UNITED STATES DEPARTMENT OF AGRICULTURE

BEFORE THE SECRETARY OF AGRICULTURE

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Post-Hearing Brief of CME Group

This post-hearing brief is submitted on behalf of CME Group. CME Group is the world's leading and most diverse derivatives marketplace offering the widest range of futures and options products for risk management. From the establishment of the Chicago Board of Trade in 1848 as a venue for grain producers to manage their price exposure, to the founding of the Chicago Butter and Egg Board in 1898, CME Group has been an integral part of agricultural markets for over a century. CME Group Agricultural futures and options markets serve as a key means for physical market participants to minimize risk and protect themselves against adverse price movements.

CME does not have a stance on the various proposals submitted to the USDA and discussed in the hearings. We would like to reiterate to stakeholders, however, that depending on the timeframe for implementation, some of the changes proposed could have an impact on risk management solutions for the dairy industry.

With the support and collaboration of the industry, CME Group has worked continuously toward the development of dairy futures and options markets since 1996 with the launch of milk futures and options on its designated contract market—Chicago Mercantile Exchange Inc. ("CME"). This collaborative effort has led to the development of the largest dairy futures and options market globally. Average open interest, or the average amount of open positions held on a daily basis, equated to over 37 billion pounds of product across futures and options in 2022 compared to just over 2 billion pounds of product in 2000.

CME dairy futures and options serve as hedge tools for physical market participants, allowing them to lock in either sale or purchase prices for milk or dairy products, and thus reduce their price risk exposure. Risk management applications for CME dairy markets can extend from producers to processors, traders, and end users of dairy products. On September 5th, during testimony from Leprino, the importance of being able to execute hedges in efficient, liquid futures markets was emphasized when Sue Taylor recalled that "going back to the early period of risk management, once futures were just launched -- but it was difficult to execute -- I had a customer, who in a period of volatility told me that if we cannot better manage our price volatility on dairy, we will formulate it out of our menu" (Tr. 2220).

In addition to acting as tools to manage price risk, futures markets also serve as a mechanism for price discovery. Forward-looking price discovery provides valuable information to the industry on expected prices which can help inform business decisions.

While commercial hedgers look to minimize their price risk, there are other market participants that are willing to assume risk and take the other side of a trade. These market participants are often referred to as liquidity providers and deliver a critical function to efficient futures and options markets. Liquidity providers frequently improve upon the best buy and sell orders in the market, and thus reduce costs for both physical buyers and sellers. The participation of liquidity providers in CME dairy markets has helped facilitate the current levels of hedge capacity being offered to the marketplace.

When market participants enter into futures and options positions, they do so based on underlying assumptions, informed by established contract terms. Futures markets are either physically or financially settled. Dairy futures products at CME Group are all financially settled using underlying USDA published pricing references.

CME dairy markets include futures and options on Class III Milk, Class IV Milk, Cash-Settled Cheese, Block Cheese, Cash-Settled Butter, Nonfat Dry Milk, and Dry Whey. Final settlement for Class III Milk futures is based upon the USDA Class III price for milk for a particular month, as first released. Likewise, final settlement for Class IV Milk futures is based upon the USDA Class IV Price for milk for a particular month, as first released. The prices for USDA Class III and IV milk, upon which our futures contract settle, are derived from Federal Milk Marketing Order ("FMMO") formulas. Final settlement for Cash-settled Cheese, Block Cheese, Cash-Settled

Butter, Nonfat Dry Milk, and Dry Whey futures are based upon the USDA monthly weighted average prices for the respective product.

As the USDA published prices for both Class III and IV milk, as well as the USDA monthly weighted average prices for the aforementioned dairy products, are dependent on the established, current FMMO formulas and collection criteria for National Dairy Product Sales Report ("NDPSR") surveys, participants within CME dairy markets enter into futures and options positions based on the current FMMO formulas and NDPSR survey methodology. Any changes to the Federal Order formulas or underlying NDPSR survey methods could result in a material change to the valuation of the contracts. Mike Brown noted on September 5th that "CME has structured their markets around Federal Order rules -- or Federal Order pricing regulations in a way that makes hedging at a very, very level of uncertainty or basis risk possible. I think when you start changing -- make big changes, you have to keep that in the back of your mind, is that going to affect that ability to do that" (Tr. 2035).

