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Part III

## Commodity Futures Trading Commission

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17 CFR Parts 4 and 50

Clearing Exemption for Certain Swaps Entered Into by Cooperatives;  
Harmonization of Compliance Obligations for Registered Investment  
Companies Required To Register as Commodity Pool Operators; Final  
Rules

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 50

RIN 3038-AD47

### Clearing Exemption for Certain Swaps Entered Into by Cooperatives

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rule.

**SUMMARY:** The Commodity Futures Trading Commission (“CFTC” or “Commission”) is adopting final regulations pursuant to its authority under section 4(c) of the Commodity Exchange Act (“CEA”) allowing cooperatives meeting certain conditions to elect not to submit for clearing certain swaps that such cooperatives would otherwise be required to submit for clearing in accordance with section 2(h)(1) of the CEA.

**DATES:** Effective September 23, 2013.

**FOR FURTHER INFORMATION CONTACT:** Brian O’Keefe, Deputy Director, 202–418–5658, [bokeefe@cftc.gov](mailto:bokeefe@cftc.gov), Division of Clearing and Risk, or Erik F. Remmler, Deputy Director, 202–418–7630, [eremmler@cftc.gov](mailto:eremmler@cftc.gov), Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581.

#### I. Background

The CEA, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”),<sup>1</sup> establishes a comprehensive new regulatory framework for swaps. The CEA requires a swap: (1) To be submitted for clearing through a derivatives clearing organization (“DCO”) if the Commission has determined that the swap is required to be cleared, unless an exception or exemption to the clearing requirement applies; (2) to be reported to a swap data repository (“SDR”) or the Commission; and (3) if such swap is subject to a clearing requirement, to be executed on a designated contract market (“DCM”) or swap execution facility (“SEF”), unless no DCM or SEF has made the swap available to trade.

Section 2(h)(1)(A) of the CEA establishes a clearing requirement for swaps, providing that “[i]t shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [DCO] that is

registered under [the CEA] or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared.”<sup>2</sup> However, section 2(h)(7)(A) of the CEA provides that the clearing requirement of section 2(h)(1)(A) shall not apply to a swap if one of the counterparties to the swap: “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps” (referred to hereinafter as the “end-user exception”).<sup>3</sup> The Commission has adopted § 39.6 (now recodified as § 50.50<sup>4</sup>) to implement certain provisions of section 2(h)(7). Accordingly, any swap that is required to be cleared by the Commission pursuant to section 2(h)(2) of the CEA must be submitted to a DCO for clearing by the counterparties unless the conditions of § 50.50 are satisfied or another exemption adopted by the Commission applies.

Congress adopted the end-user exception in section 2(h)(7) of the CEA to permit certain non-financial entities to continue using non-cleared swaps to hedge or mitigate risks associated with their underlying businesses, such as manufacturing, energy exploration, farming, transportation, or other commercial activities. Additionally, in section 2(h)(7)(C)(ii) of the CEA, the Commission was directed to “consider whether to exempt [from the definition of ‘financial entity’] small banks, savings associations, farm credit system institutions, and credit unions, including:

- (I) Depository institutions with total assets of \$10,000,000,000 or less;
- (II) farm credit system institutions with total assets of \$10,000,000,000 or less; or
- (III) credit unions with total assets of \$10,000,000,000 or less.”

In § 50.50(d), the Commission identifies which financial entities are small financial institutions and establishes an exemption from the definition of “financial entity” for these small financial institutions pursuant to section 2(h)(7)(C)(ii) (the “small financial institution exemption”). The

<sup>2</sup> See section 2(h)(1)(A) of the CEA, 7 U.S.C. 2(h)(1)(A).

<sup>3</sup> See section 2(h)(7)(A) of the CEA, 7 U.S.C. 2(h)(7)(A).

<sup>4</sup> 77 FR 74284 (Dec. 13, 2012). The Commission re-codified the end-user exception regulations as § 50.50 so that market participants are able to locate all rules related to the clearing requirement in one part of the Code of Federal Regulations. Because of this re-codification, all citations thereto in this final release will be to the sections as renumbered.

small financial institution exemption largely adopts the language of section 2(h)(7)(C)(ii) in providing for an exemption from the definition of “financial entity” for the types of section 2(h)(7)(C)(ii) institutions having total assets of \$10 billion or less.

On December 23, 2010, the Commission published for public comment a notice of proposed rulemaking (“end-user exception NPRM”) to implement the end-user exception.<sup>5</sup> Several parties that commented on the end-user exception NPRM recommended that the Commission extend relief from clearing to cooperatives.<sup>6</sup> These commenters primarily reasoned<sup>7</sup> that the member ownership nature of cooperatives and the fact that cooperatives act in the interests of members that are non-financial entities or cooperatives whose members are non-financial entities, justified allowing the cooperatives to also elect the end-user exception. In effect, they proposed that because a cooperative acts in the interests of its members when facing the larger financial markets, the end-user exception that would be available to a cooperative’s members should also be available to the cooperative. Accordingly, commenters asserted, if the members themselves could elect the end-user exception, then the Commission should permit the cooperatives to do so as well.<sup>8</sup>

<sup>5</sup> See 75 FR 80747 (Dec. 23, 2010).

<sup>6</sup> See, e.g., comments received on the end-user exception NPRM from: Agricultural Leaders of Michigan (ALM), The Farm Credit Council (FCC), Allegheny Electric Cooperative, Inc. (AEC), Garkane Energy Cooperative, Inc. (GEC), National Council of Farmer Cooperatives, Dairy Farmers of America, and National Rural Utilities Cooperative Finance Corporation (CFC). Comments received on the end-user exception NPRM can be found on the Commission’s Web site at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=937>.

<sup>7</sup> Other reasons given for providing an exemption from clearing to cooperatives, including risk considerations, are discussed below.

<sup>8</sup> In addition to the comments received on the end-user exception NPRM, the Commission notes that several Senators and members of the House of Representatives have expressed similar support in committee hearings for ensuring that the implementation of the Dodd-Frank Act does not change the way financial cooperatives operate in relation to their members. See, e.g., *Oversight Hearing: Implementation of Title VII of the Wall St. Reform and Consumer Prot. Act Before the S. Comm. on Agric.*, 112th Cong. 18 (2011) (statement of Sen. Debbie Stabenow, Chairwoman, S. Comm. on Agric.) (“I just want to make sure that . . . you’re saying or that you’re going to guarantee that the relationship between farmers and co-ops will be preserved and that farmers will continue to have affordable access to risk management tools.”); *One Year Later—The Wall St. Reform and Consumer Prot. Act: Hearing Before the S. Comm. on Agric.*, 112th Cong. 14 (statement of Sen. Amy Klobuchar, Member, S. Comm. on Agric.) (“I hope there is a way to uniquely define farmer co-ops so they can continue to do the kinds of things that they do.”);

<sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

However, section 2(h)(7) of the CEA does not differentiate cooperatives from other types of entities and therefore, cooperatives that are “financial entities,” as defined in section 2(h)(7)(i) of the CEA, are unable to elect the end-user exception unless they qualify for the small financial institution exemption. Some commenters recommended including cooperatives that are “financial entities” with total assets in excess of \$10 billion in the small financial institution exemption.<sup>9</sup> However, as explained in greater detail in the final release for § 50.50, section 2(h)(7)(C)(ii) of the CEA focused on asset size and not on the structure of the financial entity. Accordingly, only cooperatives that are financial entities with total assets of \$10 billion or less can qualify as small financial institutions under the small financial institution exemption.

Notwithstanding the foregoing, the Commission recognized that the member-owner structure of cooperatives and the merits of effectively allowing cooperatives to also use the end-user exception when acting in the interests of their members, warranted consideration. Accordingly, the Commission is using the authority provided in section 4(c) of the CEA to finalize § 50.51 (proposed as § 39.6(f)<sup>10</sup>), to permit cooperatives that meet certain qualifications to elect not to clear certain swaps that are otherwise required to be cleared pursuant to section 2(h)(1)(A) of the CEA (hereinafter referred to as the “cooperative exemption”). Under section 4(c) of the CEA, the Commission can subject such exemptive relief to appropriate terms and conditions.<sup>11</sup>

*Derivatives Reform: the View from Main St.: Hearing Before the H. Comm. on Agric., 112th Cong. 12 (2011) (statement of Rep. Timothy Johnson, Member, H. Comm. on Agric.) (“I’m also concerned, real concerned, representing an area, as a lot of us do, where rural electric cooperatives, agricultural cooperatives, and all that are an essential part of our being, critical, positive entities that really do a whole lot for the infrastructure of this country. . . . And I’m very concerned that we’re treating, in many ways, and you are, those cooperatives in a way almost identical to Goldman Sachs, and I think that’s—frankly, I think that fall[s] of its own weight.”); The Commodity Futures Trading Comm’n 2012 Agenda: Hearing Before the H. Comm. on Agric., 112th Cong. 13 (2012) (statement of Rep. Rick Crawford, Member, H. Comm. on Agric.) (“[Agricultural cooperatives provide] swaps to their members and then enter into [another swap to offset that risk]. This is critical to their ability to continue [to provide] hedging tools to member[s] of their coops. . . .”).*

<sup>9</sup> See, e.g., comments received on the end-user exception NPRM from: FCC, CFC, AEC, ALM, and GEC.

<sup>10</sup> For ease of reference, the Commission is re-codifying proposed § 39.6(f) as § 50.51 so that market participants are able to locate all rules related to the clearing requirement in one part of the Code of Federal Regulations.

<sup>11</sup> 7 U.S.C. 6(c)(1).

On July 17, 2012, the Commission published for public comment a notice of proposed rulemaking (“NPRM”) proposing the cooperative exemption as § 39.6(f) (now § 50.51).<sup>12</sup> The Commission explained that cooperatives have a unique legal structure that differentiates them from other legal business structures in terms of how they are operated and who benefits from their activities. In a cooperative, the members of the cooperative are the principal customers of the cooperative and are also the owners of the cooperative. Accordingly, the cooperatives exist to serve their member-owners and do not act for their own profit.<sup>13</sup> The member-owners of the cooperative collectively have full control over the governance of the cooperative. In a real sense, a cooperative is not separable from its member-owners. The cooperative exists to act in the mutual interests of its member-owners in the marketplace.

As described in greater detail below in section II, some cooperatives provide financial services to their members including lending and providing swaps, and the cooperatives sometimes hedge or mitigate risks associated with those lending activities with other financial entities such as swap dealers (“SDs”). The memberships of some of these cooperatives consist of entities that can each elect the end-user exception when entering into a swap. However, the end-user exception is unavailable to some of those cooperatives because they fall within the definition of “financial entity” and have assets in excess of \$10 billion. Accordingly, if the cooperative members continue to enter into loans and swaps with their cooperative, they would not receive the full benefits of the end-user exception because the cooperative would have to clear its swaps even though it is entering into the swaps to offset the risks associated with financial activities with its members or to hedge risks associated with wholesale borrowing activities, the proceeds of which are used to fund member loans. In effect, absent an exception from the clearing requirement for a cooperative that is providing certain swap services to its members, the cooperative structure would be unable—solely

<sup>12</sup> 77 FR 41940 (July 17, 2012).

<sup>13</sup> For example, the CFC was formed as a nonprofit corporation under the District of Columbia Cooperative Association Act of 1940 to arrange financing for its members and their patrons and for the “primary and mutual benefit of the patrons of the Association and their patrons, as ultimate consumers.” CFC Articles of Incorporation and Bylaws, Art. I, (last amended Mar. 1, 2005), available at [https://www.nrucfc.coop/content/dam/cfc\\_assets/public\\_tier/publicDocs/governance/CFCbylaws\\_3\\_11.pdf](https://www.nrucfc.coop/content/dam/cfc_assets/public_tier/publicDocs/governance/CFCbylaws_3_11.pdf).

because the cooperative is large and has substantial assets—to achieve the intended benefits for its members who can elect the end-user exception. In light of the foregoing, the Commission is exercising its authority under section 4(c) of the CEA to establish the cooperative exemption.

The Commission received approximately 25 comment letters and Commission staff participated in approximately two ex parte meetings concerning the cooperative exemption NPRM.<sup>14</sup> The Commission considered these comments in formulating the final regulations, as discussed below.

## II. Financial Entity Cooperatives

In the NPRM, the Commission described the structure of cooperatives that provide financial services to their members to provide context for the underlying rationale for the proposed cooperative exemption. The description provided in the NPRM is summarized below to facilitate an understanding of the comments received and the Commission’s responses thereto.

Cooperatives that are “financial entities,” as defined in section 2(h)(7)(C)(i) of the CEA, generally serve as collective asset and liability managers for their members. In this role, the cooperatives, in effect, face the financial markets as intermediaries for their members. These cooperatives sometimes enter into swaps with members and with non-member counterparties, typically SDs or other financial entities, to hedge the risks associated with the swaps or loans they execute with their members, or to hedge risks associated with their wholesale borrowing activities, the proceeds of which are used to fund member loans. If these financial entity cooperatives have total assets in excess of \$10 billion, then the cooperatives do not qualify for the small financial institution exemption and thus cannot elect the end-user exception.

Some cooperatives with more than \$10 billion in total assets have members that are non-financial entities, small financial institutions, or other cooperatives whose members consist of such entities.<sup>15</sup> For example, there are four Farm Credit System (“FCS”) banks chartered under Federal law, each of which has total assets in excess of \$10 billion.<sup>16</sup> The FCS banks are

<sup>14</sup> All comments received in response to the cooperative exemption NPRM can be viewed on the Commission’s Web site at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1237>.

<sup>15</sup> See, e.g., comments received on the end-user exception NPRM from FCC, CFC, AEC, ALM, and GEC.

<sup>16</sup> See FCA, 2011 Annual Report on the Farm Credit System, at 11, available at <http://>

Continued

cooperatives primarily owned by their cooperative associations.<sup>17</sup> The FCS banks are regulated and prudentially supervised by the Farm Credit Administration (“FCA”), an independent agency of the Federal government.<sup>18</sup> The Farm Credit Act authorizes the banks “to make loans and commitments to eligible cooperative associations.”<sup>19</sup> The FCS association members are, in turn, cooperatives authorized to make loans to farmers and ranchers, rural residents, and persons furnishing farm-related services.<sup>20</sup> In effect, FCS bank cooperatives primarily make loans to FCS association cooperatives, which lend to farmers and ranchers, rural residents, and persons furnishing farm-related services, and these borrowers are member-owners of the FCS associations, which are member-owners of the FCS banks. In addition to the example of the FCS banks, other cooperatives formed under federal and state laws also have a similar entity structure in that they are owned and governed by their members and they exist to serve those members.

The cooperative exemption, in effect, provides the end-user exception created in section 2(h)(7) of the CEA to financial entity cooperatives when acting in the interests of their members and in connection with loans to members. The exemption benefits the members that qualify for the end-user exception (or members that are cooperatives whose own members qualify for the end-user exception) because they own and control the cooperatives, which exist for the mutual benefit of its members. As described in greater detail below,<sup>21</sup> in the laws that establish financial cooperatives as legal entities distinct from other business structures, Congress and state legislatures made a policy determination to facilitate the formation of cooperatives in order to provide the cooperative members with the unique benefits of accessing markets on a cooperative basis. In this way, financial cooperatives were created to serve as an alternative source of capital for their members. Some of the laws establishing cooperatives acknowledge that cooperatives will compete with other market participants and may have certain benefits or advantages that are acceptable for promoting the benefits

that members achieve through their cooperatives.<sup>22</sup> Because the cooperatives are established to serve their members and the net earnings they generate through their activities are returned to those members, the benefits of the cooperative exemption ultimately inure to the members of the cooperative. In the context of required clearing and the end-user exception, the cooperative exemption furthers the purpose for which financial cooperatives were established, *i.e.*, to act for the mutual benefit of their members.

### III. Comments on the Proposed Cooperative Exemption Rule

#### A. Introduction

In proposing an exemption for certain swaps entered into by certain cooperatives that are financial entities, the Commission acknowledged in the NPRM that central clearing of swaps is a primary focus of Title VII of the Dodd-Frank Act. Central clearing mitigates financial system risks that could result from swaps and any exemption from central clearing should be narrowly drawn to minimize the impact on the risk mitigation benefits of clearing and should also be in line with the end-user exception requirements of section 2(h)(7) of the CEA. Accordingly, the Commission sought to narrowly tailor the cooperative exemption by limiting the types of entities that could elect the cooperative exemption and the types of swaps for which the exemption could be elected.

The Commission received a number of comment letters both supporting and opposing the proposed cooperative exemption. Fourteen rural electric cooperatives (“Rural Electric Cooperatives”)<sup>23</sup> and their trade association, the National Rural Electric Cooperative Association (“NRECA”) submitted substantially similar comment letters supporting the rulemaking. The FCC, the National Rural Utilities Cooperative Finance Corporation (“CFC”),<sup>24</sup> the Credit Union National Association (“CUNA”), the

American Farm Bureau Federation (“AFBF”), Chris Barnard (“Mr. Barnard”), and the National Council of Farmer Cooperatives (“NCFCA”) similarly supported the proposed cooperative exemption. Eleven of the twelve Federal Home Loan Banks (“FHL Banks”) submitted a comment letter supporting the concept of a cooperative exemption generally, but requested certain changes to the rule as described below.

