National Milk Producers Federation

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"Connecting Cows, Cooperatives, Capitol Hill, and Consumers"

October 28, 2010

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Agricultural Swaps ANPRM. (75 FR 59666)

To the Secretary and the Commission:

The National Milk Producers Federation (NMPF) is the voice of three-fifths of America's 55,000 commercial dairy farmers, through their membership in NMPF's 30 constituent cooperative associations ('cooperatives'). It is our mission to advance the well-being of these farmers and the cooperatives that they own. As a member of the CFTC's Agricultural Advisory Committee, NMPF appreciates the opportunity to comment on proposed rulemaking on agricultural swaps.

NMPF's members have a strong interest in both effective price discovery and price risk management. These are the two original and still most fundamental purposes of the regulated futures and derivatives markets.

NMPF offers these comments in response to CFTC's advanced notice of proposed rulemaking on agricultural swaps. We urge the Commission to minimize the regulatory burden on farmers and their cooperative associations using swaps for *bona fide* hedging as end users; and to properly recognize the nature of an agricultural cooperative as the creature, the extension, and the proper agent of their farmer-members in defining agricultural cooperatives as eligible swap participants.

Introduction

We support the Commission's traditional commitment to the protection of farmers from the "undue and unnecessary burden" of "excessive speculation" in agricultural commodity markets. We agree that there is a need to avoid chaos resulting from large speculative interests in futures, derivatives, and swaps.

The Dodd-Frank Wall Street Reform and Consumer Protection Act presents many substantial challenges to the Commission. In the case at hand, Congress made prohibition of agricultural swaps a default policy, thereby charging the Commission with regulation by exemption, and providing a limited time to do this.

Until recent years, futures markets for milk and dairy products were nonexistent or ineffectual. Today there are effective dairy futures markets for only one milk clase and very few dairy products; this limits the opportunities for producers and processors to effectively hedge their price risks in exchange-cleared futures and options markets. As a result, they have turned to swaps to manage their price risks; in the case of producers, this is often done with the assistance of their cooperative associations. These swaps are typically customized to the needs of the end user. The opposite side sometimes makes use of exchange-based futures and options to offset some of this risk. Other times, they are also end users with offsetting risks. Swaps allow smaller end users or those with limited resources for risk management to take full advantage of the opportunities provided by the market. It also allows price risk management for the very wide range of dairy products made in the U.S.

Farmers often operate on a much smaller scale than other financial actors; but they must be allowed access to a range of choices to manage price and marketing risk, through dealers and cooperatives who can tailor risk management strategies to their specific needs and circumstances.

- NMPF supports a broad allowance for commercial end-users to engage in agricultural swaps. We believe that this is necessary in order to allow the continued use and development of a wide range of customized agricultural swaps that are being tailored to the risk management needs of farmers and their cooperative associations. Without such a broad allowance, we fear that the burden of regulation will undercut innovation and flexibility in price risk management for dairy farmers and their cooperatives.
- No new clearing requirements should be imposed on agricultural swaps by end users engaged in hedging. Such swaps are often undertaken on a relatively small scale and are customized. Clearing could make these risk management opportunities prohibitively expensive for farmers, and would create a bias against small producers. Their small volume means they do not present a systemic risk to commodity or financial markets.
- Transactions within farmer cooperatives, that is, between individual farmers and their cooperatives, should be treated as internal transactions, just as transactions within any company are treated. Such transactions are a fundamental part of the collective marketing of their products.
- Finally, we generally urge the Commission to allow as much flexibility as the law will allow for agricultural swaps by commercial end users engaged in *bona fide* hedging.

Dairy farmers and dairy farmer cooperatives are hedgers and end users

The farmer-owners of our member cooperative associations have varied and *bona fide* hedging interests as sellers of milk and dairy products; as buyers of feed, fuel, and other inputs; and as both buyers and sellers of cattle. They are involved as buyers and sellers in delivery- and cash-settled futures and options markets, as well as in off-exchange swaps and forward pricing. Their cooperative enterprises similarly manage price risk as buyers of milk, as manufacturers and sellers of dairy products, as service providers to non-member farmers to whom they provide a market, and most fundamentally, as an arm of their farmer-members and on their behalf.

