

July 18, 2011

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 Policy on Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818 (May 23, 2011)**

The Coalition for Emission Reduction Policy<sup>1</sup> (“CERP”) appreciates the opportunity to submit the following comments on the Commodity Futures Trading Commission’s (“CFTC” or “Commission”) recent proposed rule providing further definition and clarification of the term “swap” (and other related terms) in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Dodd-Frank Act”).<sup>2</sup>

CERP is a coalition of companies that develop and finance projects that reduce or sequester greenhouse gas (“GHG”) emissions, as well as companies that are potentially subject to GHG regulation and that want the ability to use 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. To that end, we have provided comments to the Western Climate Initiative (“WCI”) and the State of California on the design of their respective GHG emission markets. Last September, CERP also provided comments on the Advance Notice of Proposed Rulemaking that preceded the proposed rule that is the subject of this letter.<sup>3</sup> For more information about CERP, please see [www.uscERP.org](http://www.uscERP.org).

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<sup>1</sup> The Coalition for Emission Reduction Policy was previously named the Coalition for Emission Reduction Projects.

<sup>2</sup> Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818 (May 23, 2011)

<sup>3</sup> See Comments of the Coalition for Emission Reduction Projects on Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (filed Sept. 20, 2010). CERP also provided comments on the CFTC-led study of carbon market oversight called for in section 750 of the Dodd-Frank Act. See [Response of the Coalition for Emission Reduction Projects to the Commodity Futures Trading](#)

CERP's comments on this proposed rule are focused on a single issue that is of great importance to the proper functioning of GHG markets. Section 721(a)(21) of the Dodd-Frank Act explicitly excludes forward sales of nonfinancial commodities from the definition of a "swap," provided that such forward sales are intended to be "physically settled."<sup>4</sup> In the proposed rule, the Commission invited comment on whether this forward contract exclusion should apply to sales of environmental commodities (including emission allowances, offset credits, renewable energy credits, and other compliance instruments). The Commission's question suggested that such transactions cannot be "physically settled" because environmental commodities "lack[] a physical existence other than on paper."<sup>5</sup>

CERP strongly believes that forward sales of environmental commodities should be no less eligible for the forward contract exclusion than transactions involving tangible or corporeal commodities. This view represents the most legally sound interpretation of the Dodd-Frank Act as well as the most sensible policy approach to regulating environmental commodities.

As a legal matter, it is true that the term "physical settlement" or "physically settled" is not defined in the Dodd-Frank Act. However, the very provision in which that term is embedded strongly implies that Congress did not intend for the phrase "physically settled" to limit the forward exclusion solely to contracts in tangible commodities. The full forward contract exclusion reads:

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.

Contrary to the suggestion that the phrase "physically settled" limits the forward contract exclusion to transactions in tangible commodities, the full language above shows that Congress believed even transactions in securities can be "physically settled." If Congress intended that only transactions involving tangible commodities could be physically settled, it would not have explicitly provided that a sale of a security—which exists only "on paper"—could fall within the forward contract exclusion "so long as [it] is intended to be physically settled."<sup>6</sup> Indeed, in the preamble to the very proposed rule at

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Commission's Call for Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets (filed Dec. 17, 2010)

<sup>4</sup> 7 U.S.C. § 1a(47)(B)(ii).

<sup>5</sup> 76 Fed. Reg. at 29,832. CERP also notes that the Commission raised a similar question in a subsequent proposed rule conforming certain provisions of the Commission's pre-existing regulations to the Dodd-Frank Act. Adaptation of Regulations to Incorporate Swaps, 76 Fed. Reg. 33,066, 33,069 (June 7, 2011). CERP also intends to file comments on this issue in the docket for that proposed rule.

<sup>6</sup> It is also notable that Congress allowed the forward contract exclusion to apply to any "nonfinancial commodity." The definition of "commodity" in the Commodity Exchange Act ("CEA") is extremely broad, *see* 7 U.S.C. § 1a(4), and explicitly extends to services and other intangible nonfinancial commodities. If Congress had intended for the forward contract exclusion to apply only to tangible commodities, it could easily have drafted the provision to explicitly say so. That Congress instead drafted the exclusion to apply broadly to "nonfinancial commodities" suggests that Congress wanted many classes of commodities—including intangible commodities—to benefit from the forward contract exclusion.

issue, the CFTC and the Securities and Exchange Commission (“SEC”) jointly refer to forward sales of securities as capable of being “physically settled.”<sup>7</sup>

