DFA
Risk Management

August 4, 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 Positions Limit Proposed Rule to supplement those that we filed on February 10, 2014, on behalf of our 13,000 members operating family dairy farms from Maine to California. 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.

We respectfully request that The Commodity Futures Trading Commission (CFTC) set the spot and front month's Class III position limit at 25 percent of deliverable supply, but not less than 3,000 contracts and the all months limit at four times the spot and front month limit, but not less than 12,000 contracts. Additionally, we request that agricultural trade options be exempt or excluded from the positions limit rule.

We have worked collaboratively with the National Council of Farmer Cooperatives in developing supplemental comments to the Position Limits Rule. We endorse their comments supporting our Class III recommendations as well as their comments on other aspects of the proposed rule.

The following summarizes DFA's comments to date.

- Commodity markets are ripe with differing factors impacting price discovery, convergence and other important issues. They are enough different that it is not appropriate to shoe-horn all commodities into a one-size-fits-all position limits approach. Class III is an example of a commodity whose bonafide hedgers could be harmed if its unique aspects are overlooked and position limits are implemented that fit a wrong-sized mold.

- We are concerned that the Class III position limits have been significantly narrowed and will cause problems with open interest and liquidity – harming our ability to write and hedge milk forward contracts with our members. This would hamper our efforts to assist them in managing their dairies' financial risks at a time when volatility is increasing and the demand from our members for these programs is increasing.

- Additionally, Class III hedgers are limited to a single position limit that in capsules both futures/options and swaps. Since Class III futures/options are cash settled, as are the swaps that we use, the position limit proposals sets one limit that combines both types of hedges. This is discriminatory in view of physically deliverable agricultural futures contracts that use cash-settled swaps, have separate position limits for futures and another for swaps.

- The exchanges should continue to be involved in providing hedge exemptions for bonafide hedgers.

- Commodity trade options should be excluded from the positions limit rule.

Class III is a Unique Commodity

Class III is the Federal Marketing Order classification for farm milk that is used to make cheese. Class III is a cash settled futures contract that settles to a Class III cash price that is determined by the United State Department of Agriculture (USDA). Class III futures do not have issues with price discovery, convergence, congestion or threat of market corners.

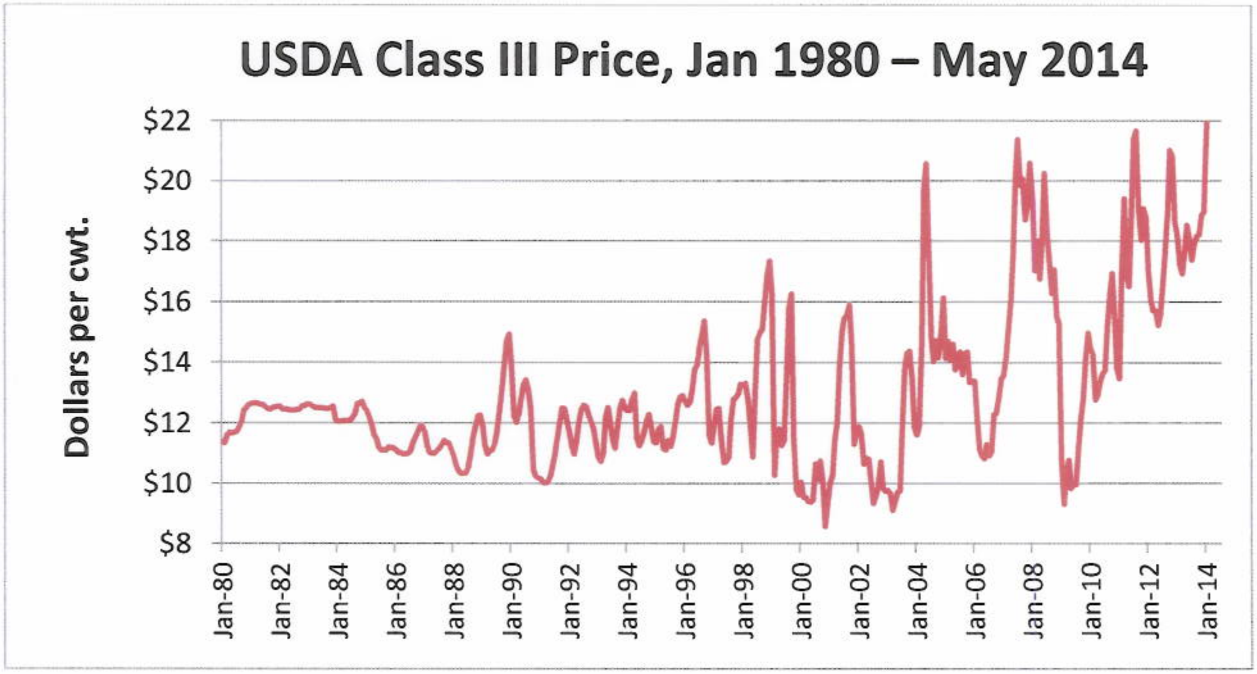
Class III futures prices are not the price discovery mechanism for Class III cash prices. Instead, Class III cash prices are derived from a formula that uses two types of American cheese prices, a butter price and a dry whey price. These four prices are called Class III "product prices". These product prices are determined by USDA by surveying and collecting spot month cash prices paid on spot wholesale transactions.

