

From: Jeremy Weinstein <jweinstein@prodigy.net>
Sent: Monday, September 20, 2010 2:04 PM
To: secretary <secretary@CFTC.gov>; dfadefinitions <dfadefinitions@CFTC.gov>;
OTCDefinitions <OTCDefinitions@CFTC.gov>; rule-comments@sec.gov
Cc: Lauren LeMunyan <llemunyan@environmentalmarkets.org>;
jfort@sonnenschein.com; thaddeus@peartree.com; LeMunyan, Lauren
<LLeMunyan@kellenccompany.com>
Subject: Environmental Markets Association comments on CFTC/SEC ANOPR
Definitions File Number S7-12-10 Passthrough
Attach: EMA CFTC ANOPR Swap comments.9.20.10.pdf

Ladies and Gentlemen:

Attached please find the comments of the Environmental Markets Association (“EMA”) to the Commodity Futures Trading Commission (“CFTC”) and Securities and Exchange Commission (“SEC”) Advance Notice of Proposed Rulemaking; Request for Comments (“ANOPR”) respecting certain definitions subject to CFTC and SEC rulemaking pursuant to the authority in The Dodd-Frank Wall Street Reform and Consumer Protection Act.

-submitted on behalf of the Environmental Markets Association by
Jeremy Weinstein
925-943-3103



750 National Press Building
529 14th Street NW, Suite 750
Washington, DC 20045
Phone: (202) 591-2465
Fax: (202) 591-2445
E-Mail: info@environmentalmarkets.org

September 20, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
Telefacsimile: (202) 418-5521 and

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Email to secretary@cftc.gov, dfdefinitions@cftc.gov and otcdefinitions@cftc.gov with
Definitions in Subject line;
Email to rule-comments@sec.gov with File Number S7-12-10 in Subject line

Re: Comments of the Environmental Markets Association ("EMA") to Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") Advance Notice of Proposed Rulemaking; Request for Comments ("ANOPR") respecting certain definitions subject to CFTC and SEC rulemaking pursuant to the authority in The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")

Ladies and Gentlemen:

The CFTC and SEC by the above-referenced ANOPR seek comments on certain definitions in the Dodd-Frank Act, including the terms "swap," "swap dealer" and "major swap participant" which Section 721(c) of the Dodd-Frank Act requires the CFTC to adopt rules to further define, and the term "security-based swap," which Section 761(b) requires the SEC to adopt rules to further define.

This letter explains why (a) traded emissions allowances and credits created under state, federal, or other applicable law, such as those traded under the Environmental Protection Agency's ("EPA") Sulphur Dioxide trading program under the Clean Air Act Amendments or the South Coast Air Quality Management District "RECLAIM" REgional CLean Air Incentives Market (collectively, "Allowances"), (b) traded environmental attributes of generation from renewable resources ("RECs") and (c) traded greenhouse gas emission reductions, such as Carbon credits ("VERs", collectively with Allowances and RECs, "Environmental Commodities") are in fact "commodities" or "nonfinancial commodities" the spot or forward delivery of which is "physically settled" and therefore when purchased and sold are within the

exclusions from the definition of “swap” in Sections 1a(47)(B)(i) and (ii) of the Commodities Exchange Act as amended by Section 721(a)(21) of the Dodd-Frank Act.

Environmental Commodities are so excluded because they are, under Section 1a(47)(B)(i) of the Commodities Exchange Act as amended by the Dodd-Frank Act, a “commodity” and under Section 1a(47)(B)(ii), a “nonfinancial commodity ... for deferred shipment or delivery, so long as the transaction is intended to be physically settled.” The purchase and sale of Environmental Commodities is “physically settled” even though the Environmental Commodities are predominately intangible and transactions in them are typically settled on electronic exchanges or through the delivery of pieces of paper representing rights to them, and even though the Environmental Commodities themselves might not necessarily possess corporeal, “physical” existence. This letter also explains how Environmental Commodities are “commodities” used by end users producing electricity.

Under the Dodd-Frank Act, there is regulation of the subject (actor, e.g., an electric utility), regulation of the verb (activity, e.g., transacting in swaps) and regulation of the object (what is bought and sold, e.g., Allowances). The Dodd-Frank Act also provides exemptions for the subject doing the verb with certain objects (e.g., an end-user exemption for an electric utility transacting in what it needs to generate electricity). The EMA sets forth in this letter why, as objects in this regulatory scheme, Environmental Commodities (a) are not “swaps” within the meaning of the Dodd-Frank Act and (b) are within the end user exemption.

Introduction

The Environmental Markets Association (EMA) is the leading US-based trade association focused on promoting market-based solutions for environmental challenges through sound public policy, industry best practices, effective education and training, and member networking. EMA represents a diverse membership including large utilities, emissions brokers and traders, exchanges, law firms, project developers, consultants, academics, NGOs and government agencies – the people making environmental markets work.

The EMA arose out of the need associated with Title IV of the 1990 Clean Air Act Amendments, the so called “Acid Rain Program.” That program is the most-cited example of the successes of a market-based system, both for environmental results and substantially lower costs than alternative regulatory programs such as “command and control.” This market based approach has been used around the country in other programs, such as the RECLAIM program in the South Coast Air Quality Management District, the Regional Greenhouse Gas Initiative, the Chicago-area Emission Reduction Management System and in several other EPA programs such as the Clean Air Interstate Rule. EMA members have been and are active in all these. We have developed several resources to aid in the understanding of such market based programs.¹ EMA would be pleased to provide any requested training or other educational programs to staff of the Commissions. We sponsor twice annual programs, open to the public, on the current state of the

¹

See the EMA’s website at <http://www.environmentalmarkets.org>.

environmental markets; we are pleased to note that members of the Commission have attended and spoken at our programs.

Our principal concern in submitting these comments is that the forthcoming rules not inhibit or stymie the benefits of these market-based programs. These markets remain small, notwithstanding their great potential. Rules and supervision of these markets are welcomed by EMA and its members. Indeed, we have adopted and published several principles for these markets.² We would be pleased to work with the Commissions in this regard.

