Statement of
Scott Cordes
President, CHS Hedging

Testimony before the House Committee on Agriculture
Subcommittee on General Farm Commodities and Risk Management

July 24, 2013

Chairman Conaway, Ranking Member Scott, and members of the committee, thank you for the invitation to testify today on reauthorization of the Commodity Futures Trading Commission (CFTC) and key issues concerning the agriculture industry's ability to use and offer risk management tools.

I am Scott Cordes, President of CHS Hedging, a commodity brokerage subsidiary of CHS Inc. CHS is a farmer-owned cooperative and a grain, energy and foods company. We are owned by approximately 55,000 individual farmers and ranchers, in addition to about 1,000 local cooperatives who represent another 350,000 producers. You might also be interested to know I grew up on a grain and dairy farm in Southeastern Minnesota that my brother still operates today.

Today, I am testifying on behalf of the National Council of Farmer Cooperatives (NCFC). NCFC represents the nearly 3,000 farmer-owned cooperatives across the country whose members include a majority of our nation's more than 2 million farmers.

Farmer cooperatives – businesses owned, governed and controlled by farmers and ranchers – are an important part of the success of American agriculture. They are a proven tool to help individual family farmers and ranchers through the ups and downs of weather, commodity markets, and technological change. Through their cooperatives, producers are able to improve their income from the marketplace, manage risk, and strengthen their bargaining power, allowing them to compete globally in a way that would be impossible to do individually.

In particular, by providing commodity price risk management tools to their member-owners, farmer cooperatives help mitigate commercial risk in the production, processing and selling of a broad range of agricultural, energy and food products. America's farmers and ranchers must continue to have access to new and relevant risk management products that enable them to feed, clothe and provide fuel to consumers here at home and around the world. Last year's drought across much of the country, which impacted so many producers so severely, once again illustrates the need for a multilayered risk management strategy in agriculture.

Cooperatives' Use of Derivative Markets

As processors and handlers of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of the futures exchanges, as well as the over-the-counter (OTC) derivatives markets. They use exchange traded futures and options and OTC derivatives to hedge the price risk of commodities they purchase, supply, process or handle for their members.

In addition to the exchange-traded contracts, OTC derivatives have become increasingly important to hedge price risks. Due to market volatility in recent years, cooperatives are increasingly using these products to better manage their exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces costs to the cooperatives and their farmer-owners. Swaps also play a critical role in the ability of cooperatives to provide forward contracts, especially in times of volatile markets. Because commodity swaps are not currently subject to the same margin requirements as the exchanges, cooperatives can use them to free up working capital.

OTC derivatives are not just used for risk management at the cooperative level, however. They also give the cooperative the ability to provide customized products to farmers and ranchers to help them better manage their risk and returns. Much like a supply cooperative leverages the purchasing power of many individual producers, or a marketing cooperative pools the production volume of hundreds or thousands of growers, a cooperative can aggregate its owner-members' small volume hedges or forward contracts. It can then offset that risk by entering into another customized hedge via the swap markets.

In addition, there are farmer-owned cooperative futures commission merchants (FCM), such as CHS Hedging, that provide brokerage services to farmers, ranchers, and commercial agribusiness. These operations perform a critical service of providing price risk management to a customer base comprised largely of physical commodity hedgers.

The Dodd-Frank Act

We greatly appreciate the ongoing oversight the House Agriculture Committee has provided as the Dodd-Frank rules have been written. Your work in encouraging the CFTC to ensure that the agriculture industry has affordable access to innovative risk management tools once the Act is implemented is commendable. With your continued leadership, we are hopeful that the agriculture industry will avoid being subject to a "one-size-fits-all" type of regulation intended for Wall Street.

As such, we have been working to ensure that the implementation of the Dodd-Frank Act preserves risk management tools for farmers, their cooperatives and others involved in the agriculture industry.

During the rulemaking process, NCFC has advocated for the following:

- Treat agricultural cooperatives as end users because they aggregate the commercial risk of individual farmer-members and are currently treated as such by the CFTC;
- Exclude agricultural cooperatives from the definition of a swap dealer;
- Acknowledge that forward contracts continue to be excluded from CFTC swap regulation;
- Maintain a bona fide hedge definition that includes common commercial hedging practices; and
- Consider aggregate costs associated with the new regulations and the impact on the agriculture sector.

We recognize the complexity in crafting rules for the implementation of Dodd-Frank that best fit cooperatives, and appreciate the work of the Commission in addressing many of our concerns in the rule-writing process. While we now know farmer cooperatives will be treated as end users and not swap dealers, there are additional questions and concerns that have arisen since many rules have been finalized and NCFC members have turned their attention to compliance.