The American Bankers Association (“ABA”), Lake City Bank, and the Independent Community Bankers of America (“ICBA”) submitted comments opposing the cooperative exemption on several grounds. All three opposed the rule on the grounds that it provides cooperatives with advantages at the expense of certain banks. The ABA and ICBA generally objected to the rule because they believe the reasoning behind the proposed rule was faulty and that the rule making did not comply with the requirements of section 4(c) of the CEA and the Administrative Procedure Act (“APA”). They also commented on the efficacy of the cost-benefit analysis in the NPRM.

The following discussion first addresses comments on each paragraph of the proposed rule followed by a discussion of the comments addressing compliance of the proposed rule with the legal parameters applicable to the rulemaking under section 4(c) of the CEA.

#### B. Regulation 39.6(f)(1) (now § 50.51(a)): Definition of Exempt Cooperative

The end-user exception is generally available to entities, including cooperatives, that are not “financial entities,” as defined in section 2(h)(7)(C)(i) of the CEA, and entities that would be financial entities, including cooperatives, but for the fact that they meet the requirements of the small financial institution exemption in § 50.50(d). The proposed cooperative exemption would add an exemption from required clearing for cooperatives that do not fall into these two categories if they meet the definition of “exempt cooperative.” Proposed § 39.6(f)(1) (now § 50.51(a)) defines “exempt cooperative” to mean a cooperative that is a “financial entity” solely as defined in section 2(h)(7)(C)(i)(VIII) of the CEA for which each member of the cooperative is either (1) a non-financial entity, (2) a financial institution to which the small financial institution exemption applies, or (3) itself a cooperative each of whose members fall into either of the first two categories.

The Commission received a number of comment letters in support of the Commission’s rationale provided in the

[www.fca.gov/Download/AnnualReports/2011AnnualReport.pdf](http://www.fca.gov/Download/AnnualReports/2011AnnualReport.pdf).

<sup>17</sup> See 12 U.S.C. 2124(c) (providing that “[v]oting stock may be issued or transferred to and held only by . . . cooperative associations eligible to borrow from the banks.”).

<sup>18</sup> See *id.* at 2241.

<sup>19</sup> *Id.* at 2128(a).

<sup>20</sup> See *id.* at 2075.

<sup>21</sup> See section IV.

<sup>22</sup> *Id.*

<sup>23</sup> See Allegheny Electric Cooperative, Inc., Coast Electric Power Association, Choptank Electric Cooperative, Claiborne Electric Cooperative, Inc., Deaf Smith Electric Cooperative Inc., Dixie Electric Cooperative, First Electric Cooperative Inc., Garkane Energy, Hoosier Energy Rural Electric Cooperative, Inc., Mountain View Electric Association, Inc., Pioneer Rural Electric Cooperative, Inc., Sullivan County Rural Electric Cooperative, Inc., Sumter Electric Cooperative, Inc., and Sunflower Electric Power Corporation.

<sup>24</sup> The comment letter from the CFC incorporates, as an attachment, the signatures of approximately 500 individuals associated with nonprofit rural electric cooperatives supporting the cooperative exemption.

NPRM for the proposed definition of exempt cooperative. The Rural Electric Cooperatives and NRECA agreed with the Commission's proposed definition of "exempt cooperative" and the Commission's reasons for establishing the exemption. The Rural Electric Cooperatives commented that the exempt cooperative definition is appropriate because members of exempt cooperatives would be eligible for the end-user exception if entering into swaps on their own. In their view, effectively extending the end-user exception available to the members of an exempt cooperative to the exempt cooperative itself is appropriate because the members act in the financial markets through the cooperatives that they own.

The FCC, the CFC, CUNA, Mr. Barnard, and the NCFC similarly supported the Commission's definition of exempt cooperative. Like the Rural Electric Cooperatives, the FCC suggested that the "unique structure of cooperatives and their relationship to their member-owners" warrants the cooperative exemption. The CFC and Mr. Barnard supported the "pass-through concept" embodied in the cooperative exemption. The FHL Banks commented that the unique ownership structure of cooperatives and the fact that cooperatives act on behalf of "members that are non-financial institutions or small financial institutions" justify the Commission issuing the cooperative exemption.

The ABA and the ICBA submitted comments opposing the definition of exempt cooperative because they believe there is no policy justification for the exemption and that the Commission's reasons for the exemption are not analytically appropriate. They commented that cooperatives do not play a unique role and are not themselves unique. The ABA suggested the Commission ignored the "fact that banks perform the same functions for customers that cooperatives perform for their members." Similarly, the ICBA commented that the Commission has not described how exempt cooperatives differ from commercial banks. According to ICBA, "community banks play the same role on behalf of their customers" that cooperatives play when facing the larger financial markets on behalf of their members. Both the ABA and the ICBA also noted that banks enter into swaps to hedge risks. The ABA noted that almost one-third of all the loans made by the FCS did not involve individual farmers or ranchers.

According to the ICBA, smaller "community" banks should be given the "same exemption as any financial cooperative of the same or larger size."

The ICBA and the ABA requested that "smaller" banks, with assets above the \$10 billion threshold in the end-user exception, be exempted from mandatory clearing along with cooperatives.

In response, the Commission does not disagree with these comments to the extent that banks often provide the same services to their customers that exempt cooperatives provide to their members. However, the nature of the services provided by cooperatives to their members is not the rationale for the cooperative exemption. The Commission's rationale is based in large part on the relationship between a cooperative and its members, which is different from the relationship between banks and their customers. The cooperative exemption in effect provides the end-user exception created in section 2(h)(7) of the CEA to entities whose members themselves qualify for the end-user exception, but would otherwise not be able to realize the full effects of the exception when those members act in the financial markets through their member-owned exempt cooperatives that do not qualify for the small financial institution exemption. The rule benefits the members who qualify for the end-user exception through the cooperatives that they own and control and exist for their mutual benefit. Because the cooperatives are established to serve their members and the net earnings they generate through their activities are returned to those members, the benefits of the cooperative exemption ultimately inure to the members of the cooperative.

The Commission notes that the definition of "exempt cooperative" is narrowly tailored so that only a cooperative for which each of its members individually, or if it has members that are cooperatives, each of the members of those cooperatives individually, would qualify for the end-user exception would qualify for the cooperative exemption. Furthermore, § 39.6(f)(2) (now § 50.51(b)) provides that the exemption is only available for swaps executed in connection with originating member loans and swaps that hedge or mitigate risk related to loans to members or arising from certain swaps with members. As such, under the final rule, an exempt cooperative shall not elect the exemption for swaps related to non-member activity of the cooperative.

Exempt cooperatives are distinct from banks not because of the services they offer, but because they exist to serve their members' interests and act as intermediaries for their members in the marketplace. The member-owners generally are the customers of the

cooperatives and the Commission drafted the proposed rule to be available only to the extent the cooperative exemption is used in connection with member-related activities. Cooperatives are owned by their members and as such, their governing bodies generally consist of members. Their net earnings are returned to their members either through rebates or distributions, often referred to as "patronage," or are retained by the cooperatives as capital to be used to provide services to members. For example, the FCC noted in its comments that FCS cooperatives were established by federal law to operate for the benefit of farmer-owners.<sup>25</sup> The FCC further noted that by law, each cooperative association in the FCS has a board of directors comprised of voting members of the association, and as required by law, at least one "outside" director.<sup>26</sup> Furthermore, voting stock may only be held by farmers, ranchers, producers of aquatic products, and cooperative associations eligible to borrow from FCS institutions.<sup>27</sup> Each owner of association voting stock is entitled to one vote in the affairs of the association, regardless of the amount of the stock held.<sup>28</sup> FCS additionally commented that each year FCS cooperatives pay patronage to their members, both in cash and allocated equity.<sup>29</sup> Furthermore, unlike for-profit entities that generally pay out dividends based on the amount of stock purchased by each investor, as discussed in greater detail below, cooperatives generally pay out or allocate earnings to the member-owners based on the amount of business

<sup>25</sup> The FCC cited Section 1.1(a) of the Farm Credit Act (12 U.S.C. 2001) ("farmer-owned cooperative Farm Credit System") and Section 1.1(b) thereof ("It is the objective of this chapter to continue to encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture which will be responsive to the credit needs of all types of agricultural producers having a basis for credit, and to modernize and improve the authorizations and means for furnishing such credit and credit for housing in rural areas made available through the institutions constituting the Farm Credit System as herein provided.").

<sup>26</sup> 12 U.S.C. 2072.

<sup>27</sup> 12 U.S.C. 2154a(c)(1)(D)(i).

<sup>28</sup> 12 CFR 611.350.

<sup>29</sup> For example, in 2011, FCS institutions distributed about \$903 million in cash patronage and \$243 million in stock patronage to the approximately 489,000 system shareholders. Farm Credit Admin., 2011 Annual Report on the Farm Credit System, 18 (2011); Press Release, Fed. Farm Credit Banks Funding Corp., Farm Credit System Reports Net Income of \$3.940 Billion for 2011, 5 (Feb. 17, 2012), available at <https://www.farmcreditfunding.com/farmcredit/serve/public/pressre/finin/report.pdf?assetId=198426>.

undertaken by each member with the cooperative.<sup>30</sup>

On the other hand, banks generally are for-profit, publicly or privately held corporations whose investor-owners are not required to be the users of the bank's services, and often are not. The governing bodies of banks, like other for-profit entities, are typically elected by the shareholders whose voting power is determined by the amount of common stock each investor owns. A board of directors of a corporation has a legal duty to the corporation and the shareholders and, accordingly, must consider shareholder value in its actions.<sup>31</sup> As such, unlike the member-focused purposes of exempt cooperatives, a primary purpose of banks is to generate value for their owners, who generally are not their customers. The mission of a cooperative is to act in the interests of its members, while the goal of a for-profit business, whatever its size, is to benefit the owners of that business, which are not necessarily its customers. Unlike a cooperative, which is an extension of its members as a business matter, a bank is not an extension of its customers. Accordingly, the Commission believes the rationale for extending the end-user exception to cooperatives does not apply to banks in the same way.

The ICBA further questioned whether "members" are any different from "customers," because, in the case of the FCS, borrowers can be considered owners or members even if they do not put their own capital into the organization. For example, according to the ICBA, an FCS borrower can become a member by paying an additional \$1,000 on a loan or one percent of the loan value, whichever is less.

The FCC commented that the Farm Credit Act and related regulations prescribe minimum stock purchase requirements for FCS borrowers and also require that FCS institutions meet minimum capital standards well in excess of the amount of purchased stock, citing 12 U.S.C. 2151. The FCC noted that as of December 31, 2011, combined FCS association capital was over \$24 billion dollars, or 19% of outstanding loans. Furthermore, the FCS noted that "[v]irtually all that capital is the result of income earned and retained."

The Commission believes that the comments of the ICBA and FCC on this issue further demonstrate the uniqueness of the member-owner relationship between exempt cooperatives and their members and how the cooperatives are, in effect, extensions of their members acting in the interests of their members in a way that is not the case for the relationship between other types of financial institutions and their customers. The earnings retained by FCS cooperatives would otherwise be paid out to members pro rata based on the amount of borrowing from the cooperatives. As such, a cooperative member has a vested, pro rata interest in its cooperative based on the amount of business the member does with the cooperative. While a for-profit entity such as a bank also may retain capital, the capital, if paid out to the owners, would be paid to the equity investors, not the customers of the entity and not based on the amount of business the customers do with the entity.

The ICBA and the ABA further commented that some of the entities that the cooperatives are "standing in the marketplace on behalf of" are sophisticated entities and are capable of entering into the swap marketplace on their own and do not need a cooperative to face the market. The ICBA also commented that all of the component entities of cooperatives would have "no trouble arranging financing from private sector sources."

The Commission did not assert in the NPRM that the members of cooperatives could only access financial markets through the cooperatives or that sole access through cooperatives was a reason for the proposed rule. Rather, the Commission recognized that certain entities for which the end-user exception is available have traditionally accessed the markets through financial cooperatives that they own and which exist for their benefit. For example, this relationship is well established and is codified into the federal law that created the FCS.<sup>32</sup> If the cooperative exemption were not adopted by the Commission, these entities would not be able to both continue to use their cooperatives and receive the full benefit of the end-user

exception created in the Dodd-Frank Act.

The ICBA questioned the Commission's statement in the preamble to the proposed cooperative exemption that "cooperatives exist to serve their member-owners and do not act for their own profit." The ICBA commented that the FCS, credit unions and other cooperatives "pay their executives millions of dollars each year."

The ICBA, Lake City Bank, and ABA also noted that the FCS and credit unions and other cooperatives that would be able to use the cooperative exemption already enjoy a number of significant advantages, such as low-cost funding, tax exemptions, and, in some cases, government sponsored enterprise ("GSE") status. They expressed concern that providing credit unions, FCS cooperatives, and other cooperatives with an exemption from mandatory clearing would "exacerbate their competitive advantage over banks." Furthermore, the ICBA stated that "FCS lenders have in recent years positioned themselves to act almost identically to banks through deposit taking arrangements, credit card offerings, check writing capabilities and outright illegitimate activities granted by their permissive regulator."

The Commission is not responsible for the creation, administration, or implementation of those legal characteristics of cooperatives referred to in the comments as being "competitive advantages." These characteristics, by and large, flow from policies enacted by Congress or state legislatures. Further, the Commission is not the regulator responsible for the laws and regulations referred to by commenters that govern cooperatives. The Commission has determined without regard to such other asserted benefits for cooperatives, to offer an elective clearing exemption to entities qualifying as exempt cooperatives to extend the full benefits of the end-user exception established in the Dodd-Frank Act to entities that would qualify for that exception, but which choose to act through their cooperatives in the financial marketplace.<sup>33</sup>

Comments regarding the compensation of executives are outside the scope of this rulemaking. The rationale for the cooperative exemption is based on the member-owner structure of cooperatives, not on how much executives are paid or whether that pay is fair. The Commission defers to the regulators who enforce those regulations

<sup>30</sup> See 18 a.m. Jur. 2d Cooperative Associations § 19 (2012) ("Ordinarily, the profits of a cooperative association are distributed to its members in the form of patronage refunds or dividends in amounts determined by the use made of the association facilities by the patrons, and statutes frequently so provide.").

<sup>31</sup> See, e.g., 18B Am. Jur. 2d Corporations 1460 (2012).

<sup>32</sup> "It is declared to be the policy of the Congress . . . that the farmer-owned cooperative [FCS] be designed to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations." 12 U.S.C. 2001(a).

<sup>33</sup> For a discussion of the related "fair competition" provision in section 4(c), see section IV herein.

for issues related to executive compensation.

With respect to swaps, the ICBA noted that cooperatives and community banks both enter into swaps to hedge the interest rate risk of loans to their customers or members. The ICBA suggested that swaps hedging the underlying risks of loans to customers pose the same lower risk to the financial system that the FCC claims regarding swaps hedging the risks of loans to its cooperative members.

The Commission notes that it is not relying on the assertion by the FCC that swaps related to hedging loans to cooperative members may be less risky than other types of swaps that financial entities may undertake as a primary reason for distinguishing exempt cooperatives from other types of lending entities.<sup>34</sup> As explained in the NPRM, the potential lower risk of such swaps is, however, one of the reasons why the Commission is restricting the cooperative exemption to swaps related to member loans.

The National Association of Federal Credit Unions requested that the Commission specify that the cooperative exemption applies to “all credit unions.” The Commission clarifies that the exemption applies to all cooperatives, including credit unions that meet the definition of “exempt cooperative” in the final rule. The Commission does not have enough information to determine whether “all credit unions” are eligible for the exemption. Whether any particular credit union meets the definition of an exempt cooperative will depend on the relevant facts and circumstances for that credit union.

The FHL Banks stated that they would not qualify as exempt cooperatives because each FHL Bank has one or more members that are financial institutions that do not qualify for the small financial institution exemption. The FHL Banks commented that the cooperative exemption, as proposed, would “unfairly and arbitrarily” penalize members of a cooperative that would qualify as small financial institutions under the end-user exception if the cooperative also has one or more large financial institutions as members. The FHL Banks stated that this would result in the inconsistent treatment of two similarly situated entities. The FHL Banks also point to the joint final rule on the definition of the term “swap dealer,” where the

Securities and Exchange Commission along with the Commission excluded all swaps between a cooperative and its members from the analysis of whether that cooperative is an SD. This regulatory treatment, according to the FHL Banks, would be “consistent” with the Commission allowing the FHL Banks to elect the cooperative exemption in certain circumstances.

The FHL Banks requested that the Commission remove the limitation that bars a cooperative from being an “exempt cooperative” if it has one or more members that are financial entities that are not themselves cooperatives with members that qualify for the end-user exception. Instead, the FHL Banks suggested that the Commission allow cooperatives to enter into swaps that hedge or mitigate commercial risk related to loans to “qualified members” or arising from swaps entered into with “qualified members” that are eligible for the end-user exception. The FHL Banks proposed the term “qualified member” to mean a member of an exempt cooperative that is (1) not a financial entity, (2) a financial entity that is exempt from the definition of financial institution under the small financial institution exemption in § 50.50(d), or (3) a cooperative, each member of which is not a financial entity or is exempt from mandatory clearing because it qualifies for the small financial institution exemption. The FHL Banks commented that their proposed approach is consistent with the Dodd-Frank Act’s objective of mandating that swaps entered into in connection with or for large financial institutions be cleared, without penalizing small financial institutions. According to the FHL Banks, their proposed revisions to the cooperative exemption would allow FHL Banks to qualify as an “exempt cooperative,” in appropriate situations. The FHL Banks also stated that this revised cooperative exemption would apply to less than 10% of the outstanding notional amount of the FHL Banks’ swaps. The ICBA, like the FHL Banks, suggested that the Commission revise the definition of exempt cooperative to not exclude the FHL Banks “to the extent that they engage in swaps for the benefit of their members who individually qualify as small financial institutions.”

