet, DFA can only provide this service to its member-owners because of its ability to enter into swaps for customizable volumes and time periods different from the applicable futures contract. DFA's mid-size and larger farmers also rely on DFA's ability to enter into swaps. Even though they may purchase larger volumes of inputs like corn and soybean meal, they rely on DFA's ability to enter into a monthly swap because corn and soybean meal futures contracts do not trade on a monthly basis. Additionally, these larger farms may not have corn and soybean meal volumes that equate precisely to one or more futures contracts.

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[3] The standard size for the corn futures contract currently listed on the CME Group, Inc. is 5,000 bushels and it trades in the following months: March, May , July, September and December. *See* CMEGROUP, CORN FUTURES (2010), *available at*: http://www.cmegroup.com/trading/agricultural/grain-and-oilseed/corn.html. The standard size for the soybean meal futures contract traded on the CME is 100 short tons, and it trades in the following months: January, March, May, July, August, September, October and December. *See* CMEGroup, SOYBEAN MEAL FUTURES (2010), *available at*: http://www.cmegroup.com/trading/agricultural/grain-and-oilseed/soybean-meal_contract_specifications.html.

DFA fully supports the CFTC's stated mission to protect consumers by bringing more transparency and oversight to the OTC derivatives markets generally and to agricultural markets specifically. DFA also recognizes the complexity involved in such significant reform and submits its comments to ensure that the CFTC has a fuller understanding of how to craft its implementing regulations in order to reduce any unintended negative impacts on dairy farmers. In a period of history when milk and input price volatility has increased substantially, and when member margins have, in some years – like 2009 – declined so severely as to create significant business continuity risk, DFA asks that the Commission do whatever it can to protect the ability of DFA's member-owners to manage commercial risks. Although DFA's swap activity is small in both transaction number and dollar volume relative to DFA's futures activity, the growing price volatility in milk, feed, fertilizer, energy, and other input prices will result in a growing demand from our member-owners to help them mitigate these risks by using innovative hedging methods tailored to their diverse sizes and needs. In many cases, the only opportunity to hedge this risk will be via swap transactions. It is important that DFA be treated as an end user of swaps, and that it be able to hedge commercial risks without added transaction, capital, and margin constraints because DFA aggregates and hedges the commercial risk of its farmer member-owners. DFA's swap transactions do not create systemic risk to the US economy. Quite the contrary, by helping to mitigate commercial risk of dairy farm businesses, it supports a stronger and growing national economy.

**B.** <u>DFA Hedges the Commercial Risk Associated with its Operation of Dairy Food Processors that Ensure a Market for its Dairy Farmer Member-Owners</u>

To ensure that all of DFA's member milk is marketed in a timely manner, DFA sells raw milk to more than 400 facilities and operates 20 dairy food processing plants that aid in the marketing of member-owner milk. DFA's member-owners jointly own these 20 processing plants and provide the equity to support their financing. These processing facilities build inventories of dairy commodities throughout the year that expose DFA to price risk in the event that prices decline before the products can be sold. DFA utilizes swap transactions to hedge the price risks associated with its inventories as well as its inputs, including raw material ingredients, energy (which is used by its processing facilities), and diesel fuel (which is used by its milk haulers and product distribution trucks).

DFA's processing facilities produce more than 15 different dairy products. Because of the wide range of commodities, relatively low volumes of some products, and diverse pricing mechanisms used to market these products, DFA needs access to tailored hedging contracts to protect against price volatility. For example, an important byproduct of cheese production is whey protein concentrate 34 ("WPC-34"). There is no WPC-34 futures contract, and there is no meaningful correlation between WPC-34 and whey futures. DFA may enter into a fixed price forward contract for WPC-34 with a customer and then enter into a swap to hedge the risks associated with the forward contract.

These hedging programs mitigate the financial risk that our member-owners have with respect to these plants. As a cooperative, the cumulative profits and losses generated by the cooperative's business activities are passed back to the member-owners (who also market through the cooperative) on an annual basis either in the form of cash or equity ownership in the cooperative.