Environmental Commodities can be traded spot, for immediate delivery on payment, can be traded for forward delivery, and can be the subject of derivative contracts. Although one can have transactions in Environmental Commodities that are swaps,³ Environmental Commodities themselves are not swaps.

The correct categorization of Environmental Commodities within the new regulatory framework of the Dodd-Frank Act is essential to the continued functioning of these markets.

I. Background on Environmental Commodities.

A. Allowances.

Allowances are limited authorizations to emit pollutants issued by a government agency that can be freely traded. A success story⁴ is the EPA's Acid Rain program. As explained on the EPA website:⁵

The Clean Air Act Amendments of 1990 set a goal of reducing annual SO₂ emissions by 10 million tons below 1980 levels. To achieve these reductions, the law required a two-phase tightening of the restrictions placed on fossil fuel-fired power plants ... Reductions in SO₂ emissions are facilitated through a market-based system for capping and trading—the centerpiece of EPA's Acid Rain Program. The allowance trading system creates low-cost rules of exchange that minimize government intrusion and make allowance trading a viable compliance strategy for reducing SO₂. ... Allowances are the currency with which compliance with the SO₂ emissions requirements is achieved. Through the market-based allowance trading system, utilities regulated under the Acid Rain Program decide the most cost-effective way to use available resources to comply with the requirements of the Clean Air Act. Utilities can reduce emissions by employing energy conservation measures, increasing reliance on renewable energy, reducing usage,

² The EMA Best Practices for Market-Based Systems are available at <http://www.environmentalmarkets.org/galleries/default-file/EMA%20Best%20Practices%20for%20Market-Based%20Systems.pdf>.

³ See, e.g., EMA Contract language for SO₂ and NO_x Allowance financial trading, available at http://environmentalmarkets.org/galleries/new-gallery/02252004_contract_template.doc.

⁴ For a brief survey of how the program has succeeded, see John Kinsman, *Emissions trading, the economy and the environment*, Environmental Finance, Oct. 2002 at p. 26, available at http://environmentalmarkets.org/galleries/default-file/ef10ema_b.pdf.

⁵ <http://www.epa.gov/airmarkets/progsregs/arp/s02.html>.

employing pollution control technologies, switching to lower sulfur fuel, or developing other alternate strategies. Units that reduce their emissions below the number of allowances they hold may trade allowances with other units in their system, sell them to other utilities on the open market or through EPA auctions, or bank them to cover emissions in future years.

In other words, instead of a command-and-control model of regulators reviewing each source of emissions and assigning emission control goals and costs to each particular source, in a market mechanism model all of the sources are aggregated, and as a whole are assigned Allowances in an amount limited to the aggregate goal of emissions cuts that the regime seeks to achieve. Failure of any particular source to achieve its required goal through either the reduction of emissions or purchase of allowances is backed by fines and jail. The sources then trade these Allowances amongst themselves, each achieving compliance at a cost that is the lesser of physically reducing emissions, for example through installing scrubbing equipment, or purchasing allowances,⁶ and the market mechanism of this trading benefits society by achieving all of the desired aggregate goals across all compliance entities at the least cost across all compliance entities.

B. RECs

An important societal value of energy from renewable resources is the “renewableness” of the energy that is so generated. The attributes of the energy that give it the unique characteristic of being “renewable,” including the right to claim the social good of causing renewable energy to be delivered to the electric grid, can be separated from the energy itself and separately traded and thereby monetized. This enables efficient capital flows to the developers of the renewable resources from purchasers who desire energy from renewable resources but who otherwise would not be able to take directly the energy from those renewable resources, due to distance, intermittency (renewable resources often can not run all the time) and transmission considerations. Through RECs, those that desire the “renewableness” of the energy from the renewable resource can acquire it, without needing to be directly connected to the resource itself. These attributes are traded by defining, through contract, rule, or statute, what is called a “green tag,” “renewable energy certificate,” “renewable energy credit,” “green attribute,” “tradeable renewable energy credits,” or other moniker, to include those rights and claims that are being monetized and transferred. Here we use the term “RECs” (renewable energy certificates), which is somewhat of a misnomer, because although some systems provide a “certificate” in the nature of proof of generation,⁷ that is not universal, and even within those systems, not all of what is typically known as a REC is represented by the “certificate.”

⁶ For a real-world discussion of this asset allocation dynamic through market mechanisms at work, see Michael Canterbury, *Portfolio management and environmental assets*, Environmental Finance, Sept. 2003 at p. 27, available at <http://environmentalmarkets.org/galleries/default-file/ef9ema27.pdf>.

⁷ For example, generation information systems such as the Western Regional Generation Information System (WREGIS) track renewable resource generation and certificate deliveries of megawatt hours to the electricity grid, which can be exchanged as evidences of renewable energy deliveries. As will be seen in the text *infra*, however, many programs, such as the California RPS, require more than proof of delivery of generation to the grid for their definition of a REC.

RECs are activity-derived environmental commodities that carry the claim to the “green” aspect of power generation. Trading in RECs is an important market mechanism to optimize and promote renewable resource use and development.⁸ In addition to expediting capital flows to the development of renewable resources by the efficient sale of a commoditized attribute produced by generation from such resources, RECs help intermittent energy resources such as wind to compete with baseload (can run all the time) resources such as gas, by allowing that commodity to be paired with generation from a baseload resource. When a REC is sold by the renewable generator, the generator is left with undifferentiated “null,” i.e., not “green,” electricity, and there are market and contractual mechanisms in place to ensure that the original resource does not again seek to sell the original energy, from which it has separated the REC, as renewable energy.⁹

In the absence of federal leadership,¹⁰ individual states have been legislating programs mandating that load-serving entities (electric utilities) procure a minimum proportion of retail energy from renewable resources.¹¹ These requirements are commonly known as renewables portfolio standards, or “RPSs.” These utilities are often permitted to use RECs for compliance.¹²

