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February 10, 2014

Melissa Jurgens, Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

RIN: 3038-AD99

Dear Ms. Jurgens:

Dairy Farmers of America offers these comments about the Position Limits Proposed Rule, on behalf of its 13,000 members operating dairy farms from Maine to California. As America's leading dairy cooperative, DFA is a diversified milk marketer, dairy food and ingredient manufacturer and farm services provider. A key member service is DFA Risk Management – offering forward contracting programs to assist members to protect their profit margins by managing their milk and input price risk. Additionally, DFA offers forward contracting services to our commercial customers purchasing milk and dairy products.

Appreciation for Implementing Speculative Position Limits on Swaps

Prices that dairy farmers pay for purchased feed – the single largest cost factor in producing milk – are dependent on the CME "board" price for the respective feed plus a local basis. The board price is the most significant portion of the cost. Generally, the futures contract underlying a feed dealer's board price is the "nearby" month that has not entered the delivery time period. For instance, a dairy farmer buying corn from its local feed dealer during January would have their price based on the March corn futures price for the day of purchase. Dairy farmers make these transactions in order to assure a feed supply – the single biggest cost on a dairy farm. Many dairy farmers choose to contract to assure a future feed supply, as opposed to running the risk of not having feed available for their commercial business. In these cases, they have no alternative to locking into a feed price, even if they suspect that board prices may be lower in the future.

Our members have been concerned about the impact of speculative interests on their livestock feed purchases for a long time. In fact, DFA requested that you impose position limits on speculative swaps, in a letter to you dated June 16, 2009. The following excerpt from that letter points out a concern about unmanaged speculation:

> Dairy farmers forward contract their feed purchases – locking in feed prices months in advance of deliveries. Regulations allowing investors to speculate, beyond reasonable limits, in non-spot months, can have a price distorting impact on dairy farmer feed prices. This can result in

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farmers locking into feed prices at levels much higher than the fundamentals would suggest. For some farms that milk large numbers of cows on a small land base, locking into a year's worth of feed prices in late summer/early fall, is customary. Since dairy feed is the lifeblood of the business, these farmers contract with neighboring farms, feed mills, or others on a yearly basis – to assure that they will have feed for their dairy farm. These feed purchase contracts are influenced by futures prices – beyond the spot month. Excessive speculative activity, beyond the spot month that results in rising prices, can contribute to higher feed costs for these dairy farms.

DFA understands the need for appropriate position limits on speculative activity. We offer some modifications to your proposed rule to provide greater balance for the needs of businesses using swaps and futures/options for commercially prudent *bona fide* hedges that reduce business risk. Additionally, we highlight some modifications needed to provide for a liquid and efficient Class III marketplace for dairy businesses that execute *bona fide* hedges.

It is critically important to the U.S. economy and to our dairy farmer members that the CFTC not take a "one-size fits all" approach to position limits. Importantly, the CFTC should not impose requirements that impede the ability of farms and other businesses to execute *bona fide* hedges, and provide hedging liquidity, without being overly burdened by reporting and other compliance requirements. A misstep in these areas could lead to reduced hedging – harming the very essence of Congress' intent with Dodd-Frank, that of reducing risk within the U.S. economy.

Position Limit Reporting Requirements are too Burdensome for *Bona Fide* Hedgers

DFA's Class III *bona fide* hedge futures position typically exceeds the proposed Class III position limits. In addition to its futures position, DFA executes a small notional volume of swaps as a means of hedging forward contracts that DFA enters into with dairy-farmer members and customers. Under the proposed rule, this would require DFA to file Form 204 on a monthly basis. The specific data that would be included in the monthly submission would vary each month; however, because the general size and nature of DFA's business is relatively constant, the differences between each monthly report would be insignificant. Accordingly, DFA respectfully submits that an annual report would provide the Commission with equally informative data as monthly submissions, with substantially less burden for DFA and other similarly situated market participants.

