Statement of
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Chairman Lucas, Ranking Member Peterson, and members of the committee, thank you for the opportunity today to discuss the role of the over-the-counter (OTC) derivatives market in helping farmers and farmer-owned cooperatives manage commodity price risks. I am pleased to be here representing the National Council of Farmer Cooperatives (NCFC) and provide input on the key issues concerning implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) as well as potential legislative reforms this committee may take under consideration in the near future.

I am Scott Cordes, President of Country Hedging, a commodity brokerage subsidiary of CHS Inc. CHS is a farmer-owned energy, grains and foods cooperative committed to providing essential resources that enrich lives around the world. CHS is owned by approximately 55,000 individual farmers and ranchers who own shares by selling us grain directly or as customer-owners of one of five dozen CHS Country Operations retail units. We are also owned by about 1,000 local cooperatives who represent another 350,000 producers. You might also be interested to know I grew up on a grain and dairy farm in Southeastern MN that my brother still operates today.

I also serve on NCFC's Commodity Futures Trading Commission (CFTC) working group, which was formed to provide technical assistance to NCFC on commodity markets, including implementation of Title VII of the Dodd-Frank Act. On behalf of the CHS farmer-owners, and more broadly the more than two million farmers and ranchers who belong to farmer cooperatives, I thank the committee for holding this hearing to discuss proposed legislation to amend the Dodd-Frank Act.

Farmer cooperatives – businesses owned, governed and controlled by farmers and ranchers – are an important part of the success of American agriculture. This ownership structure that has served CHS owners well for 80 years helps individual family farmers and ranchers thrive despite the ups and downs of weather, commodity markets, and technological change. Through their cooperatives, producers are able to improve their income from the marketplace, manage risk, and strengthen their bargaining power, allowing farmers to compete globally in a way that would be impossible to replicate as individual producers. In all cases farmers are empowered, as elected board members, to make decisions affecting the current and future activities of their cooperative. Earnings derived from these activities are returned by cooperatives to their farmer-members on a patronage basis, thereby enhancing their overall farm income and improving rural economies.

In particular, by providing commodity price risk management tools to their member-owners, farmer cooperatives help mitigate commercial risk in the production, processing and selling of a broad range of agricultural and food products. America's farmers and ranchers must continue to have access to new and innovative risk management products that enable them to feed, clothe and provide fuel to consumers here at home and around the world. Any regulatory action that could jeopardize access to these tools should be avoided.

As such, we have been working to ensure that the implementation of the Dodd-Frank Act preserves risk management tools for farmers and their cooperatives.

During the rulemaking process, NCFC has advocated for the following:

- Treat agricultural cooperatives as end users because they aggregate the commercial risk of individual farmer-members and are currently treated as such by the CFTC;
- Exclude agricultural cooperatives from the definition of a swap dealer;
- Consider aggregate costs associated with the new regulations and the impact on the agriculture sector; and
- Maintain a bona fide hedge definition that includes common commercial hedging practices.

Even though it has been more than a year since the Dodd-Frank Act was signed into law, we are still uncertain as to how farmer cooperatives will be classified and what regulations they will be subject to. The resulting uncertainty has put business plans on hold and has delayed investment to increase the capacity for cooperatives to expand their risk mitigation services.

Cooperatives' Use of the OTC Market

As processors and handlers of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of the futures exchanges, as well as the OTC derivatives markets. Due to market volatility in recent years, cooperatives are increasingly using OTC products to better manage their exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces costs to the cooperatives and their farmer-owners.

OTC derivatives are not just used for risk management at the cooperative level. They also give the cooperative the ability to provide customized products to smaller local cooperatives and individual farmer-members to help them better manage their risk and returns. Much like a supply cooperative leverages the purchasing power of many individual producers, or a marketing cooperative pools the production volume of hundreds or thousands of growers, a cooperative can aggregate its members-owners' commodity price risk. It can then offset that risk with a futures contract or by entering into another customized hedge via the swap markets.