As commercial end users of swaps, DFA and its member-owners have an important interest in how the Commission defines "agricultural commodity" and what conditions, restrictions, or protections it places on the trading of agricultural commodity swaps. The CFTC's rules governing agricultural swaps will have a significant impact on the risk management alternatives available to agricultural cooperatives and their members and, thus, their ability to provide a reliable supply of competitively priced agricultural products to consumers throughout the country.

## II. EXECUTIVE SUMMARY

DFA generally supports the Commission's proposed definition of "agricultural commodity" and also encourages the Commission to adopt rules that provide equivalent treatment for agricultural swaps and options. This will promote legal certainty and allow participants in the agricultural commodities space to continue to innovate and transact within a consistent regulatory framework. The Commission also should treat agricultural swaps the same as other commodity swaps, including by providing a broad end-user exception from clearing. This is in the public interest because the Dodd-Frank Act provides for increased oversight of all swaps.

## III. FRAMEWORK FOR AGRICULTURAL SWAP EXEMPTIONS

### A. DFA Supports the Commission's Proposed Definition of Agricultural Commodity

DFA supports the Commission's proposed definition of "agricultural commodity."[4] Having a consistent definition of agricultural commodity is in the public interest because it will promote legal certainty and allow participants in the agricultural commodities space to continue to innovate and transact within a consistent regulatory framework. To this end, DFA respectfully requests that the Commission clarify in its final rule that the second prong of the definition encompasses agricultural commodities that are not currently the subject of derivatives trading, but which may be the subject of derivatives trading in the future, without the need for additional CFTC action.

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[4] *See* 75 Fed. Reg. at 65593 (proposed definition of "agricultural commodity").

**B.** The Commission Should Adopt a Rule for Agricultural Swaps that Applies Many of the Same Concepts that the Dodd-Frank Act Applies to Other Commodity Swaps

OTC agricultural swaps markets currently function well and have not contributed to the financial crisis in the U.S. The CFTC, therefore, should not impose conditions or restrictions on agricultural swap transactions that are additional to those applicable to other commodity swap transactions. Treating agricultural swaps on an equivalent basis with other commodity swaps is consistent with the way they historically have been treated under the Commodity Exchange Act ("CEA").[5] They should continue to be subject to equivalent treatment now that they are to be regulated under the Dodd-Frank Act, which has provided for increased oversight of all commodity swaps.

The Commission should apply many aspects of the Dodd-Frank Act to agricultural swaps on an equivalent basis as other commodity swaps. In particular, the Commission should:

- require registration of swap dealers and major swap participants if they qualify as such based on their agricultural swaps transactions;[6]

- not require end-users – or swap dealers or major swap participants entering into swaps with an end-user hedging commercial risk – to post margin with regard to such swaps;

- apply business conduct standards to swap dealers and major swap participants on an equivalent basis as other commodity swaps;

- permit end-users, like DFA, who use agricultural swaps to hedge commercial risk, to choose whether or not to clear a particular swap transaction;

- not require the clearing of any pre-existing swaps;

- permit uncleared OTC agricultural swaps to be traded by "appropriate persons;"

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[5] Part 35 of the Commission's rules currently provides a very similar exemption for agricultural swaps between eligible swap participants ("ESPs") that Congress in the Commodity Futures Modernization Act ("CFMA") provided for swaps in exempt commodities between ECPs. *See* CEA § 2(h).

[6] DFA provided comments regarding the definitions of swap dealer and major swap participant on September 20, 2010. Please refer to these comments for further discussion of DFA's position regarding how these two terms should be defined. *See* Letter from DFA to David A. Stawick, Secretary, Commodity Futures Trading Commission (Sept. 20, 2010) (submitted to Commission via email on Sept. 20, 2010).

- define "appropriate persons" as eligible contract participants ("ECPs"); and
- require the reporting of uncleared agricultural swaps with an exception for those end-users who enter into a *de minimis* amount of a particular category of uncleared agricultural swaps because those swaps will not contribute to systemic risk and may significantly increase administrative costs for swap data repositories and the CFTC if they are required to be reported.