Relatedly, DFA was one of the first businesses in the U.S. to report swaps to an SDR. This process seems to be running smoothly, but it did come with additional cost to our members. The CFTC should not impose additional costs without a demonstration of significant additional regulatory benefits.

We strongly object to Dodd-Frank related changes that result in a significantly increased reporting burden – that results in higher business costs without significant regulatory benefits. The increased costs resulting from significantly more burdensome reporting will be ultimately borne by our dairy-farmer members. Like most Americans, the hard-working families that make up our membership suffered the economic consequences of the financial crisis. They viewed with disdain the Federal

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bailouts of businesses that were at the heart of the financial crisis that lead to the passage of the Dodd-Frank law. Now, tacking on additional costs, that will not go away, to facilitate a "one-size fits all" regulation that burdens businesses that in no way contributed to the financial crisis and instead were the victims – is inappropriate and unconscionable.

Allowing market participants to report information related to their *bona fide* hedging positions annually, as opposed to monthly, will reduce the regulatory burden on, and cost to, DFA, its members and other businesses that have been utilizing futures, options and swaps to limit business risk in ways that serve to reduce risk within the U.S. economy. It is time to stop the regulatory "piling-on" of burden and cost to the victims of the financial crisis.

For the Class III market, we offer a number of suggestions that would significantly improve the proposed rule.

Designated Contract Markets Should Play a Larger Role in Determining Whether a Hedging Position is *Bona Fide*

An important element that appears to be overlooked when regulating position limits for *bona fide* hedgers is the important role that Designated Contract Markets (DCMs) play in tailoring hedge exemptions to fit a business' needs – without creating overly burdensome reporting requirements. For instance, the CME Group's Class III futures speculative limit is 1,500 "net" contracts for any single contract month, and Class III futures are listed for 24 consecutive months. Because of our need to offset the price risk from our member forward contracting program, the CME Group has consistently provided DFA with a "hedge exemption" beyond the 1,500 single month contract limit. This expanded hedge exemption is tailored to our business needs – which are different than others that hold positions in Class III futures. However, the current position limits proposal does not permit *bona fide* hedgers to rely on this type of flexible and practical approach to federal position limits.

We request that any final rule allow DCMs to provide hedge exemptions that will be recognized by the CFTC under the federal speculative position limit regime. DCMs are in the best position to make case-by-case determinations and to tailor hedge exemptions to meet the *bona fide* hedging needs of a particular business, instead of the "one-size fits all" approach presented in the proposed rule. We prefer that the DCMs maintain their active role in this process, with appropriate CFTC oversight, simply because they have management expertise and are best positioned to understand the business needs of market participants, especially for smaller markets like Class III milk. The type of public-private working relationship between the CFTC and the DCM is exactly the type of government interaction that should occur – using the best expertise of both groups in a process that conforms to the regulation in a way that is the least burdensome to *bona fide* hedgers. Continuing this process will better facilitate the ability of *bona fide* hedgers to reduce their business risk.

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New Speculative Limits for Cash-Settled Contracts Should be Higher than Current Futures/Options Limits

DFA recommends that speculative position limits for Class III milk and other cash-settled contracts, which include swaps, be set at a higher level than the proposed speculative position limits for all Referenced Contracts. In explanation, we agree with your proposal to have the spot month speculative position limit of, for example corn, be 600 "net" physically delivered contracts and 600 "net" cash-settled (i.e., swap) contract equivalents. However, for cash-settled futures contracts, the additional allowance for swaps has not been accounted for.

Other "referenced" agricultural commodities will effectively have separate speculative limits for futures/options and swaps – one limit for physical delivery futures/options and another limits for cash-settled swaps. Class III would *not* have two separate limits because the Class III futures contract is cash-settled. This needs to be corrected to permit the same flexibility and liquidity offered to all other "referenced" agricultural commodities by setting the speculative limit for Class III milk at no less than 3,000 futures equivalent contracts because, for this commodity, there is no physical-delivery contract. Additionally, the DCM should be able to adjust a *bona fide* hedgers all month combined hedge exemption.