Both farmers and their cooperative associations are 'commercial end-users', as the producers and marketers of milk, as the manufacturers and marketers of dairy products, and as the users of various inputs to their production, including feed, milk, fuel, and food ingredients.

Cooperative-member transactions are internal actions

Indeed, a cooperative association undertakes all its actions as an extension of its members. A cooperative association is the creature of its members, and member farms are an integral part of the cooperative association.

A dairy farmer cooperative acts as the farmer-member when marketing the member's milk. When the cooperative performs hedging services for the same member, the hedge is undertaken as part of the larger cooperative enterprise of marketing its members' milk.

Given this fact, any pricing arrangements that a cooperative association makes with its members with respect to the pricing of their products or supplies should be considered internal to the cooperative. These should not be subject to regulation as a swap, just as activities that any company takes in managing internal, offsetting risks are not regulated.

CFTC should broadly allow commercial end users to use agricultural swaps

The Commission should generally allow commercial end users to use agricultural swaps to engage in *bona fide* hedging, without requiring clearing. Today, dairy farmers, their cooperative associations, and other dairy processors engage in a wide variety of swaps as a means of hedging risks. As end users, they produce, market, or purchase products which cannot be hedged effectively with standardized instruments, or which can be hedged, but with greater imperfection than with a customized swap. Terms of a swap can be customized for timing, for variable basis, for different product composition, for different months, and for different or varying volumes. The enormous variety sources, pricing schemes, and finished products in the dairy industry makes comprehensive risk management through standardized contracts impossible.

According to the ANPRM,

> *Generally speaking, Sec. 4(c) provides that, in order to grant an exemption [from the prohibition against agricultural swaps], the Commission must determine that: (1) The exemption would be consistent with the public interest and the purposes of the CEA; (2) any agreement, contract, or transaction affected by the exemption would be entered into by "appropriate persons" as defined in Sec. 4(c); and (3) any agreement, contract, or transaction affected by the exemption would not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the CEA.*

NMPF believes that a broad exemption for *bona fide* hedging by commercial end-users fits such a determination:

(1) **Public interest:** Agricultural production is conducted on a smaller scale than many other primary industries. This raises the proportional cost of meeting regulatory requirements for each transaction. The quality, timing, volume, and location of farm production vary considerably from farm to farm; and every plant

has a different set of circumstances dictating the characteristics of their products and their input needs and their pricing situation. As a result, many agricultural swaps are impossible to standardize. It is in the public interest to allow risk management by producers and processors without undue regulatory burden.
A broad allowance by the Commission of agricultural swaps, without clearing, by commercial end users would allow the continuation of practices that are now growing and providing farmers, processors, and retailers significant risk management opportunities. Further, it is in the public interest that U.S. dairy farmers and processors not be put at a competitive disadvantage through regulatory limits on their ability to lock in long-term prices or hedge risks on their input prices.

(2) **Appropriate persons:** Agricultural cooperative associations are generally appropriate persons, as companies with adequate direct assets, per 4(c)(3)(F). In addition, both farmers and farmer cooperative associations directly engaged in *bona fide* hedging should be granted allowance to trade swaps, per 4(c)(3)(K).

(3) **No adverse effect on regulation:** Agricultural swaps are a small but growing share of risk management by farmers and farmer cooperatives. They fill the gaps in between exchange-traded futures and options. The exchange-traded instruments are generally preferred, on the basis of cost and transparency, where they provide an adequate hedge. For this reason, agricultural swaps are generally only undertaken by end users for *bona fide* hedging when no exchange provides an adequate hedge.
However, the opposite side of many swaps is taken by traders or processors who make greater use of the exchanges to offset their risk on swaps. This can allow end users access to more diverse risk management opportunities, even as it potentially increases the volume cleared on regulated markets.

Conclusion

We would be well pleased if the Commission concluded that end user agricultural swaps, as are currently transacted, are grandfathered under Section 4(c) of the Commodity Exchange Act.