That “physically settled” transactions include transactions in intangible commodities is not just implied in the language of the Dodd-Frank Act; it also conforms to longstanding usage of that phrase by financial regulators themselves. The CFTC, for example, has used the term “physically settled” (and the related term “physically-delivered”) to refer to any contract that results in settlement in a form *other than cash payment*—i.e., through delivery of the actual commodity.<sup>8</sup> In the specific context of environmental commodities, the CFTC has as recently as 2008 referred to futures in European Union emission allowances as being “physically settled” when they result in actual transfer of the allowances in the appropriate government registries.<sup>9</sup>

The Office of the Comptroller of the Currency (“OCC”) has also referred to derivatives involving environmental commodities as “physically settled” and has referred to the market for emission allowances as “primarily physical in nature.”<sup>10</sup> Similarly, the Securities and Exchange Commission has repeatedly used the phrase “physically settled” to refer to transactions that are settled by actual transfer of a security—which is, again, an intangible interest that exists only on paper—rather than mere cash payment.<sup>11</sup> These numerous examples demonstrate that the terms “physically settled” and “physical settlement” are commonly understood among financial regulators to refer to transactions in which *actual delivery* of a commodity takes place, including intangible commodities such as environmental commodities.

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<sup>7</sup> 76 Fed. Reg. at 29,831 (“security forwards are excluded from the definitions of swap and security-based swap. The sale of the security in this case occurs at the time the forward contract is entered into with the performance of the contract deferred or delayed. *If such agreement, contract, or transaction is intended to be physically settled*, the Commissions believe it would be within the security forward exclusion and therefore *outside the swap and security-based swap definitions*.”) (emphasis added).

<sup>8</sup> See, e.g., Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4,144, 4,153 (Jan. 26, 2010) (“In fixing aggregate all-months-combined and single-month position limits across contract classes . . . the Commission would initially identify the referenced energy contracts that are based on the same commodity but that constitute a distinct class of contracts because, for example, *they are cash-settled as opposed to physically-settled . . .*”) (emphasis added); Significant Price Discovery Contracts on Exempt Commercial Markets, 73 Fed. Reg. 75,888, 75,910 (Dec. 12, 2008) (requiring that parties to potential significant price discovery contracts specify whether the transaction is settled by being either “financially settled” or “physically delivered” as the only two alternatives).

<sup>9</sup> Re: Nord Pool ASA, Request for No-Action Relief from Contract Market Designation and Derivatives Transaction Execution Facility Registration Requirements, 2008 CFTC Ltr LEXIS 16, 15 (Aug. 20, 2008).

<sup>10</sup> OCC, Administrator of National Banks, Interpretive Letter # 1040 at 1-2 (Sept. 2005).

<sup>11</sup> See, e.g., Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to Treasury Futures Traded by ELX Futures LP, 74 Fed. Reg. 68,432, 68,432 (Dec. 24, 2009) (referring to futures on Treasury bonds as being “physically settled” where they result in actual delivery of Treasury bonds); Order Granting Approval of Proposed Rule Change as Modified by Amendment No. 4 To List and Trade Options on Corporate Debt Securities, 72 Fed. Reg. 37,551, 37,552 (July 10, 2007) (referring to options on corporate bonds as being “physically settled”); Notice of Filing and Immediate Effectiveness of Proposed Rule Change by CBOE Futures Exchange, LLC Relating to Its Listing Standards for Security Futures Products, 70 Fed. Reg. 49,691, 49,691 (Aug. 24, 2005) (referring to narrow-based security index futures in which actual securities are delivered as “physically settled” contracts).

The terms “physical settlement” and “physically settled” are also commonly used by traders of emission allowances, offset credits, and other environmental commodities to refer to transactions in which actual delivery of the commodities occurs. For example, the International Swaps and Derivatives Association (“ISDA”) standard form for confirmation of forward sales of EU emission allowances describes the transactions as “physically settled.”<sup>12</sup> Likewise, the ISDA Master Agreement covering US emission allowance transactions also refers to “physical delivery” of emission allowances. The Montreal Climate Exchange (“MCX”) provides for “physical settlement” of futures contracts for Canadian carbon dioxide equivalent units.<sup>13</sup>

It is clear, then, that the terms “physical settlement” and “physically settled” are technical terms of art in the commodities trading sphere with a widely understood meaning. Where a term used in a statute is used in such a technical sense, the ordinary rule of statutory construction is that the technical meaning should be applied absent evidence of intent to the contrary.<sup>14</sup> Here, there is no indication that Congress intended for “physically settled” to have a meaning other than the one universally ascribed to it by financial regulators and the commodities trading community. Applying the usual maxim to this context, the term “physically settled” should not be interpreted to prevent forward sales in environmental commodities from qualifying for the forward contract exclusion merely because environmental commodities are intangible. As the examples above show, transactions involving intangible commodities are routinely referred to as “physically settled” within the trade and among policymakers.