We recognize the difficulty in setting position limits based on open interest that includes swaps because the CFTC does not know the commodity-by-commodity size of swap markets or the extent to which these markets are used by *bona fide* hedgers. However, we believe it is important for the Commission to use the best data available when performing this calculation. Using the DCMs' expertise to assist in setting position limits for both futures/options and swaps would reduce the potential burden on DFA and other commercial market participants by helping to ensure that the Commission establishes position limits that are necessary and sets those limits at a level that appropriately balances the needs of *bona fide* hedgers and other market participants.

Proposed Rule Reduces Speculative Position Limits In A Way That Likely Harms Class III Liquidity

The proposed rule narrows, perhaps inadvertently, the speculative position limits for Class III milk. As a result, we are concerned that the ability of dairy farmers to hedge their milk prices to protect their businesses will be harmed if the CFTC reduces the Class III speculative position limits as proposed. A Class III position limit that is too low could lead to fewer speculative trades and traders, and a loss of liquidity at a time when the demand for these instruments to be used as hedges by dairy farmers is increasing.

Class III futures and options are unique among the referenced contracts for the following, among other, reasons:

- They are cash-settled contracts.
- There are 24 consecutive months listed.

- They settle to a formula administered by the United States Department of Agriculture, which determines the price each month.
- Class III is a price designation for a classification of milk used under USDA's Federal Milk Marketing order program – meaning that Class III futures and options settle to a federally regulated price calculation.
- The underlying commodity, milk, is highly perishable.
- Because it is a perishable product, Federal law requires milk to be packaged or processed within 72 hours or it is otherwise unfit for use at a milk plant. Class III milk cannot be inventoried for more than three days.
- A super-majority of futures and option positions are held for automatic cash-settlement. As such, the need for phased down spot month position limits are unnecessary – in fact a rule requiring such would likely lead to unnecessary price volatility as a Class III futures contract went off the board.

The combination of these factors makes it very unlikely, if not impossible, for an entity to "corner" the physical market for milk using Class III futures.

Dairy futures markets are in their infancy as compared to the markets for corn, soybean and other agricultural commodity futures. Dairy futures were first introduced in the mid-1990's – allowing dairy farmers and milk manufacturers to hedge their milk price risk and cheese buyers and other end users to hedge their dairy-ingredient price risk. The demand for Class III futures was very low in its early years. More recently, as U.S. milk prices have been impacted by global supply and demand dynamics, leading to significantly higher and more volatile milk prices, Class III futures and options are being used more often by dairy farmers, milk manufacturers and end users. That said, the Class III futures and options markets are still in their infancy. To help make the point, consider a product life cycle curve that looks like a narrow, but steep bell curve. At the peak of the curve, a product has reached its maximum growth potential and to the right, its demand is declining. The position of Class III futures and options contracts on such a curve would be to the left and towards the bottom. It is a nascent market – small, but with significant growth opportunities.

Presently, less than 15 percent of U.S. dairy farmers utilize Class III futures and options, but more are finding benefits of using these instruments to mitigate their commercial risk. If these markets are permitted to develop, many more dairy farmers will utilize them to protect their dairy farms from disastrously low or unpredictably volatile milk prices – providing a mechanism to ensure a consistent cash flow and to reinvest in their dairies.

Although the term speculator can have negative connotations and speculation can be harmful if left unchecked in certain markets, speculators are necessary and important participants in the derivatives markets. Without the existing speculators utilizing Class III futures and options, dairy farmers would not be able to execute as many transactions and obtain the pricing protection they need to help support the profitability of their business. As the demand for Class III futures and options grows and more dairy farmers desire to utilize them, it will continue to be important for speculators to participate in these

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markets to assure adequate liquidity and trading volumes. This particular need may not be the same for other large and more well-established commodity futures markets.