**C.** Cooperatives Should Be Treated As End-Users

Agricultural cooperatives, like DFA, that enter into swaps with third parties or members in the course of marketing their member's agricultural products and operating processing facilities should be treated as end-users for purposes of the clearing exception. Agricultural cooperatives perform a number of important business functions for their member-owners.[7] These include marketing their members' agricultural products, supplying them with production inputs, and mitigating their commercial risk – both at the farm level and with respect to member-owned processing facilities.[8] The CFTC traditionally and consistently has treated cooperatives as end-users. For example, the CFTC and the exchanges provide cooperatives with bona fide hedge exemptions based on the products they produce and the products they market on behalf of their members.[9] CFTC Regulation 1.3(z) defines bona fide hedging transactions to include positions that arise from "the potential change in the value of assets which a person owns, produces, manufactures, processes, ***or merchandises***, or anticipates owning, producing, manufacturing, processing, ***or merchandising***."[10] As with bona fide hedge exemptions, where the CFTC looks through the cooperative to the member's underlying physical position, the CFTC should treat both the member and the cooperative as end-users and should clarify that they are excluded from the definitions of swap dealer and major swap participant. There is no legal or policy reason for the CFTC to treat cooperatives differently with respect to OTC swap contracts than it does with respect to futures contracts.

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7 Agricultural cooperatives also include federated cooperatives and/or agricultural cooperatives whose members may also include other agricultural cooperatives.

8 As explained in DFA's letter to the CFTC filed on September 20, 2010, agricultural cooperatives that enter into swaps with third parties or members in the course of marketing their member's agricultural products and operating processing facilities should, therefore, be treated as end users and excluded from the definitions of "swap dealer" and "major swap participant." *See* Letter from DFA to David A. Stawick, *supra* note 5, at 5–7.

9 DFA has received hedge exemptions from the CME for its activities hedging the commercial risk of its member-owners and member-owned plants.

10 17 C.F.R. § 1.3(z) (2010) (emphasis added).

For the same reasons, the CFTC should clarify that, for the purpose of qualifying for the end-user exception to clearing, cooperatives that enter into swaps to hedge commercial risk, including the price risks associated with marketing member milk and operating processing facilities, are "using swaps to hedge or mitigate commercial risk," and are therefore exempt from the clearing requirement in Section 723 of the Dodd-Frank Act.[11]

### **D.** <u>The Commission Should Treat Agricultural Swaps and Options Consistently</u>

The Commission should adopt a rule for agricultural swaps that treats swaps and options the same. This approach is consistent with the Dodd-Frank Act's definition of swap, which expressly includes options.[12] Importantly, options on non-enumerated agricultural commodities historically have been treated the same as agricultural swaps under the CFTC's regulations. As the Commission notes in its proposed rule regarding the definition of "agricultural commodity":

> Because the term "agricultural commodity" in the Act refers to more than just the enumerated commodities, the Commission recognizes that certain options authorized under § 32.4 (*e.g.* off-exchange options on coffee, sugar, cocoa, and other agricultural products that do not appear in the enumerated commodity list) will be considered to be swaps in an agricultural commodity—and subject to any Commission rules that specifically address agricultural swaps.[13]

Although options on enumerated agricultural commodities historically have been subject to increased regulation under the CEA, Title VII of the Dodd-Frank Act introduces a regulatory regime that provides even more comprehensive regulation of all swaps (including options). Under this framework, and given the CFTC's proposed definition of agricultural commodity, the CFTC should not require additional obligations for any agricultural options.

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11 Dodd-Frank Act § 723(a)(3). The end user exception applies to non-financial end users who use swaps to hedge or mitigate commercial risk, provided they notify the Commission that they generally meet their financial obligations associated with entering into swaps. Congress provided in Section 723(a)(3) that the CFTC may exempt farm credit system institutions having total assets of $10,000,000,000 or less from the definition of "financial entity," a term that is used to limit the end user exception. In order to protect agricultural end users from treatment as financial entities, the CFTC should expressly exempt farm credit system institutions because many farmer-owned cooperatives also have affiliated farm credit institutions that further assist the cooperative in managing the commercial risks of its farmer owner-members.

