February 7, 2014

By Commission Website

Melissa Jurgens, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW.
Washington, DC 20581

Re: RIN number 3038–AD99: 17 CFR Parts 1, 15, 17, et al., Position Limits for Derivatives; Proposed Rule, Federal Register/ Vol. 78, No. 239 / December 12, 2013

Dear Ms. Jurgens:

This letter is in response to the Federal Register notice of December 12, 2013 regarding the Proposed Rule for Position Limits for Derivatives and is made on behalf of the Innovation Center for U.S. Dairy.

The Innovation Center for U.S. Dairy® is a forum for the dairy industry to work together pre-competitively to address barriers and opportunities to foster innovation and increase sales. The Innovation Center aligns the collective resources of the industry against common priorities to offer consumers nutritious dairy products and ingredients, and promote the health of people, communities, the planet and the industry. The Board of Directors for the Innovation Center includes dairy industry leaders representing key producer organizations, dairy cooperatives, processors, manufacturers and brands. The Innovation Center is staffed by Dairy Management Inc.™, while the U.S. Dairy Export Council staffs the efforts of the Innovation Center's work on globalization.

Until the late 1980's, dairy prices in the United States were heavily influenced by federal government policies. As a result, milk and dairy commodity prices were not volatile. Given changes in government dairy policy in the 1985 Farm Bill, dairy commodity prices started to exhibit volatility similar to other agricultural commodities by the early 1990's. This led to the development of risk management tools for the industry, namely futures and options contracts along with cash forward contracts.

While dairy futures and options have existed for over twenty years, the market is still building volume and liquidity and working to attract enough hedging and speculative interest for it to be viable. Figure 1 shows the total open interest for Class III futures and options from 2000 to 2014, as well as the total share of open interest held by non-commercials. In the last few years, the growth in open interest has occurred primarily in other dairy contracts, i.e. CME Class IV milk, cheese, whey, butter, and nonfat dry milk (NFDM). Despite growth in open interest, when compared to other agricultural commodities, utilization of risk management tools in the dairy industry is still in its infancy. In particular, the total open interest in all dairy futures and options combined corresponds to barely ten percent of annual milk production in the U.S.

Figure 1. Class III Milk Futures and Options Open Interest and Non-Commercial Share of Open Interest (2000-2014)

