**From:** Kyle Danish <KWD@vnf.com>
**Sent:** Monday, September 20, 2010 2:32 PM
**To:** dfadefinitions <dfadefinitions@CFTC.gov>
**Subject:** ANOPOR on Definitions Contained in Title VII of Dodd-Frank Act
**Attach:** CERP Comments on CFTC ANOPR September 20 2010.pdf

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To Whom It May Concern:

I have attached comments from the Coalition for Emission Reduction Projects in response to the Advance Notice of Proposed Rulemaking:

"Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act"

Please do not hesitate to contact me if you have any questions or need additional information.

Best regards,

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Coalition for Emission Reduction Projects
uscerp.org

September 20, 2010

Mr. David Stawick
Secretary, Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St., N.W.
Washington, DC 20581

**Re: Comments of the Coalition for Emission Reduction Projects on Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51,429 (Advance Notice of Proposed Rulemaking, Aug. 20, 2010)**

Dear Commissioners:

The Coalition for Emission Reduction Projects (CERP) is pleased to submit the following comments on the Commodity Futures Trading Commission's (CFTC) recent Advance Notice of Proposed Rulemaking (ANOPR)[1] seeking public input on forthcoming definitions of the terms "swap," "swap dealer," and "major swap participant" in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2] CERP is a coalition of companies that develop and finance projects that reduce or sequester greenhouse gas (GHG) emissions, as well as companies that expect to be subject to GHG regulation and want the ability to use offset credits derived from these projects to meet their compliance obligations. We strive to provide a constructive voice in ongoing policy design efforts, including policy initiatives relating to oversight of offset credit markets and transactions in offset credits. A list of CERP members is provided in the Appendix to this letter.

CERP believes that well-crafted regulation is important to preserving the integrity and vitality of markets for environmental commodities such as offset credits. However, in the public debate over the Dodd-Frank Act and in comments to the Western Climate Initiative (WCI) on market oversight,[3] CERP has consistently

[1] Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51,429 (Advance Notice of Proposed Rulemaking, Aug. 20, 2010).
[2] Pub. L. No. 111-230 (2010).
[3] Coalition for Emission Reduction Projects, *Comments on the Western Climate Initiative's Draft Recommendations on Market Oversight* (May 12, 2010), *available at:* http://www.westernclimateinitiative.org/public-comments/comment/748.

expressed concern that certain regulatory approaches could interfere with the functioning of the offsets market and needlessly discourage companies from investing in GHG reduction projects. The comments below briefly review the nature of the offsets market and common transactions in offset credits, and discuss particular aspects of the above terms that should be clarified through future rulemaking. These clarifications would provide welcome certainty for participants in the offsets market and lay a foundation for appropriate regulation in the future.

Our specific recommendations are:

- CFTC should clarify the definition of "swaps" to provide that:
  - Forward transactions in offset credits and other environmental commodities can be "physically settled" and therefore qualify for the exclusion from the definition of "swaps" in 1a(47)(B)(ii); and
  - Consistent with recent precedent, only *standardized* agreements will be considered "contracts for future delivery" under the exclusion in 1a(47)(B)(i).
- CFTC should clarify the definition of "swap dealer" to exclude businesses that regularly trade in swaps in order to hedge commercial risks, as opposed to dealing in swaps as a business pursuit; and
- In refining the definition of "major swap participant," CFTC should ensure that only systemically significant market participants are included in the definition and should establish objective criteria yielding predictable classifications.

## I. Overview of the Offsets Market and Offset Transactions

*A. Background on the Offsets Market.* Offset credits are certifications awarded to sponsors of projects that generate verifiable and additional reductions in or sequestration of GHG emissions.[4] Each offset credit represents an equal quantity of GHG reductions (expressed in tons of carbon dioxide equivalents, or "CO$_2$-e"), and certifies that the reductions have been verified to meet the standards of quality established by the program that issues the offset credit. Companies purchase offset credits to use for compliance with emissions trading programs for GHGs (such as the European Union's Emission Trading Scheme); to store for potential use in future emissions trading programs; and to use on a voluntary basis to provide the public with credible assurances that the company is reducing its GHG emissions. Thus, offset credits are both an *authorization to emit* in certain emissions trading programs and a *public representation* of the GHG benefits of the offset project.