12 *Id.* § 721(a) ("the term 'swap' means any agreement, contract, or transaction—(i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness").

13 75 Fed. Reg. at 65589.

Treating options on agricultural commodities and other agricultural swaps consistently will facilitate more effective risk management by agricultural end-users like DFA and its farmer-owners. The current restrictions on OTC enumerated agricultural options, which only may be offered to a counterparty that has at least $10 million in net worth and is entering into the option for hedging purposes, is an unnecessary hurdle that may result in less risk management and hedging activities by end-users. Most dairy farmers have far less than $10 million in net worth. The importance of being able to enter into these options on an equivalent basis as other options (*e.g.,* between ECPs) is underscored by the recent increase in corn and soybean meal prices, which in turn has increased the cost of milk production for our farmer-members.[14] Under current regulations, our farmer-members cannot enter into OTC options on corn and other enumerated agricultural commodities unless they have $10 million in net worth (or are guaranteed by an entity with $10 million in net worth). Under the Dodd-Frank Act, all OTC derivatives will be subject to increased regulation, including reporting and other protections. As such, any concerns that might previously have existed with respect to OTC options in enumerated agricultural commodities should not prevent them from being treated like other commodity swaps under the Dodd-Frank Act.

### **E.** <u>Allowing Agricultural Swaps To be Executed On The Same Basis As Other Commodity Swaps Meets The Requirements of CEA § 4(c)(2)</u>

Allowing agricultural swaps (including options) to be executed on the same basis as other commodity swaps is in the public interest because the Dodd-Frank Act provides for increased oversight of all commodity swaps. Equivalent treatment also would increase regulatory certainty in commodity markets. Moreover, defining "appropriate persons" as ECPs, and allowing ECPs to enter into OTC swaps that are not able to be cleared or are eligible for an exemption from clearing is consistent with the Commission's discretion to determine who is an "appropriate person" under CEA § 4(c)(3)(K) as well as Congress' treatment of other commodity swaps under the Dodd-Frank Act. This approach will not give rise to contracts, agreements, or transactions that materially adversely effect the Commission's or any DCM's regulatory or self-regulatory duties under the CEA.

## **IV. DISCUSSION OF THE COMMISSION'S QUESTIONS FOR COMMENT**

### **A.** <u>Current Agricultural Swaps Business</u>

DFA executes only a small quantity of swaps compared to its overall futures position. However, DFA's access to OTC swap markets enables it to be able to provide important risk management services to help its member-owners mitigate the commercial risk associated with

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[14] USDA Crop Production Report 1 (October 8, 2010), *available at* http://usda.mannlib.cornell.edu/usda/current/CropProd/CropProd-10-08-2010.pdf (last visited Oct. 26, 2010).

the high volatility in milk and input prices. Specifically, DFA offers to its member-owners a forward contracting program which, among other things, allows farmers to lock in a margin between the Class III milk price and the price of feed. *See* Section I.A above. DFA uses the futures markets and, to a smaller extent, OTC swaps to provide this fixed-price certainty to its member-owners. Yet, DFA can only provide this service to its member-owners because of its ability to enter into swaps for customizable volumes and time periods different from the applicable futures contract. Although DFA's swap activity is small in both transaction number and dollar volume relative to DFA's futures activity, the growing price volatility in milk, feed, fertilizer, energy, and other input prices likely will result in a growing demand from member-owners to help them mitigate these risks by using innovative hedging methods tailored to their diverse sizes and particular needs.

DFA also utilizes swap transactions to hedge the price risks associated with its production inventories and inputs, including raw material ingredients, energy, and diesel fuel. *See* Section I.B above. Because of the wide range of commodities, relatively low volumes of some products, and diverse pricing mechanisms used to market these products, DFA needs access to tailored hedging contracts to protect it and its members against price volatility. These hedging programs mitigate the commercial risk that our member-owners have with respect to these plants.