Another important market segment is the voluntary RECs market, which in 2008 represented retail renewable energy sales of approximately 24 million megawatt-hours (MWh) according to the National Renewable Energy Laboratory (NREL).¹³

⁸ Master trading enabling agreements have been developed for transactions in RECs. An example contract that provides significant background and tools for regulators is the ABA/EMA/ACORE Masters Renewable Energy Certificate Trading Agreement, available at <http://environmentalmarkets.org/page.wv?section=RECs+Committee&name=Master+Renewable+Energy+Certificate+Purchase+and+Sale+Agreement+Is+Now+Available> and discussed at length in Jeremy Weinstein, *The New ABA/EMA/ACORE Master Renewable Energy Certificate Trading Agreement*, chapter 10 in *ENERGY AND ENVIRONMENTAL TRADING: U.S. LAW AND TAXATION* (Andrea S. Kramer and Peter C. Fusaro eds., Cameron May 2008).

⁹ See, e.g., Green-e National Energy Standard, available at http://www.green-e.org/getcert_re_stan.shtml. See also Jeremy Weinstein, *Contract Techniques for Renewable Resource Power Purchase Agreement Off-Takers*, Chapter 20 in Kramer & Fusaro, eds., *ENERGY AND ENVIRONMENTAL PROJECT FINANCE LAW AND TAXATION: NEW INVESTMENT TECHNIQUES*, Oxford University Press, 2010.

¹⁰ See, e.g., Peter Toomey and Eric Thumma, *Learning from the states*, Environmental Finance, May 2009, available at <http://www.environmentalmarkets.org/galleries/default-file/EFarticleMay2009.pdf>.

¹¹ See <http://www.dsireusa.org> for a national map. For a discussion of just how complicated this dynamic of fifty state jurisdictions pursuing these policies has become, especially when carbon and energy efficiency is included, see, e.g., Shults and Musier, *Managing the mosaic*, Environmental Finance, Apr. 2007, at p. 33, available at http://www.environmentalmarkets.org/galleries/default-file/Shults%20Musier%20ef4market%20view_p33.pdf, and Bogomolny, Felder & Weiner, *Untangling environmental markets*, Environmental Finance, Apr. 2005, at p. 27, available at <http://environmentalmarkets.org/galleries/default-file/ef4ema27.pdf>. The EMA has been at the forefront of seeking to provide contract solutions to ensure fungibility and cross-market liquidity across this entire “mosaic.” See, e.g., Jeremy Weinstein and Dan Chartier, *Standardising RECs contracting*, Environmental Finance, May 2005 at p. 21, available at http://www.jweinsteinlaw.com/pdfs/ef5ema_p21.pdf.

¹² E.g. Texas; see, e.g., Mike Sloan, *Renewable Energy Credits: a success in Texas*, Environmental Finance, Apr. 2000, at p. 23, available at <http://environmentalmarkets.org/galleries/default-file/ef04ema.pdf>.

¹³ For more information on the voluntary market for renewable energy see the Web sites of the NREL (<http://www.nrel.gov>) and Green-e (<http://www.green-e.org>), which certified half of retail voluntary renewable energy sales in 2008 (Green-e Energy 2008 Verification Report, available at <http://www.green-e.org/docs/2008%20Green-e%20Verification%20Report.pdf>). At the time of writing, approximately half of

In both compliance and voluntary markets, RECs can be transacted using registry accounts of generation information systems that have been established for transactions in RECs, or through paper attestations that represent affidavits attesting to a certain quantity of generation.

C. VERs

Verified Emissions Reductions (“VERs”) are offsets from projects that reduce emissions of greenhouse gases, such as Carbon dioxide or methane, that have been verified by a professional verifier according to an applicable protocol setting forth standards of measuring, monitoring, and verification.¹⁴ A VER is a reduction of greenhouse gases equivalent to one metric tonne of Carbon dioxide below a baseline of what would have occurred (“business as usual”) in the absence of the activity creating the offset. In contrast to Allowances, which are licenses to emit a certain quantity of an air pollutant that are allocated to, and traded among, emitters, and in contrast to RECs, which represent aspects of benefits that are created by renewable resource generation, VERs represent a reduction from emissions of greenhouse gases that would have occurred but for the activity. Strict market standards have evolved to ensure the legal and scientific legitimacy and robustness of the offsets and emissions greenhouse gas emissions reductions they represent.¹⁵ VERs will likely be part of a compliance regime, should one become applicable.¹⁶ VERs allow individuals and organizations to balance emissions of greenhouse gases produced in one place by helping fund emission reductions elsewhere. Individuals and organizations unable to reach their carbon reduction targets by direct reductions of their own emissions can purchase VERs to balance, or offset, their impact.¹⁷

VERs can be transacted in through registries, such as the Climate Action Reserve, or through paper attestations or bills of sale. Additionally, there are Environmental Commodities that would fit within the broad definition of VERs used here transacted in internationally under the trading regimes established under trading mechanisms under the Kyoto Protocol to the United Nations Framework Convention on Climate Change.

renewable energy from renewable energy generation facilities that came online since 1997 was being sold into the voluntary market (NREL).

¹⁴ See, e.g., the Climate Action Reserve, information available at <http://www.climateactionreserve.org/resources/faqs/>.

¹⁵ See, e.g., Jeremy Weinstein, comment letter in CFTC Notice of Intent To Undertake a Determination Whether the Carbon Financial Instrument Contract Offered on the Chicago Climate Exchange Performs a Significant Price Discover Function, available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/frcomment/09-010c004.pdf>. CFTC Order Finding that it didn't is FR Doc 2010-10311, Federal Register: May 4, 2010 (Volume 75, Number 85), Page 23686-23690, available at <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2010-10311.html>.