The CFTC's Commitment of Traders Report shows that most Class III futures transactions are executed by commercial hedgers. Very small percentages are executed by swap dealers and there are virtually no "managed money" trades in Class III. The lack of speculative activity in Class III markets is likely slowing the growth of Class III futures, resulting in a lack of sufficient liquidity and hampering efforts of dairy farmers and end users to find adequate volumes for hedging. Higher limits are necessary to accommodate the growth in demand from dairy farmers and end users for the Class III hedging products.

The following chart demonstrates the differences that exist in speculative activity from "Managed Money" as compared to commercial hedgers as reported in the CFTC's Commitment of Traders Report. It compares Class III futures to other agricultural commodities and points out the paucity of speculators in Class III. Even the oats contract has more managed money traders and open interest contributed by them than Class III.

Managed Money Reportable Positions

Futures Contract	Number of Traders		% Open Interest	
	Long	Short	Long	Short
Class III	4	0	2.5	0
Oats	13	*	17.7	0.7
Wheat - SRW	40	89	22.7	36
Wheat - HRW	35	25	25.4	21.9
Corn	48	87	16.8	20.6
Soybeans	93	30	28.4	4.9
Soybean Meal	58	18	30.5	9.3
Cotton No. 2 - ICE	70	23	28	4.9
Live Cattle	98	29	36.1	3.8

Data Source: CFTC Commitment of Traders Report, January 14, 2014.

Arguably, the current Class III position limits may already be restricting *bona fide* hedging activity by discouraging speculative activity from entering the Class III market place, and thereby hurting Class III liquidity. Under the circumstances, it is inappropriate to further reduce the limits while, at the same time, adding swaps to those reduced limits.

Because Class III futures and options are cash-settled and not physically-delivered, the initial proposed rule would effectively limit all positions in Class III milk, including futures, options and all economically equivalent swaps, to 1,500 futures contract equivalents in the spot month and 3,400

contracts in all-months combined. These levels likely would have a significant negative effect on speculative activity and reduce market liquidity for bona fide hedgers.

The existing Class III speculative limit is 1,500 contracts in the spot month and 1,500 contracts in each other month. There are 24 consecutive months of Class III futures contracts. There are no existing all-months-combined months' limits in Class III. However, if there were, arguably it should be 36,000 contracts (i.e., 24 months times 1,500 contracts per month). Presently, there is no limit on the number of Class III equivalent swaps that can be held. The following table provides a comparison of the existing Class III position limits and those included in the proposed rule.

Comparison of Class III Position Limits

	Current	Proposed
Spot Month (contracts)	1,500	1,500
Each Month (contracts)	1,500	N.A.
All Months Combined (contracts)	N.A.	3,400
Months of Futures Contracts	24	24
Cash-settled futures	yes	yes
Physical delivery futures	N.A.	N.A.
Swaps included in position limits	N.A.	yes

Existing position limits allow for a larger number of Class III contracts to be held by speculators than would occur if the proposed rule were implemented. Because swaps are now being included in the position limits, the new position limits should be *larger* than the current ones, *not smaller*. A higher limit is particularly important to facilitate the dairy farmer demand growth for the use of Class III futures and options.

Class III should have a combined *minimum* spot month position limit of 3,000 contracts to reflect the fact that the Core Referenced Futures Contract is cash-settled. This would bring Class III in line with other Referenced Contracts that have physically delivered and cash settled limits that, when combined, equate to two-times the current spot month position limits for physically-delivered contracts.

Additionally, the non-spot all-month-combined limit is too low. We request one of two solutions. The Commission should implement either a *minimum* single-month limit of 3,000 contracts (1,500 futures/options plus 1,500 swap equivalents) or a *minimum* all-months-combined limit of 72,000

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contracts (24 months times 3,000 contracts).[1] By setting the limits high enough, the CFTC could support the growth of liquidity in the Class III futures contract while reducing reporting costs and burdens of *bona fide* hedgers.

