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Re: Response of 3Degrees Group, Inc. ("3Degrees") to Commodity Futures Trading Commission ("Commission") Notice of Proposed Rule ("NOPR") respecting Further Definition of "Swap," "Security-Based Swap," etc., (17 CFR Part 23, RIN 3038-AC96, 76 Federal Register 29818, May 23, 2011) pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

Dear Commission:

The Commission, by the above-referenced NOPR, requests public comment on the proposed NOPR and other matters. This letter responds to the NOPR requests for comment numbered 31 and 32 on page 29832 of Federal Register/Volume 76 no. 99 (NOPR 29832). 3Degrees addresses the structure and standard practices of Renewable Energy Certificate ("REC") and Carbon Offset markets; proposed definitions for the terms Financial Commodity, Non-Financial Commodity, Physical Settlement, and Financial Settlement; and the applicability and appropriateness of the Forward Contract Exclusion to REC and Carbon Offset Agreements.

For the reasons set-forth herein, 3Degrees urges the Commission to conclude that Environmental Commodities are not swaps under Dodd-Frank qualify for the forward contract exclusion from the Dodd-Frank swaps definition, and to adopt 3Degrees' proposed definitions to several key terms.

I. Introduction

3Degrees is a leading environmental commodities sales, trading, and advisory firm that markets RECs and carbon offsets in compliance and voluntary markets across the United States. In addition to many private awards, 3Degrees has won awards from the United States Department of Energy in each of the previous four years: Non-Utility Green Power Supplier of the Year (2009 and 2010), Large Commercial Green Power Supplier of the Year (2008), and Renewable Energy Marketer of the Year (2007).

II. REC and Carbon Offset Markets

In question 32 of the NOPR the Commission asked commentators to "**please describe [environmental] commodities and please explain how these transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)?**" 3Degrees will define RECs and Carbon Offsets, (which may be jointly referred to as Environmental Commodities), describe their end uses, their principal means of transaction and settlement, and existing market oversight. 3Degrees will address issues related to physical settlement of transactions in association with the questions specific to the forward contract exclusion.

A. Definitions and Characteristics of Environmental Commodities

1. Renewable Energy Certificates (RECs)

A renewable energy certificate embodies the environmental benefits[1] of the generation of one megawatt-hour ("MWh") of renewable energy that was delivered to the electric grid.[2]

The generation of electricity from a renewable resource is the only way a REC can be created. A REC may be transferred with the underlying electricity which is commonly known as a "bundled" REC, or a REC may be transferred separately from the underlying electricity which is commonly known as an "unbundled" REC.

After a REC has been separated from the underlying electricity, the underlying electricity does not contain environmental benefits.[3] Once a public claim on a REC has been made by a party, the REC is retired in that party's name, and cannot be used by any other party.[4] A REC which has been claimed for voluntary purposes may not also be used for regulatory compliance, and vice versa.

2. Carbon Offsets/Credits

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[1] Sometimes environmental benefits are referred to as "environmental attributes," "non-power attributes," or other analogous terms.

[2] Eligible resources to generate renewable resources are commonly: Solar, Wind, Low-Impact Hydroelectric, Biomass, Biodiesel, and Fuel Cells, *Green-e Energy National Standard Version 2.1 § II(A)(1-7)*. http://www.green-e.org/docs/energy/Appendix%20D_Green-e%20Energy%20National%20Standard.pdf

[3] "By selling RECs, the company has transferred the right to characterize its electricity as renewable." *16 CFR Part 260, § VI(D)(4)(d)*. Proposed, revised Guides for the Use of Environmental Marketing Claims ("Green Guides"), October, 2010.

[4] Double counting generally occurs when an entity sells the same REC to more than one purchaser or when multiple parties make claims based on the same REC. Green Guides, § VI(D)(2)(c). See also *Green-e Energy National Standard Version 2.1 § 3(E)* "Eligible RECs or renewable energy can be used once and only once; making a claim (e.g.stating "we buy wind power") is one example of a 'use' that results in retirement."

A Carbon Offset is a verified reduction or avoidance of carbon (and other greenhouse gas) emissions into the atmosphere that is generated by a project and recorded according to a specific protocol. Similarly to RECs, only the party which owns the carbon offset has the right to retire the carbon offset for voluntary or compliance claiming or reporting rights.

B. End Use of Environmental Commodities

1. RECs

a. Compliance RECs

29 states and the District of Columbia have adopted renewable portfolio standards ("RPS") which require compliance entities (usually defined to be load serving entities within a given jurisdiction) to demonstrate that they have procured a minimum amount of electricity from renewable resources. RECs are used by compliance entities to demonstrate compliance with RPS obligations.[5] A compliance entity which has not taken delivery of sufficient RECs to meet its RPS obligations is frequently required to pay an alternative compliance penalty, which is a monetary or other penalty assessed for RPS noncompliance.[6]

b. Voluntary RECs

RECs may also be used by a party without a compliance obligation. Renewable electric generation does not emit the pollutants and greenhouse gasses which fossil fuel based generation emits; therefore renewable generation delivered to the electrical grid emits low or zero emissions and displaces less environmentally friendly types of generation creates environmental benefits. Voluntary REC buyers claim and promote these environmental benefits through REC purchases.

