



NATIONAL COUNCIL OF FARMER COOPERATIVES

February 22, 2011

Mr. David A. Stawick  
Secretary  
Commodities Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW.  
Washington, DC 20581

***RE: End-User Exception to Mandatory Clearing of Swaps; Proposed Rule (Federal Register/Vol. 75, No. 246)***

Dear Mr. Stawick:

On behalf of the more than two million farmers and ranchers who belong to one or more farmer cooperative(s), the National Council of Farmer Cooperatives (NCFC) submits the following comments in response to the Commodity Futures Trading Commission's (CFTC) request for comments: *End-User Exception to Mandatory Clearing of Swaps; Proposed Rule*, contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (17 CFR Part 39).

Since 1929, NCFC has been the voice of America's farmer cooperatives. Our members are regional and national farmer cooperatives, which are in turn composed of over 2,500 local farmer cooperatives across the country. NCFC members also include 21 state and regional councils of cooperatives.

As processors/handlers of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of over-the-counter (OTC) derivatives. Due to market volatility, cooperatives use swaps to better manage their exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces the costs of those activities.

In addition, swaps give cooperatives the ability to offer customized products to producers to help them better manage their risk and returns. A cooperative can aggregate its owner-members' small volume swaps or forward contracts and transfer that risk to a swap partner. Increasingly, those producers are depending on their cooperatives to provide them with these tools to manage price risk and lock in margins as volatility in commodity markets has increased in recent years.

As the CFTC drafts regulations to implement the Dodd-Frank Act, we strongly encourage the CFTC to take into account the unique nature of cooperatives and their future ability to provide customized risk management products and services to farmers, as well as customers to facilitate sales of their members' products. It is imperative that farmer cooperatives not be subject to the same level of regulation as the financial institutions that the Dodd-Frank Act is intended to

cover. We believe it was Congress' intent to treat entities such as cooperatives as derivative "end-users."

For reasons outlined in our submission on the entities definitions, we do not believe farmer-owned cooperatives should be classified as swap dealers, and thus should be treated as "end-users" when electing exemption to the mandatory clearing of swaps – whether it is to hedge commercial risk in the operation of the cooperatives primary businesses, or as it relates to risk management products it offers producers and customers. In that light, our comments focus on end-user to end-user transactions, and end-user to swap dealer/major swap participant transactions where the cooperative is considered the end-user.

### **Cooperative to Swap Dealer/MSP Swaps**

Farmer cooperatives enter into a number of swaps to help mitigate commercial risks of operating their businesses. These include swaps in physical commodities (agriculture and energy), interest rates, and even foreign exchange for those that are in the export business. For most of those swaps, a cooperative will look to a swap dealer to be their counterparty. In such instances, the cooperative would use the end-user exemption. For those transactions, they would be considered as hedging or mitigating commercial risk as CFTC has outlined in this proposed rule and the entity definitions, and not "held for a purpose that is in the nature of speculation, investing or trading."

Below are several examples of various swap activities cooperatives are engaged in where we believe each party to the transaction should be considered as commercial end users and meet the criteria of "hedging or mitigating commercial risk" as outlined by the Commission and thus not subject to the mandatory clearing requirement.

**Cooperative to Cooperative.** Local co-op elevators offer farmers a minimum price for future delivery of a specific volume of grain, and may also give the farmer the right to the average market price over the time period if it is better than the guaranteed price. The local elevator will then offset that risk by entering into a swap with a cooperative in a regional or federated system. The larger cooperative will then aggregate its exposure to the swaps with local elevators and enter into an offsetting swap with a dealer or other commercial counterparty.

**Cooperative to Producer.** Cooperatives assist livestock producers by offering customized contracts at non-exchange traded weights while also reducing producers' financial exposure to margin calls. Because exchange contracts are traded in 40,000-50,000 pound sizes, producers can better match the corresponding number of head they have to the swaps offered by the cooperative (20,000-25,000 pounds). These contracts are based off the CME for live cattle, lean hogs, and feeder cattle. The cooperative offsets its risk by entering into a corresponding swap with a predetermined counterparty.

