National Milk Producers Federation

2101 Wilson Blvd., Suite 400, Arlington, VA 22201
703.243.6111 • www.nmpf.org

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

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June 3, 2011

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

RE: Proposed rule on 'Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"'; RIN 3038-AD06

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 31 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 participate in the recent Advisory Committee meeting, and particularly appreciates the reopening of the comment periods for the key rules in order to allow a more comprehensive assessment of their meaning.

NMPF offers these comments in response to CFTC's proposed rule on 'Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant."' (75 FR 80174)

Based on CFTC's notice of proposed rulemaking on 'Commodity Options and Agricultural Swaps' (7 FR 6095), which suggests a unification of the regulations for agricultural and other swaps, we would anticipate that these rules would also apply to agricultural swaps. For this reason, NMPF offers its comments.

We agree that there is a substantial difference between commodity swaps and securities swaps, especially with respect to end users and end user exemptions.

We are encouraged by the Commission's clarification that they intend not to treat farmer cooperatives as swap dealers with respect to their relationship with their members.

We believe that the 'core test' of 'function' should clearly exclude most participant in the physical market – including farmers and their cooperatives, handlers, processors,

and distributors of agricultural commodities – from the definition of a swap dealer, since these participants are primarily engaged in supplying needed physical products.

Physical market participants are very different from speculative and financial market participants: they have specific risk management needs, and have developed a range of specialized instruments to address them. Further, their participation in the physical market exposes them to risk, but also typically provides them with a physical position which effectively collateralizes their risk management instruments. Finally, their hedging is necessarily limited in volume by the physical limits of the underlying product; this is not the case for financial hedging or speculative interest.

We urge broad exemptions of agricultural end users from swap regulation.

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. These are especially important as the markets for dairy farmers products and feed inputs have become increasingly volatile.

For this reason, NMPF has generally supported the pre-Dodd-Frank regulatory framework of the CFTC as appropriate to addressing regulation of agricultural commodity markets. Although we recognize the importance of the CFTC's work in reducing systemic risk in the financial markets, we see little reason to substantially increase regulation of agricultural commodity markets, especially with respect to participation by commercial end users.

This is why NMPF has been greatly encouraged by the Chairman's statements and much of the proposed rulemaking to date, which seem to allow considerable leeway for commercial end-users to hedge with agricultural swaps without mandatory clearing or margin requirements or excessive financial tests.

We also are pleased that agricultural cooperatives have been recognized as direct agents for their producer-members, and are encouraged that the commission may more broadly exempt those who do business with farmers and cooperatives from the same requirements, the burden of which would undoubtedly be passed back to the farmers and cooperatives.

The regulations that come out of this process should be targeted to addressing systemic risks. Agricultural commodity futures, options, and swaps played no role in the financial crisis that led to the Dodd-Frank Act. In particular, commercial end users of these instruments played no role in the crisis.

An excessive concentration of trading in a small number of derivative clearing organizations, however, could create new institutions that are 'too big to fail.'

This is why agricultural swaps should be broadly allowed. The Commission's new authority to regulate agricultural swaps may become important in the future, as such markets develop, but it should be wielded with a light hand until that proves to be the case and so that the markets have the opportunity to develop. This is vital to the risk management needs of famers, handlers, processors, and marketers of agricultural commodities.

NMPF urges the Commission to minimize the regulatory burden on farmers and those using swaps for *bona fide* hedging as end users.

Introduction

NMPF supports 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.

We also recognize the value to the public, including our members, of better management of systemic risk in the financial markets. This is the spur and the goal of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and has rightly been the Commission's focus in developing regulation.

With respect to agriculture, the Dodd-Frank Act presents a different challenge to the Commission. In the Act, 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. We appreciate the difficulty of remaking agricultural commodity market regulation, just as resources are taxed by financial market reform. This is another reason to approach change in the agricultural commodity markets very cautiously, with a heavy reliance on the status quo.