A large majority of Class III hedges are held to final settlement and the futures price will always settle to the cash price as announced by USDA. Holding until final settlements helps to "perfect" the hedge. Due to this, and that fact that Class III futures are not physical delivered there is no congestion issues in the front and spot months.

Class III milk is produced daily, year round and marketed daily or every other day. Loads of Class III milk are highly perishable and will spoil in a matter of days if not processed into cheese.

Federal sanitation laws prohibit the storage of raw milk beyond 72 hours. The perishability and sanitation laws make it impossible to inventory loads of Class III milk to impact futures prices or corner the market.

Dairy cows produce milk every day. Typically a dairy farmer will milk their cows twice per day, although some will milk them three or four times during the day. Class III milk is highly perishable. Due to this, it has to be marketed on a daily or every other day basis and utilized in the manufacturing process as quickly. The Class III cash milk price is determined monthly and the factors that impact the price change daily and are impacted by global supply and demand factors. This results in milk prices changing each month and being highly volatile. The attached graph shows a diagram of monthly Class III prices for the past 35 years.

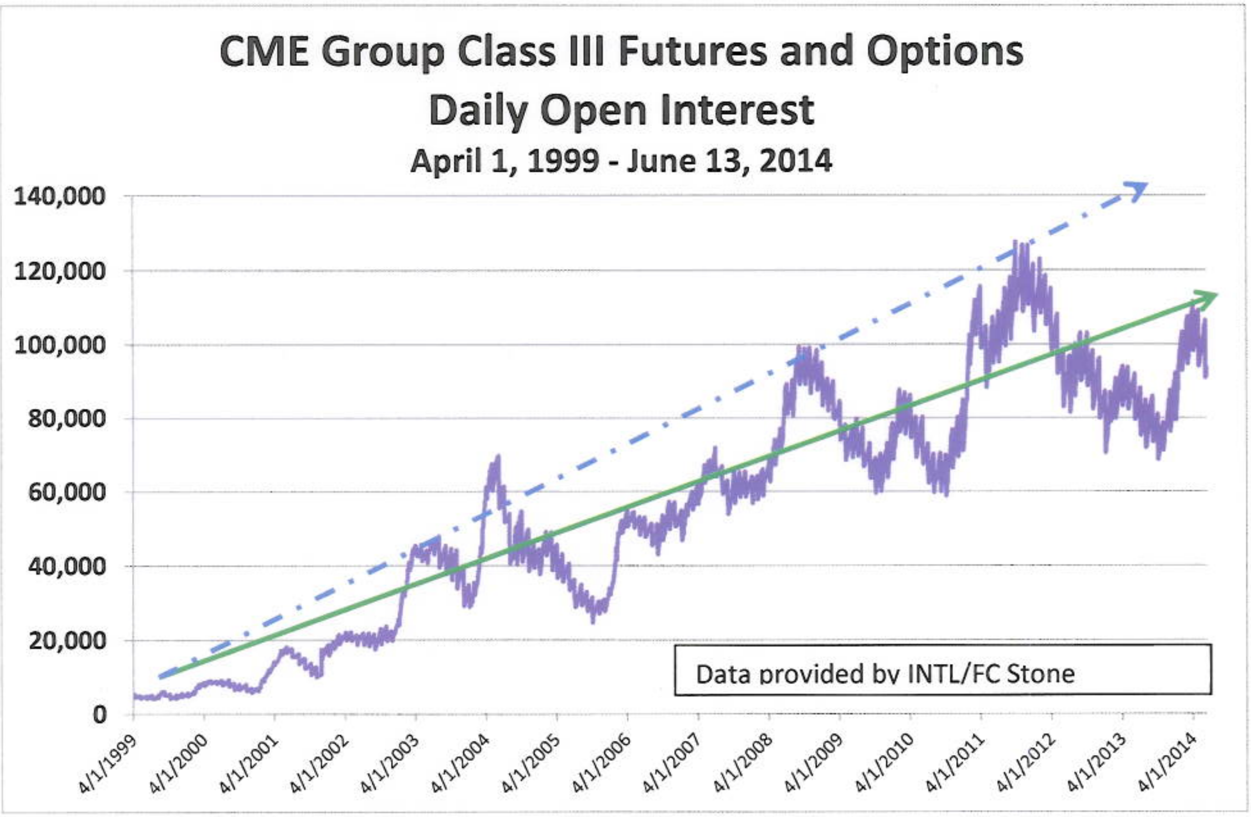


The monthly price volatility generates a need for dairy producers, manufactures and end users to hedge their milk price risk well beyond the first few contract months. It is common for dairy farmers to hedge Class III prices for 6 – 18 consecutive months. Presently, our Class III forward contracting program has assisted some of our members in hedging their Class III milk price for each month in 2015.

DFA's dairy farmer members use our milk price forward contracting program to manage the financial risks on their dairies. Our programs allow them to manage their milk price risk – the milk price makes up most of their revenue – without the concerns of funding a brokerage account. This frees up their lines of credit to be available for use on operating expenses and capital needs. Since DFA is member-owned, they understand that we are working on their behalf and through our milk marketing and member services programs and we have developed a trusting and positive relationship with them. These factors have contributed to many of our members using our forward contracting programs which results in DFA using Class III derivatives to hedge the forward contracting risk of hundreds of our members.

