Dairy Farmers of America

September 20, 2010

VIA E-MAIL: dfadefinitions@cftc.gov

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51429 (August 20, 2010)

Dear Mr. Stawick:

Dairy Farmers of America, Inc. ("DFA") respectfully submits these comments in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") and Securities and Exchange Commission's August 20, 2010 Advance Notice of Proposed Rulemaking (the "Advance Notice") regarding key definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] In addition to its individual comments, DFA supports the comments of the National Council of Farmer Cooperatives ("NCFC") as they relate to the Advance Notice. DFA is a long-time member of the NCFC and has been working with the NCFC and its other member cooperatives on issues relating to the Dodd-Frank Act and the Commission's implementing regulations.

As the CFTC begins the process of implementing the Dodd-Frank Act, DFA appreciates the CFTC's request for comments and the opportunity to address the impact that certain key definitions, including the definitions of "swap," "swap dealer," and "major swap participant" potentially will have on the business operations of end users of swaps. The definition of "swap" expressly includes "agricultural swaps" and "commodity swaps", although it is not clear exactly what rules will apply to agricultural swaps. Section 723(c) (Grandfather Provisions) provides:

> a person may offer to enter into, enter into, or confirm the execution of, any swap in an agricultural commodity pursuant to section 4(c) of [the CEA] or any rule, regulation, or order issued thereunder (including any rule, regulation, or order in effect as of the date of enactment of this Act) by the [CFTC] to

[1] Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act in 7 U.S.C. ch. 1 (the "CEA")) ("Dodd-Frank Act").

> allow swaps under such terms and conditions as the Commission shall prescribe.

Although it is not clear that all of the provisions of the Dodd-Frank Act apply to agricultural swaps, DFA respectfully requests that the Commission define the terms “swap”, “swap dealer” and “major swap participant” in a manner that, consistent with Congress’s intent, exempts end users, like DFA, who primarily use swaps to hedge commercial risk. Failure to do so likely will materially increase the costs associated with entering into swaps, and thus reduce the benefits that DFA’s farmer member-owners can achieve through hedging. If cooperatives and farmer members were required to conduct all of their hedging activities with cleared swaps and incur higher margin costs, they would have less capital available to continue their farming, marketing and processing operations.

DFA looks forward to working with the CFTC throughout the upcoming rulemakings to help design a regulatory framework that enables end users to hedge the risks related to agricultural production and marketing in a cost-effective manner. This ultimately protects consumers from increased prices that likely will arise if producers are unable to effectively engage in important risk management and hedging activities.

I. DESCRIPTION OF DFA AND ITS INTEREST IN THE ADVANCE NOTICE

A. DFA Hedges the Commercial Risk Associated with the Milk it Markets for More than 17,000 Dairy Farmer Member-Owners

DFA is a farmer-owned dairy marketing cooperative. DFA’s core business is marketing the milk of its more than 17,000 member-owners. DFA has a diverse membership spanning the continental United States. DFA’s member-owners include small traditional farms (such as a 50-cow member-owner in Pennsylvania), mid-size farms (such as a 350-cow member-owner in Wisconsin) and larger farms with 1,000 or more cows. This diversity in member-owners requires DFA to offer a broad range of tools to meet their risk management needs. DFA is passionately committed to providing marketing programs and business services to ensure the success of its members-owners’ businesses. In doing so, DFA provides important risk management services to help members mitigate the commercial risk associated with the high volatility in milk and input prices. Much of this volatility is fairly new to the dairy industry and has increased more recently with the advent of a growing and substantial global dairy market emanating from reduced trade barriers and increased feed price volatility emanating from the Federal ethanol policies. DFA offers to its members a forward contracting program as a primary means of mitigating commercial risk. As one alternative under the forward contracting program, DFA offers its member-owners a fixed price for their milk and a hedge on their feed purchases. DFA does this through the use of a “milk-over-feed margin contract,” which allows a farmer to lock in a margin between the Class III milk price and the price of feed.