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 class 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, farmers and processors have begun to use 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, including small businesses, small farmers, and limited resource farmers 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., for a wide range of marketing strategies, and in a wide range of financial situations.

Farmers generally operate on a much smaller scale than other swap participants; but they need access to a wider 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, and particularly for the smaller farmers for whom this burden would be untenable.

- No new clearing or margin 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. The costs of mandatory clearing and increased margin requirements could make specialized risk management opportunities prohibitively expensive for farmers, and would create a particular 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, NMPF generally urges the Commission to allow as much flexibility as the law will allow for agricultural swaps by commercial end users engaged in *bona fide* hedging.

> By definition, greater choice among hedging strategies means greater efficiency and lower risk management costs for hedgers, and more incentive to the exchanges to meet the needs of hedgers.

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 direct forward contracting. 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. This is a fundamental principle of cooperative law and Federal cooperative policy. It is why cooperative associations are defined as non-profit corporations, and it is why cooperatives are generally assumed to speak and act on behalf of their members.

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 or hedging input costs.

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.

Cooperatives provide important marketing services to non-members

Just as cooperative members do, many non-members similarly rely on access to risk management services provided by cooperatives. If a cooperative association provides a non-member with risk management services that are fundamentally related to their marketing relationship, that risk management activity should be exempted from additional regulations intended for swap dealers. In the same way that a cooperative association can market a limited volume of products not derived from member production without losing its fundamental cooperative identity, so should CFTC allow cooperatives broad exemptions from regulation with respect to their similarly limited marketing relationship with non-members.

Farmers rely on cooperatives and other small business for risk management

Farmers, and particularly small farmers, often rely on relatively small businesses, such as their customers, a local cooperative to which they do not necessarily belong, or their local grain elevator, for risk management opportunities tailored to their needs and, particularly, their size. Forcing these transaction into clearing would impose substantial administrative burdens on these small businesses and, in many cases, discourage them from providing the only risk management available to the small farmers they serve.

Stating the obvious: the nature of end user risks

At the risk of stating the obvious, farmers and other end users are committed to agricultural commodity markets, and exposed to their attendant risks, by necessity. Their participation in futures and options markets and agricultural swaps is of a different nature than that of speculators. An inability to find effective risk management opportunities would turn these end users into speculators. That is, reducing their choices has the effect of increasing the speculative interest in the overall market.

The objectives of the Commodity Exchange Act, even as recently amended, demand that commercial end users be given great flexibility to meet their risk management needs.

CFTC should broadly allow commercial end users to use agricultural swaps

The Commission should allow commercial end users broad exemptions from regulation to use agricultural swaps for *bona fide* hedging. 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, and for different or varying volumes. The enormous variety of sources, pricing schemes, and finished products in the dairy industry makes comprehensive risk management through standardized contracts impossible.

According to the original advance notice of proposed rulemaking, regarding agricultural swaps (75 FR 59666),

> *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 broad regulatory exemptions 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 significant risk management opportunities. It is in the public interest that U.S. farmers 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, farmers

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. Agricultural swaps undertaken by end users for *bona fide* hedging are necessarily limited.
Moreover, 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.

Our conclusion is that, with respect to *bona fide* hedging in agricultural commodity markets, commercial end users should be broadly exempted from swap regulation, from regulated net wealth requirements, and from regulated margin requirements.

Margin requirements

NMPF is encouraged by Chairman's Gensler's reassurances that the Commission recognizes that new 'margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users."

Just as end users engaged in agricultural swaps and futures should not face regulated margin requirements, neither should swap dealers acting on behalf of end users; the costs of these would ultimately be passed back to the end users. Without an exemption from margin requirements, widespread farmer use of these price risk management tools would be constrained by the limited financial resources of farmers. The ability of farmer's cooperative associations to bear the farmers' margin risk is also limited, and farmer participation in cooperative risk management programs would be similarly constrained.

Position limits

Position limits should be addressed with common sense. We offer two examples.

