



July 22, 2011

David A. Stawick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, DC 20581

RE: (RIN 3038–AD46) Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement  
Recordkeeping

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Dear Mr. Stawick:

Green Exchange LLC (“GreenX”) welcomes the opportunity to comment on the Commission’s proposed rule release regarding the definition of the term “Swap” (the “Release”).<sup>1</sup> GreenX was approved as a DCM by the Commission on July 22, 2010 and listed for trading futures and options contracts on environmental commodities such as emissions allowances and credits beginning on January 24, 2011. GreenX’s comments relate solely to the following questions posed by the Commission in the Release:

32. Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates? If so, please describe these commodities, and explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)? Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?

**THE FORWARD CONTRACT EXCLUSION FROM THE SWAP DEFINITION SHOULD APPLY TO ENVIRONMENTAL COMMODITIES**

As amended by the Dodd-Frank Act, the definition of the term “swap” in Section 1a of the Commodity Exchange Act, as amended (the “Act”), excludes “any sale of a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.” Forward contracts in environmental commodities are “physically settled” “non-financial commodities” that fall within this definition.

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<sup>1</sup> Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818 (May 23, 2011).



In broad terms, GreenX generally would describe the three types of environmental commodities discussed in the Release as follows: An emission allowance is a limited right to emit a pollutant (e.g., greenhouse gases, NO<sub>x</sub>, SO<sub>2</sub>) granted by a government or other body under a cap-and-trade type emissions trading scheme. An offset is an authorization representing a reduction in emissions of carbon dioxide or other greenhouse gases made in order to compensate for or to offset an emission made elsewhere. A renewable energy certificate is a certificate evidencing that a certain amount of electricity was generated from an eligible renewable energy resource. These environmental commodities are bought and sold by market participants with the primary purpose of using the commodity for compliance under a specific regulatory program or voluntary obligation. For example, the purchaser or seller of a renewable energy certificate may be an electric company that is required to produce a certain percentage of its electricity using renewable sources. If the electric company is not able to produce that percentage of electricity using renewable sources of its own, it may purchase renewable energy certificates in the market. Conversely, if the electric company produces more than the required percentage of electricity using renewable sources, then it may sell its excess renewable energy certificates in the market.

Although there is no other use of the term “non-financial commodity” in the Act, GreenX believes that the proper interpretation of the term “non-financial commodity” would include any commodity that is not an “excluded commodity,” as defined in Section 1a(19) of the Act. Excluded commodities generally include financial commodities such as an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, other or macroeconomic index or measures.<sup>2</sup> “Non-financial commodities” would thus include energy and metals commodities, which are exempt commodities within the meaning of Section 1a(20) of the Act, and agricultural commodities (as newly defined by the Commission).<sup>3</sup> Because the Commission also has categorized environmental commodities as exempt commodities, they also should be included as a non-financial commodity.<sup>4</sup>

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<sup>2</sup> The term “excluded commodity” also includes any other rate, differential, index, or measure of economic or commercial risk, return, or value that is not based in substantial part on the value of a narrow group of commodities not described above or based solely on one or more commodities that have no cash market; any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described above) that is beyond the control of the parties to the relevant contract, agreement, or transaction; and associated with a financial, commercial, or economic consequence.

<sup>3</sup> The definition of “agricultural commodity” will be added as Commission regulation 1.3(zz). See Agricultural Commodity Definition, 76 Fed. Reg. 41048 (July 13, 2011).

<sup>4</sup> GreenX notes, for example, that the Chicago Climate Exchange, Inc. (“CCX”), which trades contracts in emission allowances, was acknowledged by the Commission as an exempt commercial market (“ECM”).



As with other “non-financial” commodities in the spot and forward markets, participants typically intend forward contracts in an environmental commodity to be physically settled by the delivery of the underlying commodity in the form of an electronic registry certificate or allowance, rather than cash-settled by delivery of a cash payment. Physical settlement is typically required in the forward market because the environmental commodities are transferred with the primary purpose of using the commodity for compliance under a specific regulatory program or voluntary obligation. A cash payment would not suffice because there is a finite supply of a particular environmental commodity issued by the regulator, and thus is a limited supply of that environmental commodity that a market participant may use for its compliance purposes. If forward contracts were cash settled, the participant would be required to purchase the necessary environmental commodities in the spot market to comply with the applicable regulatory program, thus losing the benefit of the receiving the necessary commodities and price certainty gained with a physically settled forward contract.

This is consistent with the Commission’s discussion in the Release of the similarity of the forward contract exclusion from the swap definition with respect to non-financial commodities to the forward contract exclusion from the definition of “future delivery” in the Act, which excludes “any sale of any cash commodity for deferred shipment or delivery”. The Commission states that forward contracts with respect to non-financial 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. Because a forward contract is a commercial merchandising transaction, intent to deliver historically has been an element of the Commission’s analysis of whether a particular contract is a forward contract. As discussed above, participants in the forward contract market for environmental commodities generally intend to make or take delivery the underlying commodity (*i.e.*, the electronic registry certificate or allowance).

