



August 2, 2012

Office of the Comptroller of the Currency  
Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation  
Farm Credit Administration  
Federal Housing Finance Agency

**Re: Request for Consistent Treatment of Margin Requirements for Non-Cleared Swaps by Exempt Cooperatives with Nonfinancial End Users, RIN 1557-AD43, 7100 AD 74, 3064-AD79, 3052-AC69, 2590-AA45**

The National Rural Utilities Cooperative Finance Corporation (CFC) urges the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency (collectively, the Agencies) to adopt a final rule on margin requirements for non-cleared swaps that is consistent with the nonfinancial end user pass-through approach taken by the Commodity Futures Trading Commission's (CFTC's) proposed rule, "Clearing Exemption for Certain Swaps Entered Into by Cooperatives," (Cooperative Exemption).<sup>1</sup> CFC, as a cooperative entity that would qualify under the CFTC's proposed rule, appreciates the consideration given by the Agencies to our previous comments in connection with the issuance of a joint proposed rule by the Agencies that would establish margin and capital requirements for "swap entities" – namely, swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants – that are regulated by the Agencies (the NPR).<sup>2</sup>

CFC previously provided comments regarding the NPR to the Agencies on June 21, 2011.<sup>3</sup> While we understand that the comment period for the NPR has passed, the CFTC's issuance of the proposed Cooperative Exemption at its July 10, 2012 meeting and published in the Federal Register on July 17, 2012, is a significant new factor that warrants additional commentary and allows us and the Agencies to have a more fully informed basis for consideration of our previous letter. The proposed Cooperative Exemption is premised on the member ownership nature of cooperatives and the fact that the qualifying cooperatives are acting on behalf of their nonfinancial end-user members. The proposed Cooperative Exemption would therefore effectively pass-through the end-user exception available to members of the cooperative to the

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<sup>1</sup> 77 Fed. Reg. 41940-41952 (July 17, 2012), implementing the action taken by the CFTC on July 10th.

<sup>2</sup> "Margin and Capital Requirements for Covered Swap Entities," 76 Fed. Reg. 27564-27596 (May 11, 2011).

<sup>3</sup> The June 21, 2011 letter is attached as an exhibit for your convenience.

cooperative entities themselves, subject to the same limits imposed on end-users in the end-user exception to clearing.<sup>4</sup> Accordingly, we respectfully request that the Agencies favorably consider and accept the comments contained herein.

In its proposed rule, the CFTC explains in detail why the Cooperative Exemption makes sense, represents good policy, protects the public interest, and is consistent with both Congressional intent<sup>5</sup> and the specific provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). The preamble to the CFTC's proposed Cooperative Exemption rule specifically listed CFC as an example of a qualifying cooperative.<sup>6</sup> The CFTC further noted that CFC was formed, and still operates under, the authority of the CFC "Articles of Incorporation" filed under the District of Columbia Cooperative Association Act of 1940. The CFTC estimates that approximately ten cooperatives would be eligible for the exemption and that most of those enter into less than 50 swap transactions per year.

We respectfully request that the Agencies adopt a similar approach to that taken by the CFTC in the Agencies' final margin requirements for swap entities; namely that certain swaps entered into by qualifying cooperatives are afforded the same treatment under the final rule to swaps entered into by a qualifying cooperative's nonfinancial, end-user members. Such an approach that would be consistent with the risk-based approach taken in the NPR, as discussed below.<sup>7</sup> In particular, we request that the Agencies treat cooperatives qualifying under the Cooperative Exemption as "nonfinancial end users" for purposes of the initial and variation margin requirements for non-cleared swaps. In the alternative, if qualifying cooperatives are not treated as "nonfinancial end users," we request that the Agencies treat cooperatives qualifying under the Cooperative Exemption as "low risk financial end users" for purposes of the initial and variation margin requirements for non-cleared swaps.

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<sup>4</sup> "End-User Exception to the Clearing Requirement for Swaps," 77 Fed. Reg. 42560-42591 (July 19, 2012).

