March 28, 2011

VIA ELECTRONIC SUBMISSION

David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Position Limits for Derivatives, RIN 3038-AD15 and 3038-AD16

Dear Mr. Stawick:

Dairy Farmers of America, Inc. ("DFA") respectfully submits these comments in response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") January 26, 2011 Notice of Proposed Rulemaking regarding Position Limits for Derivatives ("Proposed Rule")[1] pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). In the Proposed Rule, the CFTC specifically requests comment on "all aspects of its proposed position limit framework."[2] DFA is, therefore, refiling the comments it submitted on September 20, 2010 and February 22, 2011, respectively, in response to the CFTC's Advance Notice of Proposed Rulemaking regarding key definitions contained in Title VII of the Dodd-Frank Act and the CFTC's Notice of Proposed Rulemaking regarding the end-user exception to mandatory clearing of swaps.[3] DFA believes that the consideration of DFA's previously filed comments will assist the CFTC in establishing an appropriate framework for setting position limits, including with respect to the definition of "*bona fide* hedging transactions and positions." Copies of our previously submitted comments are attached hereto as Appendices A and B.

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1 *Position Limits for Derivatives*, 76 Fed. Reg. 4752 (Jan. 26, 2011) (Notice of Proposed Rulemaking).

2 76 Fed. Reg. at 4758.

3 *Definitions Contained in Title VI of Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 Fed. Reg. 51429 (Aug. 20, 2010) ("Appendix A"); *End-User Exception to Mandatory Clearing of Swaps*, 75 Fed. Reg. 80747 (Dec. 23, 2010) ("Appendix B"). On October 28, 2010, DFA also filed comments in response to the CFTC's Advance Notice of Proposed Rulemaking regarding the agricultural swap provisions contained in Title VII of the Dodd-Frank Act. *Agricultural Swaps*, 75 Fed. Reg. 59666 (Sept. 28, 2010).

DFA is a dairy marketing cooperative that is owned and governed by its farmer members, who are located in each of the 48 contiguous states. DFA's core business is marketing the milk of its more than 15,000 farmer members. DFA's dairy farmer members market their milk on a daily or every-other day basis. They rely on DFA to handle the marketing function – ensuring that their milk is delivered to a milk plant (which sometimes is a DFA-owned and operated milk plant), and making sure that they receive a competitive price for their milk. DFA also offers its members a number of farm service programs to help them better manage profitability and reduce their business risk. One of DFA's most widely used and popular farm service programs is our milk price forward contracting program.[4] Our forward contracting program has matured over the years and now allows farmer members to enter into fixed-price forward contracts, as well as forward contracts that provide flexible pricing alternatives for their milk, including adjustments based on the cost of production inputs. For example, one popular program is a minimum milk price forward contract that places a floor under the milk price. We also have begun entering into milk price forward contracts that include adjustments for changes in feed prices.

DFA provides these important risk management services to help its farmer members mitigate the commercial risk associated with the high volatility in milk and input prices. DFA's forward contracting program provides real economic value to its farmer members who would otherwise struggle to manage their milk price and input risk, or worse, stop doing so altogether. DFA can provide these forward contracts to its farmer members because it is able to aggregate and hedge the physical commodity price risk that it assumes through forward contracting by using futures contracts and over-the-counter ("OTC") swaps.

DFA currently has a hedge exemption from the Chicago Mercantile Exchange ("CME") that allows DFA to exceed the speculative position limits for Class III milk in order to adequately hedge its commercial activity, including DFA's forward contracting program. DFA believes that Proposed Rule 151.5(a)(2)(iv), defining "*bona fide* hedging transactions and positions," continues to include DFA's hedging of price risk associated with its forward contracting program.[5] However, given the extensive reporting requirements[6] triggered by exceeding the position limits (outside of receiving an anticipatory hedge exemption under Proposed Rule 151.5(c)), DFA is still concerned that the Phase I spot-month limits set by the

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[4] *See* Appendix A at pages 4-5 and Appendix B at pages 3-4 for more details regarding DFA's forward contracting program.

