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February 10, 2014

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

RE: Notice of Proposed Rulemaking: Position Limits for Derivatives. Federal Register/Vol. 78, No. 239/December 12, 2013 (RIN 3038-AD99).

Dear Ms. Jurgens:

On behalf of the more than two million farmers and ranchers who belong to one or more farmer cooperative(s), the National Council of Farmer Cooperatives (NCFC) submits the following comments in response to the Commodity Futures Trading Commission's (CFTC) notice of proposed rulemaking: *Position Limits for Derivatives* (RIN 3038-AD99).

Since 1929, NCFC has been the voice of America's farmer cooperatives.[1] Farmer cooperatives – businesses owned and controlled by farmers, ranchers, and growers – are an important part of the success of American agriculture. These cooperatives allow individual farmers the ability to own and lead organizations that are essential for continued competitiveness in both the domestic and international markets.

I. Introduction

NCFC members represent a broad section of the agriculture industry. Many NCFC members rely on the derivatives markets – both exchange-traded futures and options, and over-the-counter products – to hedge the commercial risk inherent to agriculture production, processing and marketing. These cooperatives use derivatives to hedge the price risk of the commodities they supply, process or handle/merchandise; i.e. they have a physical interest in the underlying asset. As such, derivative transactions that cooperatives enter into have largely been recognized as bona fide hedges for the purpose of being exempt from speculative position limits.

Throughout the Dodd-Frank rulemaking process, NCFC has advocated for including broad exemptions for agricultural end users hedging their legitimate business risks. Consequently, we are concerned by the restrictive regulatory approach in a number of areas of the position limits proposal. We fear that some of the provisions, while intended to address "excessive speculation" in the markets, would inadvertently apply to cooperatives, grain companies, and many other end users whose hedging activities are legitimately being used to manage commercial risk. To ensure Dodd-Frank implementation achieves the goals of the law while at the same time preserving the ability of end users to effectively hedge their risk, we outline several areas where we encourage the Commission to revisit and revise in the final rule.

[1] NCFC members include regional and national farmer cooperatives, which are in turn composed of over 2,500 local farmer cooperatives across the country. NCFC members also include 22 state and regional councils of cooperatives.

II. Bona Fide Hedging Definition

Congress and the CFTC have consistently recognized the importance of protecting risk management activities through reasonable, flexible and effective regulations, and derivatives markets have evolved to provide firms and individuals with effective hedging for risk management purposes. In fact, throughout the years, the Commission has recognized the need for flexibility as it did when it first allowed for non-enumerated hedges in the 1970s. Back then the Commission stated, "The purpose of the proposed provision was to provide flexibility in application of the general definition and to avoid an extensive, specialized listing of enumerated bona fide hedging transactions and positions." As logical as it was to provide for flexibility in the past, it is even more important today as the physical and derivatives markets have become more complex, and continue to evolve.

However, it appears the CFTC intends to change course as the proposal abandons well-established concepts contained in the CFTC regulation 1.3(z) definition of "bona fide hedging transaction" in favor of a narrower interpretation. Additionally, it appears the proposed rule ignores the language of the statutory definition of bona fide hedge contained in Dodd-Frank by disallowing anticipatory merchandising hedges, in spite of the provision contained in Section 4a(c)1, as well as Section 4a(c)2, which clearly recognizes the need for anticipatory hedging by using the word "anticipates" in three separate instances.

Section 4a(c)(2) of the Act provides:

> "For the purposes of implementation of [section 4a(a)(2) of the Act] for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a bona fide hedging transaction or position as a transaction or position that—
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> > (A)(i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel;
> > (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
> > (iii) arises from the potential change in the value of—
> >
> > > (I) assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;
> > > (II) liabilities that a person owns or anticipates incurring; or
> > > (III) services that a person provides, purchases, or anticipates providing or purchasing;

The Proposal also raises issues we understood to be resolved in the previous, vacated, rulemaking in 2011 by not including certain enumerated hedges such as anticipated hedging around unfilled storage.[2]

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[2] 7. Anticipated Merchandising

a. Fact Pattern: Elevator A, a grain merchandiser, owns a 31 million bushel storage facility. The facility currently has 1 million bushels of corn in storage. Based upon its historical purchasing and selling patterns for last three years, Elevator A expects that in September it will enter into fixed-price forward purchase contracts for 30 million bushels of corn that it expects to sell in December. Currently the December corn futures price is substantially higher than the September corn futures price. In order to reduce the risk that its unfilled storage capacity will not be utilized over this period and in turn reduce Elevator A's profitability, Elevator A purchases the quantity equivalent of 30 million bushels of September CBOT Corn Referenced Contracts and sells 30 million bushels of December CBOT Corn Referenced Contracts.