In response to the FHL Banks’ and the ICBA’s comments regarding cooperatives that are ineligible for the cooperative exemption because they have one or more financial entity members, the Commission declines to extend the exemption beyond the parameters as proposed. The Commission disagrees with the FHL

Banks’ assertion that the cooperative exemption is arbitrary or unfair to financial institutions that qualify for the small financial institution exemption. Under § 39.6(f)(1)(iii)(A) (now § 50.51(a)(3)(i)) of the proposed rule, small financial institutions that meet the definition thereof in § 50.50(d) can be members of exempt cooperatives. These members can include banks, savings associations, FCS institutions, or credit unions, so long as each of them qualifies as a small financial institution under § 50.50(d) (i.e. the institution has total assets of \$10 billion or less). They would be treated in the same way as all other entities that may qualify for the end-user exception, and therefore can be members of exempt cooperatives as defined.

Furthermore, as the Commission acknowledged above and in the NPRM, it is concerned that exemptions from the clearing requirement could detract from the systemic risk reducing benefits of clearing. This is particularly a concern if the exemption could be elected for swaps that relate to risks of entities that Congress clearly intended to be subject to the clearing requirement—financial entities as defined in section 2(h)(7)(C) of the CEA that are not expressly exempted from that definition. As such, the Commission narrowed the cooperative exemption to apply solely to a cooperative whose members (or if it has members that are cooperatives, the members of those cooperatives) could themselves elect the end-user exception.

The importance of a narrow cooperative exemption is apparent when considering the possible effect of broadening the exemption in the manner requested by the FHL Banks and ICBA. A fundamental characteristic of cooperatives is that they distribute or allocate the patronage earnings of the cooperative, *i.e.*, the excess of a cooperative’s revenues over its costs arising from transactions done with or for its members,<sup>35</sup> to each member based on the amount of patronage by the member, *i.e.*, proportionally based on the amount of business each member does with the cooperative.<sup>36</sup> Accordingly, even if a cooperative with financial entity members only elected

<sup>35</sup> See FASB ASC 905–10–05.

<sup>36</sup> The distribution or allocation of patronage earnings to the members based on the amount of business they do with the cooperative is a guiding principle of cooperatives and is a necessary element for a cooperative to claim a deduction for taxation purposes under federal law. See Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background, Cooperative Information Report 44*, Part 1, 2005 Ed. (April 2005) at 50, citing, *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305, 308 (1965).

<sup>34</sup> The Commission believes, however, that because exempt cooperatives serve their members and are controlled by their members, it can be expected that cooperatives will focus their swap activity on member loan-related activities.

the cooperative exemption for swaps related to loans to members that qualify for the end-user exception, a portion of the financial benefits from those swaps in the form of higher net income may shift from the qualifying small members to the larger members as part of the full member pro rata patronage distribution or allocation. Furthermore, the risks of such swaps because they are non-cleared could also negatively impact the large financial institution members to the extent that the net income of the cooperative is negatively impacted.

As an example, consider the relative amounts of lending by the FHL Banks to those of their largest members that do not qualify for the end-user exception as compared to the FHL Banks' lending to their other members. The 12 FHL Banks had 7,774 members as of the end of 2011.<sup>37</sup> Each of the 12 FHL Banks reported the amount of lending business they did with their five largest members in the 2011 Combined Financial Report for the FHL Banks. In 2011, \$222.6 billion of the \$403.3 billion lent by the FHL Banks to their members was lent to the largest five members of each of the 12 FHL Banks.<sup>38</sup> Of those 60 large members, approximately 49 had total assets in excess of \$10 billion.<sup>39</sup> The amount loaned to those 49 members was about \$212.7 billion, or 53% of the dollar amount lent by the FHL Banks. Furthermore, those 49 members do not include all members of the FHL Banks with assets greater than \$10 billion. Accordingly, the Commission estimates the percentage of lending by the FHL Banks to members that cannot qualify for the end-user exception was higher than 53% of total lending in 2011.<sup>40</sup> If

the FHL Banks were able to use the cooperative exemption, under the cooperative structure in which patronage benefits are allocated pro rata based on the amount of business each member does with the cooperative, a significant portion of the benefits and risks from the election of the exemption could spread to the large financial entity members. This would also be the case even if the exemption were only available to swaps related to small financial institutions because the distribution of patronage to the members is based to a large degree on the amount of borrowing by each member.

Similarly, the Commission is concerned that allowing cooperatives with members that do not qualify for the end-user exception to elect the cooperative exemption could open up avenues for abuse of the exemption and evasion of clearing. For example, larger financial entities could form cooperatives capitalized by the large financial entities, but which also include small affiliates or trading partners of the larger financial entities that would qualify as small financial institutions. They could then use these cooperatives to shift their borrowing and swap needs between the large and small entities to be able to take advantage of the cooperative exemption in ways that benefit the larger institutions. The Commission considers these risks of abuse of the exemption and evasion of the clearing requirement warrant limiting the definition of exempt cooperative as written. The Commission notes that small financial institutions can elect the end-user exemption themselves.

The ICBA noted that the Dodd-Frank Act's requirement that the Commission consider exempting small financial institutions is not necessarily limited to institutions with less than \$10 billion in total assets. The ICBA commented that there are 36 "community banks"<sup>41</sup> with assets over \$10 billion, and within the category of "community banks," the asset sizes of those banks range from \$10.5 billion to \$50 billion. The ICBA suggested that the asset size test in the end-user exception be increased up to \$50 billion or that community banks be given a "ride along" provision so that

assets greater than \$10 billion. Accordingly, while the total percentage of lending to financial entities with total assets greater than \$10 billion cannot be calculated based on the information available in the financial report, it is likely significantly higher than the 53% calculated for the 49 members with over \$10 billion in total assets for which lending information is available.

<sup>41</sup> The ICBA did not specifically define the term "community banks" other than by reference to the \$50 billion maximum asset level.

community banks that do not qualify for the end-user exception could elect the same exemption as cooperatives.

With these comments, the ICBA is effectively asking the Commission to reopen and revise the end-user exception rule as applied to financial institutions generally. The Commission set forth the reasons for the \$10 billion total asset limit for small financial institutions in the end-user exception rulemaking and believes that those reasons remain appropriate. This rulemaking addresses the specific issue of whether an exemption from clearing should be granted to certain cooperatives—including the issue of whether there are relevant differences between the covered cooperatives and private banks—and is not intended as a vehicle for reopening the end-user exception regulations.

*C. Regulation 39.6(f)(2) (now § 50.51(b)): Swaps to Which the Cooperative Exemption Applies*

Proposed § 39.6(f)(2) (now 50.51(b)) limits application of the cooperative exemption to swaps entered into with members of the exempt cooperative in connection with originating loans<sup>42</sup> for members or swaps entered into by exempt cooperatives that hedge or mitigate risks related to loans to members or arising from member loan-related swaps. This provision assures that the cooperative exemption is used only for swaps related to member lending activities. Since the definition of an exempt cooperative requires that all members be entities who can elect the end-user exception or cooperatives all of whose members can, this condition assures that the exemption will benefit entities who could themselves elect the end-user exception and can be used for swaps that hedge or mitigate risk in connection with member loans and swaps as would be required by section 2(h)(7)(A)(ii) of the CEA.

The primary rationale for the cooperative exemption is based on the unique relationship between cooperatives and their member-owners. Expanding this exemption to include swaps related to non-member activities would extend the exemption beyond its intended purpose. Furthermore, allowing cooperatives to enter into non-cleared swaps with non-member borrowers, or swaps that serve purposes other than hedging member loans or

<sup>42</sup> The phrase "in connection with originating a loan" is similarly used in the definition of swap dealer in § 1.3(ggg) of the Commission's Regulations. See 77 FR 30596, 30744 (May 23, 2012). That meaning is incorporated in the final rule.

<sup>37</sup> FHL Banks, Combined Financial Report for the Year Ended December 31, 2011 (issued March 29, 2012) at 43, available at [http://www.fhlb-of.com/ofweb\\_userWeb/resources/11yrend.pdf](http://www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf).

<sup>38</sup> *Id.* at 44–45. The Commission arrived at the \$222.6 billion amount by adding together the loan values of the 60 individual members listed in the Combined Financial Report of the FHL Banks.

<sup>39</sup> The Commission estimated this number by reviewing publically available information related to the assets of each of the 60 members, such as members' annual 10-K financial reports filed with the SEC (available on the SEC's Web site and posted on the members' Web sites), other annual financial reports and information, such as press releases posted on members' Web sites, and reports published by the Federal Reserve and Federal Deposit Insurance Corporation. As an example, the Commission reviewed the Federal Reserve's Statistical Release for Large Banks, which provided information regarding the total assets held by 27 of the 60 members. See Federal Reserve, Statistical Release for Large Banks, available at <http://www.federalreserve.gov/releases/lbr/current/default.htm>.

<sup>40</sup> The FHL Banks Combined Financial Report for the Year Ended December 31, 2011, does not break down lending amount for every member. The 49 members used in the Commission's calculations do not include all members of the FHL Banks with



swaps, would give the cooperatives, which are large financial entities, an exception from regulatory requirements that would not be provided to other market participants engaging in such similar business with respect to non-members that is not justified by their cooperative structure or the provisions of the Dodd-Frank Act.

The CFC commented that it agrees with the types of swaps eligible for the cooperative exemption described by the Commission in the preamble of the NPRM. The CFC stated that the use of the phrase “related to” in the rule text is consistent with the “pass-through concept” that underlies the cooperative exemption. The FCC suggested that the Commission provide additional clarity on the “related to” standard. The FCC commented that the “related to” standard should be broad enough to cover swaps that hedge or mitigate risk related to “interest rate, liquidity, and balance sheet risks” associated with a cooperative’s lending business. The FCC pointed to the statement in the preamble to the proposed rule that explained that the “related to” test involves hedging or mitigating risks “associated with” member loans. The FCC supported this interpretation. The FCC requested that the Commission clarify that certain types of transactions would be covered by the cooperative exemption. Specifically, the FCC suggested that the following swaps should be covered by the cooperative exemption: (1) Swaps managing interest rate, liquidity, and balance sheet risk, (2) swaps qualifying as GAAP hedges of bonds and floating rate notes, and (3) swaps hedging FCS banks’ liquidity reserves that are required by the FCA.

The AFBF also requested that the Commission clarify that swaps mitigating or hedging balance sheet, interest rate, and liquidity risks associated with their cooperative lending business are eligible for the cooperative exemption.

The Commission’s rationale for the cooperative exemption is based on the unique relationship between a cooperative and its members. The primary purpose for the cooperative exemption is to, in effect, provide the full benefits of the end-user exception created in section 2(h)(7) of the CEA to entities that qualify for the end-user exception, but otherwise do not receive the full benefits of the exception if they use their cooperatives as their intermediary in the markets as they have traditionally done. Thus, the Commission will interpret this exemption to ensure that the exemption is only used for swaps that are undertaken to directly further the

interests of the members who are themselves eligible for the end-user exception. Accordingly, the Commission declines to expand the types of transactions eligible for the exemption beyond those swaps that are entered into in connection with originating a loan or loans for a member, or swaps that hedge or mitigate commercial risk related to loans with members, or hedge or mitigate the commercial risk associated with a swap between an exempt cooperative and its members in connection with originating loans to members.

With respect to the comments of the AFBF and the FCC regarding swaps that hedge balance sheet, interest rate, and liquidity risks associated with their cooperative lending business, the Commission reiterates that only those swaps relating to member loans are eligible for the exemption, not swaps related to a cooperative’s entire lending business to the extent that lending business includes loans to non-members. Accordingly, the exemption may be used for swaps that hedge balance sheet, interest rate, and liquidity risks, but only limited to the extent those risks are related to loans made by the cooperative to its members. The Commission is concerned that without this limitation, cooperatives could use this exemption for risks related to non-member-based activities, which would be inconsistent with the general rationale for the exemption and could result in a competitive benefit to eligible cooperatives that is also inconsistent with the Commission’s rationale for the exemption.

As the text of § 39.6(f)(2)(i) (now § 50.51(b)(1)) provides, the phrase “swap is entered into with a member of the exempt cooperative in connection with originating a loan or loans for the member” should be read consistent with 17 CFR 1.3(ggg)(5). Among other things, 17 CFR 1.3(ggg)(5) provides that an acceptable swap includes a swap with members for which the rate, asset, liability or other notional item underlying such swap is, or is directly related to, a financial term of such loan, which includes, without limitation, the loan’s duration, rate of interest, the currency or currencies in which it is made and its principal amount; or the swap is required, as a condition of the loan under the exempt cooperative’s loan underwriting criteria, to be in place in order to hedge price risks incidental to the borrower’s business and arising from potential changes in the price of a commodity (other than an excluded commodity).

Section 39.6(f)(2)(ii) (now § 50.51(b)(2)) also includes in the

cooperative exemption swaps that hedge or mitigate risk related to loans to members or arising from a swap or swaps with members entered into pursuant to § 39.6(f)(2)(i) (now § 50.51(b)(1)). This provision includes swaps that the exempt cooperatives may enter into with non-members to hedge or mitigate the risks incurred by the cooperatives related to their member lending activities. Such swaps can include swaps entered into with non-member parties (e.g., SDs) to hedge or mitigate risks such as interest rate risk related to funding loans to fund member loans, or liquidity or balance sheet risks, so long as those liquidity and balance sheet risks arise from activities related to member loans.

As discussed above in this section, the risks must be related to member loans only. For example, the Commission understands that cooperatives sometimes issue bonds or enter into wholesale funding transactions to fund member and non-member loans. The cooperative exemption would permit an exemption for swaps, such as interest rate swaps or interest rate caps, used to hedge those funding transactions, but only to the extent that the interest rate swaps or interest rate caps relate to member-associated loans. Only swaps hedging or mitigating risk arising from the portion of the bonds or wholesale funding proceeds that is related to, or is expected to be related to, direct loans to members are eligible for the exemption. Practically speaking, this means that for a cooperative borrowing on a wholesale basis for both member and non-member-associated loans, the aggregate notional amount of any non-cleared swaps hedging the wholesale funding loans must not exceed the aggregate principal value of the wholesale funding loans less the aggregate principal amount lent or expected to be lent to non-members. Cooperatives would need to adjust that aggregate notional amount by termination or other means as soon as practicable if that aggregate amount is exceeded during the life of any such swaps.

As another example, eligible cooperatives may want to hedge interest rate risk associated with a portfolio of loans to multiple borrowers with one or more swaps. If the loan portfolio being hedged consists solely of loans to members, then the cooperative exemption would be available for those hedging swaps if the requirements of § 39.6(f) (now § 50.51) are met. However, if the cooperative has non-member loans in the loan portfolio being hedged, then the swap may be hedging risk that is not related to

member loans and, if so, the exemption would not be available for that swap. In order to be able to elect the exemption for swaps that hedge a portfolio of member loans and non-member loans, the aggregate notional amount of any such swaps must not exceed the aggregate principal amount of the member loans in the portfolio. Cooperatives would need to adjust that notional amount by termination or other means, such as clearing certain swaps, as soon as practicable if that amount is exceeded during the life of any such swap. The same limitation applies to balance sheet risks. The exemption may be elected for swaps hedging balance sheet risks only to the extent they arise from member loan related activity. For example, balance sheet risks could be hedged with swaps for which the cooperative exemption may be available to the extent that the aggregate notional amount of such swaps does not exceed the aggregate principal amount of member loans.

With respect to FCC's comments relating to "liquidity reserves" required by the FCA, the Commission believes the same general approach described above should apply. That is, swaps hedging risks related to liquidity reserves may be eligible for the exemption only to the extent that such reserves being hedged are related to member loans. For example, if a cooperative makes loans to both members and non-members and hedges risks related to liquidity reserves for the combined loan portfolio, the cooperative would be permitted to elect the exemption for the hedging swaps to the extent that the aggregate notional amount of the swaps does not exceed an amount equal to the total liquidity reserves multiplied by the proportion of the member loans principal amount to the total principal amount of member loans and non-member loans in the cooperative's combined loan portfolio.

The CFC commented that the Commission should modify the language of section 39.6(f)(2)(ii) (now § 50.51(b)(2)), which is a cross-reference to the definition of hedging or mitigating commercial risk for the purposes of the end-user exception, to replace the term "commercial enterprise" with the term "exempt cooperative."

The requested change is not necessary. As explained in the final release for the end-user exception,<sup>43</sup> the use of the term "commercial enterprise" is intended to refer to the underlying activity to which the risk being hedged or mitigated relates in the context of the

entity's normal business activities, not simply the type of entity claiming the exemption. For example, in the context of the cooperative exemption, it would include the risks undertaken by a cooperative in the normal course of business of providing loans to members.