First, there is no need for scale-down requirements in cash-settled contracts. The current cash-settled butter futures contract on the CME has a requirement that positions be scaled down in the last 5 days of the contract. CME's efforts to eliminate this scale-down have been rebuffed by CFTC in the past. The contract is cash-settled against a broadly-based USDA-announced monthly butter price. The scale-down serves no purpose, especially since many participants, who use the same announced price as a benchmark, benefit from a perfect hedge upon final settlement of the contract. Instead, they are forced to reverse position in a relatively illiquid market before the contract settles, undermining their hedge and unsettling the market in the very ways that the scale-down is supposed to avoid in the case of physically-settled commodities.

Second, it is unfair and unnecessary that hedgers can be fined for exceeding their approved position limits by less than the speculative limit. A hedger's brief, unintentional, and small step into theoretical speculation should be noted, reported, and treated as speculation; but it should not be treated like other position limit violations. Some middle ground is appropriate.

Definitions of Swap Dealer, et al.

Based on CFTC's notice of proposed rulemaking on 'Commodity Options and Agricultural Swaps' (7 FR 6095), which suggests a unification of the regulations for

agricultural and other swaps, we would anticipate that these rules would also apply to agricultural swaps. For this reason, NMPF offers its comments.

We agree that there is a substantial difference between commodity swaps (especially agricultural commodity swaps), and securities swaps, especially with respect to end users and end user exemptions.

The fundamental identity of cooperatives with their farmer-members should clearly exempt the relationship between the member-cooperative from swaps regulation, and we are encouraged by the Commission's declarations to that effect.

More generally, handlers and processors of agricultural commodities, including cooperatives, engage in swaps in connection with the purchase or sale of physical products. The 'core test' of 'function' should effectively exclude farmers and their cooperatives, handlers, processors, and distributors of agricultural commodities from the definition of a swap dealer. Swaps are incidental to their 'regular business', which business is serving the market in supplying needed physical products. We urge broad exemptions of these end users from being defined as 'swap dealers.'

As noted above, most physical market participants are engaged in swaps markets not as a regular part of their business, but as a means of managing the risk from their regular business. Moreover, as suggested in the proposed rule (75 FR 80183), participants in the physical market have developed (and will further develop) 'highly customized transactions and market practices that facilitate efficiencies in their market in unique ways.' The difficulty of clearing and standardizing these types of contracts are even greater in agriculture, whose producers are much smaller and even more varied than participants in 'oil, natural gas, chemicals, and metals.' NMPF supports broad exemptions from the definitions in this rule for hedging by physical market participants.

NMPF supports de minimis exemptions for swap dealers. The proposed $100 million may be a reasonable limit; however, small end users might be excluded from some risk management opportunities by the transaction limit of 20 per year. That is, a potential swap dealer would be encouraged by the combination of a $100 million value limit and a 20 transaction limit to save his allotment of 20 transactions for those that are large enough to be worth undertaking. There would be an opportunity cost to executing each swap which might discourage smaller contracts and, by implication, exclude smaller farmers.

Regarding designation as a swap dealer only for certain classes of swaps, it would be reasonable to distinguish hedging from speculation, allowing a dealer to serve speculative clients while also trading on behalf of hedging end users. This would avoid forcing dealers to serve one type of client or another, and would allow commercial end users from having the costs of speculative regulation passed along by their dealers.

Regarding general definitions for 'eligible swap participant,' we would encourage the Commission to ensure that farmers are not unnecessarily excluded from risk management opportunities based on net wealth requirements; like many physical market participants, they are effectively collateralized by their physical position, including anticipated production, buyer commitments, etc.

Goals of regulation

The original Grain Futures Act and the Commodity Exchange Act essentially legalized regulated futures and options markets in order to provide price risk management and price discovery to the benefit of producers, handlers, processors, and consumers of physical commodities.[1]

With the Dodd-Frank Act, Congress is asking the CFTC to do this all over again with respect to agricultural commodities.