As such, we are doing our best to put into place policies and procedures, but often find it a challenge to understand what exactly needs to be done to address the complex regulations. Given this situation, we also have concerns regarding how CFTC will enforce the regulations. We urge the committee to encourage CFTC to work closely with industry to ensure clear understanding by all parties before beginning any enforcement actions.

Costs to End Users

Uncertainty over ultimate costs and market liquidity is an ongoing concern for farmers and their cooperatives. Agriculture is a high-volume, low-margin industry, and incremental increases in costs, whether passed on from a swap dealer or imposed directly on a cooperative will trickle down and impact farmers. Taken one rule at a time, the costs may not seem unreasonable, but to those who have to absorb or pass on the collective costs of numerous regulations it is evident. Even as end users, significant resources must be used just to comply with the additional paperwork requirements. In fact, a number of NCFC members have had to greatly increase the amounts they have spent on compliance in the last two years on additional staff, outside assistance, and investments in technology.

It is also unclear how other costs will be forced down to end users and impact their ability to hedge. We fear an increased cost structure due to higher transaction costs (or because certain risk management tools cease to exist altogether) may discourage prudent hedging practices. For example, cooperatives often use swap dealers in utilizing the OTC market to lay off the risk of offering forward contracts to producers and customers. However, the costs associated with dealers' compliance with capital, margin and other regulatory requirements remain unclear.

Additionally, we are concerned with the so-called "Prudential Regulators" margin proposal requiring bank swap dealers to collect margin from end users. As end users, cooperatives use swaps to hedge interest rates, foreign exchange, and energy in addition to agricultural commodities. Often, cooperatives look to their lenders to provide those swaps. Under the proposed rule requiring end users to post margin, costs to businesses will increase as more cash is tied up to maintain those hedges. The additional capital requirements will syphon away resources from activities and investment in cooperatives' primary business operations.

Congressional intent was clear on this point—end users were not to be required to post margin. We appreciate the House of Representatives reaffirming this just last month by passing the Business Risk Mitigation and Price Stabilization Act.

Part 1.35 Recordkeeping Requirements

As a service to their customers, farmer-owned cooperative FCMs have a network of branch operations embedded in locations such as grain elevators, whose primary business is handling the cash grain volume of their producer customers. As a branch office of a cooperatively-owned FCM, these commercial grain elevators have chosen to provide brokerage services as a means of providing access to risk management tools for their farmer customers who want to hedge their production volume through futures and/or options.

Given the infrequent and low volume of futures/options transactions handled by "branches" associated with those FCMs, complying with the oral recording requirements (recording of all phone calls) under this regulation would not be economically feasible. The necessary investment to put in place and maintain a system to comply with the regulations would exceed not only any profits, but in many cases the total revenues of those FCM branches -- to the point that those local branches could no longer provide brokerage services. The effect would be reduced risk management options, and their use, by farmers and ranchers.

Moving forward, we intend to ask CFTC for a no-action relief to this regulation, well before the compliance deadline of December, on the basis that CFTC recognized the burden that the oral communications recordkeeping requirement would have on other smaller futures brokers. We hope that you will support our efforts in gaining this relief.

The Position Limits Rule

While the rule imposing position limits for swaps and futures was vacated by a court decision in September 2012, it is our understanding that CFTC is redrafting a new proposal. We continue to advocate that CFTC recognize common commercial hedging practices, such as anticipatory hedging and cross hedging, as bona fide hedges in that rule, and look forward to providing input when the proposal is made available for public comment. We would also encourage this subcommittee to keep a close eye on that definition as the rule is rewritten.

Other aspects of this rule have also caused some confusion among NCFC's members. One example is the section that addresses aggregation of positions for the purposes of hedge limits for entities in which ownership of another is 10 percent or greater (under the original rule), or 50 percent under CFTC's earlier re-proposal of the rule. Given the nature of independent risk management functions of subsidiaries or joint ventures of some of our cooperatives, it has caused further confusion over how each partner would communicate and share that information and/or account for each other's positions on a day-to-day basis.

The Forward Exclusion

Forward contracting allows farmers, cooperatives, and other businesses to price their product into the future, take positions to try to maintain a profit margin, and protect against unknown but potentially adverse price fluctuations. Therefore, understanding what constitutes an excluded forward contract is critical in order for businesses to continue their commercial supply and sales contracts.

We appreciate the guidance set forth regarding the forward exclusion in the product definitions rule. That guidance provided certainty about what constitutes an excluded forward contract, as forward contracts in nonfinancial commodities that contain embedded price options would be excluded forward contracts and not considered to be "swaps."

