



September 14, 2012

Mr. David A. Stawick, Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, D.C. 20581

**Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,
[RIN 3038-AC97]**

The National Rural Utilities Cooperative Finance Corporation (CFC) appreciates this opportunity to comment on the Commodity Futures Trading Commission's (the CFTC's or Commission's) notice of proposed rulemaking, "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," (the NPR).¹ CFC urges the Commission to adopt a final rule on margin requirements for uncleared swaps that is consistent with the nonfinancial end-user pass-through approach taken by the Commission's proposed rule, "Clearing Exemption for Certain Swaps Entered Into by Cooperatives," (Cooperative Exemption).² CFC, as a cooperative entity that would qualify under the CFTC's proposed Cooperative Exemption, wishes to take this opportunity to again thank the Commission on behalf of our end-user members for the proposed Cooperative Exemption. We believe that the Commission should adopt an approach consistent with that taken in the Cooperative Exemption in its final margin rule. We also appreciate the fact that the CFTC has reopened the comment period for the NPR in light of the margin requirements for uncleared derivatives released on July 6 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (the "Consultative Paper"). As discussed below, we believe that the approach taken by the CFTC in the NPR, with the modifications that we suggest below, is the correct approach for the U.S. markets.

The proposed Cooperative Exemption is premised on the member-owner nature of cooperatives and the fact that 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 a cooperative's members to the cooperative entity itself, subject to the same limits imposed on end-users in the end-user exception to clearing.³ Accordingly, we respectfully request that the Commission treat cooperatives that qualify under the Cooperative Exemption as nonfinancial entities for purposes of the NPR.

¹ See 77 Fed. Reg. 41109-41110 (July 12, 2012), reopening the comment period for the NPR and "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 76 Fed. Reg. 23732-23749 (April 28, 2011).

² 77 Fed. Reg. 41940-41952 (July 17, 2012), implementing the action taken by the CFTC on July 10th.

³ "End-User Exception to the Clearing Requirement for Swaps," 77 Fed. Reg. 42560-42591 (July 19, 2012).

In the preamble to the Cooperative Exemption, the CFTC explains in detail why the Cooperative Exemption makes sense, represents good policy, protects the public interest, and is consistent with both Congressional intent⁴ and specific provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). We respectfully request that the CFTC adopt a similar approach in the final rules implementing margin requirements—namely, that swaps entered into by qualifying cooperatives are afforded the same treatment under the final rule as swaps entered into by a qualifying cooperative’s nonfinancial, end-user members. The NPR imposes requirements on swap dealers and major swap participants for which there is no prudential regulator (covered swap entities or CSEs). The NPR would not impose margin requirements on nonfinancial end-users, or “nonfinancial entities.” We request that the CFTC treat cooperatives qualifying under the Cooperative Exemption as “nonfinancial entities” for purposes of the initial and variation margin requirements for uncleared swaps entered into with CSEs. In the alternative, if qualifying cooperatives are not treated as “nonfinancial entities,” we request that the CFTC allow cooperatives qualifying under the Cooperative Exemption to qualify for the threshold treatment allowed certain financial entities, as discussed below.

Background on CFC

CFC is a nonprofit, member-owned cooperative that was incorporated under the District of Columbia Cooperative Association Act in April 1969. The 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 percent owned by and serves its membership, which consists solely of member-owned nonprofit entities or subsidiaries or affiliates of nonprofit 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 loans and other types of financing to supplement the loan programs of the Rural Utilities Service (RUS), an agency of the U.S. 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. At May 31, 2012, loans and guarantees outstanding to CFC’s borrowers totaled approximately \$20 billion.

As a nonprofit cooperative, CFC’s objective is to offer its members cost-based financial products and services consistent with sound financial management, not to maximize net income. Thus, CFC’s purpose is to serve its nonprofit, consumer-owned rural electric cooperative members. Approximately 190 CFC members receive 100 percent 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

⁴ 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) 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*).

provide reliable, affordable electricity 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 consumers 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 without any substantial offsetting public interest being enhanced.

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 members or for swaps that hedge or mitigate risk in connection with 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;⁵
- (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.⁶

⁵ That section defines a financial entity for purposes of the CEA as "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.

⁶ 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

The CFTC estimates that approximately 10 cooperatives will be eligible for the Cooperative Exemption.⁷

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).⁸

The proposed Cooperative Exemption imposes the same reporting requirements that are imposed by the end-user exception.

Qualifying Cooperatives Should Qualify as “Nonfinancial Entities”

We believe that the CFTC should adopt the pass-through approach taken in its proposed Cooperative Exemption and allow qualifying cooperatives, such as CFC, to be treated in the same manner as their nonfinancial end-user members for purposes of the CFTC’s initial and variation margin requirements for uncleared swaps. As recognized by the CFTC, the cooperative member-owner structure—comprising 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

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

⁷ 77 Fed. Reg. at 41946.

⁸ 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;...”

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 subject to. The Commission has recognized that nonfinancial entities, which use swaps to hedge commercial risk, pose less risk to CSEs than financial entities.⁹ We agree with the Commission's determination, which is consistent with Congressional intent, that margin requirements should not be imposed on such entities, in contrast to the position taken by the Consultative Paper, which would impose requirements on all uncleared swaps, regardless of the type of counterparty. The Consultative Paper's overly broad approach is not required by, and in fact seems inconsistent with, the DFA's nuanced approach. On a risk basis, entities that elect the Cooperative Exemption would offer no greater risk to CSEs than entities electing to take the end-user exception directly and should be treated in the same manner for purposes of initial and variation margin requirements. Accordingly, we request that the CFTC amend the proposed definition of nonfinancial entity to include a cooperative qualifying under the Cooperative Exemption.