Due to the current methodology for deriving USDA Class III and IV Milk prices incorporating Cheese, Butter, Dry Whey, and Nonfat Dry Milk prices, there is a relationship that exists between Class III and IV Milk futures and the corresponding dairy product futures by class. This relationship can act as a mechanism for hedgers to manage both input and output costs. This relationship also presents the trading community an opportunity to provide liquidity to the market while managing the risk they take on. While some market participants may only have exposure to either milk or processed dairy products, liquidity providers can utilize the relationship between milk and dairy products to offer additional liquidity to either side of the market through spread trading, or the simultaneous buying and selling of different commodity futures. The spread relationship and corresponding positions put on across products are dependent on the FMMO formulas.

We would like to address some of the comments made by other witnesses pertaining to a perceived sensitivity to liquidity providers in our testimony. Our chief objective in participating in the hearing is to protect market integrity and stability, with the ultimate goal of continued growth in hedging opportunities for physical market participants. Indeed, as inferred from the testimony of Ed Gallagher on August 30th, a majority (between 55% and 65%) of the U.S. milk supply still goes unhedged (Tr. 1323). As such, there remains tremendous opportunity for hedgers to manage more of their physical price exposure. The participation of liquidity providers in the space is critical to this growth, as well as maintaining current market activity. At times, the offer from a crush spread trader may be the only offer that exists in the market. A number of active liquidity providers in the dairy space are smaller firms, which may not have the resources to continuously track all possible outcomes of a hearing such as this, with the broad scope of proposed changes on the table. While there is general awareness that the FMMO formulas are currently being reviewed, there is not a clear indication of what proposed changes will be adopted or when they would take effect. Many liquidity providers trade various products and asset classes. If the risk to them becomes too great, they may consider leaving dairy to provide liquidity in a market that does not pose the same regulatory uncertainty. As Sara Dorland referenced on September 26th, “It's the very nature of what USDA does in that consistency, in discipline and rigor, in those formulas, and defining those relationships that allows risk management to do what we do” (Tr. 5379).

Additionally, we have observed that during the hearing, the call for further adjustments to the formulas to be made more frequently and on an ongoing basis has been raised. We do not oppose more regular updates to the FMMO formulas if beneficial to the industry, but we would stress the importance of sufficient and transparent notice of any such changes. As we mentioned in our testimony, we are often in support of adjustment mechanisms in contracts, as long as the adjustment mechanism and timeframe is known and established, and there is transparent data underpinning the respective mechanism. If there are changes made as a result of these proceedings without sufficient notice to the trade, the possibility of the same or similar risks being presented to the market on a perpetual basis could heavily dissuade participation in the market. Losing participation from liquidity providers would likely mean a higher cost to hedge for all.

While there may always be some regulatory risk when participating in futures and options markets, we believe that the broad scope of the proposed changes included in this hearing presents unprecedented regulatory uncertainty in CME dairy markets. This level of regulatory uncertainty is a potential deterrent not only to liquidity providers, but for all market participants including hedgers. For the sake of ensuring of market stability, we wish to encourage the USDA to provide for greater certainty where possible.

We recognize that a delay in implementation has been discussed throughout the hearing to protect risk management. While it was proposed by Edge Dairy Farmer Cooperative on August 25th (Tr. 632) that a 15.5-month delay be applied for any change to the FMMO formulas, other proposals that included a delay for risk management considerations only applied to certain changes like modifications to skim component factors, but not for all changes like modifications to make allowances. We would like to reiterate that we would consider any change that would modify the current Class III and Class IV FMMO formulas to be a material change. We would also consider the elimination of 500-pound barrel price series from the protein price formula to be a material change. We do not have a stance on whether these modifications to the formulas or NDPSR reporting should be adopted, but we do continue to stress the importance of the consideration of open interest in the implementation of any such changes. Generally, when material changes are made to contract specifications, the changes are either applied on contract months without open interest or are potentially subject to an extended regulatory approval process.