Some examples include:

- Local grain cooperatives offer farmers a minimum price for future delivery of a specific volume of grain. The local elevator then offsets that risk by entering into a customized swap with an affiliated cooperative in a regional or federated system.

- Since most individual farmers do not have the demand necessary to warrant a standard 42,000-gallon monthly NYMEX contract, individual farmers can hedge their fuel costs by entering into swaps in 1,000-gallon increments through the co-op.

- Local supply cooperatives use swaps to mitigate their price risk in both crop nutrients and propane.

- Cooperatives facilitate hedging for dairy farmers by offering a fixed price for their milk and a swap to hedge their feed purchases. Dairy cooperatives also use swaps to offset the risk of offering forward contracts to their farmers, as well as to hedge the risk of offering forward price sales contracts to their customers.

- Cooperatives offer livestock producers customized contracts at non-exchange traded weights to better match the corresponding number of animal units they have while also reducing producers' financial exposure to daily margin calls.

While my colleagues from dairy or livestock cooperatives could provide greater details on how the above programs work for those sectors, they are all similar in concept and purpose to the risk management programs we provide to our CHS member-owners. We enter into OTC derivatives to hedge the price risk of commodities that we purchase, supply, process or handle for our members.

Swaps also play a critical role in the ability of cooperatives to provide forward contracts, especially in times of volatile markets. Because commodity swaps are not currently subject to the same margin requirements as the exchanges, cooperatives can use them to free up working capital.

For example, considerable amounts of working capital have been tied up to cover daily margin calls as a result of increased volatility in grain and oilseed markets. For farmers to continue to take advantage of selling grain forward during price rallies, cooperatives have to either increase borrowing or look for alternative ways to manage such risk. Using the OTC market has become that alternative. In 2008, multinational grain companies were running out working capital due to extreme grain volatility. CHS was able to enter into swaps to free up working capital so that it could continue to contract and forward price grain with its members. As was the case during the volatile markets in 2008, swaps today allow cooperatives to free up working capital and continue to forward contract with farmers.

Definition of Swap Dealer

The uncertainty created by the "definitions" rules is NCFC's greatest concern as implementation continues. While the CFTC has proposed regulations for swaps and swap dealers, it is unclear to us who, or what transactions, will be subjected to those additional regulations. As the rule was proposed, some activities of cooperatives such as those previously mentioned would appear to push cooperatives into the "swap dealer" category.

Regulating farmer cooperatives as dealers would increase requirements for posting capital and margin on swaps it uses with other dealers to offset the risk of providing risk management products and services to its members and customers. This requirement, combined with the cost of complying with other regulatory requirements intended for large financial institutions, could make providing those services to a cooperative's member-owners uneconomical. Such action would result in the unintended consequence of increasing risk in the agricultural sector. In addition, it would severely limit the number of non-financial entities that could provide risk management tools in the form of financially settled instruments (swaps).

The two main issues in the proposed rule are the application of the "interpretive approach for identifying whether a person is a swap dealer," and the very low thresholds on the "de minimis exception." As such CFTC would likely capture a number of entities, including farmer cooperatives, which were never intended to be regulated as swap dealers. Yet farmer cooperatives do not resemble what is generally and commonly known in the trade as a swap dealer – ones that profit from the spread between the buying and selling of swaps. Cooperatives are not driven by that profit motive, but rather are hedging, or assisting their members and customers in hedging the price risks inherent to the agriculture industry. Farmer cooperatives mitigate risk as opposed to others in the marketplace who take on risk for profit.

Therefore, we support legislation to clarify what entities would be classified and regulated as swap dealers. The proposed legislation clarifies that swap dealers do not include those using swaps to hedge, or which enter into swaps ancillary to one's business as a producer, processor, or commercial user of a commodity. Both of those "prongs" capture the essence of farmer cooperatives' and their members' utilization of swaps. By providing for a commercially meaningful threshold under the "de minimis exception," the bill would ensure there are options for hedgers to find commercial swap counterparties other than just financial entities.

