



## National Milk Producers Federation

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

Agri-Mark, Inc.  
Arkansas Dairy Cooperative Association  
Associated Milk Producers Inc.  
Continental Dairy Products, Inc.  
Cooperative Milk Producers Association  
Dairy Farmers of America, Inc.  
Dairyalea Cooperative Inc.  
Dairymen's Marketing Cooperative, Inc.  
Ellsworth Cooperative Creamery  
Farmers Cooperative Creamery  
First District Association  
Foremost Farms USA  
Just Jersey Cooperative, Inc.  
Land O'Lakes, Inc.  
Lone Star Milk Producers  
Manitowoc Milk Producers Cooperative  
Maryland & Virginia Milk Producers Cooperative Association  
Michigan Milk Producers Association  
Mid-West Dairymen's Company  
Northwest Dairy Association  
Prairie Farms Dairy, Inc.  
Premier Milk Inc.  
St. Albans Cooperative Creamery, Inc.  
Scioto County Cooperative Milk Producers' Association  
Select Milk Producers  
Southeast Milk, Inc.  
Swiss Valley Farms Company  
Tillamook County Creamery Association  
United Dairymen of Arizona  
Upstate Niagara Cooperative, Inc.  
Zia Milk Producers, Inc.

July 22, 2011

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

**RE: Proposed rule on 'Further Definition of "Swap," "Security-Based Swap," "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; RIN 3038-AD46**

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 comment on the CFTC's proposed Dodd-Frank rulemaking, and especially the CFTC's continued solicitation of public input.

NMPF offers these comments in response to CFTC's proposed rule and interpretation on 'Further Definition of "Swap," "Security-Based Swap," "Security-Based Swap Agreement"; etc.' (76 FR 29818)

NMPF appreciates the substantial end-user exemptions for agricultural swaps proposed to date, and encourages the Commission to go further: by recognizing the differences between commodity hedging by commercial end users and trading among financial entities; by accommodating the special risk management needs and financial constraints of farmers, cooperatives, and other small intermediaries through regulatory restraint. This is especially pertinent with respect to issues and questions raised in this proposed rule regarding forward contracting and embedded options.

**With respect to this proposed rule, we urge CFTC to broadly exempt commercial forward contracting from swaps regulation. The 'options' embedded in nearly all commercial transactions are a normal part of doing business. They are fundamental to defining responsibility and managing risk. We therefore further urge CFTC to show the prudent restraint necessary not to burden the economy, and to generally exclude from the swap definition any forward contract between end users whose primary purpose is consistent with that of an 'end user', and in which any embedded option is directly related to 'end use.'**

Jerry Kozak, President/Chief Executive Officer

Randy Mooney, Chairman

www.nmpf.org

The following comments represent our response to **questions 22, 33, and 43** of the notice of proposed rule and interpretation.

### **Introduction**

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. We also recognize the importance of the CFTC's work in reducing systemic risk in the financial markets under the Dodd-Frank Act.

However, we do not believe there is reason to substantially increase regulation of agricultural commodity markets, especially with respect to participation by commercial end users.

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.

This is why agricultural swaps and forward contracts should be broadly exempted from regulation. The Commission's new authority to regulate agricultural swaps should be wielded with a light hand until a need for more action is clear. Such restraint is vital to allow markets to meet the varied and specialized risk management needs of farmers, handlers, processors, and marketers of agricultural commodities.

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, cooperatives, and processors have begun to use swaps and forward contracts to manage their price risks. These contracts allow smaller end users, including small businesses, small farmers, and limited resource farmers, to take 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.

It is the nature of commercial sales in any business to establish rights and responsibilities, including contingencies. Such contingencies take forms that could technically be seen as embedded options. These are essential to the smooth flow of business, and minimizing legal uncertainties. Discouraging such contingency planning through the regulation of forward contracts as swap would undermine the stability of the commercial marketplace.

**NMPF urges the Commission to minimize the regulatory burden on farmers and other end users using forward contracts to manage their commercial relationships. Forward contracts whose primary purpose is to set the terms of sale of physical commodities in the flow of business should not be defined as swaps, regardless of the forms that such embedded options may take.**

### **Previous NMPF comments on swap regulation**

In previous comments, we have laid out in detail our support for regulatory restraint by CFTC with respect to agricultural swaps by end users. (See NMPF comments on RIN 3038-AD21, RIN 3038-AD06, RIN 3038-AD10, RIN 3038-AD00, RIN 3038-AD23.) The same principles apply to the need for regulatory restraint in defining forward contracts as swaps. The burdens which concern us regarding swaps are of even greater concern if imposed upon forward contracting. Some of our comments are summarized here:

- 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.
- 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 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.

### **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, by forcing them to invest in production while speculating on their final price. In this way, reducing their risk management choices, or raising the costs of risk management, has the effect of increasing speculative interest in the overall market.

