



# National Milk Producers Federation

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

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July 25, 2011

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

## **RE: Notice of proposed rulemaking on Position Limits for Derivatives; RIN 3038-AD15 and AD16**

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.

NMPF offers these comments in response to CFTC's notice of proposed rulemaking on Position Limits for Derivatives (76 FR 4752). 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, including the Chairman's encouragement to the public to comment past deadlines. The comment deadline for this notice is several months past. However, as the result of discussions within the industry, we have since found serious concern with two elements of the definition of *bona fide* hedging (§151.5(a)).

**First, we understand CFTC's anticipated interpretation of §151.5(a)(2)(iv) will treat as a speculator any trader with a physical position in a commodity without a specific anticipated commercial outlet, and will not consider the hedging of such a position as *bona fide* hedging. Such physical positions maintain the month-to-month and season-to-season stocks that are a vital part of commodity marketing. Particularly when they are hedged, they are a value-added activity that receives a corresponding return from the market, and they are never purely speculative. Hedges of such positions are necessarily limited by the available volume of the physical commodity and are naturally collateralized by the physical product. Hedging reduces or eliminates the speculative element for such traders, as it does for farmers or processors, and is *bona fide* hedging.**

**Second, and perhaps of more concern to the dairy industry, the proposed rule would require hedges in all contracts to be reversed five days before their end. This one-size-fits-all approach would dramatically undermine hedging in certain**

Jerry Kozak, President/Chief Executive Officer

Randy Mooney, Chairman

www.nmpf.org

**cash-settled markets, particularly the dairy futures markets. Open interest in the closing days of these contracts has no impact on the underlying settlement price of the contracts, and requiring hedgers to exit their positions a week before final settlement will reduce their value as a hedging instrument and create the very sort of liquidity crunch five days before termination that such scale-down requirements are intended to avoid at contract termination. We urge the Commission to remove this blanket requirement, and replace it with agency discretion for cash-settled contracts based on the nature of the underlying settlement price.**

## **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 commercial 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, including meaningful position limits, as appropriate to addressing regulation of agricultural commodity markets, including limiting undue speculative influence over 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 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.

Farmers, cooperatives, processors, and other end users in the dairy industry 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 turns end users into speculators, by forcing them to speculate on their final price as they invest in production. 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 primary objectives of the Commodity Exchange Act, before and after its amendment by the Dodd-Frank Act, are providing end users with price discovery and risk management opportunities in rational markets. These objectives argue for allowing commercial end users considerable flexibility to meet their risk management needs.

The CFTC proposal for position limits provides for substantial hedge exemptions, as they should. However, we have two serious concerns about the details of this hedge exemption.

### **Defining *bona fide* hedging to include physical traders**

The proposed rule outlines very specifically what sort of transactions may be hedged under the *bona fide* hedge exemption from position limits. This includes most cases of a market participant holding a physical commodity for future sale. This is natural, since such holders of stock provide important benefits to the market. These are the stocks that the market relies on to overcome seasonal variation of production and year-to-year volatility. The agricultural markets are especially dependent upon such stocks, since so many factors can put agricultural markets out of balance. Agricultural commodity prices are among the most volatile in the economy, and without large stockholding, they would be much more volatile. Indeed, it has been public policy for a century to encourage investment in agricultural storage capacity and the stocking of the national granary.

However, it is our understanding from industry discussions that the CFTC does not plan to allow such a hedge exemption to ‘speculative’ stockholders, under its anticipated interpretation of §151.5(a)(2)(iv). That is, CFTC plans to treat as a speculator any trader who takes a physical position in a commodity without a specific anticipated commercial outlet, and will treat the hedging of such a position as speculation.

Such physical positions, even with a ‘speculative’ element, provide considerable value to the market and are a vital part of the physical marketing chain. Holders of such positions bear the costs of storage capacity and smooth supply and prices over time; they take on risks similar to those of commodity producers and users; and they provide both an important outlet to producers and an important source to actual end users. They are never, therefore, pure speculators; they are intertemporal distributors. In their direct involvement in the physical market, they are fundamentally different from paper speculators.

Finally, a physical commodity position ceases to be speculative and becomes an arbitrage when it is hedged. That is, once a ‘speculator’ in the physical commodity takes a position which he reasonably expects to lock in his future price, he has simply accepted a price for the ‘carry’ service he provides to the market.