[5] 76 Fed. Reg. at 4761 ("Proposed § 151.5(a)(2)(iv) also provides an exemption for agents contractually responsible for the merchandising of cash positions with a person who owns the commodity or holds the cash market commitment being offset."). *See also* 76 Fed. Reg. at 4771-4772. *See* discussion of DFA's hedge exemption pursuant to CTC Rule 1.3(z) on page 5 of Appendix A and page 5 of Appendix B.

[6] The detailed daily reporting requirements in the Proposed Rule would be extremely onerous for an organization like DFA that may have a continuing need to exceed the CFTC's speculative position limits in order to hedge its commercial activity.

CFTC may be too low.[7] DFA understands that the CFTC has used the levels currently set by the CME (*i.e.*, 1,500 Class III Milk futures contracts).[8] However, under Phase I of the Proposed Rule, swaps and futures contracts that are economically equivalent to the Class III Milk futures contract also would have to be netted. When combined, even the proposed Conditional Spot Month limit may be too restrictive.[9] In addition, the Commission's Proposed Rule is unclear as to how the spot month Class III milk limits will be calculated in Phase II. The core referenced Class III milk contract is a cash-settled, and not a physically-delivered, contract. The Proposed Rule does not detail how a spot month limit will be determined when there is no specification for delivery and, therefore, no estimate of deliverable supply. DFA urges the Commission to make this determination transparent to market participants.

Because of the popularity of DFA's forward contracting program, DFA currently is hedging even more forward contracts than it originally anticipated. Consequently, DFA has applied to the CME for an increased hedge exemption. In the meantime, DFA relies on OTC swaps in order to be able to continue to hedge its commercial risks. DFA has every reason to believe that, over the next several years, the number of DFA's members using the forward contracting program will expand significantly. This makes it critically important for DFA to have the assurance that the CFTC will fully recognize its hedging of forward contracts with members. Additionally, DFA uses Class III milk futures and swaps to hedge the business risk associated with operating member-owned milk plants and in conjunction with the marketing and sale of milk to raw milk customers. DFA anticipates that the forward contracting needs associated with these aspects of our business also will continue to grow.

DFA commends the Commission for its commitment to safeguarding the hedging and trading activities of agricultural end-users of physical commodities and swaps, and agricultural cooperatives in particular, and appreciates the opportunity to work 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.

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[7] DFA recommends that the Commission consider doubling the existing CME position limit to account for swaps that previously were not subject to the position limits, but will be included under the Proposed Rule.

[8] 76 Fed. Reg. at 4757 n.34 ("For the ICE Futures U.S. Sugar No. 16 (SF) and Chicago Mercantile Exchange Class III Milk (DA),the Commission proposes to adopt the DCM single month limits for the nearby month or first-to-expire referenced contract as spot-month limits. These contracts currently have single-month limits which are enforced in the spot month.").

[9] 76 Fed. Reg. at 4747 ("In §151.4 the Commission proposes spot-month limits, for not only referenced contracts that are futures but also referenced contracts that are economically equivalent swaps."). CME Group, Class III Milk Futures Contract Specifications, *available at* http://www.cmegroup.com/trading/agricultural/dairy/class-iii-milk_contract_specifications.html.

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
President
Dairy Risk Management Services
A division of Dairy Farmers of America, Inc.

APPENDIX A

DFA Comment Letter dated September 20, 2010

Definitions Contained in Title VI of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (Aug. 20, 2010)

September 20, 2010

VIA E-MAIL: dfadefinitions@cftc.gov

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

Re: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (August 20, 2010)

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") and Securities and Exchange Commission's August 20, 2010 Advance Notice of Proposed Rulemaking (the "Advance Notice") regarding key definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] In addition to its individual comments, DFA supports the comments of the National Council of Farmer Cooperatives ("NCFC") as they relate to the Advance Notice. DFA is a long-time member of the NCFC and has been working with the NCFC and its other member cooperatives on issues relating to the Dodd-Frank Act and the Commission's implementing regulations.