Class III Open Interest Will Grow

Class III futures and options open interest continues to be on a growth trend. As inter-country dairy trade barriers have been lowered or removed and manufacturer, end user and dairy farmer consolidation has increased- increasing business-specific financial leverage, milk price volatility and business-specific financial risk has increased considerably. The use of Class III as a means of mitigating price volatility will grow in importance, and if nurtured correctly, will result in considerable growth in the use of Class III derivatives. The following chart shows Class III futures and options open interest – over time – and depicts the recent growth.



Since 2004, each spike in open interest has coincided with record high milk price for that time. As milk prices rise, and dairy farmers can lock into profitable margins, the use of Class III derivatives increases. When futures prices are not sufficient to protect a profitable margin by dairy farmers, open interest declines. Since 2011, CME Group cheese futures have grown in demand by manufacturers and end users. With Class III being the milk price for plants making cheese, the advent of cheese futures and their popularity with some cheese manufacturers, the Class III growth curve has slowed. As the above chart shows, the slope of the growth line is not as steep, but is still increasing (see chart above where the dotted line shows the prior growth line and the solid line shows the current growth line).

The use of our forward contracting program by members is at an all-time high. That said, only about 15 percent of our members' milk is contracted under our forward contracting program – an increase from about 10% in years past. Over the next five years, DFA's members' use of our program will continue to increase and contracted milk in excess of 20% of our members' milk marketings is likely. I believe that Class III derivative use by non-DFA dairy farmers will increase, as well.