<sup>5</sup> For instance, in addition to the rationale for the proposed Cooperative Exemption described in this letter, section 722(f) of the DFA states that public interest waivers should be provided for certain swap transactions involving rural electric cooperatives. Section 722(f) states that: "If the Commission determines that the exemption would be consistent with the public interest and purposes of this Act, the Commission shall...exempt from the requirements of this Act an agreement, contract, or transaction that is entered into...between entities described in section 201(f) of the Federal Power Act...." Entities described in 201(f) can include CFC because it acts as an "instrumentality" of its member rural electric cooperatives. The Federal Power Act defines 201(f) entities to include, "an electric cooperative that receives financing under the Rural Electrification Act of 1936 (7 U.S.C. 901 et seq.) or that sells less than 4,000,000 megawatt hours of electricity per year, or any... *instrumentality of any one or more of the foregoing.*" (*emphasis added*).

<sup>6</sup> 77 Fed. Reg. at 41943, fn. 20.

<sup>7</sup> As the Agencies noted in the NPR, the DFA requires the CFTC, the Securities and Exchange Commission, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other periodically (but no less than annually) regarding these requirements. 77 Fed. Reg. 27566.

## **The Proposed Cooperative Exemption**

The CFTC's proposed Cooperative Exemption would offer an exemption from the clearing requirements, imposed by the Commodity Exchange Act (CEA), as amended by Title VII of the DFA, for certain swap transactions entered into by qualifying cooperatives. The CFTC in the preamble to the Cooperative Exemption acknowledges the unique member ownership structure of cooperatives and the merits of effectively passing through the end-user exception available to a cooperative's members to the cooperatives themselves.

The Cooperative Exemption is structured to assure that it can only be used as a pass-through for swaps (i) with members of the cooperative, who would themselves be able to elect the end-user exception, or (ii) for swaps that hedge or mitigate risk in connection with loans made to a cooperative's member and swaps entered into with members. The Cooperative Exemption sets forth qualifying cooperative requirements, including membership requirements, transaction requirements and reporting requirements, each of which we summarize in turn below.

The Cooperative Exemption is extremely narrowly constructed and applies only to cooperatives that:

- (i) are financial entities as defined in section 2(h)(7)(C)(i) of the CEA, solely because of section; 2(h)(7)(C)(i)(VIII) of the CEA;<sup>8</sup>
- (ii) are formed and existing as a cooperative pursuant to federal or state law; and
- (iii) consist only of members that are entities that could elect the end-user exception themselves.<sup>9</sup>

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<sup>8</sup> That section defines a financial entity for purposes of the CEA "a person predominately engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 1843(k) of title 12." Section 1843(k) includes lending activities within its list of enumerated activities that are financial in nature.

<sup>9</sup> Proposed § 39.6(f)(1) would provide that each member of the cooperative seeking to elect the Cooperative Exemption must be a nonfinancial entity, a financial institution to which the small financial institution exemption applies, or itself a cooperative each of whose members fall into those categories. This assures that the Cooperative Exemption will not be available to cooperatives that have members that are non-exempt financial entities as defined in Section 2(h)(7)(C) of the CEA. For example, the CFTC notes that the Cooperative Exemption would not be available to the Federal Home Loan Banks, whose membership includes financial entities that are not small financial institutions. 77 *Fed. Reg.* at 41942, fn. 15. Also excluded from qualifying cooperative membership would be the following types of entities, as listed in section 2(h)(C)(i)(I)-(VII) of the CEA:

- (I) A swap dealer;
- (II) A security-based swap dealer;
- (III) A major swap participant;
- (IV) A major security-based swap participant;
- (V) A commodity pool;
- (VI) A private fund as defined in section 80b-2(a) of title 15; or

The CFTC estimates that approximately ten cooperatives will be eligible for the Cooperative Exemption.<sup>10</sup>

In addition to limits on qualifying cooperatives, the Cooperative Exemption imposes restrictions on the types of swaps that may be exempt from clearing requirements. A qualifying cooperative may elect to not clear a swap subject to the clearing requirement if the swap:

- (i) Is entered into with a member of the exempt cooperative in connection with originating a loan or loans for the member, which means the requirements of 17 C.F.R. § 1.3(ggg)(5)(i), (ii), and (iii) are satisfied; or
- (ii) Hedges or mitigates commercial risk, in accordance with section 39.6(c), related to loans to members or arising from a swap or swaps that meet the requirements of paragraph (i) (above).<sup>11</sup>

The Cooperative Exemption imposes the same reporting requirements that are imposed by the end-user exception. Title VII of the DFA amended Section 2(h)(7)(A) of the CEA to require one of the counterparties to a swap relying on the end-user exception to notify “the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.” Part 39 implements those reporting requirements for end-users. The Cooperative Exemption proposes to apply those same requirements, outlined below, to those entities relying on the proposed Cooperative Exemption.