As the CFTC begins the process of implementing the Dodd-Frank Act, DFA appreciates the CFTC's request for comments and the opportunity to address the impact that certain key definitions, including the definitions of "swap," "swap dealer," and "major swap participant" potentially will have on the business operations of end users of swaps. The definition of "swap" expressly includes "agricultural swaps" and "commodity swaps", although it is not clear exactly what rules will apply to agricultural swaps. Section 723(c) (Grandfather Provisions) provides:

> a person may offer to enter into, enter into, or confirm the execution of, any swap in an agricultural commodity pursuant to section 4(c) of [the CEA] or any rule, regulation, or order issued thereunder (including any rule, regulation, or order in effect as of the date of enactment of this Act) by the [CFTC] to

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1 Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act in 7 U.S.C. ch. 1 (the "CEA")) ("Dodd-Frank Act").

allow swaps under such terms and conditions as the Commission shall prescribe.

Although it is not clear that all of the provisions of the Dodd-Frank Act apply to agricultural swaps, DFA respectfully requests that the Commission define the terms "swap", "swap dealer" and "major swap participant" in a manner that, consistent with Congress's intent, exempts end users, like DFA, who primarily use swaps to hedge commercial risk. 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.

DFA looks forward to working with the CFTC throughout the upcoming rulemakings to help design a regulatory framework that enables end users to hedge the risks related to agricultural production and marketing in a cost-effective manner. This ultimately protects consumers from increased prices that likely will arise if producers are unable to effectively engage in important risk management and hedging activities.

I. DESCRIPTION OF DFA AND ITS INTEREST IN THE ADVANCE NOTICE

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 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 the 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 and a hedge on their feed purchases. 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.[2] 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.

DFA fully supports the CFTC's stated mission to protect consumers by bringing more transparency and oversight to the OTC derivatives markets. 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

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[2] 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.

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 the key terms listed in the Advance Notice, including the definitions of "swap," "swap dealer," and "major swap participant." The way in which the CFTC defines and interprets these terms likely will have a significant impact on the risk management options and financial stability of 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. AGRICULTURAL COOPERATIVES HEDGE AND MITIGATE COMMERCIAL RISK FOR THEIR MEMBERS

Congress made clear that it intended to treat end users differently than swap dealers and major swap participants because end users are hedging and mitigating commercial risk.[3] Agricultural cooperatives like DFA perform a number of important business functions for their member-owners.[4] 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 its member-owned processing facilities. Agricultural cooperatives that enter into swaps with third parties or members in the course of marketing their member's agricultural

[3] 156 Cong. Reg. H5248 (daily ed. Jun. 30, 2010) (Letter from Sen. Christopher Dodd and Senator Blanche Lincoln to Rep. Barney Frank and Rep. Collin Peterson ("Dodd-Lincoln Letter")) (emphasis added) ("In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.")

[4] Agricultural cooperatives also include federated cooperatives and/or agricultural cooperatives whose members may also include other agricultural cooperatives.

products and operating processing facilities should, therefore, be treated as end users and excluded from the definitions of "swap dealer" and "major swap participant."

The CFTC has traditionally and consistently 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.[5] 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***."[6] 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 reason for the CFTC to treat cooperatives differently with respect to OTC swap contracts than it does with respect to futures contracts.

For the same reasons, the CFTC should clarify for purposes of the end user exception to clearing, that 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.[7]

III. AGRICULTURAL COOPERATIVES SHOULD BE EXCLUDED FROM THE DEFINITIONS OF SWAP DEALER AND MAJOR SWAP PARTICIPANT

A. The Definition of Swap Dealer

The Dodd-Frank Act defines "Swap Dealer" to include any person who:

(i) holds itself out as a dealer in swaps;

(ii) makes a market in swaps;

(iii) regularly enters into swaps in with counterparties as an ordinary course of business for its own account; or

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

6 17 C.F.R. § 1.3(z) (2010) (emphasis added).

7 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.

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps....[8]

Cooperatives that enter into swaps to hedge commercial risk, including risk related to marketing their members' agricultural products and operating processing facilities, are not financial dealers or market makers. They do not hold themselves out as willing to make a market in swaps or as dealers in swaps. Rather, as end users, they use swaps to hedge the commercial risks related to their member farms and processing facilities.

Moreover, the definition of "Swap Dealer" includes two express exemptions that also should apply to cooperatives. The first exemption is for those who "enter into swaps for such person's own account, either individually or in a fiduciary capacity, but not as part of its regular business."[9] The CFTC should clarify that this exemption applies to cooperatives, whose primary business is marketing member products, but who enter into swaps with members and third parties to hedge the price risks associated with such products.