#### *D. Regulation 39.6(f)(3) (now § 50.51(c)): Reporting*

The Commission believes it is appropriate to impose certain reporting requirements on any entities that may be exempted from the clearing requirement by this regulation. The reporting requirements in the final rule are effectively identical to the reporting requirements for the end-user exception. For purposes of regulatory consistency, § 39.6(f)(3) (now § 50.51(c)) incorporates the provisions of § 50.50(b) with only those changes needed to apply the reporting provisions in the specific context of the cooperative exemption. Regulation 50.50(b) requires one of the counterparties (the "reporting counterparty") to provide, or cause to be provided, to a registered SDR, or if no registered SDR is available, to the Commission, information about how the counterparty electing the exemption generally expects to meet its financial obligations associated with non-cleared swaps. In addition, § 50.50(b) requires reporting of certain information that the Commission will use to monitor compliance with, and prevent abuse of, the exemption. The reporting counterparty would be required to provide the information at the time the electing counterparty elects the cooperative exemption.

The CUNA requested that the Commission minimize the compliance burdens on cooperatives that elect to use the cooperative exemption, including the notification requirement. The ICBA requested that the Commission modify the reporting requirement when the cooperative exemption is elected. The ICBA commented that the aggregate reporting requirements of § 50.50(b) do not allow the Commission to "monitor actual risks or swaps usage." The ICBA stated that it was concerned that FCS members actively seek to lend to a number of entities that are not owners of the FCS. Because of this, the Commission, according to the ICBA, would not have a way of verifying that the swaps for which an FCS bank elected this exemption are actually eligible for the cooperative exemption. Neither the ICBA nor the CUNA proposed any specific changes to the rule text in connection with their comments.

The Commission has determined not to change the reporting requirements

proposed in § 39.6(f)(3) (now § 50.51(c)) and to keep them consistent with the reporting requirements of the end-user exception. The Commission discussed at length in the final release of the end-user exception how the reporting requirements for entities electing the clearing requirement exception are simplified through a check-the-box approach and can be reported along with the other reporting required for all swaps under the Commission's part 45 regulations.<sup>44</sup> The Commission believes that the reporting requirements will provide the Commission with sufficient information, along with the other information to be reported for all swaps and information publicly reported by cooperatives, to detect evasion of required clearing or abuse of the exemption. For example, every swap executed by a cooperative, as is the case with all swaps, must be reported to an SDR or to the Commission and the parties to that swap will be identified. Accordingly, the Commission will be able to review and analyze the economic and other details of all swaps entered into by each cooperative. As such, the Commission is able to monitor actual swap usage by cooperatives. The swap reporting requirements are not intended to monitor the risk levels of individual cooperatives. Monitoring the accumulated risk undertaken by financial cooperatives is generally the purview of their supervisory regulators.

Based on a review of publicly available information and discussions with the regulators of financial cooperatives, the Commission believes that a large majority of lending by these cooperatives is to their members. As such, at present there do not appear to be substantial incentives for cooperatives to abuse the exemption with respect to swaps that are not member related. Notwithstanding the foregoing, the limitations on using the exemption for non-member related activities is clearly established in the final rule and the Commission is confident that the tools available to the Commission for addressing abuse or evasion of the cooperative exemption are sufficient without changing the reporting requirements as proposed.

#### *E. Other Comments on the Proposed Rule*

The ABA and the ICBA commented that the FCS, as a GSE, presents a significant risk for the U.S. taxpayer. The ICBA stated that the FCS was "bailed out" by the government during the farm credit crisis in the 1980s. The ABA and the ICBA noted that the FCS,

<sup>43</sup> 77 FR 42572 (July 19, 2012).

<sup>44</sup> 77 FR at 42565-70.

if viewed as a single financial institution because of the mutual support provisions for the FCS institutions, has assets worth more than \$230 billion. According to the ICBA, the FCS may be systemically important under the Dodd-Frank Act because it has assets in excess of \$50 billion. The ICBA also suggested that the Commission should not provide any exemptions for any institution with over \$50 billion in assets because institutions over \$50 billion are considered to be potentially systemically important under the Dodd-Frank Act.

In contrast, the FCC commented that the FCS banks have strong protections in place for counterparty default, including, for example, collateral posting agreements, which are overseen by the FCA. According to the FCC, these protections have been effective throughout the recent financial crisis. Accordingly, the FCC suggested that the FCS poses no systemic risk to the U.S. financial system.

The fact that Congress designated the FCS as a GSE does not by itself imply the existence of a sufficiently higher level of risk to justify rejecting the limited exemption from clearing provided to cooperatives. The Commission notes that the FCS is supervised by the FCA, an independent Federal agency charged with overseeing the safety and soundness of the FCS.<sup>45</sup> The Commission acknowledged in the NPRM that the proposed exemption would be available to cooperatives with total assets in excess of \$50 billion. However, the Commission believes that the exemption, as narrowly drafted, is appropriate given the benefits conferred by it to the entities Congress designated for the end-user exception who are members of exempt cooperatives. Regarding the possible designation of the FCS as systemically important, the Commission notes that Congress excluded the possibility of the FCS from being designated as systemically important by the Financial Stability Oversight Council.<sup>46</sup>

The CFC requested that the Commission, when coordinating with

the other prudential regulators working to finalize the margin rules for non-cleared swaps, ensure that the final margin requirements for non-cleared swaps are consistent with the final cooperative exemption. In effect, the CFC requested that the final margin rules for non-cleared swaps not require margin for swaps eligible for the cooperative exemption.

The Commission intends to continue to work with the other prudential regulators to ensure that the cooperative exemption, along with other clearing exceptions or exemptions, are taken into consideration when finalizing the margin rules for non-cleared swaps.

The ICBA suggested that the Commission should review the exemption “every three years to see if the exemption is warranted on an ongoing basis” because cooperatives will have had time to “adjust to the evolving swaps markets and clearing systems.”

The Commission declines to include an explicit sunset or study provision in the final rule. As the Commission’s swap regulations are new and the market is evolving in response, the Commission anticipates evaluating its swap-related regulations on an as-needed basis and will modify them as appropriate.

The ABA requested that the Commission extend the comment period for this rule because of the “impending regulatory deadlines, complexity, and economic consequences” of the cooperative exemption.

The Commission declines to extend the comment period because the public was given an opportunity to, and did, participate in the rulemaking process.

#### **IV. Section 4(c) of the Commodity Exchange Act**

Section 4(c)(1) of the CEA states that “[i]n order to promote responsible economic or financial innovation and fair competition” the CFTC may exempt any agreement, contract, or transaction subject to section 4(a) from the requirements of that section or any other section of the CEA. Section 4(c) authorizes the Commission to grant exemptive relief to foster the development or continuance of market practices that contribute to market innovation and competition.<sup>47</sup> Congress, in adding section 4(c) to the CEA,

intended that the Commission, “in considering fair competition, will implement this provision in a fair and even-handed manner.”<sup>48</sup> At the same time, Congress expected that, in doing so, the Commission “will apply consistent standards based on the underlying facts and circumstances of the transaction and markets being considered, and may make distinctions between exchanges and other markets taking into account the particular facts and circumstances involved, consistent with the public interest and the purposes of the Act, where such distinctions are not arbitrary and capricious.”<sup>49</sup> While this language refers specifically to distinctions between exchanges and other markets, it implies that Congress more generally expected the Commission, in applying section 4(c)(1), to draw distinctions among different market participants where circumstances justify it.<sup>50</sup> As discussed in detail elsewhere herein, cooperatives are unique in their organizational form, in the way that they act in the interests of their members, and in the well-established public policies that support the ability of cooperative members to make use of their cooperatives for purposes of accessing markets. These unique characteristics justify an exemption specifically tailored to enable non-financial entity end users that are members of cooperatives to realize the full benefits of the end-user exception when they access markets through their cooperatives.

The end-user exception provided in section 2(h)(7) of the CEA is not available to an entity that is a “financial entity,” as defined in section 2(h)(7)(C)(i), unless the entity is exempt from the definition because it is a small financial institution based on total assets, as provided in section 2(h)(7)(C)(ii) of the CEA and § 50.50(d), or it meets one of the narrowly drawn exemptions provided in section 2(h)(7) or the Commission regulations. Section 2(h)(7)(C)(ii) does not provide special consideration for cooperatives that meet the definition of “financial entity” and, therefore, the asset size limit applies to them.

As described in the NPRM and above, cooperatives whose member-owners consist exclusively of persons or entities

<sup>45</sup> See 12 U.S.C. 2241 (establishing the FCA); 12 U.S.C. 2252 (enumerating the powers of the FCA including the power to ensure the safety and soundness of FCS institutions).

<sup>46</sup> The Financial Stability Oversight Council does not have the authority to determine that the FCS be supervised by the Board of Governors of the Federal Reserve System as a “nonbank financial company” pursuant to section 113 of the Dodd-Frank Act. The definition of “nonbank financial company” includes a “U.S. nonbank financial company” and a “U.S. nonbank financial company” specifically excludes a “Farm Credit System institution chartered and subject to the provisions of the Farm Credit Act of 1971.” 12 U.S.C. 5311(a)(4); section 102(a)(4)(B) of the Dodd-Frank Act.

<sup>47</sup> See Conference Report, H.R. Report 102–978 at 8 (Oct. 2, 1992) (“The goal of providing the Commission with broad exemptive powers . . . is to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner.”).

<sup>48</sup> *Id.* at 78.

<sup>49</sup> *Id.*

<sup>50</sup> *Cf.*, CEA section 4(c)(2)(A), 7 U.S.C. 6(c)(2)(A) (expressly requiring a determination that an exemption from CEA section 4(a), 7 U.S.C. 6, under CEA section 4(c)(1), 7 U.S.C. 6(c)(1), be consistent with the public interest and the purposes of the CEA, one of which is “to promote . . . fair competition . . . among . . . market participants”).

that could elect the end-user exception provide important financial services to their members. These cooperatives are, in many respects, an extension of their member-owners and are not separable from their members in any real sense because their mission is to act in the interests of the members. However, some of those cooperatives meet the definition of "financial entity" and have total assets in excess of \$10 billion, and therefore the end-user exception is unavailable to them. By extension, the full benefits of the end-user exemption would be unavailable to their members accessing financial services through their cooperatives. Accordingly, absent this exemption, cooperative members would lose the ability to use their cooperative for financial services and at the same time, realize the full benefits of end-user exception. Without the cooperative exemption, when a cooperative engages in financial activity that could benefit from the end-user exception and that activity is in the interest of the cooperative's members, the members would not realize the full benefits of the end-user exception because the cooperative cannot elect the exception. Although the members of a cooperative may seek out financial services from other market participants, some of which may be able to elect the end-user exception, such members would not be able to realize the same benefits as if they had acted through the cooperative. As previously explained, such other market participants were not established solely to serve the interests of its customers, and thus do not provide the same benefits to its customers as the cooperative structure provides to its members, even for similar services. Absent this exception, the members of the cooperative would no longer be able to fully realize the benefits for which the cooperatives were established of being the members' intermediary in the financial markets acting in the mutual interests of the members. In light of this, the Commission determined to exercise its authority under section 4(c) of the CEA to propose § 39.6(f) (now § 50.51) and establish the cooperative exemption.

As noted above, section 4(c) of the CEA authorizes the Commission to provide exemptions to classes of persons "to promote responsible economic or financial innovation and fair competition." Many of the comments focused on this provision. For example, the ICBA commented that the cooperative exemption does not promote financial innovation. According to the ICBA, the Commission's estimate that the

cooperative exemption would affect 500 or less swaps a year shows that there is no financial innovation by the exempt cooperatives. The ICBA also commented that the Commission has not shown financial innovation because the proposal excludes the FHL Banks, which, according to the ICBA would potentially provide just as much, "if not more," financial innovation than an exemption for the FCS and credit unions. In essence, the ICBA stated that the cooperative exemption does not promote financial innovation because it is narrowly tailored and affects only a small number of swaps and institutions. In contrast, the FCC commented that "[t]o provide tailored financing products for farmers and farm-related businesses, FCS institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk, primarily in the form of interest rate swaps."

As discussed above in this section IV, Congress contemplated that section 4(c) of the CEA would provide the Commission with the "means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner."<sup>51</sup> Financial cooperatives have existed for over 100 years and were given separate legal status by Congress as far back as 1916.<sup>52</sup> Without these cooperatives, members have less choice in where they can borrow capital and hedge risks related to those borrowing activities. Swaps are a fairly recent innovation in the financial markets that has become an integral part of borrowing and lending. The cooperative form has enabled members to manage their borrowing activities and to use swaps to hedge risks in connection therewith at a lower cost. By pooling member capital in financial cooperatives, members are in effect aggregating their resources to allow them not only to gain a lower cost of funding, but also to be able to hire experienced executives who, as employees of the cooperative, are charged with managing the financial activities of the cooperative and advising the board of directors of the cooperative for the benefit of the member-owners, who often have specific, shared purposes that are the mission focus of the cooperative.<sup>53</sup>

<sup>51</sup> See Conference Report, H.R. Report 102-978 at 8 (October 2, 1992).

<sup>52</sup> See The Federal Farm Loan Act, Public Law 64-158, 39 Stat. 360 (1916) (repealed 1923) (a predecessor to the Farm Credit Act).

<sup>53</sup> See, e.g., the mission statement of the Farm Credit Bank of Texas: "Other lenders may lend to agriculture and rural America only when it is

Further, because the cooperative members elect the board members of the cooperative on a democratic, one member, one vote, basis,<sup>54</sup> and often most, if not all, board members are cooperative members,<sup>55</sup> the membership, through the governing board, has a unique opportunity to better understand the benefits and risks of swaps used in connection with their financial activities and as a group control the thoughtful application thereof in a responsible manner and for their mutual benefit. The mutual benefit of pooling resources and acting cooperatively is one of the principal policy reasons for the establishment of cooperative structures.<sup>56</sup> These are benefits that the cooperative member-owners would not have as customers of other financial institutions that they do not own or control and that are not established with the mission of providing financing and financial services to a particular type of customer and for their benefit.

In addition, section 4(c) of the CEA does not specify that the financial

profitable to do so, but at Farm Credit, financing rural America is all we do. When Congress created the Farm Credit System in 1916, it gave the System a mission to be a competitive, reliable source of funds for eligible borrowers in agriculture and rural America. Because we specialize in these areas, we have expertise that is unparalleled among other lenders." <http://www.farmcreditbank.com/farm-credit-advantage.aspx>; See also CoBank 2011 Annual Report, 31 ("We are a mission-based lender with authority to make loans and provide related financial services to eligible borrowers in the agribusiness and rural utility industries, and to certain related entities, as defined by the Farm Credit Act. . . . We are cooperatively owned by our U.S. customers.").

<sup>54</sup> To receive treatment as cooperatives under the Internal Revenue Code, an entity must be "operating on a cooperative basis." 26 U.S.C. 1381(a). The United States Tax Court has held that one of the guiding principles for determining whether an entity is operating on a cooperative basis is if it is democratically controlled by the members. *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305, 308 (1965).

<sup>55</sup> See, e.g., 12 U.S.C. 2072, 92 (requiring boards for production credit associations and federal land bank associations be selected from its voting members); 12 CFR 701 app. A (bylaws for national credit unions requiring board members be members of the credit union); Kan. Stat. Ann. § 17-1510 (West) (requiring board members to be selected from the membership); Va. Code Ann. § 13.1-324 (West) (requiring the board, except for the public director, consist of members).

<sup>56</sup> See, e.g., the initial statement of Congress in the Farm Credit System Act, which authorizes the Farm Credit System that the FCS cooperatives are a part of: "It is the objective of this chapter to continue to encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture which will be responsive to the credit needs of all types of agricultural producers having a basis for credit, and to modernize and improve the authorizations and means for furnishing such credit and credit for housing in rural areas made available through the institutions constituting the Farm Credit System as herein provided." 12 U.S.C. 2001.

innovation realized must be of a certain size. Innovation often begins on a small scale before becoming widely accepted and implemented, if successful. Regarding whether the FHL Banks should be included because the exemption would also provide innovation through the FHL Banks, as described in detail above in section III.B of this final release, the Commission determined to carefully narrow the cooperatives that can elect the exemption to those whose members consist exclusively of entities that (or other cooperatives whose members) do qualify for the end-user exception on their own, given the clear Congressional intent in section 2(h)(7) of the CEA to exclude financial entities (the definition of which excludes small financial institutions) from the end-user exception to the clearing requirement. Given that FHL Banks are not made up exclusively of non-financial entities or small financial institutions, the cooperative exemption would not be available to them.

The ABA and ICBA also commented that the cooperative exemption does not qualify under section 4(c) and is discriminatory because it would give cooperatives a competitive advantage over banks and therefore it does not promote "fair competition." They also commented that cooperatives compete with banks for the same business opportunities, and as GSEs and tax-exempt entities, cooperatives can offer more competitive pricing than traditional banks. Lake City Bank commented that it has difficulty competing with the FCS and credit unions for business due to the GSE status of the FCS, the large amount of assets the FCS maintains, and the favorable tax status afforded to the FCS and credit unions.