¹⁶ See, e.g., Joe Nation and Roger Noll, *Designing it right*, Environmental Finance, Dec. 2008-Jan. 2009, at p. 49, available at http://www.environmentalmarkets.org/galleries/default-file/EF1208_p49.pdf. For a discussion of the offset provisions that were in the Waxman-Markey American Climate and Energy Security Act of 2009, which although not passed provides important policy examples, see Lisa Jacobsen, *Keeping a lid on costs*, Environmental Finance, Jul.-Aug. 2009, p. 32, available at http://www.environmentalmarkets.org/galleries/default-file/EF0709_p32.pdf.

¹⁷ See, e.g., discussion at http://www.3degreesinc.com/products/carbon_offset/.

II. Environmental Commodities are not Securities.

A. Allowances.

Allowances are not securities. Section 2(a)(1) the Securities Act of 1933 defines securities via a categorical enumeration of those instruments that can be classified as such. Allowances are not instruments that expressly fall within one of these enumerated categories. However, “investment contracts” are a category listed in section 2(a)(1) that courts have used to expand the definition of security. Allowances, per applicable case law, however, do not fit within the meaning of “investment contract” for the reasons that follow.

In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court outlined the following four elements of an “investment contract:” (1) an investment of money; (2) in a common enterprise; (3) with the reasonable expectation of profits; and (4) where the profits are obtained solely from the efforts of a third party. Subsequently case law further clarified these elements.

As to the investment of money prong, it need not be in the form of cash.¹⁸

As to the common enterprise prong, the courts disagree as to what this means. Several federal circuits require a showing of “horizontal commonality,” or a pooling of the investments of several investors and then an apportionment of the profits from the enterprise to investors based on their pro rata investment in the pool.¹⁹ Other federal circuits require a showing of “vertical commonality,” which requires that the fortunes of all investors be dependent on the efforts of a third party, usually a promoter.²⁰ Still other federal circuits have adopted a narrower version of the “vertical commonality” requirement, requiring the fortunes of the investor to be tied closely to the success of a promoter or of another third party.²¹

As to the expectation of profits prong, the Supreme Court has found that an expectation of profits is an expectation of capital appreciation or of earnings.²² The Supreme Court has also held that whether an investor has “reasonable expectations” of profits can turn on the intentions of the parties entering into the arrangement. If the investor is motivated by a desire to use or consume the item purchased, the securities laws do not apply.²³

As to the efforts of a third party prong, most courts have relaxed the rule that the profits come “solely” from the efforts of a third party.²⁴ Instead, an investment contract exists when the efforts of a party other than the investor are “the undeniably significant ones, those essential

¹⁸ See, *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 560 n. 12 (1979).

¹⁹ *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 221-25 (6th Cir. 1980).

²⁰ See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473,478-79 (5th Cir. 1974).

²¹ See, e.g., *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 n. 7 (9th Cir. 1973), cert. denied, 414 U.S. 821.

²² *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975).

²³ See *Forman* at 852-53.

²⁴ See, e.g., *Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144, 152 (3d. Cir. 1997).

managerial efforts which affect the failure or success of the enterprise.”²⁵ However, there must be more than market forces creating the profit for the investor.²⁶

As to the first element from the *Howey* test discussed above, Allowances often involve an investment of money. However, depending on the cap-and-trade system put in place, companies may be allocated Allowances for free in the first place and then these Allowances become valuable by being freely traded on the open market. The U.S. Acid Rain Program, for example, distributes Allowances for free, using a formula to calculate how many Allowances each facility will receive. However, states in the RGGI system auction the vast majority of their Allowances. Thus the sale of Allowances on the open market or via an auction might satisfy the first element from the *Howey* test.

The purchase of Allowances fails the common enterprise prong of *Howey* (second element of *Howey*), regardless of federal circuit. In a purchase of an allowance, an entity is merely purchasing the right to emit a certain amount of a pollutant. As a result, there is no pooling of the investments and thus there is no horizontal commonality. Furthermore, there is no vertical commonality because the value of the Allowances to a purchaser will depend entirely on its own ability to utilize the Allowances to meet its regulatory obligations, thus allowing it to continue operating its own business at a profit, or to use its own efforts to resell the allowances at a profit. Since there is no “horizontal commonality” and no “vertical commonality,” it cannot be said that the purchasers are investing in a “common enterprise.”

Depending on the intentions of the purchaser of an Allowance, the purchase of an Allowance may or may not fall within the expectation of profits prong of *Howey* (third element of *Howey*). Many purchasers of Allowances make the purchase so they can emit pollutants beyond their allocated share. These end users are consumers of Allowances and thus are not purchasing a security. On the other hand, Allowances traded between financial brokers are trading in hopes of a capital appreciation on their initial investment.

The fourth element of the *Howey* test requires an investor to have an expectation of profits resulting from the significant efforts of a party other than the investor. If the purchaser of the Allowance intends to resell it for profit, it can do so only if the market price for the allowance rises or if the purchaser, through its own efforts, can procure a higher price from a third party. In neither case is the purchaser relying on the managerial or other expertise of the third party. For these reasons, a sale of Allowances would not satisfy this prong.

Because the second and fourth elements, and in some cases, the third element, of the *Howey* test will not be satisfied, we believe that a court would not find the sale of Allowances to be the sale of a security under *Howey*.

²⁵ *Turner* at 482.

²⁶ *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996).

B. RECs.

RECs are not securities. RECs, like Allowances, are not instruments that expressly fall within one of enumerated categories of a “security” within section 2(a)(1) of the Securities Act of 1933. Additionally, RECs, like Allowances, cannot be classified as an “investment contract” within the meaning of section 2(a)(1) for the reasons that follow.

The purchase of RECs fails the second element of *Howey*, regardless of federal circuit. In a purchase of RECs by a single party, there will be no pooling of the investments of several investors, and so the “horizontal commonality” requirement would not be met. Furthermore, the value of the RECs to a purchaser will depend entirely on its own ability to utilize the RECs in order to meet its regulatory obligations, thus allowing it to continue operating its own business at a profit, or to use its own efforts to resell the RECs at a profit. The purchaser will not, in either case, rely at all on the generator, nor is the purchaser’s profit tied to the success or failure of the generator’s enterprise, after acquisition by it of the RECs. Thus, there is no “vertical commonality.” Since there is no “horizontal commonality” and no “vertical commonality,” it cannot be said that the purchasers are investing in a “common enterprise.”