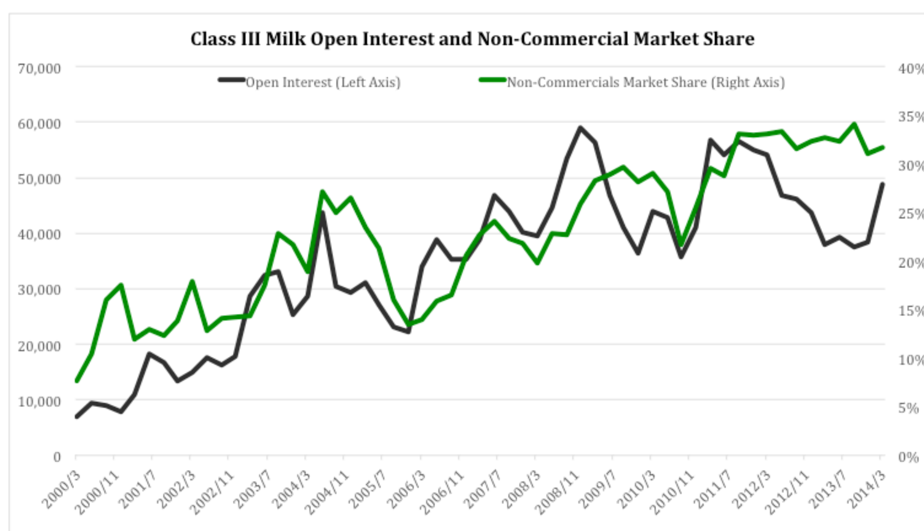


Table 1. Non-Commercial Share of Open Interest, 2007-2014

Commodity	Non-Commercial Share of Open Interest	Commodity	Non-Commercial Share of Open Interest
NYMEX Natural Gas	58%	NYMEX Platinum	39%
ICE Coffee C	46%	ICE Cocoa	38%
CBOT Wheat	46%	CBOT Soybean Oil	38%
COMEX Gold	45%	COMEX Copper	36%
CME Lean Hogs	45%	ICE Sugar 11	35%
CBOT Soybeans	44%	CBOT Soybean Meal	35%
CME Feeder Cattle	44%	KCBT Winter Wheat	33%
CME Live Cattle	44%	NYMEX Gasoline	30%
COMEX Silver	44%	CBOT Rough Rice	30%
NYMEX Crude Oil	43%	NYMEX Heating Oil	29%
CBOT Corn	43%	**CME Class III Milk**	**28%**
NYMEX Palladium	42%	CBOT Oats	22%
ICE FCOJ-A	40%	MGEX Spring Wheat	22%
ICE Cotton No. 2	40%	ICE Sugar 16	N/A

Furthermore, speculative activity in dairy markets is much lower than in most other agricultural markets. As can be seen in Table 1 (above), the average share of open interest held by non-commercial traders over the last seven years is lower in Class III milk futures and options than in 24 out of 28 markets CFTC proposed rule would cover. [1] Finally, recent academic research shows that more speculation in dairy markets is predictive of lower volatility in dairy futures prices, suggesting that non-commercial trading brings much needed liquidity to dairy futures and options markets. [2]

The dairy industry is supportive of CFTC efforts to provide oversight of agricultural markets and impose constraints where there is credible evidence that price volatility does not originate from fundamental shocks, or where market conditions reasonably warrant 'prophylactic' regulation of speculative position limits. Given the facts regarding the dairy markets, it is our opinion that the challenge before the CFTC is to implement rules that

[1] Commitments of Traders report does not include data on ICE Sugar No. 16.

[2] Bozic, M and T.R. Fortenbery. 2014. "Price Discovery, Volatility Spillovers and Adequacy of Speculation in the U.S. Dairy Markets." Working Paper No. 14-01, Program on Dairy Markets and Policy. URL: http://dairymarkets.org/PubPod/Pubs/WP14-01.pdf

stimulate, rather than needlessly arrest further growth of the dairy derivative markets. We hope you will find our comments helpful as you decide which rules to impose on fragile Class III milk derivative markets.

The Commission requested comments on four areas:

1. Establishing speculative position limits
2. Updating of some relevant definitions
3. Rewriting the exemptions from speculative limits, including for bona fide hedging
4. Extending and updating reporting requirements for exemptions from limits

While the other three areas are important, our comments are primarily focused on the establishment of speculative position limits. We understand the genesis for the proposed rule is increased interest in regulating energy markets. However, we are concerned with unintended consequences on non-energy markets, specifically the dairy markets. As a result, the following comments address some of the questions posed in the proposed rule and also highlight some important differences of the dairy market from other commodity markets included in the proposed rule.

Spot Month Limit

As noted above, increased participation by liquidity providers in the dairy markets is welcomed as the industry develops the CME dairy futures and options markets. A unique feature of milk futures and options contracts is the high number of contracts held to expiration. Since the contracts are cash-settled to the monthly milk price announced by the USDA, and the contracts are used primarily for hedging purposes by dairy farmers and end-users, there is a “buy and hold” aspect to the market that does not occur in other commodity markets, especially those with physical settlement. As a result of this phenomenon, trading volume and market liquidity is often modest. Non-commercial trading activity is needed to improve both volume and liquidity in the dairy markets. Therefore, we are concerned about proposed rules that could make the dairy markets less attractive for liquidity providers.

