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August 4, 2014

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

***RE: Notice of Proposed Rulemaking: Position Limits for Derivatives and Aggregation of Positions. Federal Register/Vol. 79, No. 103/May 29, 2014 (RIN 3038-AD99 and RIN 3038-AD82).***

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)<sup>1</sup> submits the following comments in response to the Commodity Futures Trading Commission's (CFTC) notice of proposed rulemakings: *Position Limits for Derivatives and Aggregation of Positions* (RIN 3038-AD99 and RIN 3038-AD82).

NCFC member organizations appreciated the opportunity to participate in the June 19, 2014, CFTC staff roundtable on position limits for physical commodity derivatives. We also welcome this opportunity to follow up on that roundtable discussion. NCFC's initial submission, dated February 10, 2014, can be viewed at:

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59613&SearchText=>

## **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 Wall Street Transparency and Accountability Act of 2010 (“Dodd-Frank”) rulemaking process, NCFC has advocated for including broad exemptions for agricultural end

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<sup>1</sup> Since 1929, NCFC has been the voice of America's farmer cooperatives. Farmer cooperatives – businesses owned and controlled by farmers, ranchers, and growers – are an important part of the success of American agriculture. 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 21 state and regional councils of cooperatives.

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.

## II. Bona Fide Hedging Definition

In general, we are concerned that in an attempt to diminish, eliminate or prevent excessive speculation and deter disruptive trading practices, the proposed rules place undue burden on commercial participants. As stated in NCFC’s previous comments, the proposal abandons well-established concepts contained in CFTC regulation 1.3(z) definition of “bona fide hedging transaction” in favor of a narrower interpretation that outlines fourteen “enumerated hedging transactions” that would be considered “bona fide” hedges under the rule. We believe that enumerated exemptions are far too limiting and restrictive, and may prohibit hedging practices that have been allowed for many years under the existing rules.

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. Further, 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.

Additionally, we believe CFTC needs to provide the necessary flexibility to allow hedgers to determine what is “economically appropriate” in reducing their commercial risks. To do otherwise will result in adding costs due to increased risk premiums. Those costs will ultimately be borne by consumers.

## II. Merchandising/Anticipatory Hedging

The Commodity Exchange Act (CEA) as amended by Dodd-Frank specifically includes anticipatory merchandising as a bona fide hedging transaction. However, the proposed rule does not view anticipated merchandising as such, with the CFTC noting that in absence of acquisition of inventory or entry into fixed priced contracts, any price risk from merchandising activity is yet to be assumed and any derivative position would not serve to reduce risk.

However, playing a key role in physical marketing channels by connecting producers and consumers in different parts of the world, merchants take significant risk by taking title to commodities, and assuming storage, transportation, and other variables. The inability for a merchant to adequately hedge those risks may adversely impact pricing for the end consumer, as the merchant may have increased costs related to its inability to hedge its commercial exposure. Following are examples in which merchants take on such risks.

**Unfixed Price Contracts (Cash Basis Sales)** – Co-op X may enter into forward “Unpriced Contracts” where the specific final price has yet to be determined; *however*, Co-op X has contractually agreed to the volume of a purchase or sale, as well as committed to price the commodities at a specified premium or discount *to a particular, identified futures contract and month*. The decision whether or not to price a contract at a specific time is generally driven by

customer preference (it is even possible that agreement on a final contract price may happen after delivery), or by performance risk concerns, as requiring a contract to be priced increases credit exposure.

In this example, Co-op X sells corn FOB for June delivery and contractually agrees with the customer that the contract will remain unpriced until a Letter of Credit is opened in favor of Co-op X. There also is agreement to price the cash corn at 75 cents over the July corn futures contract, and that Co-op X will accept a futures exchange (Exchange for Physical or EFP) to price the contract.

After the contract is agreed to, the cash corn market for May moves and is priced at a premium to the May corn futures contract. Since there is a binding sales contract for volume that will be delivered in June, entering into a long May futures position is the most economical origination of corn at that time. Thus, to cover the sales commitment at the lowest price, Co-op X will buy May futures as a substitute for purchasing cash corn.

Because the futures price component of the sales contract has not yet been established, taking a long position in the May contract alone would increase Co-op X's overall risk position. While Co-op X is contractually obligated to price the sale of corn with the July futures contract, it knows it will ultimately take a July long futures position from its customer via EFP. Therefore Co-op X will simultaneously sell (go short) the July futures contract. The short July futures position combined with the long May futures position is a risk-reducing transaction that is economically appropriate because it is locking in the spread between the July futures and the May futures.

If the market converges prior to the last trading date, Co-op X would sell the May contract and purchase the cash physical. However, if the cash market is still more costly than taking the May futures position into delivery, Co-op X would either a) purchase the corn from the cash market and execute an EFP to transfer the May long futures position to the seller, or b) take the long futures position through the delivery process as a substitute for buying directly in the cash market.