In contrast, the FCC commented that the cooperative exemption preserves a "level field for FCS institutions and commercial banks" that qualify for the end-user exception because FCS associations that otherwise would qualify as small financial institutions and compete with qualifying banks hedge risk at the level of the FCS bank cooperatives in which they are members. In effect, the FCC asserts that the FCS associations would be unable to use the end-user exception because the cooperative structure of the FCS system means that the associations act through the FCS bank cooperatives (all of which have total assets over \$10 billion) for their hedging activities and not directly.

As discussed previously, the essential function of cooperatives is to enable their members to access markets through a commonly-owned

intermediary. The memberships of the cooperatives that would qualify for the cooperative exemption consist of entities that can elect the end-user exception if acting on their own or other cooperatives the members of which can elect the end-user exception. However, these cooperatives meet the definition of "financial entity" and are too large to qualify for the small financial institution exemption, which, in turn, renders the end-user exception unavailable to the cooperatives. Accordingly, if the cooperative members wish to access the markets through their financial cooperative, which has been established for that same purpose, they would not receive the full benefits of the end-user exception because the cooperative would have to clear its swaps even though it is acting in the interests of its members in the markets. On the other hand, the members could enter into loans and swaps with other financial entities that can elect the end-user exception. In effect, the cooperative structure, which is intended to give the members the benefit of size by allowing them to pool their resources and act together for their mutual benefit, instead would frustrate their ability to realize the full benefits of the end-user exception when acting through their cooperatives. As such, the cooperative exemption seeks to preserve the benefits available to the members of cooperatives as intended under the cooperative legal structure.

The Commission's recognition that the cooperatives provide a means for its members to access the financial markets in a variety of ways is consistent with the intent of Congress and state legislatures in the laws establishing cooperative legal structures. As described below, some of these laws acknowledge that cooperatives may have certain benefits or advantages that other entities do not have, but that any such advantages are acceptable for promoting the benefits of cooperatives because ultimately the benefits inure to the members of the cooperatives. The cooperative exemption is being adopted by the Commission in the context of the foregoing policy determinations.<sup>57</sup>

<sup>57</sup> As an example of these legislative policy determinations, the Federal Credit Union Act states: The Congress finds the following:

(1) The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means.

(2) Credit unions continue to fulfill this public purpose, and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action.

(3) To promote thrift and credit extension, a meaningful affinity and bond among members,

Importantly, the Commission notes that the swaps that are the subject of the exemption are limited to those swaps related to member loans. Accordingly, the exemption applies only to the swaps related to lending services that financial cooperatives have been established to provide, and traditionally do provide, to their owner-members.<sup>58</sup>

The ABA and ICBA also cited to "preferred tax and funding advantages as [GSEs]" for FCS banks and the tax-exempt status that qualifying cooperatives have under Subchapter T of the Federal Internal Revenue Code ("Tax Code") as existing advantages cooperatives have over banks. On the other hand, financial cooperatives, such as the FCS and credit unions, are subject to other legal restrictions and regulated by their own regulators, who may impose restrictions that put them at a competitive disadvantage when compared to banks. For example, federal statutes and regulations applicable to FCS cooperatives restrict lending services to particular classes of borrowers, prohibit them from taking deposits (which limits their funding sources as compared to banks), and

manifested by a commonality of routine interaction, shared and related work experiences, interests, or activities, or the maintenance of an otherwise well understood sense of cohesion or identity is essential to the fulfillment of the public mission of credit unions.

(4) Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

(5) Improved credit union safety and soundness provisions will enhance the public benefit that citizens receive from these cooperative financial services institutions.

12 U.S.C. 1751. State cooperative laws also acknowledge the different status cooperatives are being provided within the competitive landscape. See N.Y. Coop. Corp. Law, which states that: "[a] cooperative corporation shall be classed as a non-profit corporation, since its primary object is not to make profits for itself as such, or to pay dividends on invested capital, but to provide service and means whereby its members may have the economic advantage of cooperative action, including a reasonable and fair return for their product and service." N.Y. Coop. Corp. Law 3 (McKinney) (emphasis added); see also Ky. Rev. Stat. Ann. § 272.1001(2) (West 2012).

<sup>58</sup> For example, with respect to the FCS, the Farm Credit Act of 1971 provides, "It is declared to be the policy of the Congress, recognizing that a prosperous, productive agriculture is essential to a free nation and recognizing the growing need for credit in rural areas, that the farmer-owned cooperative Farm Credit System be designed to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations." 12 U.S.C. 2001.

limit other services that they can provide to members. Similarly, the Tax Code, U.S. Tax Court rulings, and other guidance from the Internal Revenue Service impose limits on the business structure of cooperatives that seek cooperative tax treatment under the Tax Code that may impact their competitiveness. Also, cooperatives generally cannot raise equity capital from independent, non-customer investors. While the Commission's role is not to determine the relative overall competitive advantages or disadvantages that cooperatives or other financial institutions may have, the Commission believes that any limited advantage the cooperative exemption may provide to exempt cooperatives is likely to be small when viewed in the context of the complete competitive landscape in which financial cooperatives and banks operate.

Given that § 39.6(f) (now § 50.51) and its attendant terms and conditions would (1) promote economic and financial innovation for the benefit of the members of exempt cooperatives, (2) foster the ability of cooperative members to access the financial markets through their cooperatives and (3) further Congressional intent by providing a limited exemption from clearing that effectively extends the end-user exception to cooperatives that have end users for members, the Commission concludes that the adoption of § 39.6(f) (now § 50.51) and its attendant terms and conditions would promote responsible economic and financial innovation and fair competition in accordance with section 4(c) of the CEA.

The Commission also concludes that the cooperative exemption will be limited to entities that fall within the term "appropriate person," as required by section 4(c)(2)(B)(i) of the CEA.<sup>59</sup> Section 2(e) of the CEA renders it "unlawful for any person, other than an [eligible contract participant ("ECP")], to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market."<sup>60</sup> Since the cooperative exemption can only be elected for swaps that are executed bilaterally and not on a board of trade or contract market, both the exempt cooperatives and their respective counterparties to such swaps must be ECPs. Given that the criteria for the ECP definition covering business organizations generally is more restrictive than the comparable criteria for the appropriate person definition in

section 4(c)(3),<sup>61</sup> the Commission finds that the class of persons relying on § 50.51(a) will be limited to appropriate persons for purposes of CEA section 4(c)(2)(B)(i).<sup>62</sup>

Furthermore, the Commission concludes that the cooperative exemption will not have a material adverse effect on the ability of the Commission or any contract market or derivatives transaction execution facility to discharge their respective regulatory duties under the CEA as provided in section 4(c)(2)(B)(ii) of the CEA. The cooperative exemption effectively extends the end-user exception established in section 2(h)(7) of the CEA to cooperatives acting for non-financial entities. Section 39.6(f)(3) (now § 50.51(c)) has the same reporting requirement that the end-user exception has with the only difference being that the reporting party must report that the cooperative exemption has been elected for the swap being reported instead of the end-user exception. In this way, the Commission will be able to track the swaps for which the cooperative exemption is being elected and who is electing the exemption thereby allowing the Commission to oversee the use of the cooperative exemption in the same manner as the end-user exception. Regarding contract markets and derivatives transaction execution facilities, the cooperative exemption does not modify their regulatory duties under the CEA. Accordingly, those entities will not have any increase or reduction in their regulatory duties with regard to the exempted swaps.

#### V. Administrative Procedure Act Related Comments

The ABA and the ICBA submitted a number of comments asserting that the rule is discriminatory or violates the

<sup>61</sup> Compare CEA section 4(c)(3)(F) identifying the applicable type of appropriate person (a "corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding \$1,000,000 or total assets exceeding \$5,000,000 . . ." and section 1a(18)(A)(v) that identifies a comparable type of ECP (a "corporation, partnership, proprietorship, organization, trust, or other entity" with a net worth exceeding \$1,000,000 (and that enters into an agreement, contract or transaction for certain risk management purposes) or total assets exceeding \$10,000,000).

<sup>62</sup> Although § 39.6(f) (now § 50.51) is an exemption from the clearing requirement of section 2(h)(1)(A) of the CEA and section 2(e) of the CEA sets forth a standard for entering into a swap, section 4(c)(2)(B)(i) requires that any agreement, contract or transaction that is the subject of a CEA section 4(c)(1) exemption be "entered into" solely between appropriate persons. Therefore, focusing on section 2(e), which is an execution standard rather than a clearing standard, is appropriate, particularly given that if it is unlawful to enter into a swap in the first instance, the clearing requirement is moot.

arbitrary and capricious standard in the APA.<sup>63</sup> The ABA commented that the Commission did not provide a reasonable explanation for why cooperatives with over \$10 billion in total assets were given an exemption while banks with total assets over \$10 billion were not. According to the ABA, the Commission did not take into account the Congressional intent not to exempt banks and cooperatives with total assets above \$10 billion from mandatory clearing.

The Commission disagrees with the commenters' assertion that the Commission did not provide a reasonable explanation for the rule or that it does not fulfill Congressional intent. As discussed throughout the NPRM and as reiterated in this final release in response to specific comments, the cooperative exemption fulfills Congressional intent as expressed in section 2(h)(7) of the CEA by providing the full benefits of the end-user exception to the end-user members of cooperatives who act in the markets through their cooperatives. The limitation on the definition of "exempt cooperative" to those cooperatives whose members consist exclusively of entities and persons who may elect the end-user exception and other cooperatives whose members meet that requirement makes that readily apparent and is explained in detail in the NPRM.<sup>64</sup> Furthermore, the Commission considered both this element of Congressional intent and Congress' clear mandate that the Commission require that certain swaps entered into by financial institutions be cleared by carefully and purposefully limiting the types of swaps for which the cooperative exemption is available.<sup>65</sup> The Commission's reasoning behind the cooperative exemption based on the unique member-owner structure of cooperatives and the nature of cooperatives as entities whose primary purpose is to act in the interests of their member-owners in the financial marketplace is thoroughly discussed throughout the NPRM and reiterated in this final release. Commenters' assertions that the cooperative exemption rule is inconsistent with Congressional intent or is arbitrary and capricious are therefore without merit.

<sup>63</sup> See 5 U.S.C. 706(2)(A).

<sup>64</sup> 77 FR 41942 and 41943, and section III.B above.

<sup>65</sup> 77 FR 41942 and 41943, and section III.C above.

<sup>59</sup> 7 U.S.C. 6(c)(2)(B)(i).

<sup>60</sup> 7 U.S.C. 2(e).

## VI. Consideration of Costs and Benefits

### A. Background

In the wake of the financial crisis of 2008, Congress adopted the Dodd-Frank Act, which, among other things, requires the Commission to determine whether a particular swap, or group, category, type or class of swaps, shall be required to be cleared.<sup>66</sup> Specifically, section 723(a)(3) of the Dodd-Frank Act amended section 2(h)(1)(A) of the CEA to make it “unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [DCO] that is registered under the CEA or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared.” This clearing requirement is designed to reduce counterparty risk associated with swaps and, in turn, mitigate the potential systemic impact of such risk and reduce the likelihood for swaps to cause or exacerbate instability in the financial system.<sup>67</sup>

Notwithstanding the benefits of clearing, section 2(h)(7) of the CEA provides the end-user exception if one of the swap counterparties: “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.” Section 2(h)(7)(C)(ii) of the CEA directs the Commission to consider making the end-user exception available to small banks, savings associations, credit unions, and farm credit institutions, including those institutions with total assets of \$10 billion or less, through an exemption from the definition of

“financial entity.”<sup>68</sup> In § 39.6(d) (now § 50.50(d)), the Commission established the small financial institution exemption from the definition of “financial entity” for these institutions. The small financial institution exemption largely adopted the language of section 2(h)(7)(C)(ii) providing for an exemption for the institutions identified in section 2(h)(7)(C)(ii) that have total assets of \$10 billion or less.

On December 23, 2010, the Commission published for public comment an NPRM for § 39.6 (now § 50.50) proposing the end-user exception.<sup>69</sup> As discussed in section I hereof, several parties that commented on the end-user exception NPRM recommended that the Commission provide extend the end-user exception to cooperatives. These commenters reasoned<sup>70</sup> that the member ownership structure of cooperatives and the fact that they act in the interests of members that are non-financial entities justified an extension of the end-user exception to the cooperatives. In effect, the commenters posited that because a cooperative effectively acts as an intermediary for its members when facing the larger financial markets with its interests being effectively the same as its members’ interests, the end-user exception that would be available to a cooperative’s members should also be available to the cooperative. If the members themselves could elect the end-user exception, then, according to the commenters, the Commission should permit the cooperatives to do so as well.

The Commission is adopting the cooperative exemption herein as described in this release. Through § 39.6(f) (now § 50.51), the Commission uses the authority provided in section 4(c) of the CEA to permit “exempt cooperatives,” as defined in § 39.6(f)(1) (now § 50.51(a)) to elect not to clear certain swaps that are otherwise required to be cleared pursuant to section 2(h)(1)(A) of the CEA. In effect, the cooperative exemption makes available to exempt cooperatives the end-user exception that is available to their members, as described in greater detail above.<sup>71</sup> It is the costs and

benefits of this exemption that the Commission considered in the discussion that follows.

### B. Statutory Requirement To Consider the Costs and Benefits of the Commission’s Action: CEA Section 15(a)

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of the following five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission considers the costs and benefits resulting from its own discretionary determinations with respect to the section 15(a) factors.

Absent this rulemaking, all cooperatives that are financial entities as defined in section 2(h)(7)(C)(i) of the CEA and which are not otherwise exempt from that definition would be subject to the clearing requirement under section 2(h)(7)(A)(i) of the CEA. Thus, the scenario against which this rulemaking’s costs and benefits are considered is cooperatives within the definition of financial entity in Section 2(h)(7)(C)(i) with assets exceeding \$10 billion, which remain subject to the clearing requirement of section 2(h)(1)(A) of the CEA. Additionally, the Commission considers the rulemaking’s costs and benefits relative to alternatives considered by the Commission.

As discussed in more detail below, the Commission is able to estimate certain reporting costs. The dollar estimates are offered as ranges with upper and lower bounds, which is necessary to accommodate the uncertainty that surrounds them. The discussion below considers the rule’s costs and benefits as well as alternatives to the rule. The discussion concludes with a consideration of the rule’s costs and benefits in light of the five factors specified in section 15(a) of the CEA.

### C. Costs and Benefits of the Final Rule

#### 1. Costs and Benefits to Electing Cooperatives and Their Members

Providing an exemption from required clearing to cooperatives that meet the criteria described in the final rule will benefit them and their members in that they will not have to bear the costs of

commercial risk arising in connection with such swaps with members or loans to members.

<sup>66</sup> See section 2(h)(2) of the CEA, 7 U.S.C. 2(h)(2).

<sup>67</sup> When a bilateral swap is moved into clearing, the DCO becomes the counterparty to each of the original participants in the swap. This standardizes counterparty risk for the original swap participants in that they each bear the same risk attributable to facing the DCO as counterparty. In addition, DCOs exist for the primary purpose of managing credit exposure from the swaps being cleared and therefore DCOs are effective at mitigating counterparty risk through the use of risk management frameworks. These frameworks model risk and collect defined levels of initial and variation margin from the counterparties that are adjusted for changing market conditions and use guarantee funds and other risk management tools for the purpose of assuring that, in the event of a member default, all other counterparties remain whole. DCOs have demonstrated resilience in the face of past market stress. Most recently, they remained financially sound and effectively settled positions in the midst of turbulent events in 2007–2008 that threatened the financial health and stability of many other types of entities and the financial system as a whole. These, and other benefits of clearing, are explained more fully at: 77 FR 74284.

<sup>68</sup> See section 2(h)(7)(C)(ii) of the CEA.

<sup>69</sup> See 75 FR 80747.

<sup>70</sup> Other reasons given for providing an exemption from clearing for cooperatives are discussed above in this final rule.

<sup>71</sup> Exempt cooperatives can be financial entities that do not qualify for the small financial institution exemption because their assets exceed \$10 billion. As provided in § 39.6(f)(2) (now § 50.51(b)) of the rule, an exempt cooperative would not be required to clear swaps with members in connection with originating member loans, or swaps used by the exempt cooperative to hedge or mitigate

clearing that they would otherwise incur. Without the cooperative exemption rule, cooperatives meeting the criteria of the exemption would have to clear swaps pursuant to section 2(h)(1)(A) of the CEA when they are either: (1) Entering into a swap with a member that is subject to required clearing, or (2) transacting with another financial entity to hedge or mitigate risk related to loans with members or swaps with members related to such loans. Required clearing would introduce additional costs for cooperatives, including fees associated with clearing as well as costs associated with margin and capital requirements.

Regarding fees, DCOs typically charge Futures Commission Merchants ("FCMs") an initial transaction fee for each of the FCM customers' swaps that are cleared, as well as an annual maintenance fee for each of their customers' open positions.<sup>72</sup> As a result, cooperatives eligible for the exemption will bear lower costs related to swaps and would likely pass along these costs savings to their members either by providing swaps at more attractive rates or through larger patronage distributions or allocations.<sup>73</sup>

The ABA questioned whether the exemption would have benefits that accrue to members of exempt cooperatives. The ABA stated that in the absence of the proposed exemption, cooperative members can still exempt their swaps from clearing. Therefore, the ABA believes that "the proposed clearing exemption would solely benefit cooperatives larger than \$10 billion."