However, the long title of the Act is "The Wall Street Transparency and Accountability Act," reflecting the basic goals of addressing failures in the financial markets, not the agricultural commodity markets.

Indeed, there has been no suggestion that the agricultural commodity markets played any role in the crisis that led to the passage of the Dodd-Frank Act. While the financial markets were near melt-down in 2008 and 2009, the two biggest issues facing the agricultural commodity markets with respect to financial regulation were 1) whether there was an excess of hedge fund interest inflating futures values in out months and 2) the failure of CFTC-regulated commodity exchanges to achieve convergence between expiring grain futures and spot markets.

These were very minor issues, compared to the financial melt-down. The Commission had the authority to address both of these issues before the passage of Dodd-Frank; and the second issue raises more questions about the value of expanded clearing requirements and the efficacy of a dominant market with a regulatory near-monopoly on hedging opportunities.

The commoditization of mortgages contributed substantially to the financial crisis; the forced commoditization of agricultural derivatives will not reduce systemic financial risk.

Expanded choice for end users means fairer and more efficient markets

Granting an exchange a near-monopoly to clear forward pricing in a particular commodity would 1) force the CFTC into extremely fine regulation and supervision of that exchange or 2) undermine the risk management benefits of such forward pricing through rents accruing to the exchange or 3) both. The recent convergence issues in wheat and rice markets are a good indication of how difficult this balance is, and how problematic it would be if end users had no alternative to a single approved exchange for their risk management needs.

To avoid this, commercial end users should be given the utmost flexibility to use the exchanges or not. This would be the truest test of the efficiency of the clearing market, and the only fair outcome for agricultural end users, who are forced to be speculators when they are denied efficient risk management opportunities.

Again, the fundamental purpose of the Commodity Exchange Act is to allow futures and options trading, and now swaps, in order to provide price discovery and risk management opportunities to producers, processors, and consumers. The large exchanges have sometimes treated effective price discovery and end user risk management as secondary concerns, instead (and naturally) catering to the much larger speculative and 'investment' interests. Forcing commercial end users to make use of these exchanges would further undermine the exchanges' incentives to serve the most basic risk management and price discovery purposes of futures markets.

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[1] As the late Professor Ken Robinson of Cornell University often said, "Speculators are sinners who are forgiven because they provide liquidity to the markets."

Conclusion

NMPF has been encouraged by the rulemaking to date, and is hopeful that the final rules regulating agricultural commodity markets will provide proper regulation for the broader market, while giving farmers and their cooperative associations the flexibility needed to provide the most effective risk management tools possible.

We offer these comments in anticipation that, under the suggested unification of regulations for agricultural and other swaps, these definitions would also apply to agricultural swaps.

We agree that there is a substantial difference between commodity swaps and securities swaps, especially with respect to end users and end user exemptions.

We are encouraged by the Commission's clarification that they intend not to treat farmer cooperatives as swap dealers with respect to their relationship with their members.

We believe that the 'core test' of 'function' should clearly exclude most participant in the physical market – including farmers and their cooperatives, handlers, processors, and distributors of agricultural commodities – from the definition of a swap dealer, since these participants are primarily engaged in supplying needed physical products.

Physical market participants are very different from speculative and financial market participants: they have specific risk management needs, and have developed a range of specialized instruments to address them. Further, their participation in the physical market exposes them to risk, but also typically provides them with a physical position which effectively collateralizes their risk management instruments. Finally, their hedging is necessarily limited in volume by the physical limits of the underlying product; this is not the case for financial hedging or speculative interest.

NMPF generally urges the Commission to broadly allow the use, without clearing, or margin requirements, of agricultural swaps by end users engaged in *bona fide* hedging.

These regulations should meet the spirit of Executive Order 13563 by regulating no more than necessary. The agricultural commodity markets were not the broken piece of our financial markets in 2008: they need very little fixing.

Thank you again for the opportunity to comment on these very important rules. Please contact me if you have any questions.

Sincerely,

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