The proposed rule and its interpretation are considerably more restrictive than the definition of *bona fide* hedging in the Dodd-Frank Act (Sect. 737 (c)), which is wholly consistent with hedging of physical commodity stockholding. Given that such hedges are naturally collateralized by the physical stock held, given the value added to the market by the holding of product, and given the fundamental transformation of the position by the hedge, there is no reason not to allow such stockholders to be treated as *bona fide* hedgers.

### **No need for scale-down in cash-settled markets**

The proposed rule would only allow a hedge exemption to position limits until the last five days of the contract (per §151.5(a)(2)(v), et al.). This would force hedgers to reverse their positions before final settlement. For cash-settled dairy contracts, including the referenced Chicago Mercantile Exchange Class III Milk (DA) contract, this requirement would undermine both price discovery and risk management for the dairy industry, and to no purpose.

In early 2010, on behalf of both NMPF and the American Butter Institute, we presented a seminar on the scale-down requirement in the CME Cash-Settled Butter (CB) contract to several economists at the CFTC, with the objective of making this issue better understood. The attached working paper, based on the seminar, goes through the economic arguments in detail; they are outlined in brief below.

The Class III contract, to take the most prominent example of dairy contracts on the CME, is cash settled, so that there is no delivery squeeze undermining convergence as the contract approaches termination.

The contract settles against a monthly price announced by the USDA and used by USDA as a regulated minimum price for a large volume of milk used to manufacture cheese. This price is also used as a reference price in many contracts not bound by USDA's minimum prices. As a result, the Class III contract is a perfect hedge *at settlement* for the many producers, cooperatives, and processors who face the Class III price as a minimum or who use it as a reference price. If they are forced to reverse their position before settlement, their hedge is undermined and their price risks are increased.

The Class III price (like all the settlement prices for CME cash-settled dairy contracts) is calculated from a USDA survey of dairy product prices received by manufacturers. The settlement prices in this contract (and the other CME cash-settled dairy contracts) are monthly averages, using four to five weeks of data. The last of this data is announced on the Friday that the contracts settle; this data is for the week ending the previous Saturday. In practice, these dairy manufacturers' prices are based on spot market prices for the previous week or previous two weeks. The commercial market has determined all the prices that enter into settlement well before the proposed scale-down period begins, so the open interest in the closing days of the contract has no impact on the underlying settlement price of these contracts.

Finally, if these dairy futures contracts suffer any liquidity constraints, these are made more acute by the forced liquidation of the positions in the days before the scale-down period. Otherwise, convergence is perfect, which is why most market participants have demonstrated their strong preference for settling at termination. The result of the scale-down requirement is to force hedgers to pay a premium to terminate their contract at an undesirable time, and to distort prices in the run up to termination. Ironically, it creates the very sort of liquidity crunch that the scale down is intended to avoid. *This is why the current Class III contract has no scale down requirement, and why the requirement for the butter contract is considered so onerous by some hedgers.*

According to CFTC General Counsel Dan M. Berkovitz, futures markets' "scale down policy was adopted to prevent any trader from carrying a position which, by virtue of its sheer size, could have a negative impact on the orderly liquidation of the contract."<sup>1</sup> This problem does not exist for contracts that cash-settle against a broadly-based survey or other price that is unaffected by open interest in the futures market: a scale down policy is unnecessary, and counterproductive, in these cases.

This case is presented in greater detail in the attached paper, which we incorporate into our comments.

This one-size-fits-all scale down policy does not fit all contracts. We urge the Commission to remove this blanket requirement, and replace it with agency discretion for cash-settled contracts based on the nature of the underlying settlement price.

## **Conclusion**

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

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<sup>1</sup> Testimony of General Counsel Dan M. Berkovitz, "Position Limits and the Hedge Exemption, Brief Legislative History," presented at the CFTC's Hearing on Speculative Position Limits in the Energy Futures Markets, July 28, 2010.

discovery to the benefit of producers, handlers, processors, and consumers of physical commodities.

With the Dodd-Frank Act, Congress is asking the CFTC to do this all over again for agricultural futures, swaps, and derivatives.

NMPF has been encouraged by much 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.

We urge the Commission to show regulatory restraint, in order to focus rulemaking and regulatory resources on those instruments in those markets which demand greater oversight, while reserving the authority to broaden regulation in the future, when the need may arise. In particular, we urge two changes to the hedge exemption in the proposed position limit rules.