The Commission, however, anticipates that benefits will accrue to members of exempt cooperatives. Generally, as discussed in section IV, the mission of the cooperatives is to provide loans and other financial services to particular types of borrowers and the cooperatives operate for the mutual benefit of their respective members. As such, in keeping with its mission and purpose, a cooperative is likely to elect the exemption only if the election thereof benefits its members. As

<sup>72</sup> For example, not including customer-specific and volume discounts, the transaction fees for interest rate swaps at CME range from \$1 to \$24 per million notional amount and the maintenance fees are \$2 per year per million notional amount for open positions. LCH transaction fees for interest rate swaps range from \$1 to \$20 per million notional amount, and the maintenance fee ranges from \$5 to \$20 per swap per month, depending on the number of outstanding swap positions that an entity has with the DCO. See LCH pricing for clearing services related to OTC interest rate swaps at: [http://www.lchclearnet.com/swaps/swapclear\\_for\\_clearing\\_members/fees.asp](http://www.lchclearnet.com/swaps/swapclear_for_clearing_members/fees.asp).

<sup>73</sup> The CUNA stated that the exemption "would help minimize the additional costs and fees associated with mandatory clearing."

discussed further in this section VI, the exemption is likely to lower operational costs for exempt cooperatives and to reduce their margin requirements. As a consequence, exempt cooperatives will be able to provide lower-cost funding to their members, to retain more member allocable capital, or to pay out higher patronage distributions to their members. Ultimately, the members, as owners of the cooperatives, will benefit.

Regarding margin requirements, by allowing cooperatives to exempt certain swaps from clearing, the final rule may reduce the amount of margin that exempt cooperatives and their counterparties are required to post for swaps used to hedge or mitigate risk associated with loans to eligible members and for swaps related to those loans.<sup>74</sup> Reduced margin requirements will reduce the amount of capital that exempt cooperatives must allocate to margin, which will increase the amount of capital that exempt cooperatives may distribute or allocate to members. On the other hand, to the extent that the exemption results in exempt cooperatives and their counterparties holding less margin against exempt swap positions, each will be exposed to greater counterparty risk.

The final rule may also affect the capital that cooperatives that are financial entities are required to hold with respect to their swap positions pursuant to prudential regulatory capital requirements. As stated above, when compared to a situation in which the cooperative exemption is not available, the cooperative exemption will reduce the number of swaps that exempt cooperatives are required to clear. The Commission anticipates that reducing the number of swaps that such cooperatives clear may impact the amount of capital that exempt cooperatives are required to hold. This creates both benefits and costs. If reduced clearing lowers the amount of capital that exempt cooperatives must hold, that would increase the cooperative's lending capacity, enabling them to lend more to their members without retaining or raising additional capital. As for costs, this allows exempt cooperatives to become more highly leveraged, which increases the counterparty risk that they pose to their members and other market participants with whom they transact. On the other hand, if reduced clearing increases the

<sup>74</sup> The Commission notes that regulations addressing margin and capital requirements for non-cleared swaps have not yet been finalized. Accordingly, the Commission cannot determine, quantify, or estimate what margin, if any, may be required for the swaps exempted from clearing under the cooperative exemption.

amount of capital that exempt cooperatives must hold, that would have the opposite effect.

Cooperatives that elect the exemption will be required to report, or to cause to be reported, additional information to an SDR or to the Commission, which will create incremental costs for the reporting party. The final rule requires that exempt cooperatives adhere to the reporting requirements of § 50.50(b). For each swap where the exemption is elected, either the exempt cooperative or its counterparty (likely if the counterparty is an SD or MSP) must report: (1) That the election of the exemption is being made; (2) which party is the electing counterparty; and (3) certain information specific to the electing counterparty unless that information has already been provided by the electing counterparty through an annual filing.<sup>75</sup> In addition, for entities that are registered with the SEC, the reporting party will also be required to report with respect to the electing counterparty: (1) The SEC filer's central index key number; and (2) that an appropriate committee of the board of directors has approved the decision for that entity to enter into swaps that are exempt from the requirements of sections 2(h)(1) and 2(h)(8) of the Act.

For each exempted swap, to comply with the swap-by-swap reporting requirements in §§ 50.50(b)(1)(i) and (ii), the reporting counterparty will be required to check one box indicating the exemption is being elected and complete one field identifying the electing counterparty. The Commission expects that this information will be entered into the appropriate reporting system concurrently with additional information that is required by the CEA and part 45 of the Commission's regulations. Furthermore, the Commission estimates that there will be approximately 500 swaps per year that are exempted from clearing pursuant to this rule.<sup>76</sup> Therefore, each reporting

<sup>75</sup> The third set of information comprises data that is likely to remain relatively constant and therefore, does not require swap-by-swap reporting and can be reported less frequently.

<sup>76</sup> A review of information provided for five cooperatives that likely would be exempt cooperatives showed a range of swap usage from none to as many as approximately 200 swaps a year with most entering into less than 50 swaps a year. Using the high end of reported swaps for the five cooperatives for which information was available, an estimate of 50 swaps per year was calculated. The Commission believes this estimate is high because some of the reported swaps may not meet the requirements of the final rule and, based on discussions with other regulators, several cooperatives for which detailed information was not available to the Commission likely undertake little, if any, swap activity. However, for purposes of the cost calculations, the Commission assumes



counterparty is likely to spend 15 seconds to 2 minutes per transaction in incremental time entering the swap-by-swap information into the reporting system, or in the aggregate, 1.5 hours to 17 hours per year for all 500 estimated swaps. A financial analyst's average salary is \$208/hour, which corresponds to approximately \$1–\$7 per transaction or in aggregate, \$300–\$3,500 per year for all 500 estimated swaps.<sup>77</sup> While the above information must be reported on a swap-by-swap basis, some information may be reported annually. Regulation § 50.50(b)(1)(iii) allows for certain counterparty specific information identified therein to be reported either swap-by-swap by the reporting counterparty or annually by the electing counterparty. When exempt cooperatives enter into exempt swaps with members, the cooperative is likely to be the reporting counterparty. Furthermore, assuming the cooperative is the reporting counterparty, the time burden for the first swap entered into by an exempt cooperative in collecting and reporting the information required by § 50.50(b)(1)(iii) will be approximately the same as the time burden for collecting and reporting the information for the annual filing. Given the cost equivalence for annual reporting to reporting a single swap if the exempt cooperative is both the electing and reporting counterparty, the Commission assumes that all ten exempt cooperatives will make an annual filing of the information required for § 50.50(b)(1)(iii). The Commission estimates that it will take an average of 30 minutes to 90 minutes to complete and submit the annual filing. The average hourly wage for a compliance attorney is \$300, which means that the annual per cooperative cost for the filing is likely to be between \$150 and \$450. If all ten exempt cooperatives were to undertake an annual filing, the aggregate cost would be \$1,500 to \$4,500.<sup>78</sup>

that each of the 10 potential exempt cooperatives will enter into 50 swaps each year. Accordingly, it is estimated that exempt cooperatives may elect the cooperative exemption for 500 swaps each year.

<sup>77</sup> Wage estimates are taken from the SIFMA "Report on Management and Professional Earnings in the Securities Industry 2011." Hourly wages are calculated assuming 1,800 hours per year and a multiplier of 5.35 to account for overhead and bonuses. In light of the challenges of developing precise estimates, the results of calculations have been rounded.

<sup>78</sup> The average wage for a compliance attorney is \$300.95 [(\$112,505 per year)/(2,000 hours per year) \* 5.35 = \$300.95]. For the purposes of the Cost Benefit Considerations section, the Commission has used wage estimates that are taken from the SIFMA "Report on Management and Professional Earnings in the Securities Industry 2011" because industry participants are likely to be more familiar with them. Hourly costs are calculated assuming 2,000 hours per year and a multiplier of 5.35 to account

Furthermore, when an exempt cooperative is not functioning as the reporting counterparty (*i.e.*, when transacting with a SD or MSP), it may, at certain times, need to communicate information to its reporting counterparties in order to facilitate reporting. That information may include, among other things, whether the electing counterparty has filed an annual report pursuant to § 50.50(b) and information to facilitate any due diligence that the reporting counterparty may conduct. These costs will likely vary substantially depending on the number of different reporting counterparties with whom an electing counterparty conducts transactions, how frequently the electing counterparty enters into swaps, whether the electing counterparty undertakes an annual filing, and the due diligence that the reporting counterparty chooses to conduct. The Commission estimates that non-reporting electing counterparties will incur between 5 minutes and 10 hours of annual burden hours, or in the aggregate, between approximately 1 hour and 100 hours. The hourly wage for a compliance attorney is \$300, which means that the annual aggregate cost for communicating information to the reporting counterparty is likely to be between \$300 and \$30,000. Given the unknowns associated with this cost estimate noted above, the Commission does not believe this wide range can be narrowed without further information.<sup>79</sup>

The ABA and the ICBA suggested that the Commission's assumption that each potentially exempt cooperative engages in 50 swaps a year does not take into account the fact that the number of swaps entered into by the exempt cooperatives may change or increase over time. The ABA also commented that the Commission underestimated the number of cooperatives eligible and assumes that the number of cooperatives would not increase by either reorganization or growth.

The Commission contacted the FCA and National Credit Union Administration for further assistance in assessing whether the estimates used in the NPRM are reasonable. These regulators discussed generally the observed level of swap activity of the cooperatives they regulate. Based on these discussions, the Commission concluded that the estimates in the NPRM are reasonable and appropriate for this rulemaking. The Commission

for overhead and bonuses. All totals calculated on the basis of cost estimates are rounded to two significant digits.

<sup>79</sup> As noted above, the average wage for a compliance attorney is \$300.95 per hour [(\$112,505 per year)/(2,000 hours per year) \* 5.35 = \$300.95].

recognizes that the number of entities eligible for the exemption and the number of swaps per eligible cooperative is likely to change in the future and that the benefits of this exemption for exempt cooperatives could encourage the number or size of exempt cooperatives and of swaps used by those cooperatives to grow. However, the Commission notes that the extent to which such growth is realized also depends on several additional factors that the Commission does not have adequate information to evaluate, including: (1) Subsequent changes to laws or regulations affecting one or more types of cooperatives; (2) increases or decreases in the size of the industries served by those cooperatives; and (3) the frequency with which exempt cooperatives make loans or experience other changes that require rebalancing of their hedging strategies. Because the Commission does not have sufficient information to estimate the direction or magnitude of the effect that these forces will have on the number of exempt cooperatives and exempt swaps per cooperative, it is not possible to evaluate how future changes in either are likely to affect the costs or benefits related to the exemption.

## 2. Costs and Benefits for Counterparties to Electing Cooperatives

The benefits of the exemption for counterparties to electing exempt cooperatives differ depending on whether they are members of the cooperatives. For entities that are members of the electing cooperative, they will likely benefit from the reduced operational costs the exempt cooperative achieves through reduced clearing fees associated with the cooperative's swaps with the market. The benefit may be passed on in the form of better terms on swaps between members and the cooperative and through the cooperative's patronage distributions to members. For entities that are not members of the cooperative (*i.e.* market makers entering into swaps with the cooperative), the benefits are different. Market makers entering into swaps with cooperatives that are subject to the exemption do not participate in the pro rata patronage distributions, but may benefit from reduced clearing costs associated with non-cleared swaps.

Reduced clearing of swaps by exempt cooperatives will increase counterparty risk for both exempt cooperatives and their counterparties. Cooperatives will be more exposed to the credit risk of their counterparties, and conversely, the cooperatives' counterparties will be more exposed to the credit risk of the exempt cooperatives. This could be

problematic for an exempt cooperative if one of the dealers with which the cooperative has large non-cleared positions defaults, or if groups of members whose financial strength may be highly correlated and whose aggregate non-cleared positions with the cooperative are large, encounter financial challenges. In this way, the credit risk of one of the cooperative's counterparties could adversely impact the other counterparties of that cooperative.

Conversely, if an exempt cooperative becomes insolvent and its positions with a SD or MSP are substantial, it is possible that its non-cleared positions could be large enough to exacerbate instability at the SD or MSP or could create greater risk exposure for the members with which the cooperative entered into swaps.

The FCC stated that because FCS institutions have collateral agreements in place, "clearing offers very little additional protection to FCS institutions." The Commission acknowledges that counterparty risk can be mitigated through collateral arrangements, but also notes that the extent to which counterparty risk is reduced through collateral agreements depends on the amount of collateral required from each party to the swap, the liquidity of that collateral in stressed market conditions, the frequency with which the amount of collateral is adjusted to account for variations in the value of the swap or the collateral, and the ability of the non-defaulting party to claim the collateral quickly in the event that their counterparty defaults.<sup>80</sup> The Commission does not have adequate information to determine how effectively collateral arrangements may mitigate counterparty risk born by exempt cooperatives and their counterparties in the absence of central clearing.

### 3. Costs and Benefits for Other Market Participants

The ABA commented that the Commission did not consider competitive harm to banks when analyzing the costs and benefits of the cooperative exemption. The ABA and ICBA commented that cooperatives compete with banks for the same business opportunities and provide similar services. They further stated that the exemption would provide cooperatives with a competitive

<sup>80</sup> The 2012 ISDA Margin Survey indicates that 71% of all OTC derivatives transactions were subject to collateral agreements during 2011, but notes that the degree of collateralization may vary significantly depending on the type of derivative and counterparties entering into a transaction.

advantage because they "would have more liquidity available for lending than comparable banks would and be able to provide lower cost funding." Further, the ABA stated that "the competitive impact of the proposed exemption would grow as more cooperatives increase their swaps portfolios to take advantage of the pricing and other economic benefits it affords."

The Commission recognizes that the cooperative exemption may provide clearing cost savings related benefits to eligible cooperatives with assets in excess of \$10 billion.<sup>81</sup> However, in assessing the competitive costs and benefits of the cooperative exemption the Commission believes the policy considerations for establishing cooperatives also need to be taken into account. As described section IV, Congress and the states have established the cooperative legal structure distinct from other corporate forms to facilitate the economic advantage of cooperative action for the mutual benefit of a cooperative's members. The cooperative exemption provides the members with the benefits of the end-user exception, both directly and indirectly through their cooperatives, without having to switch from doing business with their existing cooperatives to doing business with small financial institutions or other entities that can elect to exempt their swaps from clearing, but which are not organized for the specific purpose of benefitting those members. The cooperative exemption furthers these benefits by recognizing that the cooperatives were established to act on behalf of their members in the marketplace and providing an exemption from clearing to eligible cooperatives. In effect, the cooperative exemption ensures that the existing members of exempt cooperatives can achieve the full benefits of both cooperative action and of the end-user exception.

### 4. Costs and Benefits to the Public

The public generally has an interest in mandatory clearing because of its potential to reduce counterparty risk among large, interconnected institutions, and to facilitate rapid resolution of outstanding positions held by such institutions in the event of their default. By narrowly crafting the

<sup>81</sup> The Commission notes, however, that most small banks are also eligible for the end-user exception, which can be elected for a wider range of swaps than the cooperative exemption. Section 50.50(d) of the Commission's regulations provides that banks, FCS institutions, and credit unions that have total assets of \$10 billion or less are eligible for the end-user exception with certain exceptions—primarily that they not be SDs or MSPs.

proposed cooperative exemption to incorporate qualifying criteria limiting both the types of institutions and the types of swaps that are eligible, the Commission has sought to conserve this public interest.

The ABA and the ICBA commented that the four FCS banks and FCS lending associations are jointly and severally liable for one another, and that "the aggregated asset size of these institutions is \$230 billion and growing rapidly." The ICBA also stated that the financial cooperatives affected by the exemption will grow larger over time and may present a systemic risk in the future. The ABA stated that because the FCS is a GSE, it is a potential liability to U.S. taxpayers. The CUNA, on the other hand, asserted that the exemption would not have significant impact on the overall swap market because of the small number of entities eligible for the exemption. Similarly, the FCC stated that because of collateral agreements that FCS institutions have in place that "the FCS poses no systemic risk to the U.S. financial system."

The Commission acknowledges that the magnitude of risk and potential costs to the public created by an exemption from clearing depends on several factors including: The number and size of the exempt cooperatives electing the exemption; the size, number, and type of exempt swaps held by each institution; the risks inherent in their outstanding swaps; the concentration of swaps with individual counterparties; the financial strength of counterparties to exempt swaps; and the presence of collateral agreements related to the exempt swaps.<sup>82</sup> The Commission has limited data with which to evaluate these factors. Commenters provided limited data, noting the size of the four farm credit banks<sup>83</sup> and the number and size of certain credit unions with more than \$10 billion in assets.<sup>84</sup> However, commenters did not provide, and the Commission does not have, detailed data regarding the size of exempt cooperatives' non-cleared swaps, information regarding the concentration

<sup>82</sup> As noted above, the ability of collateral agreements to mitigate counterparty risk and risk to the public depends on the details of those agreements with regard to the amount and quality of collateral required, the frequency with which it is adjusted to reflect changing valuations, and the speed with which the non-defaulting party can claim the collateral in the event that their counterparty defaults.

<sup>83</sup> ABA stated that the four Farm Credit banks have approximately \$15 billion, \$29 billion, \$76 billion, and \$90 billion in assets.