[4] References hereafter to emission "reductions" should be read to refer to both emission reductions and sequestration.

The most prominent program issuing offset credits is the Clean Development Mechanism (CDM), which operates under the auspices of the Kyoto Protocol to the United Nations Framework Convention on Climate Change. In the United States, major organizations issuing offset credits include the California Climate Action Reserve, the American Carbon Registry, and the Voluntary Carbon Standard. A number of state and regional governmental programs in the United States contemplate recognizing credits from these programs and also issuing their own offset credits; these include the Regional Greenhouse Gas Initiative, the Western Climate Initiative, and California's program under the state's A.B. 32 law.

Offset credits are generally freely traded among companies, financial institutions, commodity brokers, and investors, using transactional forms that are very similar to those used for traditional commodities (i.e., spot transactions, forwards, futures, swaps, etc.). To protect the credibility of offset credit issuers, each offset credit is customarily issued an individual registration or identification number and deposited in a registry administered either by the offset credit issuer or by an emissions trading program. Ownership of that offset credit is then recorded and monitored in the registry as it changes hands.

*B. Policy Concerns Relating to Offsets.* As oversight of GHG markets has been discussed both in the context of the Dodd-Frank Act and Federal climate change legislation, CERP has consistently expressed concern over the treatment of common contracts involving offset credits. The most important type of contract involves a deferred sale of offset credits by the developer or sponsor of a GHG reduction project. In order to attract financing for a project and "lock in" a market for offset credits issued to the project, the developer will typically sign contracts selling certain quantities of offset credits at an agreed-upon price (sometimes a price indexed to other GHG markets) with delivery at an agreed-upon future date. Because the provisions of these contracts depend on the unique characteristics and risk profile of the project itself as well as the parties, the terms of each contract are – by necessity – individually negotiated and highly non-standardized. These contracts are not interchangeable and, not surprisingly, there is no organized market for trading of these offset development contracts. A second major type of contract involves the "bundling" of offset credits from multiple projects by traders known as "aggregators." Aggregators build these contracts in order to meet the desired risk profiles or project interests of clients; accordingly, aggregated contracts also tend to be individually negotiated, non-standardized, and not actively traded in an organized marketplace.

Because of the unique nature of these contracts, and because these contracts are used primarily for commercial hedging or as marketing channels for offset credits, CERP believes it is inappropriate for these contracts to be subjected to market oversight mechanisms (such as clearing and exchange trading) that are adapted to standardized, high-volume contracts. Indeed, such requirements would seriously impair the smooth functioning of offset markets and prevent offset credits from being used as a cost-effective method of meeting GHG emission reduction targets.

## II. Comments on the Exclusion of Forwards From the Definition of "Swap"

Consistent with the general policy concerns described above, CERP believes it is important that CFTC clarify that forward sales of offset credits (such as those used by offset project developers) are excluded from the definition of "swaps" under the Dodd-Frank Act. Section 1a(47)(B)(ii) of the Commodity Exchange Act (CEA),[5] as amended by the Dodd-Frank Act, provides that the term "swap" does not include "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." Both the literal language of this exclusion and policy considerations argue in favor of interpreting this exclusion in the same manner for environmental commodities as for other types of commodities.

