

From: DeAna Dow  
Sent: Friday, December 16, 2011 4:32 PM  
To: Hammar, Julian; Aron, David  
Cc: Evan Ard  
Subject: Draft preamble language on environmental commodities

Julian, Evolution Markets met with Chairman Gensler on November 18th on product definitions. David Aron attended the meeting as well. Among other things, we discussed the confusion around treatment of environmental products under the proposed swap definition rules, including the physical nature of the products and the importance of the applicability of the forward contract exclusion. Many of the transactions brokered by Evolution Markets are cleared forward contracts in environmental products. In the interest of providing greater clarity to the proposal, we have attached draft language for your consideration that would expressly address the treatment of environmental products under the swap definition rule.

Please let me know if you have any questions. You can also contact Evan Ard directly at Evolution Markets. [eard@evomarkets.com](mailto:eard@evomarkets.com); 914-323-0210.

Thanks for your consideration and we would be happy to discuss the language with you at your convenience.

De'Ana

De'Ana H. Dow  
Senior Vice President  
Ogilvy Government Relations  
1111 19th St., N.W., Suite 1100  
Washington, DC 20036  
O: 202-729-4311  
C: 202-560-2455

## Draft Language for the Swap Definition Final Rule

### Relating to Environmental Commodities

The statutory definition of a “swap” excludes forward contracts. A “forward contract” is “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.”<sup>1</sup> In the May 23, 2011 JNOPR, the Commission sought feedback on whether transactions involving environmental commodities could be physically settled, and therefore qualify for consideration under the Forward Contract Exclusion.<sup>2</sup> Comments focused, in large part, on the genesis of environmental commodities and the ability to physically settle these transactions, although they lack a physical existence other than on paper or within an electronic registry.

In explaining the physical settlement feature of environmental commodities as distinguished from cash settlement of financial commodities, commenters, such as the International Emissions Trading Association, noted that environmental commodities transactions involve the transfer of the underlying commodity, rather than its cash value.<sup>3</sup> Moreover, environmental commodities can possess characteristics similar to traditional, tangible commodities, such as oil or coal, which can be transferred among counterparties and used for purposes other than cash value (i.e., burned to produce electricity or handed into a regulatory body to meet an environmental obligation).

---

<sup>1</sup> Commodity Exchange Act, Section 1(a)(47)(B)(ii).

<sup>2</sup> Federal Register, Vol. 76, No.99, Page 29832:

“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?”

<sup>3</sup> International Emissions Trading Association (IETA) comments dated July 22, 2011:

“A physically settled commodity is one that is not (*emphasis included*) financially settled. Whether it is tangible or not should not matter, so long as there is a transfer of the underlying commodity rather than its cash value.

“Carbon and emissions allowances are essentially rights to emit a set quantity of emissions granted by Federal or state regulatory authorities. These allowances are given serial numbers, which represent the physical ownership of the allowances. These allowances are placed in electronic accounts, and may be transferred electronically between account holders. However, environmental commodities are more analogous to physically settled instruments than financial instruments. This is because the “commodity” being traded is a right to take an action (allowances) or an ownership right to an action already taken (offsets and RECs). The action taken can be physically measured, and the serial numbers identify legal rights associated with that action. These instruments meet requirements for which cash is not a substitute, frequently in instances in which legal compliance with an emissions limit or a generation standard must be achieved—and in which there are existing criminal violations for certain acts of non-compliance. Therefore, they more closely resemble physical than financial transactions.”

The Commission also received comments explaining how environmental commodities can be “consumed”, thereby proving their ability to be physically settled. Specifically, counterparties accepting delivery of environmental commodities may “consume” these environmental commodities to comply with a Federal or state regulatory program or to meet a voluntary environmental obligation.<sup>i</sup>

The Commission agrees that, although there is not *per se* a physical existence to environmental commodities, such as emissions allowances, carbon offsets or credits, and renewable energy certificates, they can be consumed and can be physically settled. Therefore, these commodities are physical/non-financial commodities to which the Forward Contract Exclusion may apply.

###

---

<sup>i</sup> In the case of the latter, “consumption” may entail the surrender of an environmental commodity to a regulatory body or the retirement of the environmental commodity on an approved registry. For the former, “consumption” may entail similar retirement on a registry or an attestation by the consuming entity that the environmental commodity may no longer be transferred, thereby providing an offset to a portion of the entity’s environmental impact.