Cash settled futures contracts, and dairy specifically, are different than physically settled contracts. First, the concerns about “cornering” a market in a physical commodity are less relevant when the contract is settled to a cash index. For dairy, the USDA calculates average monthly prices for milk and dairy products. These government-regulated prices are used to cash settle the CME dairy futures contracts. Therefore, we question whether position limits for cash settled contracts should be thought of in the same manner as physically deliverable contracts. Additionally, unlike corn or other commodities, spot month futures are not the primary determinant of day-to-day cash market pricing for dairy commodities. Finally, milk is highly perishable and cannot be stored for more than 72 hours. Thus, it is not possible to accumulate class III milk in an attempt to “corner” the market. These important differences illustrate why the CME dairy contracts need to be viewed differently than other agricultural and non-agricultural markets.

The Commission proposes to set the initial spot month position limit levels for referenced contracts at the existing DCM-set levels for the core referenced futures contracts because the Commission believes this approach is consistent with the regulatory objectives of the Dodd-Frank Act amendments to the CEA and many market participants are already used to these levels. However, as an alternative to the initial spot month limits in proposed appendix D to part 150, the Commission is considering setting the initial spot month limits based on estimated deliverable supplies submitted by the CME Group in correspondence dated July 1, 2013. Subsequent levels would be adjusted no less frequently than every two years.
The Commission requests comments on all aspects of this alternative. Specifically, is the Commission’s discretion in administering levels of spot month limits appropriately constrained by the choice, in its discretion, of the DCM’s recommended level or the level corresponding to 25 percent of deliverable supply or a level in proposed appendix D?

We believe the spot month limit should be increased from the current level for class III milk. In the Federal Register notice, on Table 9 (page 75727), it notes the current spot month position limit for class III milk of 1500 contracts. This limit, and the all-months combined limit of 3400, is too restrictive. Since swaps are not

accounted for currently, we believe the spot month limit should be at least double the current limit of 1500. Guidance from the CME Group using the alternative approach of establishing spot month limits at 25% of deliverable supply would increase this limit to 5300 contracts. We support the methodology the CME used to calculate the new proposed limit based on the following rationale.

The term ''estimated deliverable supply'' means the amount of a commodity that can reasonably be expected to be readily available to short traders to make delivery at the expiration of a futures contract. Class III milk contracts are settled using a monthly average milk price announced by the USDA's Agricultural Marketing Service (AMS). Additionally, the Federal Milk Marketing Orders, administered by USDA AMS, collects and reports milk marketings and utilization on a monthly basis. As a result, the "estimated deliverable supply" and position limits for class III milk can be accurately defined using this government data. And since milk is highly perishable and not storable, there is no concern about potential manipulation of spot month deliverable supplies.

Non-Spot Month and All Months Combined Limit

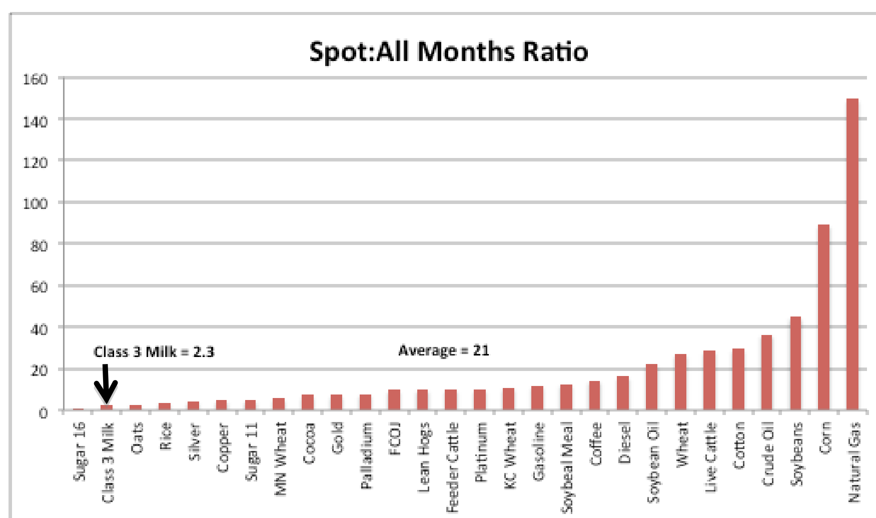
The Commission proposes setting initial levels for non-spot month and all months combined limits based on open interest in futures and swaps that are significant price discovery contracts. Subsequent levels will be adjusted no less frequently than every two years based on referenced contract open interest for a calendar year. Non-spot-month position limits (i.e., limits applied to positions in all contract months combined or in a single contract month) would be set using the 10/2.5 percent formula: 10 percent of the contract's first 25,000 of open interest and 2.5 percent thereafter. The Commission believes the non-spot month position limits would restrict the market power of a speculator that could otherwise be used to cause unwarranted price movements. The Commission is soliciting comments on its single-month and all-months-combined limits, including whether the proposed formula has effectively addressed and will continue to address the § 4a(a)(3) regulatory objectives.