Analysis: This hedging transaction meets the general requirements for bona fide hedging transactions (§§ 151.5(a)(1)(i)–(iii)) and specific provisions associated with anticipated merchandising (§ 151.5(a)(2)(v)). The hedging transaction is a substitute for transactions to be taken at a later time in the physical marketing channel. The hedge is economically appropriate to the reduction of risk associated with the firm's unfilled storage capacity because: (1) The December CBOT Corn futures price is substantially above the September CBOT Corn futures price; and (2) Elevator A reasonably expects to engage in the anticipated merchandising activity based on a review of its historical purchasing and selling patterns at that time of the year. The risk arises from a change in the value of an asset that the firm owns. As provided by §1.5(a)(2)(v), the size of the hedge is equal to the firm's unfilled storage capacity relating to its anticipated merchandising activity. The purchase and sale of offsetting Referenced

Additionally, at that time the industry was given assurances by the CFTC that commercial hedgers would be able to hedge in the derivatives markets (including anticipatory hedging) as they had previously, and be treated as bona fide hedgers.[3]

The proposal outlines fourteen "enumerated hedging transactions" that would be considered "bona fide" hedges under the rule. We believe that there are a number of common commercial practices that should be included on the enumerated list. For example, we believe hedges of "anticipated ownership" and "anticipated merchandising" transactions would be bona fide hedges under the language in the Dodd-Frank Act. However, they would not be treated as such because there is no provision under proposed rule for them as "enumerated hedges."

A simple example that has been used in various hearings and meetings in the past includes: a grain elevator "expects in the near future to enter into a forward contract with area wheat farmers at a fixed price with delivery at a later date. To hedge this risk, the elevator goes short at Kansas City Board of Trade wheat futures. This would seem to make the elevator futures transaction a speculative one and, therefore, not eligible for the commercial hedge exemption from any position limits since at the time the elevator's futures position was taken, there in fact was not an underlining physical contract." [4] To categorically classify such merchandising activity as speculative runs counter to the historical interpretation of a bona fide hedge, and should be addressed in the final rule. Similarly, CFTC should clarify that commercial producers and users should be permitted to manage legitimate business risks surrounding unfilled storage capacity.

While the CFTC has outlined a process to allow for non-enumerated hedges to be considered, the process as proposed is unclear and provides for further uncertainty. And, the process of filing for a hedge exemption appears to lead to a lengthy open-ended review by the Commission, whether or not it is commonly used as a risk management practice that previously has been recognized as a bona fide hedging activity. Without a more flexible, streamlined approach for "non-enumerated hedges, coupled with a limited number of allowable numerated examples," we are concerned that the definition of a bona fide hedge in the proposal most certainly would be narrowed from how it historically has been defined. That raises concerns that a number of common commercial hedging practices would be treated as "speculative." This would adversely affect commercial end-users who use the derivatives markets for legitimate risk management activities. Some of the practical implications of re-characterizing historically considered bona fide hedges as speculative include:

- Increased risk held by farmers because transactions currently held as hedging positions by their cooperative would no longer qualify, thus significantly reducing the cooperatives' use of those strategies as a way to provide attractive cash forward markets to their members;
- Increased hedging costs for all end users resulting from decreased ability to manage price risks inherent in physical commodity markets;
- Reduced liquidity in physical futures markets;
- Increased confusion among market participants and analysts as the rules would make public reports less transparent by requiring hedgers to report hedges as speculative positions, thereby decreasing

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Contracts are in different months, which settle in not more than twelve months. As provided under § 151.5(a)(2)(v), the risk reducing position will not qualify as a bona fide hedge in a physical-delivery Referenced Contract during the last 5 trading days of the September contract.

[3] Statements of Chairman Gensler, Commissioner Dunn, and CFTC staff at the Open Meeting on Two Final Rule Proposals under the Dodd-Frank Act, October 18, 2011.
[4] Senate Agriculture Committee hearing, Senator Roberts, Chairman Gensler, June 15, 2011; CFTC open meeting October 11, 2011, Commissioner Dunn.

"bona fide" hedging open interest and increasing "speculative" open interest in a misleading manner; and,

- Given the interconnectedness of Dodd-Frank regulations, the definition has implications for other rules, such as the end-user exception from clearing and aggregation of positions, which rely on this definition.

Currently acceptable practices NCFC believes should also be added to the enumerated hedging section, or expanded upon, include:

- Anticipatory merchandizing, as noted above;
- "Prehedging"of agricultural commodities as in the wheat example;
- Cash basis sales; and
- Cross-hedging.