Recently, however, in light of the CFTC's seven-part interpretation in the rule, some NCFC members have raised concerns over the appropriate treatment of forward contracts commonly used in physical supply arrangements that contain volumetric optionality. If the CFTC were to take a narrow view of the seven-part interpretation, it may view as options many other routine physical supply contracts in which the predominant feature is delivery. [1] Such an interpretation would require those common commercial forward contracts to come under the regulations intended for swaps such as reporting and position limits.

The uncertainty of the CFTC interpretation of these types of contracts, all previously covered under the forward contracting exclusion, will require NCFC members to expend significant labor and costs to review hundreds of sales transactions to determine if they continue to meet the forward contract exclusion. Again, this is an unnecessary resource and cost burden on end users that should be avoided. We hope CFTC will interpret this exclusion consistently with its historical understanding and prior guidance.

Customer Protection

NCFC supports strengthening protections for futures customers. We appreciate the House Agriculture Committee's hearings on this issue and the work CFTC has done in proposing new rules in this area subsequent to the failure of MF Global and Peregrine Financial Group. However, we are concerned with the potential unintended consequences that a "one-size-fits-all" regulation may have on hedgers and smaller FCMs. The proposed rules do not take into account the type of FCM – by size, the risk profile of their customers, or whether or not the FCM also has proprietary trading or is a broker-dealer. In addition to increased costs for hedgers, this proposed rule would be more burdensome to smaller firms like farmer cooperative-owned FCMs, which largely deal only with hedgers.

Regulations that would accelerate a further consolidation in the FCM industry would have the adverse effect of leaving commodity hedgers with fewer options, while concentrating risk among

[1] Many commercial parties, including cooperatives, include some volumetric flexibility in physical supply agreements for both commercial and operational reasons. This allows them to address the uncertainty caused by likely changes in supply and demand fundamentals, including, for example, changes in suppliers and customers, transportation/vessel availability and capacity, operation and maintenance of a facility, and other commercial considerations that arise in the normal course of managing a physical commodity business. For example, some dairy cooperatives utilize volumetric flexibility in the sale of milk, both to minimize marketing costs and to balance supply and demand. It is not unusual for milk sales contracts to require a monthly range in deliverable volume. This is done to address the unknown supply and demand dynamics that will occur between seasons of the year (more milk is produced in the spring time than in the fall, while plant-level demand is greater in the fall as product is made for the holiday season). Additionally, dairy cooperatives that supply beverage milk plants need to have flexibility to divert deliveries to beverage plants during high demand parts of the week (beverage bottlers have their greatest demand on a Thursday to meet supermarket customers' heaviest grocery shopping period over the weekend).

fewer FCM entities. While the issues behind the decreasing numbers of FCMs are more complex than just regulatory burden, we are concerned with several aspects of the proposed regulations, including changes around capital charges, residual interest, and establishment of risk management systems under Rule 1.11, which will be financially and operationally burdensome for smaller FCMs.

One provision would require an FCM to take a capital charge with respect to any margin call that is outstanding for more than one business day, as opposed to the current practice of three business days. This proposed rule would clearly disadvantage smaller FCMs and many retail customers. Many smaller hedgers do not transfer funds by wire, but rather write checks. As such, it is common practice for farmer cooperative-owned FCMs to pay the clearing houses or the clearing FCMs in advance of receiving customer funds. By adding the additional capital charge after just one day, FCMs will possibly be forced to require their customers to wire transfer/ACH funds or maintain excessive funds in their account. The costs associated with either option would disproportionately affect smaller hedgers, while adding little in the way of added customer protection.

Another provision would require that an FCM's residual interest in the customer-segregated account must at all times be sufficient to exceed the sum of the margin deficits that the FCM's customers have in their accounts. This requirement is counter to the historical interpretation, which requires an FCM to maintain residual interest to cover customer-segregated accounts with negative net liquidating balances (debit equity). This gives an FCM time to collect customer funds prior to the time a payment must be made to the clearing house.

In addition to increased costs for hedgers, this proposed rule would be more burdensome to firms like farmer cooperative-owned FCMs, which largely deal only with hedgers. Although the risk profile of the customer base is very low, customers are predominantly on one side of the market and therefore more susceptible to big swings in the market. To require all deficits to be covered immediately would be overly burdensome on these FCMs given the low-risk profile of their customers as hedgers. We encourage members of this subcommittee to express concerns over this proposal to CFTC.

Thank you again for the opportunity to testify today before the committee on behalf of farmer-owned cooperatives. We appreciate your role in ensuring that farmer cooperatives will continue to be able to effectively hedge commercial risk and support the viability of their members' farms and cooperatively owned facilities. I look forward to answering any questions you may have.

Thank you.