If they are not, we urge the Commission to issue a broad allowance for the use, without clearing, of agricultural swaps for end users engaged in *bona fide* hedging, similar to that provided for non-agricultural swaps, and subject only to the minimal requirements of the Dodd-Frank Act.

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Regarding the specific questions outlined in the request for comments:

2. What types of entities are participating in the current agricultural swap business?
Dairy farmers and dairy farmer cooperative associations are engaged in agricultural swaps. Milk processors are engaging dairy farmer cooperative associations to offset opposite price risk. Both are end-users, but they are in some cases not pricing milk or milk products physically delivered from the cooperative to the processor. The cooperatives may offer this as a price risk management opportunity to individual farmer-members, or they may use it to partially hedge the average price paid to all members.

Processors are using swaps to hedge commercial price risk, enabling them to offer a fixed price to a retailer they supply through a price swap with another processor

that wants to receive a fixed price for their product. This matching of desired pricing arrangements is an increasingly common means of managing the risks of price and output-input price margins in the industry.

7. What would be the practical and economic effect of a rule requiring agricultural swaps transactions (other than those eligible for the commercial end-user exemption) generally to be cleared?
Since so many agricultural swaps undertaken by end users are small volumes carefully tailored to specific conditions, requiring clearing in any fashion could become prohibitively expensive, undermining the price risk management objective of the CEA.

8. What would be the practical and economic effect of requiring agricultural swaps to be cleared under the Dodd-Frank clearing regime?
See number 7.

10. Do agricultural swaps/ATO purchasers need more protections than participants in other physical commodity swaps?
There is no reason to presume that users of agricultural swaps face a greater need for protection, especially when operating through their cooperative association.

12. Would additional protections for agricultural swaps purchasers unduly restrict their risk management opportunities?
Yes, NMPF believes that additional participant qualification and clearing requirements would add unduly and prohibitively to the cost of price risk management for the agriculture sector. As much as the law allows, agricultural swaps should face no more restrictions than non-agricultural swaps.

13. Should the Commission consider rules to make it easier for agricultural producers to participate in agricultural swaps—for example, by allowing producers who do not qualify as ECP's to purchase agricultural swaps?
Yes, farmers should have substantial freedom to seek alternative pricing opportunities, without limited regulatory burden. As noted above, the small scale on which even large farmers operate, compared to many commodity transactions, means that qualification restrictions and clearing requirements would be a disproportionate burden on their marketing activities. Farmers are already at risk for the value of their production. Keeping them from engaging in **bona fide** ***hedging in the swap market does not reduce their risk; it only prevents them from reducing it.***

14. Should agricultural swaps transactions be permitted to trade on DCM's to the same extent as all other swaps are permitted on DCM's?
Yes, to at least the same extent.

15. If yes, why?
For the reasons indicated above, farmers should have at least the same risk management opportunities as other commodity end users.

17. Should agricultural swaps transactions be permitted on SEF's to the same extent as all other swaps are permitted to transact on SEF's?
Yes, to at least the same extent.

18. If yes, why?
For the reasons indicated above, farmers should have at least the same risk management opportunities as other commodity end users.

20. Should agricultural swaps be permitted to trade outside of a DCM or a SEF to the same extent as all other swaps?
Yes, to at least the same extent.

21. If yes, why?
For the reasons indicated above, farmers should have at least the same risk management opportunities as other commodity end users.

24. In general, should agricultural swaps be treated like all other physical commodity swaps under Dodd-Frank?
Agricultural swaps should be given substantial leeway, provided they involve an end user involved in **bona fide** ***hedging. We do not believe that such swaps pose any systemic risk to the commodity or financial markets; and provided that such swaps are undertaken by appropriate persons, they should pose no more counterparty risk than the ordinary purchase and sale by end users of the analogous commodities.***

25. If yes, why?
For the reasons indicated above, farmers should have at least the same risk management opportunities as other commodity end users.

Thank you again for the opportunity to comment on this very important issue. Please call me if you have any questions.

Sincerely,

Roger Cryan,
V.P. for Milk Marketing and Economics
National Milk Producers Federation