The current non-spot month and all months combined limit for CME class III milk futures contracts of 3400 is too restrictive. This number is arrived at by using the 10/2.5 formula noted in the prior paragraph. However, we point out an inconsistency with this approach when compared to the spot month limit. If the spot month limit is established using 25% of deliverable supply, the limit is set at 5300 contracts. But, the non-spot month limit is 3400, 1900 contracts less. In basic terms, it does not make sense to establish a non-spot month limit that is less than the spot month limit. To resolve this inconsistency, we propose applying the spot month limit (e.g. 5300 as 25% of supply) to each non-spot month contract. In other words, the limit in each month would be 5300 contracts, spot and non-spot, and the all-months combined limit would effectively be 5300 contracts multiplied by the number of listed contract months (24 months for class III milk).

Dairy farmers market milk each month and routinely sell "packs" of multiple months of futures contracts. Given the continuous production aspect of milk, and the need to hedge milk sales a year or more in the future, it is imperative the futures market has enough liquidity to provide for this need. Therefore, we urge the Commission to work with DCM's (e.g. CME Group) to establish appropriate position limits that allow broad participation from all market segments.

We also point out the very low ratio of the spot month limit of 1500 to the all months combined limit of 3400 in the proposed rule (figure 2). The ratio of 2.3 is the 2nd lowest of all commodities included in the proposed rule and well below the average of 21. We believe the Commission should accept a higher ratio that is more in line with other commodities. As an example, if the spot month limit were set at 5300 and using a ratio of 10, the all months combined limit would be 53,000. In short, our concern is setting limits that would restrict the ability of non-commercial traders to use the dairy markets, thereby limiting their use and growth.

Figure 2. Ratio of Spot Month to All Months Combined Limits



The 10/2.5 formula is appropriate for mature commodity markets, but the dairy futures market is still developing. As a result, using open interest data to establish class III milk position limits is flawed. The Commission proposes to establish non-spot month limits using futures and swaps that are significant price discovery contracts. For class III milk, volume data for swaps was not made available in the proposed rule, so we cannot comment on the appropriateness of position limits using that methodology. There is an established dairy OTC market, but like the CME contracts, it is relatively small when compared to energy or other OTC markets. In addition, for class III milk, and dairy products in general, futures, options, and swaps have limited use as price discovery mechanisms. Instead, all dairy contracts are cash-settled to government price indices. For these reasons, we request the Commission not apply the 10/2.5 formula to dairy contracts, and instead define the all months combined limit using the same number as the spot month limit times 24 months. If the 25% of deliverable supply method is used, we support updating the non-spot month limits every two years using current exchange information.