DFA uses the futures markets, and to a smaller extent, over-the-counter (“OTC”) swaps to enable it to provide fixed-price certainty to its members through its forward contracting program. These risk mitigation tools are critical for DFA’s farmers. For example, a 50-cow farm that purchases one third of its feed each month typically may need to hedge about 300 bushels of corn and 2.5 tons of soybean meal per month. This farmer would not be able to use the futures markets to hedge its input risk because of the larger volumes underlying the relevant futures contracts and because the corn and soybean contracts do not trade on a monthly basis.[2] However, through DFA's forward contracting program, DFA can offer a more customized solution for its farmer member-owners. Yet, DFA can only provide this service to its member-owners because of its ability to enter into swaps for customizable volumes and time periods different from the applicable futures contract. DFA's mid-size and larger farmers also rely on DFA's ability to enter into swaps. Even though they may purchase larger volumes of inputs like corn and soybean meal, they rely on DFA's ability to enter into a monthly swap because corn and soybean meal futures contracts do not trade on a monthly basis. Additionally, these larger farms may not have corn and soybean meal volumes that equate precisely to one or more futures contracts.

DFA fully supports the CFTC's stated mission to protect consumers by bringing more transparency and oversight to the OTC derivatives markets. DFA also recognizes the complexity involved in such significant reform and submits its comments to ensure that the CFTC has a fuller understanding of how to craft its implementing regulations in order to reduce any unintended negative impacts on dairy farmers. In a period of history when milk and input price volatility has increased substantially, and when member margins have, in some years – like 2009 – declined so severely as to create significant business continuity risk, DFA asks that the Commission do whatever it can to protect the ability of DFA's member-owners to manage commercial risks. Although DFA's swap activity is small in both transaction number and dollar volume relative to DFA's futures activity, the growing price volatility in milk, feed, fertilizer, energy and other input prices will result in a growing demand from our member-owners to help them mitigate these risks by using innovative hedging methods tailored to their diverse sizes and needs. In many cases, the only opportunity to hedge this risk will be via swap transactions. It is important that DFA be treated as an end user of swaps, and that it be able to hedge commercial risks without added transaction, capital and margin constraints, because DFA aggregates and hedges the commercial risk of its farmer member-owners. DFA's swap transactions do not create systemic risk to the US economy. Quite the contrary, by helping to mitigate commercial risk of dairy farm businesses, it supports a stronger and growing national economy.

B. <u>DFA Hedges the Commercial Risk Associated with its Operation of Dairy Food Processors that Ensure a Market for its Dairy Farmer Member-Owners</u>

To ensure that all of DFA's member milk is marketed in a timely manner, DFA sells raw milk to more than 400 facilities and operates 20 dairy food processing plants that aid in the marketing of member-owner milk. DFA's member-owners jointly own these 20 processing plants and provide the equity to support their financing. These processing facilities build inventories of dairy commodities throughout the year that expose DFA to price risk in the event that prices decline before the products can be sold. DFA utilizes swap transactions to hedge the

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[2] The standard size for the corn futures contract currently listed on the CME Group, Inc. is 5,000 bushels and it trades in the following months: March, May , July, September and December. *See* CMEGROUP, CORN FUTURES (2010), *available at*: http://www.cmegroup.com/trading/agricultural/grain-and-oilseed/corn.html. The standard size for the soybean meal futures contract traded on the CME is 100 short tons, and it trades in the following months: January, March, May, July, August, September, October and December. *See* CMEGroup, SOYBEAN MEAL FUTURES (2010), *available at*: http://www.cmegroup.com/trading/agricultural/grain-and-oilseed/soybean-meal_contract_specifications.html.

price risks associated with its inventories as well as its inputs, including raw material ingredients, energy (which is used by its processing facilities) and diesel fuel (which is used by its milk haulers and product distribution trucks).