First, the *bona fide* hedge exemption should be generally be extended holders of physical commodities, who maintain the monthly and seasonal stocks that are vital to every agricultural industry. Hedging these positions transforms speculative physical positions into a simple market service, whether future sale has been arranged or not. Such positions are never purely speculative. Just as a processor turns milk into cheese, a stockholding commodity trader can turn March cheese into August cheese or next year's cheese. This is a physical transformation of a sort that is not undertaken by paper speculators, and the return that the physical trader receives from the market is associated with real value added. Such positions are limited by available product and are naturally collateralized by the physical stocks. Hedging of such positions, which reduces or eliminates the speculative element, is *bona fide* hedging and should be defined as such by the Commission.

Second, blanket scale down policy is a one-size-fits-all approach that does not fit all contracts. Such a policy would undermine hedging in all or most cash-settled markets, including the CME cash-settled dairy futures markets. Futures market activity in the closing days of these contracts has no impact on their underlying settlement prices. Requiring hedgers to exit their positions a week before final settlement will reduce their value as a hedging instrument and creates the very sort of liquidity crunch five days before termination that such scale-down requirements are intended to avoid at termination. We urge the Commission to remove this blanket requirement, and replace it with agency discretion for cash-settled contracts based on the nature of the underlying settlement price.

We thank the Commission again for the opportunity to comment on these very important rules, and the Chairman's solicitation of comments throughout the rulemaking process. Please contact me if you have any questions about these comments.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Roger Cryan', with a stylized flourish at the end.

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

# Working Paper

## CME Scale-down Requirements for the Cash-Settled Butter Futures Contract

Roger Cryan

American Butter Institute

National Milk Producers Federation

### Introduction

Dairy producers benefit from risk management and price discovery in the markets for corn, soybeans, and other inputs, as well as milk and milk component values derived from dairy product prices. Many dairy processors use futures markets to manage risks for the sales price of their products, and for the purchase prices for raw milk, dairy ingredients, sugar, energy, and other inputs.

The recent development of cash-settled dairy futures and options has brought new risk management opportunities for producers, processors, and users. Most of these contracts are cash-settled against USDA-defined monthly prices, so they are a good – and often perfect – hedge against dairy price risks, especially for market participants who face USDA-regulated minimum prices. These contracts have speculative limits to avoid distortion or manipulation of prices over the life of the contract by large players. There are *bona fide* hedge exemptions for commercial participants.

However, most of these contracts also have scale-down requirements, even for hedgers. Because of the special characteristics of the cash-settled dairy complex, these are unnecessary and even disruptive to the market. The scale-down is unnecessary because the monthly announced prices against which these contracts settle are based on a very broad-based survey of prices for a month's worth of manufacturers' sales. Because of the particular way that the settlement prices for these contracts are discovered, positions in the futures market cannot affect the final settlement price. Because of the market's logical and overwhelming preference for final cash settlement (rather than reversing position before settlement), a requirement that large hedgers reverse their position before settlement is disruptive to the market and undermines the risk management value of these instruments.

The current scale-down requirement for the cash-settled butter futures contract, upon which this paper focuses, forces commercial suppliers and end users to abandon a perfect hedge 5 days before settlement. Worse, the requirement that a certain volume of open interest be reversed 5 days before settlement can create disorderly market conditions at the deadline – the very disorder that the scale-down requirements are intended to avoid.

Given the special characteristics of the contracts, scale-down requirements are unnecessary in the cash-settled dairy markets, and are particularly disruptive to *bona fide* hedges. These requirements should be eliminated, at least for hedgers, in the cash-settled dairy futures and options contracts.

### The Dairy Futures and Options Complex

Dairy futures trading began in 1993 with delivery-based cheese and nonfat dry milk powder futures contracts on the Coffee, Sugar, and Cocoa Exchange, and was extended with delivery-based milk contracts on both the CSCE and the Chicago Mercantile Exchange (CME) and a butter contract on the CME.

All these delivery-based contracts are now defunct except for the CME butter contract, and on May 20, 2010, that contract's total open interest was two contracts. These commodities can be perishable and variable in composition and quality. Milk, in particular, is bulky, perishable, and requires refrigeration, so that it has large and volatile variation in location value. This made basis risk unacceptably high.

