NATIONAL COUNCIL OF FARMER COOPERATIVES

February 22, 2011

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

RE: Joint proposed rule; proposed interpretations. Further Definition of "Swap Dealer, "Security-Based Swap Dealer," "Major Swap Participant," Major Security-Based Swap Participant" and "Eligible Contract Participant." (Federal Register/Vol. 75, No. 244)

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: *Further Definition of "Swap Dealer, "Security-Based Swap Dealer," "Major Swap Participant," Major Security-Based Swap Participant" and "Eligible Contract Participant,"* contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (17 CFR Part 1).

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.

I. Overview

Farmer cooperatives – businesses owned and controlled by farmers, ranchers, and growers – are an important part of the success of American agriculture. These cooperatives allow individual farmers the ability to own and lead organizations that are essential for continued competitiveness in both the domestic and international markets. In all cases farmers are empowered, as elected board members, to make decisions affecting the current and future activities of their cooperative. Earnings derived from these activities are returned by cooperatives to their farmer-members on a patronage basis thereby enhancing their overall farm income.

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 can reduce 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 that the CFTC take into account the unique nature of cooperatives and their continued 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." If cooperatives are not treated as "end-users," but rather as "swap dealers," increased regulatory costs will significantly curtail the ability of cooperatives to offer farmers and ranchers risk management tools.

II. Application of the core tests to "swap dealers" and "security-based swap dealers"

NCFC believes that by applying the "interpretive approach for identifying whether a person is a swap dealer" as outlined in the proposed rule, CFTC will likely capture a number of entities that were not intended to be regulated as swap dealers, including farmer cooperatives. Given the "distinguishing characteristics of swap dealers" as outlined in the proposed rule (bullets copied below), many cooperatives would likely be required to register and be regulated as dealers. This is because cooperatives engage in activities that look very similar to those characteristics when they enter into swaps with farmers, local elevators, customers and others, as they provide risk mitigation services and products throughout the agriculture and energy sector.

- Dealers tend to accommodate demand for swaps from other parties;
- Dealers are generally available to enter into swaps to facilitate other parties' interest in entering into those instruments;
- Dealers tend not to request that other parties propose the terms of swaps; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and
- Dealers tend to be able to arrange customized terms for swaps upon request, or to create new types of swaps at the dealer's own initiative.

While some cooperative activities would appear to fall under those characteristics of a dealer, cooperatives differ significantly from entities that make markets in swaps on a for-profit basis. Farmer-owned cooperatives differ from those entities in several ways:

- Farmer cooperatives are farmer-owned, financed, and governed and net returns are distributed to members in cash and/or patronage-equity certificates or available as equity distribution if kept as retains. Cooperatives offer risk management tools to members as a service in support of their members' farming/cooperatively-owned operations.

- The purpose of cooperatives' activities is "hedging or mitigating commercial risk," as outlined in the entities definition and the end-user exemption to mandatory clearing of swaps proposed rules. 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. they have a physical interest in the underlying asset. Cooperatives do not hold swaps for speculative, investment, or trading purposes.

- Cooperatives are recognized as bona fide hedgers for the purpose of being exempt from position limits under the Commodity Exchange Act, another determining circumstance that the Commission has proposed to deem a swap used for hedging or mitigating commercial risk. 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 (cooperatives are considered bona fide hedgers on the Chicago Mercantile Exchange and are not subject to speculative trading limits).

- While cooperatives need commercial counterparties to take the other side of a swap, they are doing so to hedge commercial risk of their members, either directly at the farm or to help protect their investment in their cooperatively-owned businesses.

- Cooperatives enter into swaps that hedge other swaps that are held for hedging purposes. Swap transactions are used to offset the risk of aggregating agricultural producers' and other cooperatives' hedges. By entering into swaps to offset risk of aggregating those hedges, cooperatives are providing a service to their owner-members. A swap dealer or other commercial counterparty would otherwise not have the interest in servicing such small entities.

- Cooperatives serve a segment in the agricultural sector that consists of contracts in low volume and odd lot amounts that would not be of significance to be formally listed on an exchange with a futures contract. Increased requirement for capital and margin, business conduct standards, reporting and recordkeeping, if imposed on cooperatives, could render the cost of the transaction higher than the value of continuing to provide a needed risk management tool.