DFA's processing facilities produce more than 15 different dairy products. Because of the wide range of commodities, relatively low volumes of some products, and diverse pricing mechanisms used to market these products, DFA needs access to tailored hedging contracts to protect against price volatility. For example, an important byproduct of cheese production is whey protein concentrate 34 ("WPC-34"). There is no WPC-34 futures contract, and there is no meaningful correlation between WPC-34 and whey futures. DFA may enter into a fixed price forward contract for WPC-34 with a customer and then enter into a swap to hedge the risks associated with the forward contract.

These hedging programs mitigate the financial risk that our member-owners have with respect to these plants. As a cooperative, the cumulative profits and losses generated by the cooperative's business activities are passed back to the member-owners (who also market through the cooperative) on an annual basis either in the form of cash or equity ownership in the cooperative.

As commercial end users of swaps, DFA and its member-owners have an important interest in how the Commission defines the key terms listed in the Advance Notice, including the definitions of "swap," "swap dealer," and "major swap participant." The way in which the CFTC defines and interprets these terms likely will have a significant impact on the risk management options and financial stability of agricultural cooperatives and their members and, thus, their ability to provide a reliable supply of competitively priced agricultural products to consumers throughout the country.

II. AGRICULTURAL COOPERATIVES HEDGE AND MITIGATE COMMERCIAL RISK FOR THEIR MEMBERS

Congress made clear that it intended to treat end users differently than swap dealers and major swap participants because end users are hedging and mitigating commercial risk.[3] Agricultural cooperatives like DFA perform a number of important business functions for their member-owners.[4] These include marketing their members' agricultural products, supplying them with production inputs, and mitigating their commercial risk – both at the farm-level and with respect to its member-owned processing facilities. Agricultural cooperatives that enter into swaps with third parties or members in the course of marketing their member's agricultural

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[3] 156 Cong. Reg. H5248 (daily ed. Jun. 30, 2010) (Letter from Sen. Christopher Dodd and Senator Blanche Lincoln to Rep. Barney Frank and Rep. Collin Peterson ("Dodd-Lincoln Letter")) (emphasis added) ("In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business.")

[4] Agricultural cooperatives also include federated cooperatives and/or agricultural cooperatives whose members may also include other agricultural cooperatives.

products and operating processing facilities should, therefore, be treated as end users and excluded from the definitions of "swap dealer" and "major swap participant."

The CFTC has traditionally and consistently treated cooperatives as end users. For example, the CFTC and the exchanges provide cooperatives with bona fide hedge exemptions based on the products they produce and the products they market on behalf of their members.[5] CFTC Regulation 1.3(z) defines bona fide hedging transactions to include positions that arise from "the potential change in the value of assets which a person owns, produces, manufactures, processes, ***or merchandises***, or anticipates owning, producing, manufacturing, processing, ***or merchandising***."[6] As with bona fide hedge exemptions, where the CFTC looks through the cooperative to the member's underlying physical position, the CFTC should treat both the member and the cooperative as end users and should clarify that they are excluded from the definitions of swap dealer and major swap participant. There is no reason for the CFTC to treat cooperatives differently with respect to OTC swap contracts than it does with respect to futures contracts.

For the same reasons, the CFTC should clarify for purposes of the end user exception to clearing, that cooperatives that enter into swaps to hedge commercial risk, including the price risks associated with marketing member milk and operating processing facilities, are "using swaps to hedge or mitigate commercial risk," and are therefore exempt from the clearing requirement in Section 723 of the Dodd-Frank Act.[7]

III. AGRICULTURAL COOPERATIVES SHOULD BE EXCLUDED FROM THE DEFINITIONS OF SWAP DEALER AND MAJOR SWAP PARTICIPANT

A. <u>The Definition of Swap Dealer</u>

The Dodd-Frank Act defines "Swap Dealer" to include any person who:

(i) holds itself out as a dealer in swaps;

(ii) makes a market in swaps;

(iii) regularly enters into swaps in with counterparties as an ordinary course of business for its own account; or

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5 DFA has received hedge exemptions from the CME for its activities hedging the commercial risk of its member-owners and member-owned plants.

6 17 C.F.R. § 1.3(z) (2010) (emphasis added).