#### **Qualifying Cooperatives Should Qualify as “Nonfinancial End Users”**

We believe that the Agencies should adopt the CFTC’s pass-through approach and allow qualifying cooperatives, such as CFC, to be treated in the same manner as their nonfinancial end-user members for purposes of the Agencies’ initial and variation margin requirements for non-cleared swaps. As recognized by the CFTC, the cooperative member owner structure - comprised of entities that themselves would qualify as nonfinancial end users – warrants special consideration.

The Cooperative Exemption operates on a pass-through basis and may only be elected by cooperatives whose members qualify for the end-user exception for transactions that are directly related to loans made to the cooperative’s members. Therefore, swaps exempt under the Cooperative Exemption may only be used to hedge or mitigate commercial risk, including interest rate risk. As noted above, entities that elect the Cooperative Exemption will be subject to the same reporting and monitoring requirements that entities electing the end-user exception are

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(VII) An employee benefit plan as defined in paragraphs (3) and (32) of section 1002 of title 29.

<sup>10</sup> 77 Fed. Reg. at 41946.

<sup>11</sup> Section 39.6(c) of the CFTC’s regulations note that a swap is used to hedge or mitigate commercial risk if such swap is economically appropriate to the reduction of risks arising from, among other things, “any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person’s current or anticipated assets or liabilities;...”

subject to. The Agencies emphasized that the margin and capital rule NPR adopts a risk-based approach in proposing rules to establish margin requirements for covered swap entities. Based on the above discussion, on a risk-based basis, entities that elect the Cooperative Exemption would offer no greater risk to the financial system than entities electing to take the end-user exception directly.

**If Qualifying Cooperatives are Not Treated as a Nonfinancial End Users, Qualifying Cooperatives Should be Treated as “Low-Risk Financial End Users”**

The CFTC recognizes in the Cooperative Exemption that it will be effectively passing through the end-user exception available to members of a qualifying cooperative to the cooperative entities themselves, subject to the same types of limits on qualifying swaps activities. For those reasons, and because the Cooperative Exemption will subject qualifying cooperatives to the same reporting and monitoring regime that commercial end-users are subject to, qualifying cooperatives should qualify as low-risk financial end users. The CFTC as the primary regulator of the swaps markets has determined that swaps subject to the Cooperative Exemption pose a low risk to the financial system. Because the Agencies propose to apply the margin and capital requirements on a risk-based basis, qualifying cooperatives should be treated as low-risk financial end users if they are not treated as nonfinancial end users.

The CFTC acknowledges the low risk posed by swap activities subject to the Cooperative Exemption. In the preamble to the Cooperative Exemption, the CFTC notes that:

Several commenters who requested an exemption for cooperatives justified the request in part on the basis that cooperatives principally use swaps in connection with originating loans to members. These commentators noted that such swaps are relatively low risk. To minimize the risk a cooperative exemption might pose to the financial system, the proposed rule would limit the exemption to swaps in connection with originating loans to members and swaps used by the cooperatives to hedge or mitigate risks related to member loans or risks arising from swaps entered into with members on such loans.<sup>12</sup>

Therefore, the CFTC as the primary regulator of the swaps markets further mitigates the risk potentially posed by such activities by narrowing prescribing the types of swaps that may qualify for the Cooperative Exemption.