If nurtured appropriately, within five years the Class III open interest will exceed the 2014 open interest of Class III and cheese combined, which exceeded the combined totals for 2011, because price volatility, business consolidation, financial leverage and the attending risk will not abate but instead increase – increasing the need to utilize Class III derivatives.

Liquidity Providers Necessary to Facilitate Class III Derivative Growth

Liquidity providers play an important role in providing workable and efficient derivative markets. This is no less the case for Class III as for any other market. Our earlier comments provided data that attempted to show that liquidity providers were not yet prominent users of Class III. However, DFA's experience has seen a modest increase in market makers entering the dairy derivatives complex, recently. We are concerned that position limits that are narrowed will discourage new liquidity providers from entering the dairy complex and could reduce activity by those presently active in the Class III market. This could undermine the ability for the Class III futures market to grow to meet the expanding needs of bonafide hedgers. Similarly, position limits that are not broad enough can also be harmful to growth in Class III liquidity.

Presently, there are a few liquidity providers serving the Class III derivatives market. These liquidity providers support a larger number of bonafide hedgers. We need these liquidity providers to have ample room to support those of us looking to them to provide additional liquidity allowing our bonafide hedging programs to grow as demand for these programs grows.

In setting Class III position limits, it would be prudent to err on the liberal side as opposed to risk stifling bonafide hedging demand by erring on the conservative side.

The Position Limits Rule Does Not Expand Class III Position Limits as it Regulates Swaps

There are no position limits on Class III swaps, as of this writing. Putting this in perspective, it means that position limits on Class III swaps are an infinite factor times the position limits for futures. Congress has required the CFTC to place position limits on swaps. In doing so, it recognized that swaps are a legitimate derivative and allows swaps to be used.

A practical way of viewing the desire of Congress would be to place a position limit on futures and a position limit on swaps. As an example using Class III, if the intent was to reduce the infinite factor to "1X" the futures position limits, and using the current Class III position limits, there would be a 1,500 contract single month limit for futures and a 1,500 single month limit for Class III swaps.

In your proposed position limits rule, you chose to address the swap position limits by setting limits on physically settled and cash settled contracts – each having a position limit. Unfortunately, this approach discriminates against DFA, our members and the broader dairy industry since the Class III futures contract is cash-settled. Since Class III swaps are also cash settled, your proposed rule provides a "zero-X" factor for swaps. To be clearer, this means that you have not provided any allowance for Class III swap position limits for DFA and our members and others in the dairy industry that regularly exceed your proposed Class III position limits.

10% Plus 2.5% Formula Impractical for Class III

The proposed formula (10 percent of the first 25,000 open interest contracts plus 2.5% of open interest thereafter) to determine the non-spot month and all-months combined limits for Class III futures and swaps is impractical. This would provide a proposed non-spot month and all-months Class III limit of 3,400 contracts according to your calculations.

The Class III futures contract trades for 24-consecutive months. Presently, each month has a 1,500 contract individual month limit. There is no specified all-month limit. Since each month has a 1,500 contract limit, the all month limit would be 36,000 contracts (24 months times 1,500 contracts per month). Presently, we have a single month hedge exemption that exceeds 1,500 contracts. It is not unusual for our program to hedge our member and customer contracts and our own internal manufacturing needs and exceed 1,500 contracts for a number of months.

Limiting Class III position limits for all-months combined to 3,400 contracts is impractical considering how the members of DFA and other dairy cooperatives use Class III forward contracting programs. The 3,400 contract all-months limit may cover our hedging needs for a few months but is too low for our hedge positions that may go out 18 consecutive months or more. Limiting the all-months to 3,400 contracts may result in DFA filing CFTC Form 204 on a monthly basis. The data requested in Form 204 is very time consuming to develop, it would show nominal change from month-to-month. We view a scenario resulting in monthly submission of Form 204 as an unnecessary regulatory burden that was not intended by Congress. This scenario can largely be avoided by expanding Class III position limits beyond those currently proposed.