**B.** <u>Agricultural Swaps Clearing</u>

It is very important that the CFTC provide an end-user exception from any mandatory clearing of agricultural swaps. Failure to do so likely will materially increase the costs associated with entering into swaps, and thus reduce the benefits that DFA's farmer member-owners can achieve through hedging. If cooperatives and farmer members were required to conduct all of their hedging activities with cleared swaps and incur higher margin costs, they would have less capital available to continue their farming, marketing and processing operations. They also may be forced to pass some or all of the increased hedging costs along to their customers.

Cooperatives like DFA use swaps to hedge the commercial risks of their member farms and processing facilities. The CFTC should expressly recognize that cooperatives are end-users that enter into swaps in order to hedge the commercial risks associated with marketing their member's agricultural products and operating processing facilities. *See* Section III.B above.

**C.** <u>Trading</u>

Agricultural markets function very effectively. Consequently, the Commission should not impose conditions or restrictions on the trading of agricultural swaps that are additional to, or more burdensome than, those imposed on other commodity swaps under the Dodd-Frank Act. OTC agricultural swaps contracts provide a critical hedging mechanism for cooperatives, farmers, and other agricultural end users. The costs of imposing additional obligations on this well-functioning market would substantially outweigh any potential benefits.

**D.** Agricultural Swaps Purchasers

A broad range of commercial market participants – from farmers and cooperatives to grain elevators, processing facilities, and food manufacturers – currently rely on OTC swaps markets to cost-effectively hedge commercial risks. *See* Section I.A-B and Section IV.A above for a full discussion. Agricultural swap purchasers do not need more protections than other commodity market participants. Moreover, imposing more onerous obligations on agricultural swaps than on other commodity swaps likely would limit access to important hedging opportunities for farmers and cooperatives. *See* Section IV.B above.

**E.** Designated Contract Markets

Agricultural swaps transactions should be permitted to trade on designated contract markets ("DCMs") to the same extent as other commodity swaps. Consequently, all market participants should be permitted to trade agricultural swaps on DCMs because they would be cleared and subject to the highest degree of oversight by the CFTC. The CFTC should ensure that all market participants trading swaps on DCMs have equal access to clearing alternatives offered by the DCM.

**F.** Swap Execution Facilities

Agricultural swaps transactions should be permitted to trade on swap execution facilities ("SEFs") to the same extent as other swaps. Consequently, all market participants should be permitted to trade agricultural swaps on SEFs because they would be cleared and subject to the extensive oversight by the CFTC. The CFTC also should ensure that all market participants trading on SEFs have equal access to clearing alternatives offered by a SEF.

**G.** Trading Outside of DCMs and SEFs

Agricultural swaps should be permitted to trade OTC (*i.e.*, outside of a DCM or SEF) to the same extent as all other commodity swaps. In other words, OTC agricultural swaps should be allowed to be executed between ECPs to the extent that they are not able to be cleared or are eligible for the end-user exception from clearing. OTC agricultural swaps markets currently are functioning well and have not contributed to the financial crisis in the U.S. The CFTC, therefore, should not impose conditions or restrictions on agricultural swap transactions that are additional to, or more burdensome than, those applicable to other swap transactions. Treating agricultural swaps on an equivalent basis with other commodity swaps is consistent with the way they historically have been treated under the CEA. They should continue to be subject to equivalent treatment now that they are to be regulated under the Dodd-Frank Act, which has provided for increased oversight of all swaps. *See* Section III.B above for a detailed discussion.

## V. CONCLUSION

DFA commends the Commission for its commitment to safeguarding the hedging and trading activities of agricultural end-users of physical commodities and swaps, and looks forward to working with the Commission throughout the Dodd-Frank Act rulemaking process. We welcome the opportunity to discuss these issues further with the Commission and its Staff.

Please contact me or my colleague, Renee Cool, at (888) 332-6455, if you have any questions regarding DFA's comments.

Respectfully submitted,

Edward W. Gallagher

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