Finally, we note that the Agencies’ proposed definition of a “low-risk financial end user” requires an entity to be subject to capital requirements established by a prudential regulator or state insurance regulator. As we did in our previous comment letter, we urge the Agencies to reevaluate their approach in drafting that definition. The approach advanced in the NPR offers preferential treatment to entities that are subject to certain types of regulatory regimes (e.g., depository institutions). We would suggest a more inclusive approach that, while consistent with a risk-based approach, would not disadvantage those entities that are not structured in a manner that would subject them to capital requirements established by a prudential regulator or state insurance regulator. Given the CFTC’s narrow construction of the Cooperative Exemption and

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<sup>12</sup> 77 Fed. Reg. at 41943.

the reporting requirements contained therein, from a prudential risk management perspective (as well as from a historical perspective as demonstrated by the recent financial crisis) it is difficult to argue that qualifying cooperatives and their non-cleared swap activities would pose a greater risk to the financial system than an entity subject to capital requirements, such as those entities regulated by the Agencies. As we suggested in our previous comment letter, the Agencies could, for institutions not subject to regulatory capital requirements, mandate a particular debt-to-equity ratio or some other relevant measure of financial soundness that takes into account the unique nature of these exempt cooperatives.<sup>13</sup>

### **Background on CFC**

CFC is a non-profit, member-owned cooperative that was incorporated under the District of Columbia Cooperative Association Act in April 1969. National Rural Electric Cooperative Association, an association of approximately 1,000 nonprofit, rural electric utility cooperatives serving rural America was instrumental in forming CFC. As a cooperative, CFC is 100% owned by and exclusively serves its membership, which consists solely of member owned non-profit entities or subsidiaries or affiliates of non-profit entities. The great majority of CFC members are member owned cooperatives, with a small number being public corporations, utility districts or national, regional or statewide associations of cooperatives.

From its inception, CFC's purpose has been to provide its members with debt, and other types of financing, to supplement the loan programs of the Rural Utilities Service (RUS), an agency of the Department of Agriculture. With the help of CFC financing, its members acquire, construct, maintain, upgrade and operate all types of electric distribution, generation, transmission and related facilities, including wind and solar generation, and technological upgrades to combat emissions. As of February 29, 2012, loans and guarantees outstanding to CFC's members totaled approximately \$19.8 billion.

As a nonprofit cooperative, CFC's objective is to offer its members cost-based financial products and services consistent with sound financial management and is not to maximize net income. Thus, CFC's purpose is to maximize benefits for its nonprofit, consumer-owned rural electric cooperatives. Approximately 200 CFC members receive 100% of their financing from CFC, with the balance of approximately 800 members receiving financing at varying levels from CFC, RUS and other sources. CFC's members provide reliable, low cost power in 48 states to individuals, families, public agencies and businesses encompassing a population of approximately 42 million people.

We – and our members – depend on the flexibility and cost-effectiveness of the over-the-counter interest rate swaps market. A key component of CFC's ability to keep funding costs low and provide members with attractive interest rates has been CFC's ability to utilize over-the-counter derivatives to hedge interest rate risk, never to speculate. As a result, our members benefit by paying lower rates on their loans. Those benefits are ultimately passed on to the rural ratepayer customers our members serve. If we were required to post margin, as contemplated in the NPR, our costs would rise significantly, and we would have to pass those costs on to our members.

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<sup>13</sup> For additional clarification on this point, please see our June 21, 2011 comment letter, which is attached for your convenience.

**Conclusion**

For the reasons noted above, we urge the Agencies to treat a cooperative that is entering into a swap that qualifies for the Cooperative Exemption the same as nonfinancial end users, and allow the covered swap entity to establish an initial margin threshold it deems appropriate for such qualifying cooperative without the limits imposed on swap entities and financial end users. This could be accomplished in the final rule by including cooperatives entering into a swap that qualifies for the Cooperative Exemption in the definition of “nonfinancial end user,” or alternatively in the definition of “low-risk financial end user.”

We appreciate your consideration. We would welcome the opportunity to further discuss our views. Please do not hesitate to contact Richard E. Larochelle, CFC’s Senior Vice President of Corporate Relations, at (703) 467-7406, [rich.larochelle@nrucfc.coop](mailto:rich.larochelle@nrucfc.coop) should you wish to discuss any of our comments or need additional information.

cc: Commodity Futures Trading Commission