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These contracts were supplanted by cash-settled contracts based on USDA dairy product price surveys and milk price formulas based on those surveys. The cash-settled butter contract had 4,251 contracts of open interest on May 20, equal to 85 million pounds; and the cash-settled Class III milk price contract had 38,322 open futures and options contracts, equal to 7.7 billion pounds.

The solution adopted by CME was cash settlement against regulatory benchmark prices established by USDA each month. Today, the dairy futures complex on the Chicago Mercantile Exchange consists of cash-settled contracts for butter, non-fat dry milk, dry whey, Class III milk (milk used for cheese production), and Class IV milk (milk used for nonfat dry milk and butter). These contracts are of value particularly because they reflect the minimum regulated prices established by the USDA under the Federal milk marketing order program.

### Federal Milk Marketing Orders and Dairy Price Discovery

Under the Federal milk marketing order system, minimum prices are established for four classes of milk. Two of these classes are Class III, used to price milk used for manufacture of cheese and dry whey powder, and Class IV, used to price milk used for manufacture of butter and other dry milk powders. Both classes are priced with yield formulas that incorporate the product prices. The milk price formulas can be simplified as follows:

$$\text{CI III milk price} \approx 9.64(\text{cheddar cheese price}) + 5.86(\text{dry whey price}) + 0.42(\text{butter price}) - 3.16$$

$$\text{CI IV milk price} \approx 8.59(\text{nonfat dry milk price}) + 4.24(\text{butter price}) - 2.16$$

In both cases, the coefficients represent the yield of each product from 100 pounds of milk, and the negative constants represent the 'make allowances', or the amount that USDA allows as the cost of transforming 100 pounds of milk into the respective products sets. Each month these prices are calculated as the minimum value that participating milk handlers must pay for milk used in these classes.

The value of butterfat in the milk is also set by USDA, using the butter price:

$$\text{Butterfat price per lb.} \approx 1.211 * (\text{butter price}) - 0.21$$

The coefficient represents the yield of butter per pound of butterfat and the negative constant represents the allowed cost of converting a pound of butterfat into butter. The prices used in these formulas are the result of weekly dairy product price surveys conducted by USDA. The monthly prices used in the milk price calculations are aggregated from the weekly survey results. The weekly reports are generally published on Friday; so the monthly calculation is generally made on the last Friday on or before the 5<sup>th</sup> of the month, using the 4 or 5 weeks of data surveyed since the last monthly calculation.

The products specified for inclusion in the survey are standardized bulk commodities, so that the prices resulting from the survey will be as consistent as possible. These are: nonfat dry milk, cheddar cheese, sweet dry whey, and butter.

The weekly survey published each Friday is a weighted average price for the sales of each of these products, and covers sales for the week ending the previous Saturday. The monthly aggregations are also weighted averages and, of course, cover 4 or 5 weeks of sales.

The surveys capture the prices of shipments from manufacturing plants on the day of the shipment. These prices may be fixed up to 30 days before the shipment, under USDA's rules. By industry convention, butter sales are often priced on the CME spot market prices the week before; and

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cheddar cheese sales are typically priced on the CME spot price on the day the cheese was made, so that there is about a two-week lag between spot prices and commercial sales prices. These lags show up consistently in analysis of price transmission. Nonfat dry milk and whey are often priced on the basis of currently reported spot prices; but they tend to be contracted over time and in volume, and the prices of sales on the day of shipment will generally show at least some modest lag between price negotiations and shipment.

### Position Limits and Scale-down Requirements

Limits on speculative position have an important part in the effective regulation of futures markets. The history of position limits, including bona fide hedge exemptions, was well outlined by CFTC General Counsel Berkovitz in his statement to the Commission on July 28, 2009.<sup>1</sup> Individual speculators should be limited to avoid manipulation of futures and options prices throughout the life of the contracts. Overall speculative interest is properly damped down to limit the distortion of prices by herds of portfolio “investors” who can bias prices in one direction and limit the risk management benefits for buyers or sellers. Hedge exemptions should be limited to legitimate hedging for direct business purposes, with some reasonable margin of error. This properly distinguishes between hedging and speculation. Stricter definitions of *bona fide* hedging are appropriate for these reasons.

As described by the CFTC, the CME’s “scale down policy was adopted to prevent any trader from carrying a position which, by virtue of its sheer size, could have a negative impact on the orderly liquidation of a contract.”<sup>2</sup> Scale-down requirements were initiated by the exchanges, but they have been adopted wholesale by CFTC. They deserve a closer look.