Cash basis sales: The grain trade often uses a cash basis trade to price cash grain sales domestically and internationally. This allows for the sale of a physically delivered product to be priced (futures) closer to the actual date of shipment. While these contracts represent an obligation to perform on delivery, the practice helps the grain merchandising company/exporter hedge its price risk through the use of spread trades, which also serves an important purpose of enhancing convergence in the market. Outlined below is an example of such a sale. As this has become a vital hedging arrangement to facilitate U.S. grain exports and domestic sales, we urge CFTC to include this practice under the list of "enumerated hedges" in the final rule.

Step 1

- *Grain Merchandising Company (GMC) sells corn FOB U.S. Center Gulf for January 5-25 Delivery, basis +.75 the March (H) corn futures contract. On the pricing date, GMC will take long (H) futures contracts from the buyer (via an Exchange for Physical, or EFP) to price the cash corn.*

- *Terms include Letter of Credit (LC) payment; no futures pricing until the LC is open to limit flat price exposure with the customer; and the LC is to be opened 15 days prior to delivery period (Dec 20).*

Step 2

- *The cash corn market is a premium versus taking delivery of corn on the December (Z) futures contract.*

- *To cover its sales commitment at the cheapest price, GMC buys December (Z) futures and sells March (H) futures.*

Step 3

- *If purchasing corn in the cash market is still more expensive than taking delivery on its long futures contract position as the market enters into the delivery cycle, GMC takes delivery during the December delivery cycle (actual delivery against the futures contract is determined by the entity that is short futures and makes delivery).*

- *The corn delivered via the Z futures contract position will be loaded out and will arrive by barge in the Gulf between December 25 - January 10. The end user prices futures on the basis contract on January 10th. When the customer prices futures on the basis contract, GMC offsets its short H futures position with the long H futures position it receives via the EFP. GMC is contractually obligated to perform on the basis contract.*

Cross-hedging: As noted in the proposal, the Commission has long recognized cross-hedging as bona fide hedging activity. This practice is particularly important for commercial entities that process or transform commodities into products which may not be traded commodities. For example, the ability to hedge feed inputs such as Distillers Dried Grains (DDGs) with corn contracts is a well-recognized reasonable cross hedge in which many commercial firms engage. While this is a very straightforward example, there are other legitimate cross-hedge strategies that are more complex, and that may not qualify under the proposed rule. For example, in dairy, it is not unusual to combat liquidity issues in cheese and nonfat dry milk futures by using Class III, or Class III and whey to hedge cheese prices, and Class IV, or Class IV and butter to hedge nonfat dry milk prices. Additionally, it is becoming more popular for dairy farmers to forward contract a milk feed margin milk price with their cooperative which results in the cooperative taking hedge positions in both milk and feed derivatives simultaneously.

The proposal contemplates requiring a two part test: “Under the proposed enumerated exemption, cross-commodity hedging would be conditioned on: (i) the fluctuations in value of the position in the commodity derivative contract (or the commodity underlying the commodity derivative contract) are substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap (the “substantially related” test);” The proposal further outline those requirements:

> *Qualitative factor: As a first factor in assessing whether a cross-commodity hedge is bona fide, the target commodity should have a reasonable commercial relationship to the commodity underlying the commodity derivative contract. For example, there is a reasonable commercial relationship between grain sorghum (commonly called milo), used as a food grain for humans or as animal feedstock, with corn underlying a commodity derivative contract. In contrast, there does not appear to be a reasonable commercial relationship between a physical commodity and a stock price index; while long-term price series of such commodities may be statistically related by either inflation or measures of economic activity, such disparate commodities do not appear to have the requisite commercial relationship. Such correlation appears for this purpose to be spurious.*
>
> *Quantitative factor: The target commodity should also be offset by a position in a commodity derivative contract that provides a reasonable quantitative correlation and in light of available liquid commodity derivative contracts. The Commission will presume an appropriate quantitative relationship exists when the correlation (R), between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract (or the price series for the derivative contract used to offset risk), is at least 0.80 for a time period of at least 36 months. When less granular price series than daily are used, R typically will be higher. Thus, price series data of at least daily frequency should be used, if available.*

The rationale for CFTC to be proposing this approach is unclear, as is what concern is being addressed, particularly as it relates to the “quantitative factor” test. Again, this takes a very narrow, prescriptive approach to a provision that necessitates some degree of flexibility. We believe that this approach likely will create more issues (limiting hedging options), rather than correcting an unknown problem. Therefore, we request that these circumstances be assessed on a case-by-case basis at the exchange level (DCM), where there is already familiarity with various commercial practices, instead of the “one-size fits all” approach presented in the proposed rule. This process will provide more flexibility and better facilitate the ability for bona fide hedgers to reduce their business risk. Additionally, it is paramount that the resolution of the “interpretive process” is completed within 24 hours, permitting bona fide hedgers to manage the commercial business risks they face.