The second exemption is for those who engage in a "*de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."[10] The CFTC should clarify that the quantity of transactions to be considered for purposes of the "*de minimis*" threshold excludes transactions that cooperatives enter into with third parties and members to hedge the price risks associated with marketing member milk and operating processing facilities. This is consistent with the CFTC's traditional treatment of cooperatives, including with respect to providing bona fide hedge exemptions that allow cooperatives to exceed speculative position limits for purposes of hedging the risks associated with their members' products.[11]

B. The Definition of Major Swap Participant

The Dodd-Frank Act defines "Major Swap Participant" to include any person who is not a swap dealer and who:

> (i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding—(I) positions held for hedging or mitigating commercial risk; ...
>
> [or]
>
> (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets....

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8 *Id.* § 721(a)(21) (to be codified at CEA § 1a(49)(A)).

9 *Id.* § 721(a)(21) (to be codified at CEA § 1a(49)(C)).

10 *Id.* § 721(a)(21) (to be codified at CEA § 1a(49)(D)).

11 *See* 17 C.F.R. § 1.3(z) (2010) and Section III above.

(B) DEFINITION OF SUBSTANTIAL POSITION.—For purposes of subparagraph (A), the Commission shall define by rule or regulation the term 'substantial position' at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.[12]

Positions held for hedging or mitigating commercial risk are expressly excluded from the term "substantial position." The CFTC should expressly recognize that swaps that cooperatives enter into in order to hedge commercial risks, including those related to marketing their members' agricultural products and operating processing facilities, constitute "positions held for hedging or mitigating commercial risk," and thus are excluded from the calculation of "substantial position." This is consistent with the CFTC's treatment of a cooperative's futures position for purposes of providing hedge exemptions to allow the cooperative to exceed speculative position limits. Whether a person has a "substantial position" in swaps should be determined only by looking at a person's <u>speculative</u> position in uncleared swaps for which no collateral has been provided to protect against counterparty credit risk.

The CFTC also should clarify that commercial end users, such as DFA, are not "systemically important" and cannot significantly impact the financial system of the United States. As Representative Peterson mentioned in a colloquy on the House floor, "[i]n crafting the House bill and the conference report, we focused on creating a regulatory approach that permits the so-called end users to continue using derivatives to hedge risks associated with their underlying businesses…. End users did not cause the financial crisis of 2008. They were actually the victims of it."[13] It is intuitive that using swap transactions to hedge commercial risk reduces the likelihood of business failure, and thus supports economic activity as opposed to harming it.

IV. THE FORWARD CONTRACT EXCLUSION FROM THE DEFINITION OF "SWAP" SHOULD BE INTERPRETED CONSISTENTLY WITH THE CFTC'S PRIOR FORWARD CONTRACT INTERPRETATIONS AND PRECEDENT

In the Dodd-Frank Act, Congress expressly excluded from the definition of swap, any "sale of a nonfinancial commodity or security for deferred shipment or delivery, *so long as the*

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[12] Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33)).

[13] Cong. Rec. H5245 (daily ed. Jun. 30, 2010) (statement of Rep. Peterson).

transaction is intended to be physically settled."[14] This provision is similar to the forward contract exclusion from the definition of "future delivery."[15]

The Commission should interpret this exclusion from the definition of "swap" consistently with the Commission's prior guidance with respect to excluded forward contracts. It is very important that the CFTC provide consistent guidance in order to increase legal certainty with respect to this foundational term. This is consistent with Congress's expressed intent. In fact, the Chairs of the Senate Banking and Agricultural committees stated in a joint letter that:

> In implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject . . . .[16] nderstanding what constitutes an excluded forward contract is critical in order for farmer cooperatives to continue to be able to offer hedging alternatives for farmer members. The CFTC should, therefore, provide as much certainty as possible about what constitutes an excluded forward contract. Forward contracting allows farmers to price their product into the future, take positions to try to maintain a profit margin, and protect agains the unknown but potentially negative impact of adverse price fluctuations.