If Qualifying Cooperatives Are Not Treated as Nonfinancial Entities, Qualifying Cooperatives Should Qualify for the Threshold Treatment

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 swap activities. The CFTC articulated in the Cooperative Exemption that swaps subject to the Cooperative Exemption pose a low risk to the financial system. 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 for the threshold treatment that the CFTC has described in the NPR.

The threshold treatment described in the NPR will allow certain financial entities to avail themselves of a threshold to the margin requirements; in other words, a CSE may apply a threshold to the initial and variation margin requirements of a financial entity counterparty if the counterparty meets certain requirements.¹⁰ Initial and variation margin requirements do not apply to transactions below the threshold amounts. The requirements for a financial entity to qualify for threshold treatment include that the entity be subject to capital requirements established by a prudential regulator or state insurance regulator and, therefore, mirror the requirements for a financial entity to be considered a "low-risk financial end user"¹¹

⁹ 77 Fed. Reg. at 23736.

¹⁰ For a financial entity to qualify for threshold treatment under the CFTC's NPR it must meet the following requirements: (1) be subject to capital requirements established by a prudential regulator or State insurance regulator; (2) not have a significant uncleared swaps exposure; and (3) predominately use uncleared swaps to hedge or mitigate the risks of its business activities, including interest rate, or other risk.

¹¹ For a financial entity to qualify as a "low-risk financial end user" for purposes of the prudential regulators' proposed margin requirements it must: (1) not have a significant swaps exposure; (2) predominately use swaps or security-based swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk; and (3) be subject to capital requirements established by a prudential regulator or State insurance regulator.

in the margin and capital requirements rulemaking issued by the prudential regulators.¹² The prudential regulators in their margin-related rulemaking have adopted a two-tiered system for margin requirements for financial entities, with entities either qualifying for treatment as either a “low-risk financial end user” or “high-risk financial end user.” The CFTC adopts this approach by allowing “certain financial entities,” that is entities that would qualify as “low-risk financial end users,” to qualify for the threshold treatment. If qualifying cooperatives are not treated as non-financial entities, we believe that they should be included in the definition of financial entities qualifying for threshold treatment.¹³

The CFTC’s proposed definition of a financial entity that qualifies for the threshold treatment requires an entity to be subject to capital requirements established by a prudential regulator or state insurance regulator. We urge the Commission to re-evaluate its approach in drafting that definition. The approach advanced in the NPR offers preferential treatment for 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.

Specifically, we recommend that entities that qualify for the Cooperative Exemption based on the Commission’s proposed rule qualify for the threshold treatment, regardless of whether they are subject to a state insurance or prudential regulator. This approach is consistent with the Commission’s acknowledgement of 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.¹⁴

Given the CFTC’s narrow construction of the Cooperative Exemption and 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 uncleared 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 prudential regulators. Accordingly, we request that the CFTC modify the definition of a financial entity that may qualify for the threshold treatment to include cooperatives that qualify for the Cooperative Exemption.

¹² “Margin and Capital Requirements for Covered Swap Entities,” Fed. Reg. 27564-27595 (May 11, 2011).

¹³ As currently drafted, qualifying cooperatives would be considered to be financial entities for purposes of the NPR because of section 2(h)(7)(C)(i)(VIII) of the CEA.

¹⁴ 77 Fed. Reg. at 41943.

Request for Comment

In the preamble to the NPR, the Commission requested comment on a number of issues:

- Is the proposed definition of financial entity appropriate?

Comment: CFC believes that the proposed definition of financial entity should be modified to exempt from that definition cooperatives that qualify under the Cooperative Exemption. This modification would be consistent with the pass-through approach taken by the Commission in the Cooperative Exemption.

- Should the Commission instead define financial entity as a person that is not eligible to claim an exception from mandatory clearing under Section 2(h)(7) of the Act?

Comment: CFC agrees that the Commission should instead adopt an approach where financial entity is defined as a person that is not eligible to claim an exception from mandatory clearing under Section 2(h)(7) of the Act. Moreover, CFC believes this approach should be expanded to include entities that qualify for other exemptions from mandatory clearing, in particular for cooperatives that qualify under the Cooperative Exemption, or alternatively for any entity that may claim an exemption from mandatory clearing under an exemption granted by the Commission pursuant to its authority under Section 4(c) of the CEA. Moreover, as we explained in our comments above, it is consistent with Congressional intent to afford swap transactions involving rural electric cooperatives special consideration.¹⁵

- Do the definitions adequately identify financial entities that have different levels of risk?

Comment: As we have explained in our comment letter, CFC does not believe that the definitions adequately identify financial entities that have different levels of risk. CFC, as a nonprofit cooperative that exists exclusively to serve its members, is a low-risk enterprise that does not engage in speculative derivatives transactions and limits its utilization of over-the-counter derivatives to hedge interest rate risk arising from our member financing activities. The proposed definitions primarily distinguish between regulatory regimes and would unfairly disadvantage entities that are not subject to prudential oversight.

Conclusion

For the reasons noted above, we urge the Commission to treat a cooperative that is entering into a swap that qualifies for the Cooperative Exemption the same as a nonfinancial entity, and allow the covered swap entity to establish an initial margin threshold that it deems appropriate for such qualifying cooperative without the limits imposed on financial entities. 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 entity,” or alternatively to allow qualifying cooperatives to qualify for the threshold treatment described in the NPR.

¹⁵ See *supra* fn. 4.

We appreciate your consideration, and 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 or rich.larochelle@nrucfc.coop, should you wish to discuss any of our comments or need additional information.

cc:

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