Certainly, scale-down requirements are crucial in delivery-settled contracts, in order to avoid convergence problems and to limit forced delivery of physical products that would discourage liquidity in the overall market. There can also be a nexus between physical markets and certain futures markets that are cash-settled against a narrowly-based index determined in a very few days just before termination; such a nexus can create potential incentives for distortion and manipulation of potentially thin markets upon which the futures market depends for settlement. In such cases, a scale-down requirement can be a reasonable restriction upon even a *bona fide* hedger.

### Cash-Settled Dairy Futures Markets Do Not Benefit from Scale-down Requirements

There are now scale-down requirements in the cash-settled futures and options contracts traded on the CME for butter, dry whey, and nonfat dry milk in the last 5 days of the contract, and Class IV milk in the last month. However, special characteristics of the cash-settled dairy contracts, and the prices against which they are settled, argue against scale-down requirements, especially for *bona fide* hedgers in all these contracts.

The speculative position limit for the butter contract is 500 contracts; this is scaled down to 100 contracts in the last 5 days of trading. *Bona fide* hedgers have been similarly limited. In one case, a butter manufacturer who sought a hedge exemption was granted a smaller limit than he applied for, and faced a requirement to scale down his hedge position by 75% in the five-day scaled down period, to far less than his hedging requirements.

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<sup>1</sup> Testimony of General Counsel Dan M. Berkovitz, “Position Limits and the Hedge Exemption, Brief Legislative History,” presented at the Commission’s Hearing on Speculative Position Limits in Energy Futures Markets, July 28, 2009.

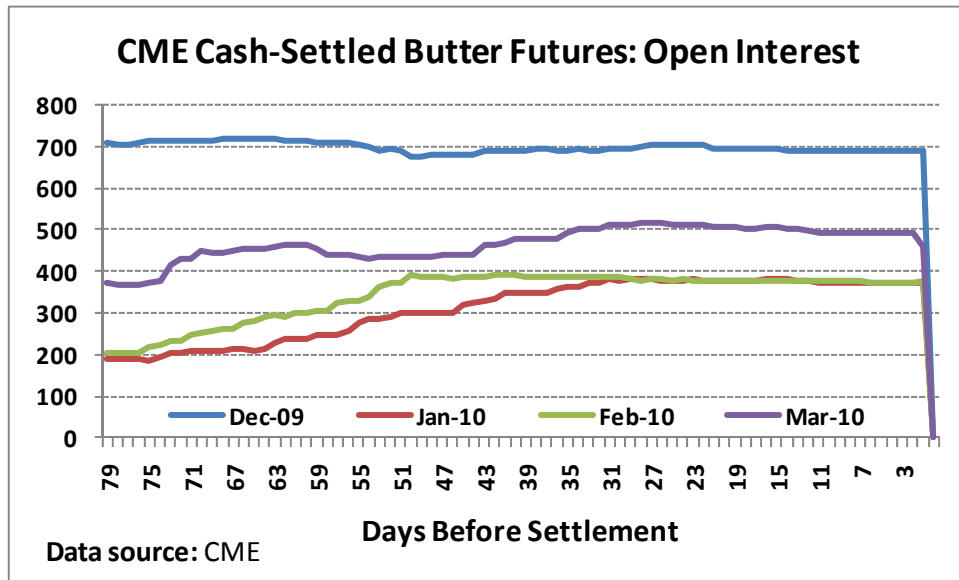
<sup>2</sup> “Rule Enforcement Review of the Chicago Mercantile Exchange”, CFTC Division of Trading and Markets, October 15, 1999. Found at <http://www.cftc.gov/tm/tmcmerer101599.htm>



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This scale-down is unnecessary for the cash-settled dairy contracts for several reasons unique to this complex.

**First**, the cash settlement of these contracts means that large positions cannot create convergence and delivery issues as the contract nears termination. Cash settlement at termination is a desirable outcome for most participants, so the assurance that the contract can be carried to termination actually becomes a guarantee *against* manipulation. The open interest for the last 4 contract months (below) demonstrates an overwhelming preference by market participants to cash settle the butter futures contract at termination.