Whether the third element of the *Howey* test, which requires the investor to have a reasonable expectation of profits, is satisfied will depend on the nature of the purchaser of the RECs. Where the generator sells the RECs to electric utilities, it is likely that the intention of the purchaser will be to use the RECs to comply with the purchaser’s regulatory obligations under the RPS of the state. Often such programs require “permanent retirement” of such RECs on an electronic registry system.²⁷ In such a case, the purchaser will “consume” the product, and the transaction will not satisfy the third element of the *Howey* test. If, however, the generator sells the RECs to a broker or an aggregator, the purchaser likely intends to resell the RECs at a higher price in the future. These purchasers may be found to have an expectation of profits by way of appreciation. In these cases, the third element of the *Howey* test will be satisfied.

The fourth element of the *Howey* test requires an investor to have an expectation of profits resulting from the significant efforts of a party other than the investor. If the purchaser of the RECs intends to resell them for profit, it can do so only if the market price for RECs rises or if the purchaser, through its own efforts, can procure a higher price from a third party. In neither case is the purchaser relying on the managerial or other expertise of the generator. For these reasons, a sale of RECs would not satisfy the fourth element of the *Howey* test.

Because the second and fourth elements, and in some cases, the third element, of the *Howey* test will not be satisfied, we believe that a court would not find the sale of RECs be the sale of a security under *Howey*.

²⁷ E.g., California Energy Commission, Renewables Portfolio Standard Eligibility Commission Handbook (3rd Edition), p. 7, fn. 12; Western Renewable Generation Information System Operating Rules Rule 16 available at http://www.wregis.org/uploads/files/73/20070704_WREGIS_Operating_Rules_1v1_Final.doc.

C. VERs.

VERs are not securities. VERs, like Allowances and RECs, are not instruments that expressly fall within one of enumerated categories of a “security” within section 2(a)(1) of the Securities Act of 1933. Additionally, VERs, like Allowances and RECs, cannot be classified as an “investment contract” within the meaning of section 2(a)(1) for the reasons that follow.

The purchase of VERs fails the second element of *Howey*, regardless of federal circuit. While the money from the buyers of VERs can go towards development of the project that creates them, there is no apportionment of the profits based on their investments. Rather, the money is paid to obtain a commoditized end product. Since there is no commonality, it cannot be said that the investors are investing in a “common enterprise.”

The investment in VERs does not fall within the expectation of profits prong of *Howey* (third element of *Howey*). The “investor’s” only financial stake in the success or failure of the project that produced the VERs is in the continued performance of the project in performing the obligations of measuring, monitoring, leakage and permanence, as required by the applicable protocol under which the VERs are created, that are promises of the seller that go with the initial sale. The project’s performance of these obligations simply enables the buyer to keep what it has purchased; it is in the nature of a product warranty. Therefore, there is no expectation of profits.

The fourth element of the *Howey* test requires an investor to have an expectation of profits resulting from the significant efforts of a party other than the investor. Although the project entity that develops the VERs for sale might have an expectation of profits from the activities of its project managers in developing and selling the VERs as a commodity produced by project activities, the purchaser of the VERs itself is in a situation similar to that of a purchaser of RECs- the commodity may be surrendered for compliance, in the event a compliance regime accepting that VER becomes applicable, and it may appreciate or decline in value through market forces, as is the case with any other tradeable commodity. Although the purchaser of a VER can have continued reliance on the continued performance to the contract of the seller of the VER- for example, a purchaser of an offset from a forestry project could lose that offset if the seller allows the forest to burn down later- the purchaser simply keeps what it originally bargained for, rather than share in any profit, through the activities of the project management.

Because the second, third, and fourth elements of the *Howey* test will not be satisfied, we believe that a court would not find the sale of VERs to be the sale of a security under *Howey*.

D. Security-Based Swaps.

Environmental Commodities are not securities, as explained above, and so therefore they are not “security-based swaps” when priced against an index.

III. Environmental Commodities are “commodities” and “nonfinancial commodities” the spot or deferred delivery of which is “physically settled”

Although there can be swaps within the meaning of the Commodities Exchange Act that are transactions based on pricing and other aspects of Environmental Commodities, Environmental Commodities themselves are not “swaps” within the meaning of the Commodities Exchange Act.

The EMA writes this letter in large part because our members wish to emphasize that Environmental Commodities represent “commodities” within the meaning of the exclusion of Section 1a(47)(B)(i) and are “nonfinancial commodities” that are “physically settled” within the meaning of the exclusion of Section 1a(47)(B)(ii), even though they are generally intangible evidence of “real world” positive environmental impacts and may not necessarily have a “physical” existence beyond electronic entries in compliance accounts on government and private registries²⁸ and paper title transfer documents.

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.²⁹ Moreover, the term “physical settlement” is often used to refer to actual delivery in forward contracts concerning intangible commodities (for example, foreign currency).³⁰ 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 Environmental Commodities 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.

Other than its occurrence in Section 1a(47)(B)(ii) of the Commodities Exchange Act as amended by the Dodd-Frank Act, no use of the term “nonfinancial” is made in the remainder of the Commodities Exchange Act. Perhaps “nonfinancial commodities” means “everything other than excluded commodities under Section 1a(19).” Current CFTC regulations allow exempt commercial markets (“ECMs”) to operate only if those markets list exempt commodities. The Chicago Climate Exchange (“CCX”), approved by the CFTC, is such an ECM,³¹ and it lists

²⁸ Registries on generation information systems for renewable energy that measure and are used to generate electronic certificates of proof of generation can be, and often are, used in voluntary contexts as well. Examples of voluntary registries for VERs include the Climate Action Reserve, <http://www.climateactionreserve.org/> and the Voluntary Carbon Standard, <http://v-c-s.org/projects.html>.