The objectives of the Commodity Exchange Act, before and after its amendment by the Dodd-Frank Act, demand that commercial end users be given great flexibility to meet their risk management needs.

### **Forward contracts are not swaps**

Forward contracts between end users are not swaps, and should not be treated as swaps for the purposes of this regulation. In this context, we would define a forward contract as any contract whose primary purpose is to set the terms of the future sale of a physical commodity between end users.<sup>1</sup>

Almost every forward contract has some characteristics of an option contract, though, as is noted in the proposed rule: heating oil contracts (with a price fixed for variable volumes), property leases (with an option to renew), mortgages (with the option to prepay), etc.

We offer some other examples:

- Some dairy processors offer forward contracts to buy all of a producer's milk for a fixed or formula price. It is the producer's option to make changes in his operation – including adjustments to his feeding practices, or herd expansion or reduction – that would change the volume of milk sold to the plant.
- Some retailers demand a fixed price (or a formula price with escalators and de-escalators, as noted in the proposed rule) from food manufacturers over 6 or 12 months. It is the retailer's option to order more or less, as the result of sales driven by his allocation of shelf space to the product, his decisions about product promotion, or the mark-up he adds to the product's price.
- When a fixed price, fixed volume contract is signed between end users, one party is occasionally unable to deliver on the contract, and penalties may be assessed under the contract. Such a penalty may be seen as an option held by one party to not deliver on the contract.

Such examples are legion. Any well-written business contract will contain some element that resembles, in its form, an option. Any penalty or unilateral decision allowance built in to a purchase contract looks like an option.

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<sup>1</sup> For this purpose and others, we would define end users to include producers, processors, distributors, and actual users. This should include traders purchasing physical stocks for 'speculation'. Such stock-holding represents an important part of the marketing system: holding stocks from season to season and year to year provides the supply buffers that the world depends upon to manage seasonal and annual variation in production or demand. In addition, such physical stock holding for 'speculation' is very commonly a provision of service to the market in response to market signals: if the carry in the futures market justifies holding physical commodities, the market is working when 'speculators' hold stock. More significantly, when the carry justifies holding stock, and the 'speculator' hedges his position, he is actually arbitraging between the futures and spot markets, contributing to the efficiency of the market through the performance of a vital market service.

However, the contract itself is not an option or a swap if the primary objective of the contract is to do actual business in the commodity in question. That is, if the contract embeds an option incidental to the objective of buying or selling milk or cheese or corn or microwave ovens, it does not become a swap.

The practical implications of defining such contracts as swaps are staggering and must certainly be beyond the intent of the Congress or the Commission. Nearly every commercial contract would be subject to CFTC review. To avoid such regulation, business contracts would be stripped of important contingency provisions, and made so rigid as to undermine commerce. Finally, many businesses would abandon standard business risk management practices and inventory cycles would be exacerbated. Such overregulation would increase the systemic risk to the economy. **Such overregulation would be devastating.**

**Once again: we would exclude from the ‘swaps’ definition any forward contract whose primary purpose is to set the terms of the future sale of a physical commodity between end users.<sup>2</sup>**

If the Commission determines that it has no choice but to identify such a forward contract with an embedded option as a swap, it should apply a broad regulatory exemption based on a similar definition.

### **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.<sup>3</sup>

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. 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.

### **Conclusion**

NMPF has been encouraged by most of 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.

To reiterate, NMPF appreciates the Commission’s proposal to provide substantial end-user exemptions for agricultural swaps and encourages the Commission to go further in broadly excluding forward contracts from regulation as swaps. This is vital to farmers and to business generally.

Forward contracting is embedded throughout the economy. Millions of transactions each year involve contingencies, from the option to cancel a magazine subscription despite ‘locking in’ a

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<sup>2</sup> See footnote 1.

<sup>3</sup> As the late Professor Ken Robinson of Cornell University often said, “Speculators are sinners who are forgiven because they provide liquidity to the markets.”

3-year rate, to a plant offering a fixed price to purchase a varying volume of milk from a farm over 24 months, to a ‘cost-plus’ contract to build an office building.

The burden on business from regulation of these contracts as swaps would nearly be matched by the burden on CFTC to enforce that regulation. Such regulation would discourage effective business contracts, burden the civil courts with lawsuits over failure to meet very rigid contract terms, generally raise the cost of doing business, and disadvantage small business and agriculture.

**If the primary purpose of a forward contract is to set the terms of sale of physical commodities in the flow of business, it should not be defined or regulated as a swap, regardless of the options that may be embedded in it. NMPF urges the Commission to adopt this interpretation in order to minimize the regulatory burden on farmers and other end users using forward contracts to manage their commercial relationships.**

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

Sincerely,



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