**Second**, the monthly announced prices against which these contracts settle are the result of a very broad-based mandatory manufacturers' survey of a full month's worth of transactions. The captures the manufacturers' price of more than 95% of the commodities that meet the USDA definition. For the dairy contracts, the open interest in the futures and options markets does not overwhelm the underlying survey volume, as many other futures markets overwhelm the underlying physical market. In all cases, the price determination is not the product of a thin market, but the universally reported prices of nearly all U.S. products made to the benchmark specifications. For example, the monthly price announcement used to settle September contracts contained survey prices for 4 weeks, and captured the manufacturers' sales prices for 12 million pounds of butter, compared to 16 million pounds of open interest in September futures and options. Other cash-settled contracts are settled against a few days worth of spot prices, but the USDA dairy product prices survey is simply too broad, and conducted over too long a period of time, to be effectively manipulated through positions in the last days of the contract.

**Third**, the price discovery for the butter, nonfat dry milk, cheese, and dry whey prices, upon which all the cash-settled dairy futures contracts rely, is concluded well before the scale-down period. This can be seen by following

Product	Surveyed	Sept. 15 Open Interest,	
	Sales Volume	Futures & Options	Contracts
	Lbs.	Lbs.	
<b>Cheddar cheese</b>	83,540,319	n/a	n/a
<b>Nonfat dry milk</b>	50,481,407	5,148,000	117
<b>Butter</b>	11,755,081	16,480,000	824
<b>Whey</b>	45,259,322	10,384,000	236
<b>Class III milk eq.</b>	804,660,353	2,135,000,000	10,675
<b>Class IV milk eq.</b>	223,362,601	800,000	4

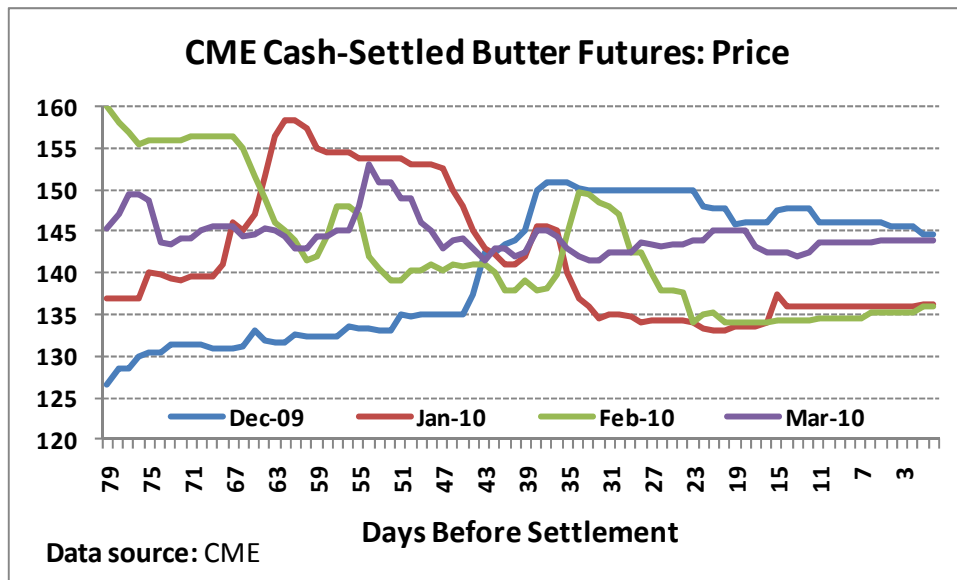
Sources: CME, USDA

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the flow of price discovery from spot market to USDA monthly price announcement:

- The monthly price is based on 4 to 5 weeks' data, and USDA's survey of commercial sales is reported a week after the period surveyed. As a result:
  - o There is one trading day on the exchange between the beginning of the scale-down period for the butter contract and the last surveyed commercial transaction that enters into the settlement price takes place.
  - o After the scale down period begins, there are only two commercial business days (including Saturday) out of 4 to 5 weeks of surveyed transactions that enter into the settlement price.
- CME spot prices for butter set the commercial sales prices for the following week, per a proven lag.<sup>3</sup>
  - o In practice, all price discovery that enters into the cash-settled butter futures contract's final settlement price is done a week before the scale-down period begins.

There is no significant nexus between activity on the futures markets on the last 5 days of the contract and the prices against which the contracts are settled. Positions on the futures and options markets during the scale-down period cannot affect the final settlement price. This is demonstrated by the degree to which the butter futures price converges toward settlement in the last two weeks of trading (below).