We would also like to clarify our stance on a line of questioning that arose during our testimony on August 28th. This line of questioning attempted to draw parallels to a typical hedge scenario, where market factors such as supply and demand drive hedge gains or losses. Ultimately if a market participant was truly engaged in a hedge, they would experience the opposite gain or loss on their physical exposure, resulting in a net neutral impact and successful hedge. We do not believe that possible impacts to contract valuation as a result of changes to the FMMO formulas without advanced notice should be seen as a typical hedge gain or loss. Generally, a hedger would be able to assume that the contract terms, and underlying assumptions to those contract terms, are set until that contract expires. In this scenario, if the market is considering some risk premium factored into futures prices, the futures price will reflect the expected reformed rules, and the associated gain or loss will represent the difference between expected and actual FMMO rules and formulas. Meanwhile the physical market price change during that period will reflect the difference between the prior and actual reformed FMMO rules. Thus there is a probable disconnect in the hedge relationship.

Risk management tools outside of futures and options, such as Dairy Revenue Protection, also rely on market information from CME dairy markets. Marin Bozic detailed on August 25th that "Dairy Revenue Protection uses the end of day prices on Class III, Class IV, butter, cheese, dry whey, and nonfat dry milk futures, to inform expected prices, and we use end-of-day option premiums, both puts and calls, at the money puts and calls, to inform or calculate volatility -- measures of risk so that we can properly set the premiums that are generated each afternoon. So, yes, DRP heavily depends on CME" (Tr. 657).

In addition to producer insurance programs, the OTC marketplace is highly dependent on CME dairy markets. While OTC providers may be able to match some buyers and sellers of OTC derivatives internally, it is our understanding that they depend on CME dairy markets to lay off their risk. If they cannot continue to access the same liquidity in CME dairy markets, the capacity of the OTC providers to offer hedge tools to the industry will be challenged as well.

CME dairy futures and options contracts are listed for 24 months at a time. While there isn't always open interest in all 24 listed contract months, hedge participation takes place throughout the curve. While some participants throughout the hearing estimated that the liquidity resides in the first 6 months, we'd like to refer back to the Figure 3 below from our testimony, highlighting that there is significant participation beyond 6 months, nearly 25% of all open interest when looking from 2018-2022. Additionally, we heard across various testimonies from hedgers throughout the hearing that they are continuously looking 18 months out on the forward curve to potentially lock in hedges. Eric Palla expressed this sentiment in his testimony, saying "It is important to the success of my business that the Federal Orders do not change the milk price formulas for transactions I may have entered into prior to my knowledge of the change in the timing of its implementation. Ideally, I would like an 18-month delay. This is necessary to protect my transactions from additional risk that was not in the marketplace at the time I made the transaction" (Tr. 2636-2637).

Figure 3

Average Open Interest Distribution (2018-2022)

All CME Dairy Futures & Options

Days to Expiration	Estimated Month Equivalent	Percentage of OI Covered on Average	Cumulative Percentage of OI Covered on Average
<90	3	47.49%	47.49%
91-180	6	27.65%	75.14%
181-270	9	15.24%	90.38%
271-360	12	6.96%	97.34%
361-450	15	2.26%	99.60%
451-540	18	0.38%	99.97%
541-630	21	0.03%	100.00%
631-720	24	0.00%	100.00%

During CME Group testimony on August 28th, we noted that we had seen a reduction in open interest over 360 days out. To expand on that, when looking at 2023, dairy futures and options open interest over 360 days declined 36 % vs the previous 5-year average. We have heard from both hedgers and speculators that they have already been reluctant to put positions on as far out as they typically would, due to the regulatory uncertainty currently residing over the market.

CME supports the USDA's efforts to evolve with the industry's needs over time. CME strives to do the same as it pertains to price risk management solutions. We would like to thank the USDA for calling CME Group to testify and for including risk management as a topic of discussion throughout the hearing. While we appreciate that there is a need to make potential changes to the FMMO formulas in a timely manner, we would continue to advocate that changes are made in a manner as to not adversely impact the dairy industry's ability to manage risk overall. Considering an implementation date that would not impact contract months with significant open interest once a final decision is issued could alleviate many concerns around the future viability of risk management tools for the U.S. dairy industry.

CERTIFICATE OF SERVICE

Milk in the Northeast and Other Marketing Areas
Docket No.: 23-J-0067

Having personal knowledge of the foregoing, I declare under penalty of perjury that the information herein is true and correct, and this is to certify that a copy of the POST-HEARING BRIEF OF CME GROUP has been furnished and was served by electronic mail upon the following parties on April 3, 2024 by the following:

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