Separate from the foregoing legal considerations, the interpretation of “physically settled” that CERP advocates here is also the most sensible policy approach for regulation of forward sales of environmental commodities. As the Commission noted in the preamble to the present proposed rule, forward contracts in nonfinancial commodities are “commercial merchandising transactions” in which “the primary purpose of the contract is to transfer ownership of the commodity and not to transfer solely its price risk.”<sup>15</sup> The forward contracts exclusion from futures regulation under the CEA was created to avoid burdening ordinary, non-speculative sales of commodities with the full weight of federal oversight. This is because, as one court has noted, “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.”<sup>16</sup>

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<sup>12</sup> <http://www.isda.org/publications/pdf/ISDA-Allowance-Forward-Confirmation.pdf>.

<sup>13</sup> MCX – Futures Contracts on Canada Carbon Dioxide Equivalent Units, [http://www.mcx.ca/products\\_MCX\\_en](http://www.mcx.ca/products_MCX_en). Note that this contract is scheduled to be delisted from trading on the MCX after June of this year.

<sup>14</sup> See Sutherland Statutory Construction § 47:29 (“In the absence of legislative intent to the contrary, or other overriding evidence of a different meaning, technical terms or terms of art used in a statute are presumed to have their technical meaning. If a term is connected with and used with reference to a particular trade, the term will have the meaning given by experts in the particular trade.”) (citing, e.g., *Corning Glass Works v. Brennan*, 417 U.S. 188 (1974)).

<sup>15</sup> 76 Fed. Reg. at 29,828.

<sup>16</sup> *Andersons v. Horton Farms*, 166 F.3d 308, n.14 (6<sup>th</sup> Cir. 1998) (quoting *Salomon Forex, Inc. v. Tauber*, 8 F.3d 966 (4<sup>th</sup> Cir. 1993)).

Forward sales of environmental commodities, such as emission allowances and offset credits, are commercial merchandising transactions that equally require the exclusion from regulation that has historically been afforded to forward sales of tangible commodities. Forward sales of environmental commodities are “commercial merchandising transactions” because both buyer and seller ultimately intend the *actual* transfer of ownership of the emission allowances or offset credits. The buyer of an allowance or offset credit in a forward transaction is typically motivated by the need to comply with a current or future requirement of an emissions trading program. Because these programs require surrender of allowances and offset credits, the buyer *must* take ownership of the emission allowances or offset credits. The seller, similarly, is primarily motivated by the desire to transfer the emission allowance or offset credit to generate revenue; indeed, in the case of offset credits sold by offset project developers, actual transfer of the offset credit often generates the predominant revenue stream for the seller. In their form and motivation, such transactions are therefore indistinguishable from forward sales in other more tangible commodities, and are clearly not devices for mere transfer of price risk.

The basic principle that CEA regulation should not apply to ordinary commercial merchandising transactions applies with equal logic to forward sales in environmental commodities as well as transactions involving tangible commodities. Severe disruptions in the markets for environmental commodities would result if CFTC were to hold otherwise. As CERP has previously noted in comments to the Commission, many parties to allowance and offset credit transactions are small and medium-size entities that have neither the wherewithal nor the experience to bear the costs and regulatory burdens associated with clearing, exchange trading, transaction reporting, and other requirements that might be imposed in the absence of the forward contract exclusion. Small and medium-size entities need low transaction costs in order to participate in the markets for environmental commodities and meet their compliance obligations. The Commission should not needlessly interfere with the functioning of environmental markets by creating an arbitrary distinction between forward sales of tangible commodities and forward sales of environmental commodities.

CERP appreciates the Commission’s thoughtful consideration of these comments. We would be pleased to provide further information or analysis on request. Please direct any inquiries regarding these comments to CERP’s counsel, Kyle Danish, at (202) 298-1876 or [kwd@vnf.com](mailto:kwd@vnf.com)

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