Section 750 of the Dodd-Frank Act called for a study by an interagency working group, led by the CFTC, of the oversight of proposed and existing carbon markets (the “Carbon Markets Study”).<sup>5</sup> In the Carbon Markets Study, the Commission states “absent specific action by

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As only exempt commodities may be traded on an ECM, the emission allowances traded on CCX are necessarily exempt commodities. In addition, the Commission staff has listed emission allowances as exempt commodities in various of its publications and testimony, including:

Venues for the Trading of Exempt Commodities Under the Commodity Exchange Act (CEA), available at: [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/exemptcommoditiesvenues\\_091207.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/exemptcommoditiesvenues_091207.pdf), and Dan M. Berkovitz, General Counsel, Commodity Futures Trading Comm’n, Statement on Meeting to Consider Significant Price Discovery Contract Determinations: A Brief Legislative History of the Regulation of Significant Price Discovery Contracts (April 27, 2010), available at: <http://www.cftc.gov/pressroom/speechestestimony/berkovitzstatement042710.html>.

<sup>5</sup> In considering the carbon markets, the Commission points out that it is instructive to draw on experiences from foreign emission allowance programs for greenhouse gas emissions and U.S. emission



Congress, neither the CFTC nor any other federal agency may have any authority to routinely monitor trading in the secondary markets [*i.e.*, the forward and spot market] or to create rules or regulations that would apply to these markets.” In so stating, the Commission correctly recognizes that the forward contract exclusion from the swap definition applies to environmental commodities.<sup>6</sup>

### **ENVIRONMENTAL COMMODITIES ARE PHYSICALLY DELIVERED**

Environmental commodities share the same characteristics as tangible physical commodities, such as agricultural products, energy products, metals or currencies, in all key respects.

1. There is a limited supply of these rights or authorizations, and they can be bought, sold, traded and consumed (*i.e.*, submitted for compliance).
2. While each environmental commodity is unique (*i.e.*, European Union Allowances are different from Regional Greenhouse Gas Initiative Allowances), within each category of environmental commodity, the commodity is fungible (*i.e.*, allowances issued under a particular program are fungible).
3. The focus of environmental commodities markets is obtaining the regulatory compliance benefit, rather than just a cash-settled product. The benefit received by a participant to a forward contract is the actual environmental commodity that it will use for compliance purposes. The participant is not concerned with whether it receives an allowance with a particular serial number or that was issued by a particular government within the program, so long as it meets the specifications needed for a participant’s compliance purposes. This is a fundamental principle in physical delivery commodities – the commodity delivered must meet the contract specification. For example, a person receiving physical delivery of corn is primarily concerned with whether the corn meets the contract specification, they are not concerned with whether it was grown in Illinois or Iowa.
4. The settlement of the purchase, sale and transfer of environmental commodities is identical to that of many tangible physical commodities. For physical commodities such as agricultural and metals products, the purchase, sale and transfer is evidenced by an electronic transfer of a warehouse receipt, the underlying commodity does not move – it remains in the warehouse or vault, but its ownership changes in the records of the warehouse. For currencies, the purchase, sale and transfer is evidenced by an electronic transfer to a bank account, but the underlying currency remains in a vault. In the case of a physically-settled forward contract in an

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allowance markets for other pollutants. Although the Carbon Markets Study addressed only the carbon markets, its findings also are instructive to environmental commodities generally.

<sup>6</sup> The Commission also notes that it has broad enforcement authority to bring actions against individuals or entities believed to be involved in the price manipulation of a commodity’s price in interstate commerce.



environmental commodity, delivery typically would take place by electronic delivery of the credit or allowance from the registry account of the seller to the registry account of the buyer. The allowance remains on the books of the registry, but its ownership changes in the records of the registry. This physical delivery mechanism is used to physically settle futures contracts in environmental commodities, such as those listed on GreenX.

**APPLICATION OF THE FORWARD CONTRACT EXCLUSION WOULD NOT PERMIT TRANSACTIONS THAT SHOULD BE SUBJECT TO THE SWAP REGULATORY REGIME TO FALL OUTSIDE THE DODD-FRANK**

Like any other physically settled forward contracts in a non-financial commodity, forward contracts on environmental commodities should fall outside of the swap regulatory regime of the Dodd-Frank Act. As with any other commodity, to the extent a transaction did not meet the forward contract exemption, it would be a swap subject to Commission regulation. The existence of standardized futures contracts, which are traded on Commission-regulated designated contract markets and cleared at Commission-regulated derivatives clearing organizations, already has brought much of the secondary market in environmental commodities under the regulation of the Commission.

If the forward contract exclusion did not apply, forward contracts in environmental commodities might be considered swaps that would be required to be traded on a swap execution facility and subject to mandatory clearing. It would have the unintended effect of moving these transactions where there are no such requirements. As participants are able to enter these as forward transactions in European markets, burdensome Commission regulation of transactions in environmental commodities in the U.S. likely would simply increase the share of these transactions in Europe and decrease or eliminate these transactions in the U.S.

Thank you for the opportunity to provide these comments to the Commission. Should the Commission have any questions regarding GreenX's comments, please contact me at 212-299-2510 or [Kari.Larsen@theGreenX.com](mailto:Kari.Larsen@theGreenX.com).

Sincerely,

A handwritten signature in blue ink, appearing to read 'Kari S. Larsen', with a long horizontal line extending to the right.

Kari S. Larsen  
General Counsel, Chief Regulatory Officer