III. Position Limits – Flexibility Needed In Setting Limits Across Commodities

As purchasers, processors, marketers and merchandisers of commodities, and as suppliers of farm inputs, cooperatives use derivatives to hedge or mitigate commercial risks associated with price movements in various commodities such as grain, dairy products, livestock, cotton, energy, and fertilizer. Given the significant differences in those specific markets, we believe it would be very difficult to overlay one particular

formula in creating or setting speculative position limits across the board. Clearly, this is another example of where a one-size-fits-all regulatory approach would not be desirable, and the need for a more flexible approach is needed.

For example, the dairy futures markets are not as well established as the grain markets, having fewer participants and lower liquidity. There are also differences in that milk is continuously produced and isn't readily storable for any length of time, as opposed to grain that is harvested seasonally and readily storable – necessitating differing hedging needs over differing time periods. This creates unique circumstances for the dairy sector that should be taken into account in setting dairy position limits. Perhaps unintentionally, the Class III position limits were significantly reduced while it was not acknowledged that those contracts are cash settled futures and swaps[5]. The dairy industry needs expanded position limits to help increase liquidity and to support growing demand for derivatives from farmers and their cooperatives. Specifics about dairy issues can be found in separate filings by Dairy Farmers of America, the National Milk Producers Federation and the U.S. Dairy Industry Innovation Center.

Another example of nuances of specific markets in setting limits can be found with wheat contracts. Currently, all three domestic wheat contracts are treated equally as to position limits. Under the proposed formula approach, the current HRSW spot-month speculative limit of 600 contracts could drop as a result of lower stocks at delivery locations in prior years. The current non-spot month MGEX HRSW speculative limit of 12,000 contracts would decrease to just 3,300 contracts, while the KC HRW limit would decrease to 6,500 contracts, and the CBOT SRW limits would actually increase to 16,200 contracts. This results in different position limits for all three wheat contracts.

Market Participants have long appreciated the position limit parity among the three wheat contract markets, particularly as it relates to non-spot months. Having the same limits makes cross-hedging and spread trading easy to monitor and is a legitimate risk management tool. In the event position limits are set at different levels for each of the three wheat contracts as proposed, price volatility or concentration in one contract may unduly affect the price of the others. Therefore, NCFC urges the Commission when setting the new limits to maintain equality between three U.S. Wheat markets, CBOT, KCBT and MGEX.

IV. Trade Options Should Not Be Subject to Position Limits

NCFC members seldom utilize trade options as defined in the products definition rule. Largely, the contracts that contain any degree of volumetric optionality qualify as excluded forward contracts, and thus are not subject to position limits. However, to the degree any of those contracts would qualify as trade options, including them in determining position limits would be problematic in markets such as dairy. Based on the proposed (and reduced) Class III position limits, and without the ability for a DCM to provide additional hedge exemptions, the regulation of one such sales contract could inadvertently result in an entity exceeding position limits.

IV. Reporting Requirements

The proposed rule imposes unnecessary and onerous reporting requirements on bona fide hedgers. New special reporting requirements for all types of anticipatory hedges are burdensome and impractical, especially the requirement that even bona fide hedgers must file a report ten days prior to anticipated hedging needs. Among other things, allowing expanded hedging exemptions for bona fide hedgers that result in annual rather than monthly position limit reporting, will reduce the regulatory burden on NCFC members and other businesses legitimately hedging their commercial risk.

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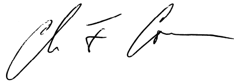
[5] The proposed rule provides referenced agricultural commodities a position limit for swaps (i.e., cash-settled derivatives) equal to the position limits for physically delivered futures/options. Class III is a cash-settled futures/options contract. In the case of Class III, the proposed position limits should be, at a minimum, two times the level of the existing position limits to be on par with the other referenced agricultural commodities.

V. Conclusion

We ask that CFTC craft clearer and more flexible regulations that take into account the legitimate hedging needs of farmer cooperatives and other commercial end users. Agricultural end users, as the backbone of the commodity markets, should be encouraged to manage their risks and not forced into a one-size-fits-all regulatory approach. Therefore, any federal speculative position limits rule should not unduly burden commercial end-users who utilize derivatives markets for economically appropriate risk management activities. Accordingly, it is crucial the Commission avoid undue limitation on the ability of end-users to hedge commercial risk in the derivatives markets when adopting federal position limits. Further, to minimize the impact to commercial market participants, we urge the Commission to retain many of the elements of CFTC's historical interpretation of the bona fide hedge exemption, while aligning it with the statutory definition by including merchandising hedges in the definition of "bona fide hedging transaction." In short, we hope the Commission will undertake an effort to improve the final rule defining a *bona fide* hedge by providing a broader, more functional definition.

We appreciate your consideration of the above points in drafting the final position limits rule.

Sincerely,



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