²⁹ 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).

³⁰ 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).

³¹ See posting classifying the CCX as an ECM at <http://services.cftc.gov/SIRT/SIRT.aspx?Topic=TradingOrganizations&implicit=true&type=ECM&CustomColumnDisplay=TTTTTTTT>.

several types of Environmental Commodities, including something like a VER.³² Additionally, the CFTC has indicated that emissions allowances are exempt commodities as well.³³ The Green Exchange of the New York Mercantile Exchange also lists certain VERs and Allowances.³⁴ RECs would likewise be commodities because they are fungible contract rights like the emissions allowances that are traded on both futures exchanges and ECMs.³⁵

Perhaps “nonfinancial” means “not financial.” Allowances, RECs, and VERs are clearly nonfinancial commodities. In the case of Allowances, they represent an authorization to emit as a means of regulatory compliance. In the case of RECs, they constitute proof of a beneficial activity. And in the case of VERs, they represent activity reducing GHG emissions. 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.

Commodity Futures Trading Comm’n v. Erskine, 512 F.3d 309 (6th Cir. 2008) (“*Erskine*”) illustrates the distinction between a “future” and a “forward.” In forwards, parties contemplate “physical transfer of the actual commodity,”³⁶ “physical delivery of the actual commodity,”³⁷ “physical delivery of the subject goods,”³⁸ or “physical delivery of the asset.” Even though a particular instance of an Allowance, REC, or VERs may not be certificated, there is in fact a “physical” delivery or transfer of the actual commodity by the transfer of the asset in the registry Allowances are transferred in the EPA’s or applicable state system. For RECs, the Generation Information System’s electronic registry records a change of owners or a physical transfer of paper attestations occurs. For VERs, a physical transfer of title pursuant to a contract or attestation typically occurs, and in some cases there is also an electronic transfer of ownership on the applicable registry, such as those maintained by the Climate Action Reserve, the Voluntary Carbon Standard, the American Carbon Registry or the Chicago Climate Exchange. These result in actual delivery of the Environmental Commodities into these centralized databases, or through attestation documents that include language that functions as bills of sale.

Transactions in Environmental Commodities are capable of being abused,³⁹ just as can be transactions in any other type of commodity. Although the relative newness of Environmental

³² See specification for Carbon Financial Instrument at <http://www.chicagoclimatexchange.com/content.jsf?id=483>; see also CFTC Order Finding That the Carbon Financial Instrument Contract Offered for Trading on the Chicago Climate Exchange, Inc. Does Not Perform a Significant Price, FR Doc 2010-10311, Federal Register: May 4, 2010 (Volume 75, Number 85), Page 23686-23690, available at <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2010-10311.html>.

³³ Athena Velie, Melissa Dorn and Paul Pantano, “Navigating the World of Renewable Energy,” 29 Futures and Derivatives Law Report 5 (May 2009) FN 4.

³⁴ See <http://nymex.greenfutures.com/products/index.html>.

³⁵ Athena Veile, Melissa Dorn and Paul Pantano, “Navigating the World of Renewable Energy,” 29 Futures and Derivatives Law Report 5 (May 2009).

³⁶ *Erskine* at 315.

³⁷ *Erskine* at 317.

³⁸ *Erskine* at 318.

³⁹ Enron’s false booking as a sale of a loan from Barclays Bank against the security of SO₂ allowances is described at Jeremy Weinstein, *Examining Enron’s SO₂ emission trades*, Environmental Finance, March 2003, page 22, available at <http://jweinsteinlaw.com/pdfs/ef3enron.pdf>. Note that in this transaction, Barclays took a security interest in the asset of the SO₂ allowances; in other words, Barclays correctly concluded

Commodities has often given rise to heightened regulatory concern, concerns about bad behavior should be addressed directly through the authorities granted, rather than through denying Environmental Commodities their characteristics as “commodities” that can be “physically settled.”

IV. Environmental Commodities are “commodities” used by end users within the meaning of the Dodd-Lincoln Letter

We have shown above that Environmental Commodities are “commodities” that are capable of being “physically settled.” Here we will discuss a letter evidencing legislative intent with respect to another aspect of the application of the Dodd-Frank Act to Environmental Commodities.

The Dodd-Frank Act states that margin requirements “shall” be set against “all” uncleared swaps. However, many market participants indicated that they should be exempted from that requirement, because they are not speculators, but rather end users seeking to hedge their risks. These entities fear that their costs would be driven up to a degree as to take them out of the market, leaving them unable to hedge their retail customer and other risks. Senators Dodd and Lincoln sought to quell this fear through a letter to the Senate Chairmen (the “Dodd-Lincoln Letter”). The goal of the letter can be summed up in this quote from it: “The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk . . . [i]f regulators raise the costs of end user transactions, they may create more risk.”

The letter goes on to say “For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used as either a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business.” Allowances and RECs, and potentially eventually VERs, are required by regulators, even if not “fuel,” to “produce” the electricity or supply gas. Swaps therein by the end users are hedges of such end users’ commercial risk.

Each of the Environmental Commodities is used by electric utilities produce electricity and are therefore “commodities” within the meaning of the foregoing quote from the Dodd-Lincoln Letter.