- A reasonable amount of agricultural inputs and products that cooperatives process and market are not traded in volumes necessary for conventional futures markets to offer contracts (fertilizer and some dairy products, for example). Swaps are often the only risk management option for those inputs and products.

A key element of the Dodd-Frank Act is increasing transparency and competition, and narrowing bid-ask prices. However, for this to occur, entities have to "shop" around among a number of counterparties and be prepared to execute swap transactions with a larger number of counterparties. In doing so, the cooperative attempting to hedge the aggregated commercial risk of its members would meet a swap dealer definition on many levels including by their action of "shopping" around. We do not believe it was the intent of Congress for these activities of an agricultural cooperative to have them designated as swap dealers.

As noted in previous comments NCFC has submitted concerning implementation of the Dodd-Frank Act, farmer cooperatives are aggregators of end-users and should not be subject to the requirements that will be imposed on dealers. If cooperatives are required to clear agricultural swaps and are subject to other regulatory requirements intended for dealers, such as increased recordkeeping and margining, the increased costs likely would render some vital marketing tools unavailable for cooperatives to offer producers. For example, as agricultural swaps can be subject to considerable market volatility, margin would be a particular concern related to increased costs. As farmers work to manage their margins through forward contracting with their cooperatives, the cooperatives work to mitigate the risk of ownership. As forward contracts are not considered to be swaps there is no respective margin to the farmer. If clearing is required on the offsetting hedge, agricultural cooperatives, while fully hedged, may experience cash flow timing issues due to one side of the hedge being subject to margin requirements and the other not. This could put a considerable cash constraint on farmer-owned organizations and/or it could result in fewer risk management opportunities to farmers as they would become cost prohibitive.

Sometimes cooperatives enter into swaps to free up working capital for itself and its members. Cooperatives do this so they can continue to offer forward pricing options for farmers to manage production risk; this happened in 2008 and is taking place today. Mandatory margining of these swaps would render them useless.

It should be noted that as end-users, cooperatives will already be faced with increased cost structure due to the Dodd-Frank Act. In addition to anticipated higher transaction cost with dealers, cooperatives will likely be the reporting entity in end-user to end-user swaps with producers and their customers.

III. Application of the De Minimis Exemption on "Aggregators"

As outlined in the proposed rule, the de minimis exemption is set too low, both in aggregate effective notional amount of $100 million and total number of swaps (20) and counterparties (15), to exclude cooperative activities from dealer regulations. A number of cooperatives enter into swaps in several commodities. For example, a dairy cooperative may enter into dairy product swaps with customers it supplies, while offering grain swaps to their members to hedge feed costs. And a grain/farm supply cooperative may enter into grain swaps with local elevators and energy swaps with local farm supply cooperatives that offer forward pricing to producers. Attached are some examples of how cooperatives use swaps to provide hedging tools.

Although the numbers of producer members that take part in swap offerings to hedge feed costs, energy costs, or livestock prices for example, is relatively small as a percentage of cooperative members, the proposed threshold of counterparties would easily be exceeded. Additionally, depending on the commodity being hedged, producers may elect to put a position on every 30-60-90 days, 5-6 months etc., correspondingly increasing the number of swaps a cooperative might provide its members.

On the grain marketing/farm supply side, a federated cooperative may be owned by more than 100 local cooperatives. The number of swaps each local cooperative might enter into in a given year with the federated cooperative will vary. However, as an example, a local elevator may enter into a swap on a daily or weekly basis with a cooperative in a regional or federated system to offset the risk of offering farmers minimum price forward contracts. The frequency of those transactions may increase as price volatility increases, i.e. there is a greater need to enter into swaps as more risk is introduced into the commodity markets.

The $100 million threshold is artificially low and would easily be exceeded. For example, in today's environment it would only take nine million bushels of soybeans or 18 million bushels of corn to exceed that threshold.[1] Additionally, it is counterintuitive – at higher commodity prices, less volume can be hedged. Thus, when there is a greater need to provide risk management tools, there would be less of an ability to deliver them. While cooperatives net at zero or near zero on their swap positions at any given time, we would have concerns about putting a notional cap in place that did not account for changing market conditions, such as the ability to adjust to higher commodity prices or a greater need and interest among our members to offer hedging instruments in the future.

