Dairy Farmers of America

February 22, 2011

VIA ELECTRONIC SUBMISSION

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

Re: End-User Exception to Mandatory Clearing of Swaps, RIN 3038–AD10; and Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," RIN 3038–AD06

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") December 23, 2010 proposed rule on the End-User Exception to Mandatory Clearing of Swaps ("End-User NOPR")[1] and December 21, 2010 joint proposed rule on Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" ("Swap Dealer NOPR").[2] DFA also repeats, and incorporates herein, its comments filed with the CFTC on September 20, 2010 and October 28, 2010. Appreciating that the process for proposing and implementing regulations under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is ongoing, DFA reserves the right to supplement these comments upon further regulatory developments.

DFA appreciates the CFTC's request for comment and the opportunity to address the appropriate conditions, restrictions, or protections to be included in any rule, regulation, or order governing the trading of agricultural swaps.

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1 75 Fed. Reg. 80,747 (Dec. 23, 2010).

2 75 Fed. Reg. 80,174 (Dec. 21, 2010).

<u>Overview</u>

DFA supports the efforts of the Commission as it implements the economically important regulations stemming from the Dodd-Frank Act. Clearly, regulation of large, systemically important swap dealers is necessary to safeguard the US economy and to promote competition. As the Commission deliberates on these issues and the implementation of the Dodd-Frank Act, we ask that it maintain a balanced view that incorporates the public interest, the regulatory need, and the federal cost, and that also allows businesses to flourish economically.

DFA and other agricultural cooperatives, by our very nature, operate in a manner that reduces farm-level business risk and promotes business prosperity for family farms across the US. Our businesses and our member-owners were not the cause of the financial crisis that undermined all of our economic opportunities. Instead, we were among the victims. As such, we urge the Commission to bring the right balance that supports our continued and collective efforts that have made the US agricultural sector a strategically important component of our national economy, and the marvel of production growth and efficiency, worldwide.

To this end, we ask that:

- forward contracting programs continue to be excluded from regulation under the Dodd-Frank Act;
- agricultural cooperatives continue to be treated as end-users for purposes of the end-user clearing exception; and
- margining requirements not be imposed on swap dealers with respect to swaps entered into with end-users who elect not to clear the transaction because it is likely that swap dealers will pass this obligation through to end-users.

<u>DFA's Ownership Structure and Core Business</u>

DFA is the leading milk marketing cooperative in the US. It is owned and governed by more than 17,000 dairy farmers operating in each of the 48 contiguous states. These farms and their operations are quite diverse. Our membership includes small traditional farms (such as a 50-cow member-owner in Lancaster, PA), mid-size farms (such as a 350-cow member-owner in Wisconsin), and larger farms with 1,000 or more cows. Despite this diversity, each has the following in common, in that they all:

- provide management and labor from family members;
- are owners of DFA;
- have the ability to take part in the governance of DFA's business operations; and

- receive patronage and equity distributions on any and all earnings made by DFA during a given year.

Dairy farmers market their milk on a daily or every-other day basis. Our members rely on DFA to handle the marketing function – ensuring that their milk is delivered to a milk plant (which sometimes is a DFA-owned and operated milk plant), and that members receive a competitive price for their milk.

DFA owns and operates 20 dairy manufacturing facilities throughout the US. The profitability of these manufacturing facilities directly affects DFA's farmer member-owners. Seasonality of milk causes production of some commodities to be greater than the current demand. DFA, therefore, enters into swaps with various counterparties in order to hedge the inventory and raw material risks associated with the manufacture of various DFA-produced dairy products. Oftentimes, these swaps are for commodities that are less than the full size of an exchange-traded contract, which creates the need for a variety of risk management tools, including access to exchange-traded markets and swap markets (especially for those dairy products that do not have an exchange-traded contract).

DFA's milk-marketing and manufacturing activities comprise DFA's core business and utilize most of DFA's management, employee and capital resources.

DFA Farm Services Overview

Profitability on a dairy farm is more than a function of milk price. It is also a function of production cost and cash flow. To this end, DFA offers a variety of Farm Services to assist our members in being more profitable. These include production input buying services, health and workers' compensation programs, programs to promote energy efficiency and on-farm energy production, programs to promote low-input grazing strategies, and risk management services, to name a few. The Farm Services programs are important ancillary services offered by DFA to its members, but are all far smaller than our core milk marketing business.

The Importance of DFA's Forward Contracting Programs

One of DFA's most widely used and popular Farm Services is our milk price forward contracting program. Our forward contracting programs have matured over the years and now include not only fixed-price forward contracts, but also forward contracts that provide farmers with flexible pricing alternatives for their milk, including adjustments based on the cost of production inputs. For example, one popular program is a minimum milk price forward contract that places a floor under the milk price. We also have begun writing milk price forward contracts that include adjustments for changes in feed prices.

Given the rising prices and volatility for inputs like livestock feed since the implementation of federal ethanol mandates and the growth in feedstuff demand from China and emerging market economies, we expect these milk-feed forward contracts to grow in importance and use among our members. All dairy farmers purchase livestock feed to supplement home-grown feed. This is the number one cost input on dairy farms and can represent more than 50 percent of production costs on farms that cannot afford to buy land to grow a large proportion of their feed. Today's dairy farmer needs to be able to simultaneously manage the price risks associated with the sale of its milk, as well as the purchase of feed, in order to secure a profitable margin or margin safety net.