A. Allowances.

Allowances are used to produce electricity because they must be acquired and tendered to the applicable regulator in order to have permission to generate a given quantity of emissions from a given resource that produces electricity. For example, a coal-fired power plant will emit approximately a ton of sulphur dioxide for each megawatt hour of electricity produced. Under

that the rights of Enron in the SO₂ allowances were sufficient to enable them to represent property on which Barclays could foreclose.

the Acid Rain Program, a coal-fired power plant must tender an appropriate SO₂ Allowance to emit that ton of sulphur dioxide. Allowance prices are variable and need to be hedged.⁴⁰

B. RECs.

RECs are also used to produce electricity. They can be used for compliance. For example, many states require that a certain quantity of electricity delivered to retail buyers be generated from renewable resources.⁴¹ Investor owned utilities and retail marketers that have obligations to comply with a state's RPS can use RECs to demonstrate compliance.⁴² In such systems, once one of these entities submits its RECs for compliance, it is said to have "retired" the RECs.⁴³ Once retired, the RECs are removed from the entity's compliance account and cannot be sold or used in a subsequent year. Depending on the state law, RECs that remain after demonstrating compliance with the RPS can "bank" the remainder for use in future years.⁴⁴ Compliance REC pricing is variable and needs to be hedged.⁴⁵

Additionally, RECs have value to business entities that want to demonstrate to the public that they operate a green business in providing product. These voluntary RECs markets are driven by corporations, cities and other individuals and entities that wish to purchase green power for sustainability, marketing, and other purposes.

Further, many retail energy companies offer customer choice programs, giving customers the option to purchase renewable energy for their homes instead of power from fossil fuels. Since customer homes cannot be directly connected to distant wind farms, this is done through RECs. For example, DTE Energy offers a program titled "GreenCurrents" which gives its customers the option to purchase energy for a premium in order to encourage the development of renewable energy sources in Michigan. According to DTE's website, "the purchase of RECs by

⁴⁰ See, e.g., Gary Payne, *The variables behind the volatility*, Environmental Finance, Feb. 2006 at p. 33, available at <http://www.environmentalmarkets.org/galleries/default-file/ef2ema33.pdf>, and Gene Maze, *Where is the SO₂ market going?*, Environmental Finance, Oct. 2003 at p. 23, available at <http://environmentalmarkets.org/galleries/default-file/ef10emap23.pdf>.

⁴¹ For a full listing of state renewable portfolio standards, see: http://www.dsireusa.org/documents/summarymaps/RPS_map.pptx.

⁴² See, e.g., Jeremy Weinstein, *A Western renewables marketplace*, Environmental Finance, Apr. 2004 at p. 15, available at http://emissions.org/publications/member_articles/ef4ema15.pdf. See also Gregory Lawrence & Athena Velie, "Developing Markets for Renewable Energy Certificates and Their Impact on Project Finance" p. 95, Chapter 5, and Jeremy Weinstein, "Contract Techniques for Renewable Resource Power Purchase Agreement Offtakers," p. 493, Chapter 20, both in Kramer & Fursaro, eds., *ENERGY AND ENVIRONMENTAL PROJECT FINANCE LAW AND TAXATION: NEW INVESTMENT TECHNIQUES*, Oxford University Press, 2010.

⁴³ E.g., California Energy Commission, *Renewables Portfolio Standard Eligibility Commission Handbook* (3rd Edition), p. 7, fn. 12; Western Renewable Generation Information System Operating Rules Rule 16 available at http://www.wregis.org/uploads/files/73/20070704_WREGIS_Operating_Rules_1v1_Final.doc. See also Athena Veile, Melissa Dorn and Paul Pantano, "Navigating the World of Renewable Energy," 29 *Future and Derivatives Law Report* 4 (2009).

⁴⁴ For a discussion of policy implications of various allowance banking regulatory alternatives, see, e.g., Eric Haites, *Banking on reductions*, Environmental Finance, Feb. 2005 at p. 28, available at <http://environmentalmarkets.org/galleries/default-file/ef2ema28.pdf>.

⁴⁵ See, e.g., Greg Pool, *An eye on investors*, Environmental Finance, Dec. 2005-Jan. 2006 at p. 47, available at <http://environmentalmarkets.org/galleries/new-gallery/efpool%20dec05-jan%2006.pdf>.

DTE Energy and others has so far enabled the construction of four wind farms and biomass energy plants in Michigan.”⁴⁶

C. VERs.

Likewise, although VERs might not yet be required of electricity generators as are Allowances and RECs under applicable compliance programs,⁴⁷ VERs can be used in customer choice programs in the generation of electricity. For example, PG&E offers its customers under its ClimateSmart™ Program a means to balance out the GHG emissions associated with their usage of natural gas and electricity. PG&E does this by giving its customers the option to pay a small volumetric monthly premium on their PG&E bill and in return PG&E spends 100 percent of customers’ contributions on VER purchases from new, independently verified GHG emission reduction projects in California. With these funds, PG&E has entered into VER purchase agreement contracts with a wide range of providers, with substantial positive environmental impacts.⁴⁸

If carbon-constraining regulation becomes applicable, gas and electric utilities, among other end users, will seek to hedge the costs of such regulation.⁴⁹ Additionally, there are voluntary market uses of VERs similar to those applicable in voluntary RECs markets.⁵⁰

V. Unintended Consequences Should Be Avoided.

The Dodd-Frank Act should not be applied by the Commissions in a way that makes it more difficult for the regulators with primary jurisdiction over programs establishing Environmental Commodities, such as the Environmental Protection Agency, to protect the environment and to otherwise implement⁵¹ and carry out the purposes of their programs,⁵²

⁴⁶ <http://www.dteenergy.com/dteEnergyCompany/environment/renewableEnergy/support.html>.

⁴⁷ For a discussion of an example of a locally mandated use of offsets in Canada, see Hendrickson, Venalainen & Van Schie, *Offsets and Olympics*, Environmental Finance, Feb. 2009 at p. 31, available at http://www.environmentalmarkets.org/galleries/default-file/EF0209_p31.pdf. There can be compliance Carbon instruments that are allowances rather than offsets, see, e.g., Gary Helm, *Under the hammer*, Environmental Finance, Nov. 2008 at p. 20, available at http://www.environmentalmarkets.org/galleries/default-file/EF1108_p20.pdf, for a discussion of Carbon allowances under the Regional Greenhouse Gas Initiative.

⁴⁸ See, e.g., “Santa Cruz Mountains lures cash for trapping carbon,” San Jose Mercury News, Aug. 31, 2010, available at http://www.mercurynews.com/california/ci_15951274?nclick_check=1.