The above scenario would only be executed at a time where the cash market and the futures market prices are not aligned/converged. If that was not the case, no hedges would be placed on the July sale contract and Co-op X would source the corn in the cash market. Additionally, Co-op X would intend to take the futures long through the delivery process (i.e. past the last 5 days of trading) and as such, the futures month where the long was held would align with the delivery window of the sales contract, including reasonable timelines for logistics for the sales delivery location.

It should be noted that Co-op X would take the same actions in the futures market, regardless of whether the sale of cash corn had been fixed, except that Co-op X would have held a long in July and the sale of July futures would have offset that existing long vs. the long received via EFP at the pricing date offsetting an existing short. The May futures execution would remain the same under both scenarios.

This example should be considered a bona fide hedge, not only because it is analogous to an anticipatory merchandising hedge, but also because Co-op X has a legally binding contract that specifies how and when the sale contract will be priced – and in order to fulfill its delivery obligation it must buy cash corn. *In addition to being “risk reducing” to Co-op X (the market exposure of the relative value between the deferred cash delivery that is unpriced, and the*

*current cash physical price), these transactions serve to promote convergence between the cash and futures market.*

**Fixing of Un-Fixed Forward Contracts** – The proposed rule indicates that Unpriced Contracts do not give rise to price risk and are not covered by any of the enumerated exemptions. However, unpriced forward contracts may expose a commercial enterprise to counterparty performance risk. Therefore, to ensure the making or taking of delivery in these situations, it is appropriate to take a futures position to offset the risk of the counterparty's risk to perform on an unfixed price forward contract.

For example, Co-op X may not allow a customer to price a contract due to performance concerns. In the event that Co-op X has already purchased grain on a fixed price basis (May delivery, for example), but has sold on an Un-fixed Forward Contract basis for July delivery, Co-op X is exposed to performance risk if the price were to decrease and the customer did not take delivery of the grain.

Synthetic Price Fixing of that sales contract would entail simultaneously buying back the May futures, and selling out the July futures in order to establish and lock in the margin. This also provides a reliable sales channel for Co-op X to sell the grain through the delivery mechanism in the event of a default by its customer.

If the customer fulfills its commitment, Co-op X would either accept a long EFP from the customer or purchase a long position in the market to flatten its July short upon price fixing.

*Forcing parties into long-term fixed-price contracts makes them incur increased credit risk.*

**Last 5 Days Restrictions** – The proposed rule includes enumerated hedging exemptions for general positions, but in the last 5 days of trading some of the exemptions no longer apply. For example, anticipatory hedging for unsold production, offsetting unfixed purchases and sales, and cross commodity hedges, among others.

If the futures market is the cheapest source to originate grain (as in the above unfixed price example), holding a position through the last 5 days would be necessary in order to buy the grain and fulfill the contract. It would be illogical to force market participants to exit a position if they are willing and capable to take delivery given it may be the most economically sound option available.

### **III. Process for Non-enumerated Hedge Exemption**

The proposed process for seeking a non-enumerated hedge exemption is overly burdensome and lengthy. The process would constrain and potentially prohibit participants from entering into legitimate hedges that they feel are prudent for managing their business risks. The current process provides a time limit for response, whereby the proposed process introduces uncertainty as to whether an exemption will be granted and gives little guidance as to the criteria the CFTC will use to make a determination. In addition, adding a public comment period process would only complicate the matter and create more confusion and delay, further limiting bona fide hedgers' ability to manage commercial risks.

We believe the policy objectives in CEA Section 4a(a)(3) should continue to guide the review process for exemptions. In addition, the existing requirements for Initial Statement under 1.47 (b) should be sufficient for the CFTC to make its determination, with particular emphasis given

to the explanation provided by the applicant as to why the activity is economically appropriate to the reduction of risk to their particular business.

As noted in our previous comments, NCFC supports the exchanges participating in a bona fide hedge application review. This seems especially appropriate given that Designated Contract Markets (DCMs) have a long history of reviewing hedging activities, and it will take time for CFTC staff to build their knowledge and become more familiar with commercial hedging practices. Repeated requests to a DCM for similar exemptions should be reviewed with the CFTC and potentially submitted for public comment in order to expand the list of enumerated exemptions.

#### **IV. Gross Hedging**

In the Proposed Rule, CFTC acknowledges that “gross hedging may be appropriate under certain circumstances, when net cash positions do not measure total risk exposure due to differences in the timing of cash commitments, the location of stocks and differences in grades or types of the cash commodity being hedged.” However, in other circumstances, CFTC asserts that a commodity derivative contract would not qualify as a *bona fide* hedging position because the hedge resulted in “increased value exposure of the enterprise.”

Market participants need flexibility to hedge the risk in their portfolios on a gross or net basis. As long as the derivatives position is intended as a bona fide hedge, and in the reasonable opinion of the hedger the position is economically appropriate to the reduction of risk for that specific transaction or on a portfolio basis, then it should be viewed as a bona fide hedging position regardless of the overall Enterprise risk profile.