Further, some cooperatives, such as CHS, are currently at risk of being designated as swap dealers due to their unique structure. For example, a federated grain or farm supply cooperative is owned by many local cooperatives which are separate business entities. Unlike a traditional corporate structure where risk can be transferred internally, the ability to transfer risk from the local level to the federated cooperative – in this case in the form of a swap – is treated as an external transaction under the draft rules. Thus we are very interested in having those transactions addressed in the "inter-affiliate" legislation introduced by Representatives Marcia Fudge and Steve Stivers. While their legislation as introduced is specific to affiliate transactions between parties under common control, the same justification can be made for similar transactions between affiliated cooperatives and their affiliated member-owners. Because of the bottom-up ownership structure of a cooperative, the affiliates are not under "common control" of the larger cooperative. Therefore, we would like to see an additional provision included in this legislation to include transactions between a cooperative and its member-affiliates, taking into account the differing structure of cooperative ownership from that of a traditional corporate entity.

Many agricultural cooperatives, like CHS, borrow from CoBank, which is also a cooperative. We are concerned that CFTC would classify CoBank as a swap dealer because CoBank sells swaps to its customers in conjunction with providing loans. Congress specifically exempted

these types of swaps from qualifying a commercial bank as a swap dealer. The exemption, however, was inadvertently limited only to "insured depository institutions," and as a Farm Credit System institution, CoBank is not an insured depository institution. We urge CFTC to ensure CoBank's swaps are treated the same as other regulated lenders and do not qualify the bank as a swap dealer. Otherwise, our co-op, as well as others like us who borrow from CoBank, will be penalized.

Cost-Benefit Analysis

Agriculture is a high-volume, low-margin industry. Incremental increases in costs, whether passed on from a swap dealer or imposed directly on a cooperative, will trickle down and affect producers. It is important to keep in mind the aggregate costs associated with the many new regulations and the implications it will have for the agriculture sector. Taken one rule at a time, the costs may not seem unreasonable to those who are writing the rules. But to those who have to absorb or pass on the collective costs of numerous regulations, it is clearly evident those costs are significant. While the Commission believes it is doing its due diligence in providing cost-benefits analyses of the regulations it is proposing, we think better analysis is called for to consider their aggregate effect.

For example, one so-called "small" change in the regulations is contained in the conforming amendments proposed rule and has to do with additional recording requirements. We are concerned this proposal would not only add swaps to the new recordkeeping requirements, but also extend the new requirements to cash purchase and forward cash contracts entered into by any member of a designated contract market (DCM).

As a result, all farmer cooperatives that are members of DCMs (Chicago Mercantile Exchange, Kansas City Board of Trade, Minneapolis Grain Exchange, etc.), and by extension every one of their local facilities, to be bound by this regulation. Farmer cooperatives that are members of DCMs have an integrated network of grain elevators to originate and store grain purchased from farmers. The proposed change would require those elevators to record, among other things, all oral communications (telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device or other digital or electronic media) that lead to execution of cash transactions with farmers. In addition, each transaction record must be maintained as a separate electronic file identifiable by transaction and counterparty and kept for five years.

While some traders now record certain conversations in order to provide a record of order execution, the CFTC's proposal would require employees at hundreds of operations to record all face-to-face and phone conversations with farmers, even when tape recording has never been their practice in the past. Such a requirement would impose huge regulatory burdens and costs on cooperatives and other businesses and farmers in rural America. For example, CHS buys grain at over 350 grain elevators across the United States. To install and maintain such recordkeeping systems would cost us over $6 million dollars. In fact, the necessary investment to put in place and maintain such a system would not only greatly add to the cost of doing business, but would be an extreme compliance burden for the cash grain community. Since farmers would not be too keen having all their marketing conversations recorded and kept for five years, this would penalize those who are members of DCMs relative to other facilities. For

those reasons, we believe this will have a net effect of driving grain industry participants to drop their membership in the exchanges. Further, we do not believe this regulatory burden is necessary to achieve the stated goals in the cash commodity markets. I would note that this "small" change tucked into one of the thousands of pages of proposed rules was not called for under the Dodd-Frank Act but rather has been initiated by the CFTC.