For example, the CFTC should continue to treat as forward contracts those that require delivery but provide for some price flexibility (*i.e.*, embedded options).[17] DFA's members rely on forward contracts that allow some measure of "upside" price opportunity. These types of programs include minimum price forward contracts and minimum/maximum price forward contracts. These "upside" price contracts allow members to increase their forward contract price when the price of milk increases. These contracts now represent more than 50 percent of DFA's forward contracting volume – when, just a few years ago, members locked in a fixed price nearly 100 percent of the time, with no opportunity to capture increases in the price of milk. DFA's member-owners rely on DFA's forward contracting programs for a number of reasons, including lack of available capital to fund a futures account, the mismatch in volume and products offered as futures contracts, and ease of transaction execution. DFA has recently increased the volume

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[14] Dodd-Frank Act § 721(a)(21) (to be codified at at 7 U.S.C.CEA § 1a(47)(B)) (emphasis added).

[15] The CEA grants the CFTC jurisdiction over "transactions involving contracts of sale of a commodity for future delivery." CEA § 2. Moreover, the CEA provides that "the term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery." *Id.* § 1a(19). This is generally referred to as the "forward contract exclusion."

[16] 156 Cong. Rec. H5249 (Dodd-Lincoln Letter).

[17] *See, e.g., In re Cargill, Inc.*, 2000 CFTC LEXIS 260; Comm. Fut. L. Rep. (CCH) P28,425, at *19 (ALJ 2000) (in which the ALJ found that the contracts at issue were not options because both parties were required to perform if the conditions in the contract were met, *i.e.,* if the grain price reached the strike price).

of milk hedged through its forward contracting program. Without it, many members would not be able to adequately mitigate their risks.

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 agricultural cooperatives in particular, and looks forward to working with the Commission throughout the Dodd-Frank Act rulemaking process. As explained herein, we encourage the Commission to define the Dodd-Frank Act's key terms to exclude commercial end users. 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
President,
Dairy Risk Management Services
A division of Dairy Farmers of America, Inc.

cc (via e-mail):
rule-comments@sec.gov
SEC File Number S7–16–10

APPENDIX B

DFA Comment Letter dated February 22, 2011

End-User Exception to Mandatory Clearing of Swaps
75 Fed. Reg. 80747 (Dec. 23, 2010)

Dairy Farmers of America

February 22, 2011

VIA ELECTRONIC SUBMISSION

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

Re: End-User Exception to Mandatory Clearing of Swaps, RIN 3038–AD10; and Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," RIN 3038–AD06

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") December 23, 2010 proposed rule on the End-User Exception to Mandatory Clearing of Swaps ("End-User NOPR")[1] and December 21, 2010 joint proposed rule on Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" ("Swap Dealer NOPR").[2] DFA also repeats, and incorporates herein, its comments filed with the CFTC on September 20, 2010 and October 28, 2010. Appreciating that the process for proposing and implementing regulations under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is ongoing, DFA reserves the right to supplement these comments upon further regulatory developments.

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.

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1 75 Fed. Reg. 80,747 (Dec. 23, 2010).

2 75 Fed. Reg. 80,174 (Dec. 21, 2010).

Overview

DFA supports the efforts of the Commission as it implements the economically important regulations stemming from the Dodd-Frank Act. Clearly, regulation of large, systemically important swap dealers is necessary to safeguard the US economy and to promote competition. As the Commission deliberates on these issues and the implementation of the Dodd-Frank Act, we ask that it maintain a balanced view that incorporates the public interest, the regulatory need, and the federal cost, and that also allows businesses to flourish economically.

DFA and other agricultural cooperatives, by our very nature, operate in a manner that reduces farm-level business risk and promotes business prosperity for family farms across the US. Our businesses and our member-owners were not the cause of the financial crisis that undermined all of our economic opportunities. Instead, we were among the victims. As such, we urge the Commission to bring the right balance that supports our continued and collective efforts that have made the US agricultural sector a strategically important component of our national economy, and the marvel of production growth and efficiency, worldwide.