7 Dodd-Frank Act § 723(a)(3). The end user exception applies to non-financial end users who use swaps to hedge or mitigate commercial risk, provided they notify the Commission that they generally meet their financial obligations associated with entering into swaps. Congress provided in Section 723(a)(3) that the CFTC may exempt farm credit system institutions having total assets of $10,000,000,000 or less from the definition of "financial entity," a term that is used to limit the end user exception. In order to protect agricultural end users from treatment as financial entities, the CFTC should expressly exempt farm credit system institutions because many farmer-owned cooperatives also have affiliated farm credit institutions that further assist the cooperative in managing the commercial risks of its farmer owner-members.

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps….[8]

Cooperatives that enter into swaps to hedge commercial risk, including risk related to marketing their members' agricultural products and operating processing facilities, are not financial dealers or market makers. They do not hold themselves out as willing to make a market in swaps or as dealers in swaps. Rather, as end users, they use swaps to hedge the commercial risks related to their member farms and processing facilities.

Moreover, the definition of "Swap Dealer" includes two express exemptions that also should apply to cooperatives. The first exemption is for those who "enter into swaps for such person's own account, either individually or in a fiduciary capacity, but not as part of its regular business."[9] The CFTC should clarify that this exemption applies to cooperatives, whose primary business is marketing member products, but who enter into swaps with members and third parties to hedge the price risks associated with such products.

The second exemption is for those who engage in a "*de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers."[10] The CFTC should clarify that the quantity of transactions to be considered for purposes of the "*de minimis*" threshold excludes transactions that cooperatives enter into with third parties and members to hedge the price risks associated with marketing member milk and operating processing facilities. This is consistent with the CFTC's traditional treatment of cooperatives, including with respect to providing bona fide hedge exemptions that allow cooperatives to exceed speculative position limits for purposes of hedging the risks associated with their members' products.[11]

B. <u>The Definition of Major Swap Participant</u>

The Dodd-Frank Act defines "Major Swap Participant" to include any person who is not a swap dealer and who:

> (i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding—(I) positions held for hedging or mitigating commercial risk; …
>
> [or]
>
> (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets….

8 *Id.* § 721(a)(21) (to be codified at CEA § 1a(49)(A)).

9 *Id.* § 721(a)(21) (to be codified at CEA § 1a(49)(C)).

10 *Id.* § 721(a)(21) (to be codified at CEA § 1a(49)(D)).

11 *See* 17 C.F.R. § 1.3(z) (2010) and Section III above.

(B) DEFINITION OF SUBSTANTIAL POSITION.—For purposes of subparagraph (A), the Commission shall define by rule or regulation the term 'substantial position' at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.[12]

Positions held for hedging or mitigating commercial risk are expressly excluded from the term "substantial position." The CFTC should expressly recognize that swaps that cooperatives enter into in order to hedge commercial risks, including those related to marketing their members' agricultural products and operating processing facilities, constitute "positions held for hedging or mitigating commercial risk," and thus are excluded from the calculation of "substantial position." This is consistent with the CFTC's treatment of a cooperative's futures position for purposes of providing hedge exemptions to allow the cooperative to exceed speculative position limits. Whether a person has a "substantial position" in swaps should be determined only by looking at a person's speculative position in uncleared swaps for which no collateral has been provided to protect against counterparty credit risk.

The CFTC also should clarify that commercial end users, such as DFA, are not "systemically important" and cannot significantly impact the financial system of the United States. As Representative Peterson mentioned in a colloquy on the House floor, "[i]n crafting the House bill and the conference report, we focused on creating a regulatory approach that permits the so-called end users to continue using derivatives to hedge risks associated with their underlying businesses…. End users did not cause the financial crisis of 2008. They were actually the victims of it."[13] It is intuitive that using swap transactions to hedge commercial risk reduces the likelihood of business failure, and thus supports economic activity as opposed to harming it.