Given arbitrary and static thresholds, the de minimis provision as structured would not provide cooperatives the latitude needed to offer customized hedging solutions. And, simply stated, the practical effect of having to comply with dealer regulations would be that some cooperatives would cease to offer those services – largely to the detriment of smaller producers.

IV. Eligible Contract Participant

The threshold for farmers to use swaps and swap options should be set the same at $1 million in net worth. However, as NCFC noted in earlier comments, farmers that do not meet the ECP requirements should be allowed to purchase agricultural swaps through Designated Contract Markets or their agricultural cooperative. This would enable smaller farmers access to margin management tools that enable them to weather markets with increased volatility. These small farmers do not access the futures markets to hedge because of the large volumes underlying the relevant futures contracts. Providing access to these tools would enable the smaller producers to customize their hedging needs to the appropriate volumes and time periods not applicable to futures contracts. The burden of due diligence would be put on the cooperative when making a decision whether to enter into a swap with those producers.

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[1] The U.S. produced 12.4 billion bushels of corn and 3.3 billion bushels of soybeans in 2010.

V. 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 to help them better manage their risk and returns and, ultimately, provide more predictable profitability.

In order to provide risk mitigation services to their farmer-members, a local cooperative must have the ability to enter into swaps with a member of its cooperative federation (or a member's subsidiary). In addition, cooperatives must have affordable access to the OTC market with other commercial counterparties. This allows the cooperative to "aggregate" the risk of offering forward contracts and swaps to farmers. Although the function is similar in nature to that of a "swap dealer" as outlined in CFTC's draft regulations, cooperatives are not speculating. Rather, they are seeking to hedge commercial risk and support the viability of their members' farms and cooperatively-owned facilities. As such, agricultural cooperatives should be treated as commercial end-users of swaps, and not regulated as "dealers."

If farmer cooperatives were to be regulated as "dealers" in swaps they offer farmers or use to offset the risk of providing forward pricing and swaps to farmers, increased requirements for posting capital and margin, complying with reporting, record keeping and other regulatory requirements intended for large financial institutions, would make providing those services cost prohibitive. Therefore, as the Dodd-Frank Act is implemented, CFTC needs to be clear that farmer cooperatives are not captured under the same rules, and regulated to the same degree, as firms that pose systemic risk to the nation's financial system.

We appreciate your consideration of the above points in drafting the definitions rule.

Sincerely,

Charles F. Conner
President & CEO

Farmer and Cooperatives' Use of Swaps to Hedge Commodity Price Risks

Outlined below are several examples of how cooperatives in different sectors of U.S. agriculture participate in the swaps market and provide valuable risk management services to their farmer-members. Many of the examples only trade as 1-5 contracts at a time, and thus are not set up to be centrally cleared.

- **Dairy:** Co-ops provide customized hedging solutions to dairy farmers, allowing them to lock in positive margins. To guarantee those margins, farmers buy financial futures on corn and soybean meal, while selling Class III milk futures. However, many farms are not large enough to utilize CME contracts. Due to the size and scale, co-ops have the ability to facilitate that hedging for farmers through the use of swaps. For other milk producers, co-ops help to greatly reduce cash flow risk with swaps as the farmer is not subjected to daily mark-to-market (margin) requirements put forth by the exchanges. This encourages risk management strategy implementation and helps ensure future profitability.

- **Grain:** Local co-op elevators will 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.

- **Livestock:** 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 of those contracts with producers by entering into a corresponding swap with a predetermined counterparty (through a broker).

- **Fertilizer:** Large inventories of fertilizer are necessary to provide farmers with timely service as fertilizer is produced year round and there are only seasonal applications. However, fertilizer producers and distributors do not have access to exchange-traded fertilizer contracts. A growing OTC market for fertilizer products helps co-ops hedge away inventory/price risk during volatile times, such as those experienced in 2008.

- **Fuel:** Customized solutions are developed by the co-op to assist individual farmers with their fuel hedging needs as individual farmers do not have the fuel demands necessary to consume a standard 42,000-gallon monthly NYMEX contract.

- **Small Producers:** A cooperative can aggregate its members' small volume swaps or forward contracts and transfer that risk to a swap partner. A swap dealer or other commercial counterparty would otherwise not have the interest in servicing such small entities.