To this end, we ask that:

- forward contracting programs continue to be excluded from regulation under the Dodd-Frank Act;
- agricultural cooperatives continue to be treated as end-users for purposes of the end-user clearing exception; and
- margining requirements not be imposed on swap dealers with respect to swaps entered into with end-users who elect not to clear the transaction because it is likely that swap dealers will pass this obligation through to end-users.

DFA's Ownership Structure and Core Business

DFA is the leading milk marketing cooperative in the US. It is owned and governed by more than 17,000 dairy farmers operating in each of the 48 contiguous states. These farms and their operations are quite diverse. Our membership includes small traditional farms (such as a 50-cow member-owner in Lancaster, PA), mid-size farms (such as a 350-cow member-owner in Wisconsin), and larger farms with 1,000 or more cows. Despite this diversity, each has the following in common, in that they all:

- provide management and labor from family members;
- are owners of DFA;
- have the ability to take part in the governance of DFA's business operations; and

- receive patronage and equity distributions on any and all earnings made by DFA during a given year.

Dairy farmers market their milk on a daily or every-other day basis. Our members rely on DFA to handle the marketing function – ensuring that their milk is delivered to a milk plant (which sometimes is a DFA-owned and operated milk plant), and that members receive a competitive price for their milk.

DFA owns and operates 20 dairy manufacturing facilities throughout the US. The profitability of these manufacturing facilities directly affects DFA's farmer member-owners. Seasonality of milk causes production of some commodities to be greater than the current demand. DFA, therefore, enters into swaps with various counterparties in order to hedge the inventory and raw material risks associated with the manufacture of various DFA-produced dairy products. Oftentimes, these swaps are for commodities that are less than the full size of an exchange-traded contract, which creates the need for a variety of risk management tools, including access to exchange-traded markets and swap markets (especially for those dairy products that do not have an exchange-traded contract).

DFA's milk-marketing and manufacturing activities comprise DFA's core business and utilize most of DFA's management, employee and capital resources.

DFA Farm Services Overview

Profitability on a dairy farm is more than a function of milk price. It is also a function of production cost and cash flow. To this end, DFA offers a variety of Farm Services to assist our members in being more profitable. These include production input buying services, health and workers' compensation programs, programs to promote energy efficiency and on-farm energy production, programs to promote low-input grazing strategies, and risk management services, to name a few. The Farm Services programs are important ancillary services offered by DFA to its members, but are all far smaller than our core milk marketing business.

The Importance of DFA's Forward Contracting Programs

One of DFA's most widely used and popular Farm Services is our milk price forward contracting program. Our forward contracting programs have matured over the years and now include not only fixed-price forward contracts, but also forward contracts that provide farmers with flexible pricing alternatives for their milk, including adjustments based on the cost of production inputs. For example, one popular program is a minimum milk price forward contract that places a floor under the milk price. We also have begun writing milk price forward contracts that include adjustments for changes in feed prices.

Given the rising prices and volatility for inputs like livestock feed since the implementation of federal ethanol mandates and the growth in feedstuff demand from China and emerging market economies, we expect these milk-feed forward contracts to grow in importance and use among our members. All dairy farmers purchase livestock feed to supplement home-grown feed. This is the number one cost input on dairy farms and can represent more than 50 percent of production costs on farms that cannot afford to buy land to grow a large proportion of their feed. Today's dairy farmer needs to be able to simultaneously manage the price risks associated with the sale of its milk, as well as the purchase of feed, in order to secure a profitable margin or margin safety net.

DFA operates one of the more innovative milk price forward contracting programs in the US. Our program has gained the respect and admiration of members, other dairy farmers, other milk cooperatives and companies, the agricultural lending industry and the wider agri-business community. Our programs provide real economic value to members that would otherwise struggle to manage their milk price and input price risk, or worse, stop doing so altogether. They provide a means for our members to mitigate their operational risk and create a much more financially stable milk production sector. Many of our farmer member-owners cannot hedge their milk price risk directly in the futures market because their monthly milk production is less than a futures contract size. Similarly, many of our members cannot hedge their feed price risk directly in the futures markets because the corn and/or soybean meal quantities that they purchase monthly often are (1) less than futures market contract sizes, and (2) inclusive of months that do not trade in futures contracts. It is, therefore, vitally important to the financial health and well-being of our members that they continue to be able to use our forward contracting programs to help them hedge the commercial risk involved in operating a dairy farm.