For purposes of the hedging definition, an enterprise should not always be viewed as an aggregated entity. Portfolios are dynamic and not all groups within the same enterprise may have the same market view.<sup>2</sup> Having to coordinate global positions is burdensome, requires technology solutions and may result in additional unintentional risks being taken or drive organizational changes that do not make sense commercially. Additionally, with a global business there may be tax and/or local accounting concerns and complications for a foreign entity not maintaining its own hedge position. Individual risk managers should continue to have hedging tools available to manage risks of their independent risk positions. Managing risk on an aggregate basis would be inefficient and ineffective, as risk management strategies are designed for specific risk profiles and an aggregate view may not offset risks as well as individual strategies, and may ultimately serve to increase the overall risk profile of an Enterprise.

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<sup>2</sup> Business Units and even Operating Units within the same Business Unit structure often operate independently of each other and do not consult on position management at an aggregate or Enterprise level. This is critically important in the management of the enterprise and allows independent and timely hedging decisions. Each Business Unit will have its own daily Risk Report, daily Position Report, as well as separate P/L's and Balance Sheets. Operating Units within the same Business Unit will also have individual daily position reports and separate P/L's and balance sheets. Separate futures accounts may also be maintained. These reports are available and can demonstrate the relationship between cash physical activities, inventories and derivatives positions. In addition, it can be demonstrated that the business units' organizational structure drives separate decision-making.

## **V. Dairy (Class III) Limits**

NCFC's dairy cooperative members have expressed concerns over Class III position limits. The proposed rule results in narrowing the position limits as they exist today. This will result in some of our members regularly submitting Form 204 reports requesting a hedge exemption. This would be an administrative burden created by an unnecessary regulatory decrease in all months' position limits.

Additionally, the proposed rule's narrowing of the limits will harm Class III derivatives growth potential, as it may reduce activity by liquidity providers and in some cases it could discourage their participation in the Class III derivatives markets. The Class III derivatives market is a fairly young market that has rapidly grown over the past 10 years and will see its demand by dairy cooperatives, dairy farmers, manufacturers and end users increase substantially over the next 10 years. To help facilitate this growth in demand, existing Class III liquidity providers will need to become more active and new liquidity providers will be needed to enter the market. A narrowing of the Class III position limits will likely discourage this from occurring and create challenges for bona fide hedgers to efficiently mitigate their Class III price risk in the coming years.

Our dairy cooperative members are requesting that the Class III front month position limit be equal to the spot month, and that it be set at 25 percent of deliverable supply, but no less than 3,000 contracts. Additionally, the dairy cooperatives request that the all months limit be four times the spot month limit. NCFC supports these requests and respectfully asks the Commission to include these broader Class III position limits in its final rule.

## **VI. Wheat Equivalence Determinations**

As outlined in NCFC's February comments, the Commission should maintain parity between the three U.S. Wheat markets – CBOT, KCBT and MGEX. The proposed regulations would end the current limit equality among these three markets, which could greatly impact the potential for risk-mitigating strategies between these contract markets. If different limits are set, price volatility or concentration in one wheat contract may unduly affect the price of the other wheat contracts.

## **VII. Aggregation of Positions**

While we share the Commission's mission to increase transparency and promote market integrity within the financial system, we have concerns over how the recent position aggregation proposal could affect commercial hedgers. The primary flaw in the proposed rule is that it focuses on ownership as the basis for determining whether to aggregate positions. In most cases, ownership is an irrelevant factor. It would be inappropriate to require a partial owner, who has no control over specific trading activities of owned entities, to aggregate the positions of that owned entity. Two companies that operate separately in every aspect would be forced to coordinate trading strategies and share information in order to comply. This does not further the goals of the Commission, and it puts an undue burden on commercial hedgers.

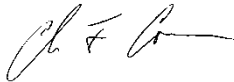
With regard to position aggregation, the focus should be on control rather than ownership. The control test should be conducted at the trading level rather than the owner level, as there is very little day-to-day knowledge of trading activities at the owner level. When there are two companies with completely separate business/trading strategies, in separate locations, with different systems and traders, it is extremely difficult to require them to coordinate for position

aggregation purposes only. The way in which companies trade is separate and distinct, and if they were to be aggregated, it would change their business/operations strategy. When the focus is on control as opposed to ownership, the coordination and information sharing between the two companies already exists. It is the ability to control trading that is fundamental in determining whether positions should be aggregated.

### **VIII. 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. Any federal speculative position limits rule should not unduly burden commercial end-users who utilize derivatives markets for economically appropriate risk management activities. We appreciate your consideration of these comments, as well as our February 10, 2014 comments, in drafting the final position limits rule.

Sincerely,

A handwritten signature in black ink, appearing to read 'C. F. Conner', with a long horizontal flourish extending to the right.

Charles F. Conner  
President & CEO