<sup>84</sup> ABA stated that there are four credit unions with more than \$10 billion in assets and are likely to be several more within the next year. They also stated that one credit union has nearly \$50 billion in assets and another has more than \$25 billion.

of non-cleared positions with particular counterparties, or information regarding the financial strength of those counterparties. In addition, while commenters noted the potential for collateral agreements to mitigate counterparty risk in the absence of clearing, they did not provide data or additional information regarding the agreements that they anticipate will be used. Each of these factors could have a significant bearing on how much risk is created for the public by exempting eligible counterparties from the clearing requirement.

Notwithstanding the limited data available, the Commission considered the potential risks that could arise from cooperatives entering into non-cleared swaps and the Commission believes it has mitigated these risks with the conditions imposed in the rule that limit the number of entities and types of swaps eligible for the cooperative exemption. These conditions are described in sections I, II and III above.

In addition, the Commission notes that cooperatives that may qualify as exempt cooperatives are supervised by other regulators that have access to more detailed information regarding the swaps executed by the cooperatives and that are likely to have additional information regarding the risk factors discussed above. These regulators can monitor the use of swaps by these cooperatives and the risk factors related to that swap activity. Using this information, these regulators can assess the risks related to the non-cleared swaps in the context of the overall regulatory framework applicable to the cooperatives and the changing financial condition of the cooperatives and in that context address the potential systemic risk with the cooperatives using their regulatory authority.

Finally, while it is important to consider the potential risks noted above, it is also important to assess the benefits provided by the cooperative exemption. The Commission believes ensuring that the members of exempt cooperatives can continue to use their cooperatives in the manner intended and also realize the full benefits of the end-user exception through their cooperatives is appropriate given the unique nature of cooperatives and the statutory and policy considerations discussed above in section III.

#### *D. Costs and Benefits Compared to Alternatives*

There were several alternatives proposed by commenters that the Commission considered including: Providing a “ride along” exemption for community banks larger than \$10

billion; and including cooperatives with members that are financial entities, either with or without additional restrictions on the eligibility of swaps conducted by such cooperatives.

The Commission considered a “ride-along” provision, proposed by the ICBA, which would provide a clearing exemption for community banks that exceed the \$10 billion total assets threshold. Providing a “ride-along” provision could mitigate the potential competitive effects of the exception, as alleged by the ICBA, but would also increase the potential risk to the public by increasing the number of large financial entities eligible for an exemption from clearing.

Moreover, expanding the exemption in this way could also make it possible for SDs, MSPs, and other large financial institutions to avoid clearing by using exempt community banks as an intermediary for their swap transactions. Finally, allowing non-cooperatives to use the exemption would not reflect the unique structure of cooperatives that is the basis for the exemption and result in an expansion of the small financial institution exemption beyond the parameters detailed in the final release for the Commission's regulations implementing the end-user exception.<sup>85</sup> For these reasons, the Commission has determined not to include the suggested “ride-along” provision.

The ICBA also stated that the cooperative exemption does not include the FHL Banks, and that thousands of small banks that are members of the FHL Bank system will be disadvantaged by the cooperative exemption because the FHL Banks will not be able to provide the same or similar low cost financing to community banks as FCS lenders do for their cooperative associations. The ICBA and the FHL Banks commented that the FHL Banks should be included as exempt cooperatives either generally, or to the extent they provide services to their members that qualify for the small financial institution exemption from the definition of financial entity.

In the NPRM, the Commission considered including cooperatives consisting of members that could not elect the end-user exception, as suggested by the FHL Banks. Such an exemption would assist in ensuring that a greater number of cooperatives are able to elect not to clear swaps. However, as described in greater detail in section III, if the cooperatives elected the exemption when transacting with or for the benefit of members that are not

eligible for the end-user exception (i.e. financial institutions with total assets greater than \$10 billion) it could significantly increase the number of swaps that are exempt from the clearing requirement and result in exemptions for entities that Congress has not provided any indication should be exempt from the clearing requirement.<sup>86</sup> If the cooperative exemption were expanded in this way, it would reduce the benefits derived from required clearing. By contrast, with the limiting conditions included in the cooperative exemption rule, the Commission is ensuring that the exemption is only available to cooperatives whose members can elect the end-user exception or are themselves cooperatives whose members can elect the end-user exception.<sup>87</sup>

The FHL Banks suggested that this problem could be addressed by limiting the exemption to swaps that hedge risks associated with loans to eligible members. However, allowing new or existing cooperatives with financial entity members to elect not to clear swaps related to activities with members that are eligible for the end-user exception would dilute the benefits that qualifying members achieve through the exemption thereby undermining the purpose for the exemption. For example, as described above in section III, if the FHL Banks elect the cooperative exemption only for swaps related to members who qualify as small financial institutions, the decision not to clear those swaps could create clearing cost savings for the FHL Banks. Those savings would increase the capital that the FHL Banks distribute or allocate to their members as part of the full member pro rata patronage distribution. If larger members hold a large ownership stake in the cooperative, those members would also receive a proportionately large share of the distributions, including a proportionately large share of the savings that result from the cooperative

<sup>86</sup> Note, for example, that while the FHL Banks have thousands of members that qualify for the small financial institution exemption and who therefore can elect the end-user exception, over one hundred members of the FHL Banks would not qualify because they are financial entities with total assets in excess of \$10 billion. These members include some of the largest financial entities in the United States. In addition, as described above in section III, financial entities with assets in excess of \$10 billion have borrowed more than half the amount lent by the FHL banks to members.

<sup>87</sup> The Commission notes that banks and other entities that qualify for the small financial institution exemption from the financial entity definition are not excluded under the regulation from being members of exempt cooperatives.

<sup>85</sup> 77 FR 42559 (Jul. 19, 2012).

exemption.<sup>88</sup> In other words, members that are eligible for the end-user exception would not receive the full benefits of the exemption that is extended to the cooperative. By contrast, with the limiting conditions included in the cooperative exemption rule, the Commission is ensuring that the exemption is only available to cooperatives whose members could all elect the end-user exception or are themselves cooperatives whose members could elect the end-user exception, and thus the additional pro-rata patronage distributions that an exempt cooperative makes because of the cooperative exemption will only go to such entities.

The FCC requested clarification with respect to the Commission's view on what swaps are "related to" a cooperative's loans to its members, and advocated a broad interpretation. They also stated that "clarification of these items will serve to increase the likelihood that the System's farmer and rancher member borrowers will be able to benefit from this proposed exemption from clearing." The broader interpretation requested by the FCC could increase the number of swaps that are eligible for the exemption by including swaps that serve non-member related purposes, which would further reduce clearing-related costs for eligible cooperatives, but would also increase the counterparty risk that eligible cooperatives and their counterparties bear due to decreased clearing. In the Commission's view, this broader exemption is not justified given the rationale behind the cooperative exemption. As stated above, the term "related to" is intended to include swaps that the exempt cooperatives may enter into with non-members to hedge or mitigate the risks incurred by the cooperatives related to their member lending activities. For example, where cooperatives obtain wholesale funding, only the portion of funding that is not used to make non-member loans may be hedged with exempt swaps.<sup>89</sup> By limiting the eligibility of exempt cooperatives' swaps in this way, the Commission reduces the counterparty risk that exempt cooperatives and their counterparties could experience due to decreased clearing.

<sup>88</sup> See section II above for a full discussion of the relative benefits available to different sized members of the FHL Banks.

<sup>89</sup> See section III.C above.

### E. Section 15(a) Factors

#### 1. Protection of Market Participants and the Public

As described above, if exempt cooperatives elect to exempt certain swaps from required clearing, these cooperatives may not need to pay DCO and FCM clearing fees for clearing those swaps. In addition, the exemption may reduce the amount of capital that exempt cooperatives must allocate to margin accounts with their FCM. This, in turn, provides benefits to the members of exempt cooperatives, that may otherwise absorb such costs as they are passed on by the cooperatives to their members in the form of fees, less desirable spreads on swaps or loans conducted with the cooperative, or lower member allocated capital or patronage distributions.

The exemption will create certain reporting costs for eligible entities. However, as described in the rulemaking for the end-user exception where the specific reporting requirements were addressed, the reporting required uses a simple check-the-box approach and elective annual reporting of certain information that should minimize per swap reporting costs, particularly for cooperatives that enter into multiple swaps.

The exemption is narrowly tailored to exempt only a relatively small number of institutions and to include only swaps that are associated with positions established in connection with originating loans made to customers, or that hedge or mitigate risk arising in connection with such member loans or swaps. These limitations will tend to mitigate the risk to the public that could result from the exemption.

In addition, this exemption is likely to increase counterparty risk for counterparties to exempted swaps as well as for the exempted cooperatives. However, as described above, exempted cooperatives and their counterparties may use collateral agreements with exempted swaps to mitigate counterparty risk.

#### 2. Efficiency, Competitiveness, and Financial Integrity of Swap Markets

While the cooperative exemption would take swaps out of clearing, it mitigates the impact on the financial integrity of the swap markets by limiting the types of entities and swaps that are eligible. As discussed above, the exemption is designed to include only cooperatives that are made up entirely of entities that could elect the end-user exception, and only swaps associated with loans between the cooperative and such members.

The exemption may have competitive effects by allowing the members of exempt cooperatives to achieve additional benefits from the actions of their cooperatives. The Commission believes such benefits are consistent with the intended public interests served by the establishment of cooperative structures as a separate legal form by Congress and the states. The Commission addresses these issues in section IV and VI.C.3. Commenters did not provide, and the Commission does not have, information that is sufficient to quantify the competitive effects that will result from the exemption.

#### 3. Price Discovery

Clearing, in general, encourages better price discovery because it eliminates the importance of counterparty creditworthiness in pricing swaps cleared through a given DCO. That is, by making the counterparty creditworthiness of all swaps of a certain type essentially the same, prices should reflect factors related to the terms of the swap, rather than the idiosyncratic risk posed by the entities trading it.<sup>90</sup> To the extent that the cooperative exemption reduces the number of swaps subject to required clearing, it will lessen the beneficial effects of required clearing for price discovery. However, the Commission anticipates that the number of swaps eligible for this exemption, currently estimated at approximately 500 a year, will be a de minimis fraction of all those that are otherwise required to be cleared. Therefore, the Commission believes that there will not be a material impact on price discovery.

#### 4. Sound Risk Management Practices

To the extent that a swap is removed from clearing, all other things being constant, it is a detriment to a sound risk management regime. To the extent that exempt cooperatives enter into non-cleared swaps on the basis of this rule, it likely increases the exposure of exempt cooperatives and their counterparties to counterparty credit risk. For the public, it increases the risk that financial distress at one or more cooperatives could spread to other financial institutions with which those cooperatives have concentrated positions. However, as discussed above, this additional risk may be reduced by the presence of bilateral margin agreements, which the Commission

<sup>90</sup> See Chen, K., et al. "An Analysis of CDS Transactions: Implications for Public Reporting," September 2011, Federal Reserve Bank of New York Staff Reports, at 14.

believes are often used in the absence of clearing.

#### 5. Other Public Interest Considerations

The Commission believes that the cooperative exemption serves the public interest by furthering the public benefits cited by Congress and state legislatures in legislation authorizing cooperative business forms as discussed in section IV above. The cooperative structure allows the members to pool their resources, achieve economies of scale, and realize the benefits of acting in markets through larger entities. However, absent the cooperative exemption, the exempt cooperatives would be unable to elect the end-user exception because the amount of their assets precludes them from qualifying as small financial institutions. In effect, the cooperative structure, which is intended to provide advantages to its member-owners by creating a large entity whose mission is to serve their interests, instead prevents the members from receiving the full benefits of the end-user exception when using their large cooperatives. The cooperative exemption therefor is in the public interest because it resolves a conflict between the small financial institution language of section 2(h)(7) of the CEA and the general policy behind establishing cooperatives of creating large financial institutions with the mission of serving the mutual interests of their member-owners.

### VII. Related Matters

#### A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities<sup>91</sup> and, if so, provide a regulatory flexibility analysis respecting the impact.<sup>92</sup> Regulation § 39.6(f) (now § 50.51) would affect cooperatives, their members, and potentially the counterparties with whom they trade. These entities could be SDs, MSPs, and eligible contract participants ("ECPs").<sup>93</sup> Regulation § 39.6(f) (now

§ 50.51) would additionally affect SDRs. As noted in the NPRM, the Commission has previously determined that SDs, MSPs, and SDRs are not small entities for purposes of the RFA.<sup>94</sup>

It is possible that some members of cooperatives may be small entities under the RFA. For these members to be impacted by the cooperative exemption compliance requirements they would have to be entering into swaps with the exempt cooperative and the exemption would need to be elected. In order for two counterparties to a swap to enter into a swap bilaterally, both parties must be ECPs.<sup>95</sup> Based on the definition of ECP in the Commodity Futures Modernization Act of 2000, and the legislative history underlying that definition, the Commission has previously determined that ECPs should not be small entities for purposes of the RFA.<sup>96</sup> The Commission has been made aware in other contexts that some ECPs, specifically those that do not fall within a category of ECP that is subject to a dollar threshold, may be small entities. If there are cooperative members that are both ECPs as defined in the CEA and small entities for purposes of the RFA, the exemption is nevertheless most likely to provide an economic benefit to the cooperative member. Furthermore, if elected, the cooperative exemption would impose the same or similar costs of compliance on members that the previously adopted end-user exception from the clearing requirement imposes. The end-user exception provides effectively the same type of relief from clearing. Accordingly, the cooperative exemption does not create any materially new or different compliance costs than similar regulations that were previously adopted. Finally, the cooperative exemption is elective. If a member that is a small entity wanted to clear its swap, the cooperative exemption does not require them to enter into swaps with their cooperatives and they could execute swaps with other parties that would agree to clearing. Accordingly, the cooperative exemption would not cause any new significant economic impact on these members.

The Chairman, on behalf of the Commission, certified in the NPRM, pursuant to 5 U.S.C. 605(b), that § 39.6(f) (now § 50.51(a)) will not have

board of trade. See section 5(d)(11) of the CEA, 7 U.S.C. 7(d)(11). In effect all swaps entered into by a cooperative or a member that is not an ECP will need to be executed on a board of trade and therefore will be cleared.

<sup>94</sup> See 77 FR 30596, 30701 (May 23, 2012); see also 75 FR 80898, 80926 (Dec. 23, 2010).

<sup>95</sup> 7 U.S.C. 2(e).

<sup>96</sup> See 66 FR 20740, 20743 (Apr. 25, 2001).

a significant impact on a substantial number of small entities. The Commission requested comment on this decision in the NPRM.

The ICBA commented that the proposal impacts a substantial number of small community banks because they are members of the FHL banks and the FHL banks are not exempt cooperatives. According to the ICBA, the small bank members of the FHL bank system would be disadvantaged because the FHL banks will not be able to provide the same or similar low cost financing to community banks as FCS lenders will for their cooperatives.

The Commission also received two comments regarding the impact of Regulation § 39.6(f) (now § 50.51(a)) on the competition between banks that are small entities and cooperatives that elect the cooperative exemption. According to the ABA, the Commission's analysis of the economic impact on small entities did not consider that economic impact on the "hundreds of end-user banks that are competing with cooperatives for the same business opportunities." Similarly, the ICBA commented that the "competitive advantages afforded to large credit unions and large FCS funding banks . . . would allow these institutions advantages in competing directly against small community banks even if they have a small financial institution exemption." The ICBA then referenced CoBank as an example of an FCS funding bank with a wide geographic footprint over two dozen states that could grow larger.

The ABA and the ICBA asserted that the Commission is obliged under the RFA to consider the impact of the regulation on small banks, including small banks that are members of the FHL bank system. Specifically, commenters asserted that the Commission should consider the competitive benefit the cooperative exemption might give to exempt cooperatives as compared to small banks that might be small entities for purposes of the RFA both on their own and because small banks are members of the FHL bank system.<sup>97</sup> The Commission has applied the RFA to entities that are cooperatives who may elect the cooperative exemption and their members. Small community banks that are not members of exempt cooperatives are not subject to the cooperative exemption. The Commission also notes that, as discussed above, to the extent a small

<sup>97</sup> The FHL banks would not qualify for the cooperative exemption because they have large financial entity members. See section IV above.

<sup>91</sup> The Small Business Administration identifies (by North American Industry Classification System codes) a small business size standard of \$7 million or less in annual receipts for Subsector 523—Securities, Commodity Contracts, and Other Financial Investments and Related Activities. 13 CFR parts 1, 121.201.

<sup>92</sup> 5 U.S.C. 601 et seq.

<sup>93</sup> It is possible that a cooperative or members thereof may not be ECPs. However, pursuant to Section 2(e) of the CEA, if a counterparty to a swap is not an ECP, then such swap must be entered into on, or subject to the rules of, a board of trade designated as a contract market under Section 5 of the CEA. All such swaps must be cleared by the

community bank is or becomes a member of an exempt cooperative and enters into a swap bilaterally with an exempt cooperative for which the cooperative exemption is elected, that member would have to be an ECP, in order to enter into the swap bilaterally, and also an entity that could elect the end-user exception. Accordingly, the Commission continues to believe that the cooperative exemption will not have a significant economic impact on small entities.

Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the final regulation would not have a significant economic impact on a substantial number of small entities.