Finally, we believe legitimate concerns over potential harm from "excessive speculation" are better dealt with by the exchanges through existing market surveillance programs on a contract-by-contract basis, rather than through federally mandated position limits. Exchanges, in coordination with the CFTC, have developed an expertise in maintaining orderly markets, including setting appropriate reporting levels, position limits, and accountability levels relative to energy, metals and agricultural markets. This system provides the flexibility necessary to prevent market-disrupting speculation while preserving transparent and liquid markets.

Definition of Bona Fide Hedges

The Commission has long recognized cross-commodity hedging, noting in 1977 that sales for future delivery of any product or byproduct which is offset by the ownership of fixed-price purchase of the source commodity would be covered by the general provisions for cross- commodity hedging in § 1.3(z)(2). The proposed rule details the substantially related test, proposing two factors for non-exclusive safe harbor for cross-commodity hedges. The first factor is a qualitative measure of whether a cross-commodity hedge is bona fide. To pass this test, the target commodity should have a reasonable commercial relationship to the commodity underlying the commodity derivative contract. Dairy contracts are regularly used for cross-hedging (e.g. class III milk futures for cheese). We support the qualitative assessment, but urge caution as to not impede the continued development of the futures and options contracts when used for cross-hedging purposes. The other factor, a quantitative assessment, is more concerning. Given the guidance in place from FASB 815 on hedge effectiveness, we request any quantitative assessment resulting from the proposed rule would not exceed or be in conflict with the requirements in FASB 815 in order to avoid confusion and additional record keeping burdens on companies.

Another area of concern is potential limits on anticipatory hedging by bona fide hedgers. It is imperative that any speculative position limits rule closely adheres to the CEA in further defining a bona fide hedge, as the CEA recognizes the commercial risk management necessity of anticipatory hedging by including language related to anticipatory ownership, production, manufacturing, processing, and merchandising explicitly in the statute as amended by Dodd-Frank.

We also request the Commission continue to use the exchanges to adjust hedge exemptions for bona fide hedgers. With CFTC oversight, the exchanges should be able to set hedge exemptions for bona fide hedgers since the exchanges have a better understanding of individual market dynamics.

Reporting Requirements

While increased reporting requirements have been anticipated, it is not clear what additional burden these requirements will place on companies, so we offer no specific guidance on the proposed rules for this area. However, we express concern for any additional reporting requirements that are in conflict with other regulatory requirements, and request the Commission consider this as the final rule is developed.

Summary of Comments

We thank the Commission for the opportunity to provide comments on the proposed rule for position limits. Our comments and recommendations are summarized as follows:

- We support using the alternative approach of establishing spot month limits for class III milk at 25% of deliverable supply and support updating the spot month limits every two years.
- Do not apply the 10/2.5 formula for establishing non-spot month limits.
- To resolve the inconsistency in a higher spot month limit (5300) than the non-spot month limit (3400), we propose applying the spot month limit to each individual non-spot month.
- The all months combined limit should be defined as the non-spot month limit multiplied by the number of total contract months.
- The initial position limits proposal of 1500 spot month contracts and 3400 all months combined is too low and will restrict market growth. In the absence of the 25% of deliverable supply methodology, class III milk position limits should be at least two times greater than currently exist to account for swap transactions.
- For the definition of bona fide hedging and reporting requirements, we request the Commission consider any additional reporting requirements that are in conflict with other regulatory requirements, and ensure they are aligned with existing reporting requirements.

The dairy industry has put significant effort behind developing risk management tools such as futures and options contracts at the CME Group. We are concerned about the potential to limit the activity of liquidity providers in dairy markets when efforts are being made to increase it. Impeding growth in those markets will result in the continued inability for our industry to use those tools. Our interest is in developing robust risk management tools for the dairy industry to manage the price volatility from an increasingly global dairy market.

We thank you for considering our comments and recommendations.

Sincerely,

Steve Shelley, Schreiber Foods, Inc.

Chair, Risk Management Work Team
Globalization Operating Committee of the Innovation Center for U.S. Dairy

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