DFA operates one of the more innovative milk price forward contracting programs in the US. Our program has gained the respect and admiration of members, other dairy farmers, other milk cooperatives and companies, the agricultural lending industry and the wider agri-business community. Our programs provide real economic value to members that would otherwise struggle to manage their milk price and input price risk, or worse, stop doing so altogether. They provide a means for our members to mitigate their operational risk and create a much more financially stable milk production sector. Many of our farmer member-owners cannot hedge their milk price risk directly in the futures market because their monthly milk production is less than a futures contract size. Similarly, many of our members cannot hedge their feed price risk directly in the futures markets because the corn and/or soybean meal quantities that they purchase monthly often are (1) less than futures market contract sizes, and (2) inclusive of months that do not trade in futures contracts. It is, therefore, vitally important to the financial health and well-being of our members that they continue to be able to use our forward contracting programs to help them hedge the commercial risk involved in operating a dairy farm.

<u>DFA's Use of Swaps to Mitigate Its Physical Commodity Price Risk</u>

DFA is able to provide these forward contracts to its members because it can aggregate the physical commodity price risk that it takes on from members and hedge that risk by entering into swaps with other businesses, which may include agri-businesses and financial institutions, among others.[3]

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[3] DFA has a general concern that the Commission has set what we view as commercially impracticable threshold levels for qualification for the *de minimis* exception from the definition of swap dealer, which may have an impact on the number of counterparties that can or will be willing to execute swaps with end-users like DFA. The Commission should consider adopting a *de minimis* exception with higher threshold levels than those proposed in the Swap Dealer NOPR to mitigate the impact on end-users.

Although we have chosen to focus on milk and feed price risk as it relates to our member-owners, our plant and marketing operations also enter into swap transactions. For instance, our plant operators may want to hedge the price risk of buttermilk powder (to lock in a sale price or protect inventory values), which has no corresponding futures market or strong price correlation with any existing dairy futures contract. To mitigate this physical commodity risk, our plant operators would seek to hedge via a swap transaction. Swap transactions also are used by plant operators to hedge fuel and other energy and input price risk. Due to the nature of our ownership and governance structure, our plant and marketing level hedging programs seek to mitigate risks that otherwise would be borne by our member-owners. As such, these swap transactions are a natural extension of our members' farm business.

The End-User Exception

The CFTC should clarify that agricultural cooperatives, like DFA, qualify for the end-user exception from clearing with respect to the swaps they enter into to hedge the risks associated with their processing plants and member-owner milk production. The CFTC has traditionally and consistently looked through the cooperative to the members' underlying physical position, and treated both the member and the cooperative as end-users. For example, pursuant to CFTC Regulation 1.3(z), 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.[4] 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*."[5] DFA agrees with the Commission's proposal to continue to treat as bona fide hedges those transactions that have been considered hedges under Regulation 1.3(z).[6] There is no reason for the CFTC to treat cooperatives differently with respect to over-the-counter swap contracts than it does with respect to futures contracts. Moreover, DFA needs to be able to hedge the aggregate physical commodity price risk it takes on through forward contracts with member-owners. For these 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

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

5 17 C.F.R. § 1.3(z)(i) (2010) (emphasis added).

6 75 Red. Reg. at 80,757 (Proposed Rule 36.9); 75 Fed. Reg. at 80,214-15 (Proposed Rule 1.3(ttt)).

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]

Additional Margin and Clearing Concerns

Although DFA clearly does not fit within the definition of "swap dealer," as it only enters into swaps to hedge the physical commodity risks associated with the forward contracts it enters into with members and DFA's plant operations, it also submits these comments in response to the Swap Dealer NOPR to underscore one critical point. As Chairman Gensler recently commented in his testimony before the House Agricultural and House Financial Services Committees, margin requirements should not be imposed on swap dealers with respect to swaps they enter into with end-users who opt not to clear the swap.[8] As Chairman Gensler stated:

> Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. Transactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities . . . . Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.[9]

Moreover, if margin were imposed on swap dealers with respect to these transactions, the swap dealer likely would pass that requirement through to the end-user. As an end-user, DFA appreciates having the alternative to require the clearing of trades in certain instances. However, we ask that the CFTC not impose a margining requirement on swap dealers with respect to uncleared end-user swaps because this would raise our hedging costs – which ultimately would increase costs for our member-owners. Additionally, these margin requirements may exceed the

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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.

8 Testimony of CFTC Chairman Gary Gensler before the House Committee on Financial Services, February 15, 2011; Testimony of CFTC Chairman Gary Gensler before the House Committee on Agriculture, February 10, 2011.

9 *Id.*

capital available for our forward contracting programs. Both of these issues, cost and capital, could curtail our ability to offer customized hedging programs to our membership.

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 appreciates the opportunity to work with the Commission throughout the Dodd-Frank Act rulemaking process. 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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