#### B. Paperwork Reduction Act

Regulation § 39.6(f)(3) (now § 50.51(c)) requires a cooperative to conform with certain reporting conditions if it elects the cooperative exemption. These new requirements constitute a collection of information within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>98</sup> Under the PRA, an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it has been approved by the Office of Management and Budget ("OMB") and displays a currently valid control number.<sup>99</sup> This rulemaking contains new collections of information for which the Commission must seek a valid control number. The Commission therefore requested that OMB assign a control number and OMB assigned control number 3038-0102 for this new collection of information. The Commission has also submitted the proposed rulemaking, this final rule release, and supporting documentation to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for these new collections of information is "Rule 39.6(f) Cooperative Clearing Exemption Notification." Responses to these information collections will be mandatory if the cooperative exemption is elected.

With respect to all of the Commission's collections, the Commission will protect proprietary information according to the Freedom of Information Act and 17 CFR part 145, "Commission Records and Information." In addition, section 8(a)(1) of the Act strictly prohibits the Commission, unless specifically authorized by the Act, from making public "data and information that would separately disclose the business

transactions or market positions of any person and trade secrets or names of customers." The Commission also is required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

#### 1. Information To Be Provided by Reporting Parties

For each swap where the exemption is elected, either the cooperative, or its counterparty if the counterparty is an SD or MSP, must report: (1) That the election of the exemption is being made; (2) which party is the electing counterparty; and (3) certain information specific to the electing counterparty unless that information has already been provided by the electing counterparty through an annual filing. As noted in the NPRM, the third set of information comprises data that is likely to remain relatively constant for many, but not all, electing counterparties and therefore, does not require swap-by-swap reporting and can be reported less frequently. In addition, for entities registered with the SEC, the reporting party will also be required to report: (1) The SEC filer's central index key number; and (2) that an appropriate committee of the board of directors has approved the decision for that entity to enter into swaps that are exempt from the requirements of section 2(h)(1)(A) of the CEA.

Exempt cooperatives entering into swaps with members and electing the exemption will likely be responsible to report this information. When cooperatives enter into swaps with SDs or MSPs, the SDs or MSPs will be responsible for reporting the information, but cooperatives would bear some costs related to the personnel hours committed to reporting the required information.

As discussed in the NPRM, for purposes of estimating the cost of reporting in connection with the cooperative exemption, the Commission estimated that each of the ten exempt cooperatives would enter into 50 swaps per year on average. Accordingly, the Commission estimated that exempt cooperatives would elect the cooperative exemption for 500 swaps each year. The reporting cost estimates are discussed separately below according to each requirement.

The Commission invited public comment on any aspect of the reporting burdens discussed in the NPRM. The Commission received two comments on the Commission's approach to calculating the estimated cost burdens. The ABA questioned whether the Commission had underestimated its

estimations of the number of cooperatives eligible for the exemption, and the number of swaps each eligible cooperative engages in per year. The ABA also commented that the figures used are static and as such do not allow for potential future growth in the number of potential exempt cooperatives and number of swaps in which they may transact. The ICBA similarly commented on the static nature Commission's approach, and noted that the approach does not account for future growth when the use of swaps in the OTC market has grown significantly in recent years. Furthermore, the ICBA noted that the CFTC looked at information from five of the ten estimated cooperatives that may be eligible for the cooperative exemption, but did not indicate which of the five cooperatives it considered or what the reason was for not reviewing information from the other five cooperatives.

In response to the comments received, the Commission notes that the commenters provided no data or other information to support their assertions that the number of cooperatives and the number of swaps that may be eligible for the cooperative exemption may be low or inaccurate. The summary information regarding swap activities of five prospective exempt cooperatives was provided to the Commission on a voluntary basis through the FCC and CFC. Based on discussions with these entities, the Commission believes that these five cooperatives were more active than the other potential exempt cooperatives in using swaps and therefore this sampling of information was appropriate for estimating the number of swaps executed by the ten potential exempt cooperatives identified by the Commission. Subsequent to receipt of the comments on the NPRM, the Commission contacted the regulators for FCS cooperatives and federal credit unions and these regulators expressed a view that the Commission's estimates were not inappropriate.

In response to the comments that the estimates represent only a current snapshot of activity, the Commission recognizes that the number of entities eligible for the exemption and the number of swaps per eligible cooperative is likely to change in the future and that the benefits of this exemption for exempt cooperatives could encourage more exempt cooperatives to use swaps and could increase the number of swaps used by those cooperatives. However, the Commission notes that whether such growth is realized also depends on

<sup>98</sup> 44 U.S.C. 3501 *et seq.*

<sup>99</sup> *Id.*

additional factors that the Commission does not have adequate information to evaluate such as: (1) Subsequent changes to laws or regulations affecting one or more types of cooperatives and the extent to which they may use swaps; (2) increases or decreases in the total amount of borrowing undertaken by the members of those cooperatives; and (3) the frequency with which exempt cooperatives make the types of loans or experience other business changes that might increase or decrease the use of swaps. It is not possible to evaluate how future changes in these factors are likely to affect the number of swaps for which the cooperative exemption may be elected. Accordingly, the Commission believes using a static estimate is reasonable.

a. Regulation § 39.6(f)(3) (now § 50.51(c)): Reporting Requirements

Regulation § 39.6(f)(3) (now § 50.51(c)) requires exempt cooperatives that are reporting counterparties to comply with the reporting requirements of § 50.50(b), which require delivering specific information to a registered SDR or, if no SDR is available, the Commission. An exempt cooperative that is the reporting counterparty would have to report the information required in § 50.50(b)(1)(i) and (ii) for each swap for which it elects the cooperative exemption.

As discussed in the NPRM, the Commission anticipates that to comply with § 50.50(b)(1)(i) and (ii), each reporting counterparty would be required to check one box in the SDR or Commission reporting data fields indicating that the exempt cooperative is electing not to clear the swap. The Commission estimated that the cost of complying with this requirement for each reporting counterparty to be between less than \$1 and \$7 for each transaction, or approximately \$300 to \$3,500 per year for all transactions.

The Commission did not receive any comments concerning the cost to exempt cooperatives from complying with § 50.50(b)(1)(i) and (ii).

b. Regulation § 50.50(b)(1)(iii): Annual Reporting Option

Regulation 50.50(b)(1)(iii) allows for certain counterparty specific information identified therein to be reported either swap-by-swap by the reporting counterparty or annually by the electing counterparty. As discussed in the NPRM, the Commission anticipates that the exempt cooperatives will make annual filings of the information required. The Commission estimated the annual per cooperative cost for the filing to be between \$200

and \$590, or \$2,000 to \$5,900 as the aggregate cost for all exempt cooperatives.

The Commission did not receive any comments concerning the cost to exempt cooperatives for electing the annual reporting option under § 50.50(b)(1)(iii).

c. Updating Reporting Procedures

As discussed in the NPRM, the Commission anticipates that cooperatives electing the exemption that are reporting counterparties may need to modify their reporting systems to accommodate the additional data fields required by the rule. The Commission estimated that the modifications to comply with § 39.6(f)(3) (now § 50.51(c)) would likely cost each reporting counterparty between \$340 and \$3,400, with the aggregate one-time cost for all potential exempt cooperatives to be \$3,400 to \$34,100.

The Commission did not receive any comments concerning the cost to exempt cooperatives in updating their reporting systems to comply with § 39.6(f)(3) (now § 50.51(c)).

d. Burden on Non-Reporting Cooperatives

As discussed in the NPRM, when an exempt cooperative is not functioning as the reporting counterparty (*i.e.*, when transacting with an SD or MSP), the Commission anticipated that it may, at certain times, need to communicate information to its reporting counterparties in order to facilitate reporting. This information might include whether the exempt cooperative has filed an annual report pursuant to § 50.50(b), and information to facilitate any due diligence that the reporting counterparty may conduct. The Commission estimated that a non-reporting exempt cooperative would incur an annual aggregate cost for communicating information to the reporting counterparty between \$400 and \$39,000.<sup>100</sup>

The Commission did not receive any comments concerning the cost a non-reporting exempt cooperative will incur in communicating information to the reporting counterparty.

**List of Subjects in 17 CFR Part 50**

Business and industry, Clearing, Cooperatives, Reporting requirements, Swaps.

Accordingly, the CFTC amends 17 CFR part 50 as follows:

<sup>100</sup>The Commission noted the wide range in this estimation, but explained the range could not be narrowed given the unknowns associated with the cost estimate.

**PART 50—CLEARING REQUIREMENT AND RELATED RULES**

■ 1. The authority citation for part 50 continues to read as follows:

**Authority:** 7 U.S.C. 2 and 7a-1 as amended by Pub. L. 111-203, 124 Stat. 1376.

■ 2. Add § 50.51 to read as follows:

**§ 50.51 Exemption for Cooperatives.**

*Exemption for cooperatives.* Exempt cooperatives may elect not to clear certain swaps identified in paragraph (b) of this section that are otherwise subject to the clearing requirement of section 2(h)(1)(A) of the Act if the following requirements are satisfied.

(a) For the purposes of this paragraph, an *exempt cooperative* means a cooperative:

(1) Formed and existing pursuant to Federal or state law as a cooperative;

(2) That is a “financial entity,” as defined in section 2(h)(7)(C)(i) of the Act, solely because of section 2(h)(7)(C)(i)(VIII) of the Act; and

(3) Each member of which is not a “financial entity,” as defined in section 2(h)(7)(C)(i) of the Act, or if any member is a financial entity solely because of section 2(h)(7)(C)(i)(VIII) of the Act, such member is:

(i) Exempt from the definition of “financial entity” pursuant to § 50.50(d); or

(ii) A cooperative formed under Federal or state law as a cooperative and each member thereof is either not a “financial entity,” as defined in section 2(h)(7)(C)(i) of the Act, or is exempt from the definition of “financial entity” pursuant to § 50.50(d).

(b) An exempt cooperative may elect not to clear a swap that is subject to the clearing requirement of section 2(h)(1)(A) of the Act if the swap:

(1) 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 § 1.3(ggg)(5)(i), (ii), and (iii) are satisfied; *provided that*, for this purpose, the term “insured depository institution” as used in those sections is replaced with the term “exempt cooperative” and the word “customer” is replaced with the word “member;” or

(2) Hedges or mitigates commercial risk, in accordance with § 50.50(c), related to loans to members or arising from a swap or swaps that meet the requirements of paragraph (b)(1) of this section.

(c) An exempt cooperative that elects the exemption provided in this section shall comply with the requirements of § 50.50(b). For this purpose, the exempt cooperative shall be the “electing

counterparty,” as such term is used in § 50.50(b), and for purposes of § 50.50(b)(1)(iii)(A), the reporting counterparty, as determined pursuant to § 45.8, shall report that an exemption is being elected in accordance with this section.

Issued in Washington, DC, on August 13, 2013, by the Commission.

**Melissa D. Jurgens**,  
Secretary of the Commission.

**Note:** The following appendix will not appear in the Code of Federal Regulations.

### Appendix to Clearing Exemption for Certain Swaps Entered Into by Cooperatives—Commission Voting Summary

#### Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Chilton, O’Malia, and Wetjen voted in the affirmative.

[FR Doc. 2013–19945 Filed 8–21–13; 8:45 am]

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## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 4

RIN 3038–AD75

### Harmonization of Compliance Obligations for Registered Investment Companies Required To Register as Commodity Pool Operators

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rule.

**SUMMARY:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is adopting final regulations with respect to certain compliance obligations for commodity pool operators (“CPOs”) of investment companies registered under the Investment Company Act of 1940 (“registered investment companies” or “RICs”) that are required to register due to the recent amendments to its regulations. The Commission is also adopting amendments to certain provisions of part 4 of the Commission’s regulations that are applicable to all CPOs and Commodity Trading Advisors (“CTAs”).

**DATES: Effective dates:** This rule is effective August 22, 2013, except the amendments to §§ 4.7(b)(4), 4.12(c)(3)(i), 4.23, 4.26, and 4.36 which are effective September 23, 2013.

**Compliance dates:** Registered CPOs seeking exemption under these rules shall be required to comply with the conditions adopted in § 4.12(c)(3)(i) when the associated registered

investment company updates its prospectus as described in Section II.F., below, and files the prospectus with the SEC. Moreover, the publication of these rules trigger the conditional compliance date that was established in the Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations rulemaking. 77 FR 11252, 11252 (Feb. 24, 2012). With the publication of these rules, registered CPOs of RICs must comply with § 4.27 on or before October 21, 2013.

#### FOR FURTHER INFORMATION CONTACT:

Amanda Leshar Olear, Associate Director, Telephone: (202) 418–5283, Email: [aolear@cftc.gov](mailto:aolear@cftc.gov), or Michael Ehrstein, Attorney-Advisor, Telephone: 202–418–5957, Email: [mehrstein@cftc.gov](mailto:mehrstein@cftc.gov), Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581.

#### SUPPLEMENTARY INFORMATION:

##### I. Background

This rulemaking is related to the final rule adopted under RIN 3038–AD30.

##### A. Recent Amendments to § 4.5 as Applicable to RICs

The Commodity Exchange Act (“CEA”) <sup>1</sup> provides the Commission with the authority to require registration of CPOs and CTAs, <sup>2</sup> to exclude any entity from registration as a CPO or CTA, <sup>3</sup> and to require “[e]very commodity trading advisor and commodity pool operator registered under [the CEA] to maintain books and records and file such reports in such form and manner as may be prescribed by the Commission.” <sup>4</sup> The Commission also has the authority to “make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate the provisions or to accomplish any of the purposes of [the CEA].” <sup>5</sup>

In February 2012, the Commission adopted modifications to the exclusions from the definition of CPO that are delineated in § 4.5 (“2012 Final Rule”). <sup>6</sup>

<sup>1</sup> 17 U.S.C. 1, *et seq.*

<sup>2</sup> 17 U.S.C. 6m.

<sup>3</sup> 17 U.S.C. 1a(11) and 1a(12).

<sup>4</sup> 17 U.S.C. 6n(3)(A). Under part 4 of the Commission’s regulations, unless otherwise provided by the Commission, entities registered as CPOs have reporting obligations with respect to their operated pools. See 17 CFR 4.22.

<sup>5</sup> 17 U.S.C. 12a(5).

<sup>6</sup> 17 CFR 4.5. See 77 FR 11252 (Feb. 24, 2012); correction 77 FR 17328 (March 26, 2012). Prior to this Amendment, all RICs, and the principals and employees thereof, were excluded from the definition of “commodity pool operator,” by virtue of the RICs registration under the Investment Company Act of 1940. The 2012 amendment to

Specifically, the Commission amended § 4.5 to modify the exclusion from the definition of “commodity pool operator” for those entities that are investment companies registered as such with the Securities and Exchange Commission (“SEC”) pursuant to the Investment Company Act of 1940 (“’40 Act”). <sup>7</sup> This modification amended the terms of the exclusion available to CPOs of RICs to include only those CPOs of RICs that commit no more than a de minimis portion of their assets to the trading of commodity interests that do not fall within the definition of bona fide hedging and who do not market themselves as a commodity pool or other commodity investment. <sup>8</sup> Pursuant to this amendment, any such CPO of a RIC that exceeds this level, or markets itself as such, will no longer be excluded from the definition of CPO. Accordingly, except for those CPOs of RICs who commit no more than a de minimis portion of their assets to the trading of commodity interests that do not fall within the definition of bona fide hedging and who do not market themselves as a commodity pool or other commodity investment, an operator of a RIC that meets the definition of “commodity pool operator” under § 4.10(d) of the Commission’s regulations and § 1a(11) of the CEA must register as such with the Commission. <sup>9</sup>

##### B. Harmonization Proposal

In response to the Commission’s February 2011 proposal to amend the § 4.5 exclusion with respect to CPOs of RICs, <sup>10</sup> as well as a staff roundtable held on July 16, 2011 (“Roundtable”), <sup>11</sup> and meetings with interested parties, the Commission received numerous

§ 4.5 maintained this exclusion for those RICs that engage in a de minimis amount of non-bona fide hedging commodity interest transactions. See *id.* Specifically, the amendment to § 4.5 retained this exclusion for RICs whose non-bona fide hedging commodity interest transactions require aggregate initial margin and premiums that do not exceed five percent of the liquidation value of the qualifying pool’s portfolio, or whose non-bona fide hedging commodity interest transactions’ aggregate net notional value does not exceed 100 percent of the liquidation value of the pool’s portfolio.

<sup>7</sup> 15 U.S.C. 80a–1, *et seq.* “SEC” as used herein means the Securities and Exchange Commission or its staff, as the context requires.

<sup>8</sup> 17 CFR 1.3(yy).

<sup>9</sup> Pursuant to the terms of § 4.14(a)(4), CPOs are not required to register as CTAs if the CPOs’ commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which they are registered as CPOs. 17 CFR 4.14(a)(4).

<sup>10</sup> 76 FR 7976 (Feb. 11, 2011).

<sup>11</sup> See Notice of CFTC Staff Roundtable Discussion on Proposed Changes to Registration and Compliance Regime for Commodity Pool Operators and Commodity Trading Advisors, available at [http://www.cftc.gov/PressRoom/Events/opaevent\\_cftcstaff070611](http://www.cftc.gov/PressRoom/Events/opaevent_cftcstaff070611).