DFA's Use of Swaps to Mitigate Its Physical Commodity Price Risk

DFA is able to provide these forward contracts to its members because it can aggregate the physical commodity price risk that it takes on from members and hedge that risk by entering into swaps with other businesses, which may include agri-businesses and financial institutions, among others.[3]

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[3] DFA has a general concern that the Commission has set what we view as commercially impracticable threshold levels for qualification for the *de minimis* exception from the definition of swap dealer, which may have an impact on the number of counterparties that can or will be willing to execute swaps with end-users like DFA. The Commission should consider adopting a *de minimis* exception with higher threshold levels than those proposed in the Swap Dealer NOPR to mitigate the impact on end-users.

Although we have chosen to focus on milk and feed price risk as it relates to our member-owners, our plant and marketing operations also enter into swap transactions. For instance, our plant operators may want to hedge the price risk of buttermilk powder (to lock in a sale price or protect inventory values), which has no corresponding futures market or strong price correlation with any existing dairy futures contract. To mitigate this physical commodity risk, our plant operators would seek to hedge via a swap transaction. Swap transactions also are used by plant operators to hedge fuel and other energy and input price risk. Due to the nature of our ownership and governance structure, our plant and marketing level hedging programs seek to mitigate risks that otherwise would be borne by our member-owners. As such, these swap transactions are a natural extension of our members' farm business.

The End-User Exception

The CFTC should clarify that agricultural cooperatives, like DFA, qualify for the end-user exception from clearing with respect to the swaps they enter into to hedge the risks associated with their processing plants and member-owner milk production. The CFTC has traditionally and consistently looked through the cooperative to the members' underlying physical position, and treated both the member and the cooperative as end-users. For example, pursuant to CFTC Regulation 1.3(z), 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.[4] 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*."[5] DFA agrees with the Commission's proposal to continue to treat as bona fide hedges those transactions that have been considered hedges under Regulation 1.3(z).[6] There is no reason for the CFTC to treat cooperatives differently with respect to over-the-counter swap contracts than it does with respect to futures contracts. Moreover, DFA needs to be able to hedge the aggregate physical commodity price risk it takes on through forward contracts with member-owners. For these reasons, the CFTC should clarify, for purposes of the end-user exception to clearing, that cooperatives that enter into swaps to hedge commercial risk (including the price risks associated with marketing member milk and

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

5 17 C.F.R. § 1.3(z)(i) (2010) (emphasis added).

6 75 Red. Reg. at 80,757 (Proposed Rule 36.9); 75 Fed. Reg. at 80,214-15 (Proposed Rule 1.3(ttt)).

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.[7]

Additional Margin and Clearing Concerns

Although DFA clearly does not fit within the definition of "swap dealer," as it only enters into swaps to hedge the physical commodity risks associated with the forward contracts it enters into with members and DFA's plant operations, it also submits these comments in response to the Swap Dealer NOPR to underscore one critical point. As Chairman Gensler recently commented in his testimony before the House Agricultural and House Financial Services Committees, margin requirements should not be imposed on swap dealers with respect to swaps they enter into with end-users who opt not to clear the swap.[8] As Chairman Gensler stated:

> Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. Transactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities . . . . Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.[9]

Moreover, if margin were imposed on swap dealers with respect to these transactions, the swap dealer likely would pass that requirement through to the end-user. As an end-user, DFA appreciates having the alternative to require the clearing of trades in certain instances. However, we ask that the CFTC not impose a margining requirement on swap dealers with respect to uncleared end-user swaps because this would raise our hedging costs – which ultimately would increase costs for our member-owners. Additionally, these margin requirements may exceed the

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[7] 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.

[8] Testimony of CFTC Chairman Gary Gensler before the House Committee on Financial Services, February 15, 2011; Testimony of CFTC Chairman Gary Gensler before the House Committee on Agriculture, February 10, 2011.

[9] *Id.*

capital available for our forward contracting programs. Both of these issues, cost and capital, could curtail our ability to offer customized hedging programs to our membership.

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 appreciates the opportunity to work 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
President,
Dairy Risk Management Services
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