⁴⁹ For a discussion of ratepayer cost of Carbon regulation, see, e.g., Cameron Prell, *Looking out for the ratepayers*, Environmental Finance, Oct. 2008 at p. 25, available at http://environmentalmarkets.org/galleries/default-file/EnvironmentalFinance_MarketView_200810.pdf. For an early but still accurate discussion of the risks of not hedging, or at least including the potential costs of Carbon compliance in investment decisions, see Mark Trexler, *Is \$0 your best guess?*, Environmental Finance, May 2002 at p. 23, available at <http://environmentalmarkets.org/galleries/default-file/ef5ema.pdf>.

⁵⁰ See, e.g., John Melby and Reiner Musier, *The age of substantiation*, Environmental Finance, Sept. 2008 at p.33, available at http://www.environmentalmarkets.org/galleries/default-file/EF0908_The%20Age%20of%20Substantiation.pdf.

⁵¹ For a discussion of the mechanics of allowance pricing using auctions in federal and state programs, see, e.g., Roman Kramarchuk, *All-out auctions?*, Environmental Finance, Mar. 2007 at p. 45, available at http://www.environmentalmarkets.org/galleries/default-file/Kramarchuk%20ef3marketview_p45.pdf.

especially when the plain language of the Commodities Exchange Act as amended by the Dodd-Frank Act clearly places Environmental Commodities outside of the definition of “swaps.”⁵³

EMA supports well-regulated markets for Environmental Commodities. At this stage in their development, and in light of the wide range of types and sizes of environmental markets, we would urge the Commissions to proceed with caution. Well-intended rules may actually defeat the usefulness of Environmental Commodities. There is nothing in the history of markets for Environmental Commodities which suggests that they are especially subject to abuse or excessive risk.⁵⁴ Moreover, none of these markets are of a size, at least to date, to suggest any systemic risk to the financial systems, or to the compliance activities of the regulated entities.

⁵² For a discussion of an example of some of the challenges already faced by EPA in the implementation of market-based solutions under authorizing legislation, see, e.g., Alison Wood, *Will the EPA embrace cap and trade*, Environmental Finance, Mar. 2010, at p. 31, available at <http://www.environmentalmarkets.org/galleries/default-file/ef3marketview201003.pdf>.

⁵³ We do recognize that there can be swaps based upon the pricing of Environmental Commodities, even if Environmental Commodities themselves are not swaps. See footnote 3, above. We also recognize that swaps in Environmental Commodities offer the potential for a high degree of exoticism. See, e.g., Jeremy Weinstein, *Carbon-denominated weather swaps*, Environmental Finance, Nov. 2001 at p. 27, available at <http://environmentalmarkets.org/galleries/default-file/ef11ema27.pdf>, and Jeremy Weinstein, *Weather derivatives for environmental risk management*, Energy & Power Risk Management, Sep. 2001 at p. 36, available at <http://www.jweinsteinlaw.com/pdfs/EPRM%2001%20Sep%20Weather.PDF>.

⁵⁴ See, e.g., the following discussion of the many ways in which a failed attempt to regulate VERs in California went wrong. Center for Resource Solutions California Market Advisory California Senate Bill 722 (Steinberg) at <http://www.resource-solutions.org/pressreleases/2009/061809.htm>:

Center for Resource Solutions and Green-e would like to draw your attention to recent California legislation regarding the sales and marketing of carbon offsets. California Senate Bill 722 (Steinberg) is written ostensibly to protect consumers of carbon offsets located in the state of California. But SB 722 also has the potential to curtail the market for renewable energy certificates, and potentially green electricity products, within California. ... While the voluntary renewable energy market is not the primary target of this bill, it is also not explicitly protected from the potential effects of the bill's implementation. Senator Steinberg's bill ... limits offsets to those that meet at least one of the following conditions:

(a) The credit or emission reduction meets methodologies that have been adopted by the State Air Resources Board

(b) The credit or emission reduction complies with one or more protocols for voluntary emission reductions of greenhouse gases adopted by the California Climate Action Registry ... and is registered with the California Climate Action Registry.

(c) The person demonstrates, and discloses in any advertising or other sales or promotional material made available to the public, that the credit or emission reduction meets all of the following conditions: ... (3) The credit or emission reduction is verifiable by a state, regional, or local agency within the State of California.

No mechanism currently exists for a credit to be “verifiable by a state, regional, or local agency within the State of California,” and the intent of this section is unclear. The California Climate Action Registry, State of California, and State Air Resources Board (ARB) currently have no protocols for approving renewable energy credits, and the green power market is not clearly exempt from SB 722. ... Although SB 722 is a laudable attempt to address potential confusion in the carbon marketplace, it could also result in even more confusion, while enacting civil penalties and opening a cause of action for citizen lawsuits against sellers of carbon offsets that are not certified as specified (in specifying that “any person” may sue under this provision, the new bill allows for recovery of attorney fees and costs by the prospective plaintiffs). ... Many consumers and businesses in California, and across the country, currently purchase renewable energy or renewable energy certificates to reduce or offset the GHG impacts of electricity consumption. This a widely accepted practice endorsed by the U.S. EPA Climate Leaders program, as well as many leading

Conclusion.

For the reasons set forth above, Environmental Commodities are “commodities” that can be “physically settled” and therefore are not themselves “swaps.” Furthermore, Environmental Commodities fit into the end user exemption from swaps because they are commodities used to generate electricity.

This letter represents a submission of the EMA, and does not necessarily represent the opinion of any particular member thereof.

Yours truly,
ENVIRONMENTAL MARKETS ASSOCIATION

/s/
Thaddeus Huettemann
Chairman

/s/
Jeffrey C. Fort
Chair, Market
Oversight Committee

/s/
Jeremy D. Weinstein
Member

registries and environmental groups. By omitting the legitimate role that regional and national renewable energy purchases can make in reducing GHG emissions in the electricity sector, this bill inadvertently dramatically reduces Californians’ ability to choose renewable energy as a means to reduce the GHG emissions associated with their electricity use.