*A. Plain language.* First, environmental instruments are clearly nonfinancial commodities because – as noted above – they constitute both an authorization to emit and a public representation of GHG emission reductions. They are not a form of currency and are not akin to commodities that are typically regarded as "financial" in nature (such as stock indices, interest rates, or exchange rates).[6]

Second, the transactions described above clearly satisfy the phrase "sale of a . . . commodity . . . for deferred shipment or delivery" as it has been defined by CFTC and the Federal courts of appeals in the context of Section 1a(19) of the CEA.[7] In the past, the CFTC has held that a sales agreement that is intended to result in eventual *actual delivery* of a commodity (as opposed to a cash payment) is a contract of sale for "deferred shipment or delivery" and is therefore a forward contract exempt from

[5] Dodd-Frank Act, § 721(a)(21) (amending 7 U.S.C. § 1a).

[6] That offset credits are "commodities" within the meaning of the CEA appears clear. Section 1a of the CEA (as amended by the Dodd-Frank Act) defines the term "commodity" to include a list of enumerated goods as well as "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." Offset credits could be considered either a "right," "interest," or "good" under this definition, and can be the subject of contracts for future delivery. Moreover, CFTC has regulated similar instruments ($SO_2$ allowances established under Title IV of the Clean Air Act) as exempt commodities under the CEA. *See* Mark Jickling, *Regulating a Carbon Market: Issues Raised by the European Carbon and U.S. Sulfur Dioxide Allowance Markets* (Congressional Research Service, April 30, 2008)

[7] 7 U.S.C. § 1a(19) (2010) (as amended by the Dodd-Frank Act, this definition will be codified at 7 U.S.C. § 1a(27)).

most regulation under the CEA.[8] Offset development contracts and aggregation contracts are satisfied by actual delivery of offset credits, accomplished by a change of title in the offset credit and a transfer of the credit within a registry. The purchasers of offset credits under these contracts typically seek to engage in further marketing of the offset credits, or use the offset credits for their own business objectives – *not* financial speculation. So long as this actual delivery condition is met, then, contracts for offset credits should be considered contracts for "deferred shipment or delivery." Because these offset contracts are also highly non-standardized, CERP believes that they would also qualify as contracts for "deferred shipment or delivery" under the tests that have been more recently articulated in the Sixth and Seventh Circuit Courts of Appeals (discussed further below).[9]

Third, offset contracts that result in actual delivery of offset credits are clearly "physically settled." As CFTC is aware, the term "physical settlement" is commonly used in the commodity trading industry to refer to cases where the future sale of a commodity is satisfied through means other than a cash payment; in other words, a contract that results in actual delivery of the commodity.[10] Moreover, the term "physical settlement" is often used to refer to actual delivery in forward contracts concerning intangible commodities (for example, foreign currency).[11] Nothing in the language of the Dodd-Frank Act suggests that Congress intended anything other than this common usage of "physical settlement" in crafting the exclusion from swaps for forward contracts. Thus, a transaction that results in actual delivery of offset credits should be regarded as "physically settled" within the meaning of Section 1a(47)(B)(ii) of the CEA, just as would be the case for a conventional commodity.

*B. Policies Motivating the Exclusion of Forwards.* CERP notes that even if CFTC believes the language of Section 1a(47)(B)(ii) is ambiguous in its application to offset credits, policy considerations support the interpretation we advance here. Previous CFTC decisions and judicial opinions have recognized that Congress excluded forwards from the CEA in order to avoid burdening ordinary, non-speculative commercial transactions with pervasive regulation. As CFTC has noted,

[8] *See* Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 31,188, 31,191 (Sep. 25, 1990) (describing CFTC's past emphasis on physical delivery, and determining that forward contracts also include transactions where one party has an enforceable right to demand physical delivery and bears economic risks associated with possession of the commodity).

[9] *See CFTC v. Erskine,* 512 F.3d 309, 325 (6th Cir. 2008); *CFTC v. Zelener,* 373 F.3d 861, 865-66 (7th Cir. 2004) (holding that the presence of non-standardized terms is a key distinguishing characteristic of forward contracts).

[10] *See* Robert D. Aicher, *Derivatives: Legal Practice and Strategies* § 1.01[B][1] (describing "cash settlement" and "physical settlement" as the two alternatives for closing a forward or futures contract).