DFA supports the CFTC in determining spot month position limits based on deliverable supply and allowing for five times the amount of positions in the spot month. However, for Class III, the resulting position limits should be no less than 3,000 contracts in the spot month and 72,000 contracts across all months.

In the Class III milk market, the risk is setting limits at a level that is inappropriately low and that leads to:

- Reduced liquidity in the Class III contract,
- Diminished ability for dairy farmers to hedge their business risk; and,
- Increased costs due to overly stringent reporting requirements.

Accordingly, DFA requests higher Class III position limits in order to encourage liquidity in the Class III contract and support the *bona fide* hedging needs of the dairy industry.

Non-Referenced Dairy Contracts

There are a number of other dairy futures contracts that are not included as one of the referenced contracts in the position limits rule. We would ask that prior to proposing any rule on those contracts, the Commission engages in dialogue with dairy market participants about how best to establish appropriate limits. In general, each of the other non-referenced dairy contracts raises similar issues and should be handled similarly to our request for Class III position limits:

- Combined spot month limits that are at least two times the existing limits to reflect the fact that the underlying Core Referenced Futures Contract is cash-settled;
- All-months-combined limits that are at least 24 times the existing single month limit; and
- Allowance of the DCM to recognize non-enumerated *bona fide* hedging positions.

Five-Day Rule as it Relates to Cash-Settled Contracts

Cash-settled futures contracts should not be required to meet any five-day rule requirements, as is included in the proposed rule. Using Class III futures as an example, most positions are held until financial settlement. A rule that would require earlier liquidation would result in significant price volatility because the demand to take the opposite side of the transactions may be limited. As discussed

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[1] In reality, speculators will likely not execute Class III transactions beyond 18 months out. Therefore, having an all-months combined speculative limit of at least 54,000 contracts (18 months times 3,000 contracts) also would be supportive of Class III liquidity growth.

above, this type of volatility would be disruptive and counter-productive to the growth and use of milk futures and other cash-settled derivatives.

Cross Commodity Hedges

We encourage the CFTC to allow for more flexibility relative to cross-commodity hedges. It is these types of transactions where innovation occurs that provides *bona fide* hedgers more liquidity and more practical hedges for participant's unique circumstances. To best suit the needs of *bona fide* hedgers, the DCMs, with oversight from the CFTC, should be allowed to make interpretive determinations of whether a particular transaction qualifies as a *bona fide* hedge. In so doing, the entity making this determination must have a streamlined process that will quickly and efficiently respond to a business' interpretive request.

For instance, DFA offers members unique milk price forward contracting opportunities to lock into a milk-feed margin, a blend price or a producer price differential. In some cases, we may be the only business that offers these types of forward contracting opportunities. We hedge these contracts using a variety of Class III, Class IV, nonfat dry milk and/or butter futures or swaps – depending on the opportunities that can achieve the best price for members. Members have asked us to provide these types of forward contracting options for them to help mitigate the commercial risk on their dairies and to facilitate a process to assist them in managing a profitable business. However, if our ability to hedge these transactions becomes limited by a new, narrower interpretation of *bona fide* hedging, we may be unable to continue to offer these valuable risk management services to the same extent as we do today.

As the U.S. dairy industry takes on a larger role in supplying dairy products to global end users, new hedging strategies will be developed that will likely be based on a combination of different listed and OTC derivatives products, including some subject to position limits and others that are not. It is vitally important to the U.S. dairy industry to have a flexible process of assuring that these transactions remain commercially viable as *bona fide* hedges, as intended by the parties involved.