IV. THE FORWARD CONTRACT EXCLUSION FROM THE DEFINITION OF "SWAP" SHOULD BE INTERPRETED CONSISTENTLY WITH THE CFTC'S PRIOR FORWARD CONTRACT INTERPRETATIONS AND PRECEDENT

In the Dodd-Frank Act, Congress expressly excluded from the definition of swap, any "sale of a nonfinancial commodity or security for deferred shipment or delivery, *so long as the*

[12] Dodd-Frank Act § 721(a)(16) (to be codified at CEA § 1a(33)).

[13] Cong. Rec. H5245 (daily ed. Jun. 30, 2010) (statement of Rep. Peterson).

transaction is intended to be physically settled."[14] This provision is similar to the forward contract exclusion from the definition of "future delivery."[15]

The Commission should interpret this exclusion from the definition of "swap" consistently with the Commission's prior guidance with respect to excluded forward contracts. It is very important that the CFTC provide consistent guidance in order to increase legal certainty with respect to this foundational term. This is consistent with Congress's expressed intent. In fact, the Chairs of the Senate Banking and Agricultural committees stated in a joint letter that:

> In implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject . . . .[16] nderstanding what constitutes an excluded forward contract is critical in order for farmer cooperatives to continue to be able to offer hedging alternatives for farmer members. The CFTC should, therefore, provide as much certainty as possible about what constitutes an excluded forward contract. Forward contracting allows farmers to price their product into the future, take positions to try to maintain a profit margin, and protect agains the unknown but potentially negative impact of adverse price fluctuations.

For example, the CFTC should continue to treat as forward contracts those that require delivery but provide for some price flexibility (*i.e.*, embedded options).[17] DFA's members rely on forward contracts that allow some measure of "upside" price opportunity. These types of programs include minimum price forward contracts and minimum/maximum price forward contracts. These "upside" price contracts allow members to increase their forward contract price when the price of milk increases. These contracts now represent more than 50 percent of DFA's forward contracting volume – when, just a few years ago, members locked in a fixed price nearly 100 percent of the time, with no opportunity to capture increases in the price of milk. DFA's member-owners rely on DFA's forward contracting programs for a number of reasons, including lack of available capital to fund a futures account, the mismatch in volume and products offered as futures contracts, and ease of transaction execution. DFA has recently increased the volume

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[14] Dodd-Frank Act § 721(a)(21) (to be codified at at 7 U.S.C.CEA § 1a(47)(B)) (emphasis added).

[15] The CEA grants the CFTC jurisdiction over "transactions involving contracts of sale of a commodity for future delivery." CEA § 2. Moreover, the CEA provides that "the term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery." *Id.* § 1a(19). This is generally referred to as the "forward contract exclusion."

[16] 156 Cong. Rec. H5249 (Dodd-Lincoln Letter).

[17] *See, e.g.*, *In re Cargill, Inc.*, 2000 CFTC LEXIS 260; Comm. Fut. L. Rep. (CCH) P28,425, at *19 (ALJ 2000) (in which the ALJ found that the contracts at issue were not options because both parties were required to perform if the conditions in the contract were met, *i.e.*, if the grain price reached the strike price).

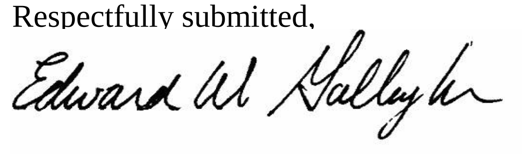
of milk hedged through its forward contracting program. Without it, many members would not be able to adequately mitigate their risks.

V. CONCLUSION

DFA commends the Commission for its commitment to safeguarding the hedging and trading activities of agricultural end users of physical commodities and swaps, and agricultural cooperatives in particular, and looks forward to working with the Commission throughout the Dodd-Frank Act rulemaking process. As explained herein, we encourage the Commission to define the Dodd-Frank Act's key terms to exclude commercial end users. We welcome the opportunity to discuss these issues further with the Commission and its Staff.

Please contact me or my colleague, Renee Cool, at (888) 332-6455, if you have any questions regarding DFA's comments.

Respectfully submitted,



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