[11] *See CFTC v. UForex Consulting LLC,* 551 F.Supp. 2d 513, 544 (W.D. La. 2007) (providing an example of a forward contract that provides for "physical delivery" of foreign exchange).

such transactions are typically entered into by "a producer, processor, fabricator, refiner, or merchandiser" who seeks to shift price risk or carry on commercial functions.[12] Congress believed that such ordinary transactions neither merited extensive regulation nor posed much risk: as one court stated: "Transactions in the commodity itself which anticipate actual delivery did not present the same opportunities for speculation, manipulation, and outright wagering that trading in futures and options presented."[13]

The same policy considerations that underlie the exclusion of forward contracts in traditional, tangible commodities apply with equal force to offset credits and environmental instruments. An offset development contract or an aggregation contract has at least one party that is (a) a producer of offset credits, (b) a marketer or merchandiser of offset credits, or (c) an end-user of offset credits (for compliance or other legitimate business purposes). The object of the contract is to secure a price and delivery date for *actual delivery* of offset credits, not to generate a cash payment at the termination of the contract. Thus, offset development and aggregation contracts are no different in kind from other forward contracts entered into by producers and marketers of conventional commodities. Moreover, because these contracts are non-speculative and result in actual delivery of the credits into a registry, the total quantity of such contracts is naturally limited by the number and scale of registered offset projects – meaning they pose negligible systemic risk. Thus, transactions that meet the characteristics previously set forth by CFTC and the courts as indicative of forward contracts – that is, actual delivery and non-standardized terms – should be excluded from the definition of "swaps" for the same reason that forwards have traditionally been considered exempt from regulation under the CEA.

## III. Comments on the Exclusion of Futures From the Definition of "Swaps"

CERP asks that CFTC also clarify CEA Section 1a(47)(B)(i) (as amended by the Dodd-Frank Act), which excludes "any contract of sale of a commodity for future delivery" from the definition of "swaps," to ensure that it reflects the most recent jurisprudence. As CFTC is aware, the phrase "contract of sale . . . for future delivery" is not defined in the CEA and its scope has been litigated frequently over the last twenty years. Moreover, the classification of a contract as a future has significant regulatory consequences: according to our reading of the Dodd-Frank Act, all contracts for future delivery must be traded on a CFTC-regulated Designated Contract Market (DCM)— with no exception for "exempt" commodities or hedging of commercial risk by end-users. Thus, it is important that CFTC provide clear and

[12] 55 Fed. Reg. at 31,191.

[13] *Andersons v. Horton Farms,* 166 F.3d 308, n.14 (6th Cir. 1998) (quoting *Salomon Forex, Inc. v. Tauber,* 8 F.3d 966 (4th Cir. 1993)).

legally defensible guidance as to what constitutes a "contract of sale . . . for future delivery."

In this regard, CERP supports the interpretation of "contract of sale . . . for future delivery" set forth in the cases of *CFTC v. Erskine* and *CFTC v. Zelener.* Under these precedents, the hallmark of a futures contract is that its terms are *standardized*, such that parties to a future trade "in the contract" rather than "in the commodity." In addition to being endorsed by two circuit courts, the *Erskine / Zelener* interpretation has the practical advantage of ensuring that only agreements that are capable of being traded on a DCM come within the definition of a "futures" contract.

## IV. Comments on the Definition of "Swap Dealer"

CERP believes that the statutory definition of "swap dealer" must be clarified in order to avoid subjecting ordinary commercial "end users" of swaps to the rigorous capital, margin, clearing, and exchange trading requirements that apply to swap dealers under the Dodd-Frank Act. Under the Dodd-Frank Act, a "swap dealer" includes any person who "regularly enters into swaps with counterparties as an ordinary course of business for its own account."[14] Read literally, this definition would sweep in countless firms that use swaps for ordinary hedging of commercial risks.