We understand that the CFTC has provided for an alternate route to seek specific approval for cross-commodity hedges that do not meet the .80 correlation. However, U.S. businesses interacting in a highly competitive global marketplace and facing significant operational risk due to price volatility do not have the luxury of time when determining how best to manage their programs to maintain their competitiveness and execute *bona fide* hedging transactions to protect against price volatility. U.S. businesses cannot afford an extended period of uncertainty while awaiting a CFTC decision as to whether a transaction is a *bona fide* hedge. The DCMs should be permitted to make these decisions with respect to annual hedge exemption; if not, then the CFTC needs to allow more flexibility and if prior approval is required, do so within 24 hours. Additionally, U.S. businesses should not be impeded by a CFTC system that always says "no" or that uses lack of funding or appropriate staffing to delay responses for interpretive guidance. The expertise in reviewing these requests does not reside solely at the CFTC, but also with the DCMs. It is imperative that the CFTC develop a streamlined process that includes DCM expertise to quickly make a determination as to whether a particular transaction is an acceptable bona fide hedge.

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Milk Sales Agreements Should not be Treated as Trade Options or Be Subject to Position Limits

There is still a significant amount of uncertainty regarding how to characterize supply arrangements with embedded volumetric optionality. In the dairy market, all of these arrangements should be characterized as excluded forward contracts because they specifically deal with pricing arrangements relative to supplying milk to processing and manufacturing plants. In executing these arrangements, it is the intent of the parties to economically manage the purchase and sale of a highly perishable and highly seasonable commodity – both from a production stand point and a consumer demand stand point. In no cases are these arrangements considered speculative derivatives by either the buyer or seller. However, because of the ambiguity with the seven-part interpretation with respect to forwards with embedded volumetric optionality, it is unclear whether the CFTC may view some of these contracts as commodity trade options (CTOs).

If some degree of embedded optionality causes routine dairy supply arrangements to be inaccurately characterized as CTOs such that position limits are applied to such transactions, the implications could be extremely adverse to DFA and other end users. Subjecting trade options to speculative position limits is particularly troubling because based on the proposed (and reduced) Class III position limits, the execution of a single supply agreement with embedded volumetric optionality could cause DFA to exceed position limits. This problem is exacerbated by the fact that DCMs may not have the ability to provide commercially reasonable hedge exemptions.

Like a forward contract with a member, a sales contract with embedded optionality is typically the instrument *to be hedged* – not the instrument *used to hedge*. As a result, it is unclear whether these agreements would, as the Commission suggests, fall within the definition of a *bona fide* hedging position in the Proposed Rule. Nevertheless, these positions would be subject to speculative limits. The combination of speculative limits without any relief for hedging would likely restrict a substantial amount of *physical* market activity. DFA respectfully submits that such a result would be unintended and unproductive. Accordingly, the Commission should revise the proposed rule to provide that milk sales contracts are not trade options, in any form, or counted towards position limits.

Implementation Date Should be Longer than 60 Days

DFA recommends a longer period of time for implementation of the position limits and aggregation rules. As proposed, there is a considerable increase in reporting requirements that will necessitate significant administrative and operational build outs. We suggest that market participants be given at least 180 days from publication of the final rule in the Federal Register.

Summary

In closing, DFA appreciates the CFTC's proposal to bring speculative transactions under greater scrutiny. However, in so doing, it must remain flexible in its approach of regulating *bona fide* hedge transactions by businesses that are appropriately managing their business risk – which, at least in the Class III milk market, is the majority of businesses engaged in futures and swap transactions.

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Congress and the U.S. business community are counting on you to provide the "right" regulation of the swap marketplace without burdening *bona fide* hedgers in a way that creates greater business risk for businesses that are trying to mitigate risk. A one-size fits all rule and one that concentrates the decision and administrative process in the CFTC, without using other expertise such as that at the DCMs, will frustrate legitimate hedging activity and create an environment that may reduce liquidity in important markets, such as the dairy markets.

Of particular concern to us are the greater limitations being placed on Class III speculators that will likely lead to challenges for *bona fide* hedgers in accessing the necessary level of liquidity and that will require much more burdensome reporting. We urge the CFTC to adopt our suggested modifications to the proposed position limits rule.

Sincerely,

Edward W. Gallagher

Edward W. Gallagher
President
DFA Risk Management
a division of Dairy Farmers of America