### The Scale-down Requirement Undermines CFTC's Objectives in the Dairy Markets

Beyond being unnecessary, the scale-down is actually disruptive to the CFTC's objectives of promoting price discovery and commercial risk management, for at least two reasons:

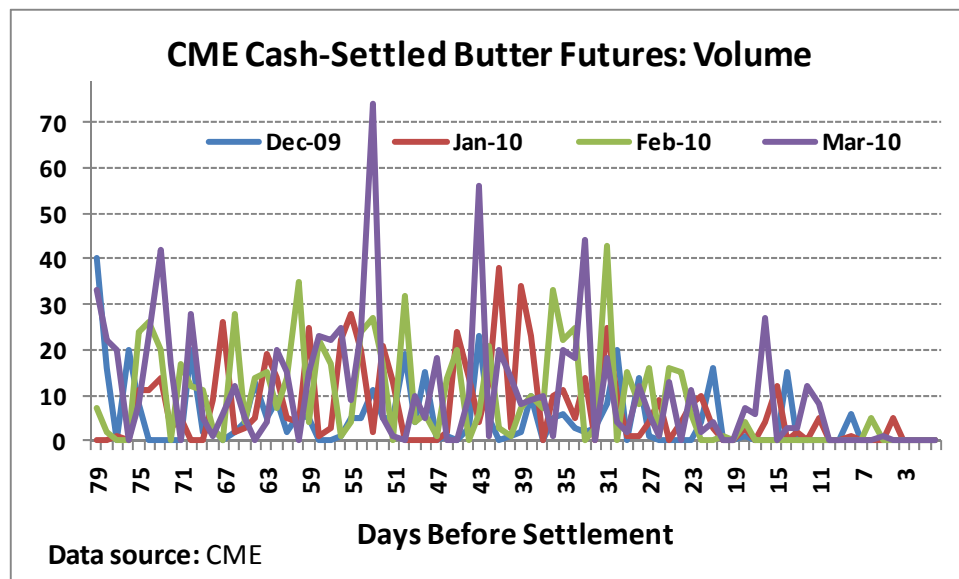
**First**, the scale-down requirement forces commercial suppliers to abandon a perfect hedge 5 days before settlement. As noted above, the settlement prices for these contracts are the basis for minimum prices established by USDA, and serve as benchmark prices against which many dairy sales are settled at the end of the month. As a result, for most commercial hedgers, holding these contracts until settlement represents a perfect hedge for their commercial price risk. When they are forced to reverse their positions 5 days before settlement, they are forced to accept additional price risk.

<sup>3</sup> Cheese prices lag 1½ to 2 weeks.

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**Second, and worse**, when commercial hedgers are forced to reverse much of their position 5 days before settlement, they face the very sort of convergence issue that the scale-down is intended to avoid. Large hedgers have been forced to reverse their position at a loss equal to the premium needed to shake loose hedgers and speculators on the other side, who have strong incentives to otherwise carry their positions to termination. In this way and for these contracts specifically, the scale-down requirements create the very chaos that they successfully avoid for other commodities. This undermines effective risk management and distorts price discovery at the scale-down deadline. If these contracts were allowed to continue to termination, the positions would be reversed at termination cleanly, without market disruption, and without added basis risk.

In fact, one of the great benefits of cash-settled contracts is that effective hedging can be achieved in a relatively illiquid market if an acceptable price can be once found, because settlement at termination will automatically converge with the desired benchmark price. This benefit is lost for positions that must be reversed for a required scale-down. The small volume near termination of recent butter contracts demonstrates the extreme thinness of the market as the scale-down date approaches.



### Conclusion

Speculative position limits are crucial to limiting the potential for manipulation and helping fundamentals drive price discovery. Scale-down requirements are also justified in the many markets in which a strong nexus exists between action on the futures market and the price discovery which determines final settlement of that market.

However, the special characteristics of the cash-settled dairy contracts make scale-down requirements unnecessary for all participants, and particularly disruptive to *bona fide* hedgers. The current scale-down rules discourage participation by hedgers, undermine risk management objectives, and distort price discovery.

These scale-down requirements should be eliminated in the cash-settled dairy futures and options contracts, particularly for *bona fide* hedgers.

May 25, 2010