Failure to expand the all-months Class III position limit may reduce activity by liquidity providers and discourage new entrants. This would harm the ability for the Class III derivatives markets to grow to meet expected demand. It is vitally important to DFA and its members that the Class III all-months limit be expanded beyond the Proposed Rule level to support the growth in Class III derivatives.

We strongly suggest that the CFTC abandon the "10% plus 2%" formula as it relates to Class III.

Class III Spot Month Limits are Not Relevant

Since Class III futures are cash-settled, the spot month is the last few days prior to the contract settling and going "off the board". Because Class III futures and option contracts are cash settled and most are held until final settlement, the front month limit is of more importance than the spot month. Present Class III futures contracts have a single month position limit of 1,500 contracts. If you maintain a Class III front month limit, it should be at the same level as the spot month limit. Having a spot month limit lower than the front month limit would serve no purpose and would be disruptive, leading to increased price volatility immediately before and during the spot month and could result in bonafide hedgers closing out of their positions a few days prior to the announcement of the cash settlement price. Having a spot month limit that exceeded the front month limit would have no usefulness to bonafide hedgers. Transaction costs may be greater than the price risk during the few days of the Class III spot month.

The CEA Allows for Commodity-by-Commodity Regulatory Flexibility in Setting Position Limits

Congress and prior Commissions have long recognized a need for flexibility in determining commodity-specific position limits. The Commodity Exchange Act provides the Commission ***flexibility*** in setting position limits. Specifically 7 US Code, Chapter 1, Section 6(a) states: "Nothing in this section shall be construed to prohibit the Commission from fixing different trading or position limits for different commodities……”. The current regulatory structure resulting in the existing position limits has occurred by addressing the unique nature of each commodity and has not been administered via a rigid formulaic process that lacks creative flexibility, as needed.

Position Limit Request

DFA respectfully requests that the spot month and front month position limit be based on 25 percent of deliverable supply but be no less than 3,000 contracts – as requested in our earlier comments. Using your data, the 25 percent formula would result in a 5,300 contract spot month and front month limit.

Instead of using the 10% plus 2.5% formula to determine the all month limits, we suggest using a multiple of the spot month and front month limit. In arriving at the multiple, we have considered how dairy farmers utilize hedges and how we will need help from liquidity providers to match up against those hedges. As stated earlier, dairy farmers commonly take hedge positions that go out six to eighteen months. We will also need liquidity providers to have enough capacity to be able to extend out that far, in a meaningful way, before hitting their all-months position limit. The mid-point of the six to eighteen month range is 12 months. Presently, a Class III liquidity provider could cover 18,000 contracts (1,500 contracts per month times 12 months). The 18,000 contracts is a multiple of 3.4 times the spot month and front month limit of 5,300 contracts. Since the new position limits will also include Class III swaps, the position limit should be larger than 18,000 contracts. To provide some additional headroom for the fact that Class III derivatives are all cash settled, and there will not be an opportunity to have an additive position limit for futures/options and swaps, as there are in other agricultural commodities, the all month position limit should be at least a factor of 4 times the spot month limit, but no less than 12,000 contracts (the requested minimum level of 3,000 times four).

Agricultural Trade Options

The dairy industry uses a variety of marketing contracts to help balance the inherent seasonality of production and demand in milk markets. As stated in our February submission, these contracts are not derivatives. In the odd case that a marketing contract with imbedded delivery optionality were construed to be a derivative, the volume in such a contract should not be included in the accumulator determining a position limit for Class III.

February 10, 2014 Comments

DFA continues to support our comments about the Position Limits Proposed Rule filed on February 10, 2014 and provide these supplemental comments to further clarify our prior recommendations.

In closing, we appreciate the opportunity to provide additional clarity to our earlier comments and support the efforts of the Commission as they work with DFA and others to implement the derivative market regulatory reform brought about by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Sincerely,

Edward W. Gallagher

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