End-User Exemption From Margin Requirements

Consistent with congressional intent, NCFC supports the CFTC's proposed rules to clarify that it "would not impose margin requirements on non-financial entities," and that "parties would be free to set initial and variation margin requirements in their discretion and any thresholds agreed upon by the parties would be permitted." Farmer cooperatives are an extension of their members who are end-users. By extension, a farmer cooperative should also be an end-user.

However, we are concerned the so-called "Prudential Regulators" margin proposal requires bank swap dealers to collect margin from end-users. As I noted earlier, swaps play a critical role in the ability of cooperatives to provide forward contracts, especially in times of volatile markets. This is because commodity swaps are not currently subject to margin requirements such as contracts on the exchanges and t can be used to free up working capital.

As end users, cooperatives use swaps to hedge interest rates, foreign exchange, and energy in addition to agricultural commodities. Often, cooperatives look to their lender to provide those swaps. Under the proposed rule requiring end users to post margin, costs to businesses will increase as more cash is tied up to maintain those hedges. The additional capital requirements will be syphoned away from activities and investment in cooperatives' primary business ventures. Furthermore, cash for margin is often borrowed from lenders through the use of credit lines. As a result, we could see a situation where a commercial end-user would have to borrow cash from its lender, and pay interest on it, just to give it back to the same lender to hold as margin. Congressional intent was clear on this point—end users were not to be required to post margin. We support legislation that would reaffirm this intent.

Bona Fide Hedge Definition

Although legislation has not yet been introduced to address the bona fide hedge definition in the position limits rule, I bring this issue to your attention as the Commission is scheduled to vote on that rule in the near future. Once again, it appears the Commission may be going well beyond what Congress intended in the Dodd-Frank Act. In the draft rule, CFTC has classified common commercial hedging practices as speculative in nature. These include such practices as anticipatory hedging and cross hedging. For example, an anticipatory hedge could involve selling a corn future Friday afternoon, knowing that grain will be bought throughout the weekend. Common cross hedges would include hedging a dried distillers grain position with corn or hedging a cheese position with Class III milk, butter and whey.

For NCFC's dairy cooperative members, the "five-day rule" poses a significant problem. Six of the seven dairy futures contracts, and the swaps that use these futures for settlements, are cash-settled instruments. Five of the six cash-settled futures contracts have open interest of less than

5,000 – spread across 24 months of futures contracts. One of the dairy contracts that has physical delivery currently has zero open interest.

Due to these instruments settling against U.S. Department of Agriculture determined cash prices, there is perfect convergence of futures to cash. There are not any issues associated with deliverable contracts held during the last few days prior to settlement. Since this is the case, the dairy industry users hold these instruments until their positions close out on the settlement date. If these instruments were required to close out prior to settlement date, it would result in unusual price changes in the last few days – especially for the contracts that have very low open interest. Imposing the five-day rule in the dairy sector would reduce the effectiveness of hedges and possibly reduce the use of these instruments by dairy farmers and their cooperatives, resulting in increased risk.

I would encourage this committee to take a close look at this definition when the final rule is issued. The implications are not only contained to the position limits themselves, but also other rules, such as what will be considered hedging or mitigating commercial risk for the purposes of commercial end users being able to access the end user exception to the clearing requirement.

In summary, we hope you will give consideration to the following: treating agricultural cooperatives as end users; excluding agricultural cooperatives from the definition of a swap dealer; consider the aggregate costs associated with the new regulations that impact agriculture; and, maintain a bona fide hedge definition that includes common commercial hedging practices.

Thank you again for the opportunity to testify today before the committee on behalf of farmer-owned cooperatives. Your leadership and oversight in the implementation of the Dodd-Frank Act is to be commended. We especially appreciate your role in ensuring that farmer cooperatives will continue to be able to effectively hedge commercial risk and support the viability of their members' farms and cooperatively owned facilities. I look forward to answering any questions you may have.

Thank you.