It is unlikely that Congress intended for CFTC to adopt such an expansive view of the definition of "swap dealer." The term itself – "swap dealer" – connotes an enterprise that is engaged in buying and selling of swaps as a business pursuit unto itself, not a person that engages in swaps to hedge risks arising from some other line of business. This distinction is reinforced by language in the definition of "swap dealer" that excludes firms that transact in swaps "not as part of a regular business."[15]

In addition, an expansive view of "swap dealer" would prevent most firms that engage in swaps to hedge commercial risks from invoking the "end user" exception from swaps regulation – a result that would effectively nullify the "end user" exemption. Such a reading would run contrary to the norm of statutory interpretation that seeks to give effect to every provision of a statute.

Arguably, an expansive reading of "swap dealer" would also create an absurd regulatory outcome. The statutory scheme Congress created in the Dodd-Frank Act subjects almost all swaps (apart from those entered into by end users) to clearing,

[14] Dodd-Frank Act, § 721(a)(21) (adding Section 1a(49)(A)(iii) to the CEA).

[15] Dodd-Frank Act, § 721(a)(21) (adding Section 1a(49)(C) to the CEA).

exchange, and reporting requirements; additional regulatory scrutiny (including registration, capital, and margin requirements) applies to two categories of systemically important actors – namely, “swap dealers” and “major swap participants.” An expansive reading of “swap dealer” would upset this scheme by subjecting almost any firm that regularly uses swaps to the panoply of requirements that apply to swap dealers, and blurring the distinction between a major swap participant and a swap dealer.

CERP recommends that CFTC instead interpret the definition of “swap dealer” more narrowly, to refer to firms that enter into swaps for their own account as their *sole or dominant* line of business. Under this interpretation, a firm that regularly uses swaps as an incident of doing business – to hedge commercial risks, for example – would not for that reason alone be considered a “swap dealer.”

## V. Comments on the Definition of “Major Swap Participant”

CERP has not formulated a recommended interpretation of the term “major swap participant.” However, we recognize that the regulatory consequences associated with being designated a “major swap participant” are quite serious – including registration with the CFTC, capital and margin requirements, and a prohibition on invoking the end user exception. We believe Congress intended to reserve this intense regulatory scrutiny for market participants whose trading activity is so significant as to create a risk to systemic stability. This intent is manifest in the language of the definition itself, which directs CFTC to define the term “substantial position” with a view to prudent regulation of “entities that are systemically important or can significantly impact the financial system of the United States.”[16] Thus, we urge CFTC to define “major swap participant” in such a way as to capture only the largest and most systemically important market players. This approach is consistent with Congress’ express intent and will ensure that CFTC’s resources and attention are focused on the entities that pose the greatest risks.

Given the consequences associated with designation as a “major swap participant,” we also believe that users of swaps should have reasonable certainty as to what types of activities and what level of trading will cause them to attain this status. We urge CFTC to develop objective and predictable criteria – preferably, a quantitative threshold – for determining whether an institution has a “substantial position” in swaps or creates “substantial counterparty exposure” (both factors that would cause it to be designated a “major swap participant”).

[16] Dodd-Frank Act, § 721(a)(16) (adding Section 1a(33) to the CEA).

## VI. Conclusion

CERP looks forward to reviewing CFTC's proposed definitions and clarifications of the terms discussed above, and providing further comment as appropriate. We would welcome the opportunity to meet with your staff at any time to provide further information and discuss concerns related to the offsets markets and the regulation of transactions involving offset credits. Please direct any inquiries regarding these comments to Kyle Danish at the address and phone number listed below.

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Counsel to the Coalition for
Emission Reduction Projects

## Appendix

## Members of the Coalition for Emission Reduction Projects

Alpha Natural Resources

American Electric Power

Blue Source

Camco

C-Trade

Deutsche Bank

Dominion

DTE Energy

Duke Energy

Element Markets

El Paso Corporation

Environmental Credit Corp

Equator Environmental

Leaf

Natsource LLC

Noble Carbon Credits

PG&E Corporation

Verdeo Group