**Cooperative to Customer.** Dairy cooperatives enter into agreements to supply a guaranteed volume of dairy product to a food manufacturer over the next year. The cooperative will enter into a swap agreement with a customer to hedge its price exposure over the given period. Correspondingly, the customer will be seeking to limit its price exposure as well. Often,

businesses that use large quantities of cheese, butter, nonfat dry milk or other dairy products – for instance the purchase of nonfat dry milk by a bakery business – will enter into a swap to hedge their financial exposure. Many times a swap is the preferred method of hedging because it can be customized to fit the need, and, because of the large volume covered, dairy futures markets may have too little volume to accommodate it. In some cases, this swap may not be end-user to end-user, but instead handled by an intermediary.

Often cooperatives will use non-cleared swaps as opposed to cleared swaps or the commodity exchanges for the above transactions because they are dealing with contracts in low volumes and odd lot amounts that are not formally listed on an exchange or cleared. In addition, non-cleared swaps provide the means to customize hedging strategies. These swaps are not “held for a purpose that is in the nature of speculation, investing or trading,” but rather the underlying activity to which a cooperative enters into swaps is commercial in nature. NCFC members enter into OTC swaps to hedge the price risk of the commodities they supply, process or handle; i.e. those in which they have a physical interest in the underlying asset.

If those swaps were required to be cleared through an exchange or standardize a non-standard transaction (both in terms of quantity and structure), costs would likely increase to a point where the use of swaps as a bona fide hedge/risk management tool would not be available to segments of the agricultural marketplace. In addition, the low volume, small sizes and odd lots likely would not be attractive for exchanges or clearing houses to offer those specific products. This would increase the price risk to cooperatives and farmers, and would be counter to the intent of the Dodd-Frank Act to decrease risk to the market place.

To the extent that the Commission believes that a cooperative would not be eligible for the end-user exemption to mandatory clearing for any of those swaps, we believe that because their nature and purpose is to reduce risk in the agricultural economy, and because they pose no systemic risk to the U.S. economy, special consideration should be made for agricultural cooperatives using these tools.

### **Notification to the Commission**

Our overall concern with the proposed rule is the potential administrative burdens and costs associated with small, customized transactions could render those products cost prohibitive. Given the natural relationship of cooperatives with their producers and customers, it would most likely be the cooperative reporting the swaps as well as how the parties meet the financial obligations requirements (clearly, having individual producers report that information would generate additional work for regulators while providing questionable information).

To the extent swaps are entered into between a cooperative and its members (producer/elevator) or customers, it is unclear whether both counterparties would need to provide information on how they meet their financial obligations. While the cooperative likely would do the reporting (and we would assume be the party to elect the end-user exemption), would the counterparty also need to provide information relating to the Financial Obligations Notice? If so, would the cooperative be required to verify the information provided from the other counterparty? Such

requirements may pose potential costs that would make entering into “small” swaps cost prohibitive.

It is also unclear at this time whether there will be a Swap Data Repository (SDR) that will take information on low frequency, odd lot transactions that cooperatives enter into with their members and customers. If not, will the CFTC have the resources to accept such data and information?

It is unclear as to whether an end-user would have to provide specific information as to how it expects to meet its financial obligations for each individual type of swap it enters into. Because a cooperative may enter into a number of types of swaps with dealers, members and customers in the course of mitigating commercial risk, the financial obligation notice requirement should be general enough to encompass all of those transactions. We believe that is the intention of the language contained in the bill which states “notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligation associated with entering into noncleared swaps.” For smaller entities that may not have the resources to put in place an automated system to report this information for every noncleared swap, it may be more efficient to have them provide that information once over a given time period, with the Commission having the ability to request additional information if necessary.

## **Conclusion**

As processors and marketers of commodities, and suppliers of farm inputs, cooperatives use swaps to hedge or mitigate commercial risks associated with price movements in commodities, such as grain, dairy products, livestock, energy, and fertilizer. In addition, swaps give cooperatives the ability to offer customized products to producers that help them better manage their risk and returns and, ultimately, provide more predictable profitability.

Many of those products are not readily available on an exchange or through cleared swaps. Therefore cooperatives’ use of non-cleared swaps has increased in recent years, both in an effort to provide producers with better risk management tools, and to effectively mitigate risks in the volatile commodity markets. Several NCFC members believe that less than one percent of cooperatives’ agricultural swaps are currently being cleared. If the costs associated with reporting and other requirements on those noncleared swaps becomes over-burdensome, it would likely result in cooperatives being less able to provide customized risk management products.

We appreciate your consideration of the above points in drafting the end-user rule.

Sincerely,



Charles F. Conner  
President & CEO