The end-users of voluntary RECs are typically: corporations who wish to make claims that they purchase renewable energy or that their products are produced with renewable energy; organizations who wish to certify buildings as meeting the United States Green Building Council's Leadership in Energy and Environmental Design requirements; non-profit organizations with an environmental focus; and other organizations, corporations, and individuals that purchase RECs through their utility in order to acquire the REC claiming rights.[7]

2. Carbon Offsets

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[5] The relevant RPS may require that RECs be bundled or unbundled.

[6] As an example, California requires non-compliant entities to pay a fine of $50 for each MWh below its regulatory requirements a compliance entity falls.

[7] These programs, frequently called utility green power/pricing programs, allow the consumer to choose to pay an amount in addition to their monthly electrical bill to purchase RECs through their utility to match all or a portion of their electricity usage. The RECs corresponding to the consumer's electricity usage are retired in the consumer's name. Through this purchase, the consumer acquires the claiming rights associated with the REC(s) retired in their name.

a. Compliance Carbon Offsets

Cap and trade programs set regulatory caps on the amount of carbon dioxide (and other greenhouse gasses) which can be emitted from compliance entities. Compliance entities must reduce their emissions and/or retire emissions allowances or other compliance instruments equal to the capped greenhouse gasses they emitted into the atmosphere during the applicable compliance period.

Some cap and trade programs use carbon offsets as compliance instruments in addition to emission allowances. A compliance entity may use carbon offsets as a compliance instrument to decrease its obligation to purchase emissions allowances in proportion to the number of carbon offsets it used for compliance.[8] There is frequently a limit on the number of carbon offsets a compliance entity is able to use as compliance instruments.

b. Voluntary Carbon Offsets

A party without a compliance obligation may purchase carbon offsets to claim the benefits of the emission reduction activity, thereby reducing its carbon footprint. As with RECs, the end users of voluntary carbon offsets are typically corporations who wish to claim the benefits of carbon offsetting activity, non-profits or other organizations with an environmental focus, and corporations and individuals who purchase carbon offsets through their utility in order to acquire the claiming rights.[9]

C. REC and Carbon Offset Transactions Are Non-Standardized and Usually Traded in Individually Negotiated Over-the-Counter "OTC" Agreements

1. RECs

Depending upon the preferences or requirements of the end user, there may be a great deal of fungibility across different environmental commodity markets, or there may only be one narrowly tailored product which meets the end user's needs.

a. Fungibility and Non-Standardization in Compliance RECs

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[8] Although a cap and trade program may cap a number of greenhouse gasses, compliance is simplified by converting the global warming potential of each of the capped greenhouse gasses into the single common unit of carbon dioxide. Both carbon offsets and emission allowances are measured in metric tons of carbon dioxide equivalent (MtCO2e).

[9] These programs allow the consumer to choose to pay an amount in addition to their monthly electrical bill to purchase carbon offsets through their utility proportion to the emissions associated with their electricity or natural gas usage. The carbon offsets corresponding to the consumer's electricity or natural gas usage are retired in the consumer's behalf.

There is limited fungibility between different compliance RECs, because state legislatures and utility commissions set eligibility rules for RPSs in a manner which maximizes benefits for constituents in their state. For example:

- California's RPS has established a preference for in-state generation by capping the percentage of RECs from out-of-state facilities a compliance entity may use for compliance purposes.[10]

- Missouri offers an additional partial REC for in-state generation over out of state generation.[11]

- In Michigan, a party which generates a REC from a facility which utilizes Michigan labor is granted a bonus REC.[12]

- New Mexico has carve outs for its preferred resources.[13]

There may also be REC subcategories within an RPS. The value of compliance RECs based upon the legislature's preferences of geography, resource, banking, compliance periods, multipliers and exemptions. Thus, depending upon the end user, a compliance REC may be perfectly fungible with another state's compliance REC, or have no compliance value at all.

There are also compliance REC contracts for Connecticut, Massachusetts and New Jersey traded on the Chicago Climate Futures Exchange ("CCFE").[14] These contracts have very low open interest and represent only a minute fraction of the RECs transferred in the industry.[15] Although it is impossible to know every transaction which takes place, it is highly likely that CCFE trades represent far less than 1% of the market. The lack of sufficient liquidity and the rigidity of the exchange traded products have discouraged many market participants from transacting on exchanges.

State legislators are inherently political, and states have very different goals and resources. Therefore RPS' regulations will always be changing, and harmonization in the REC market is likely a long way away.

b. Fungibility and Non-Standardization of Voluntary RECs

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[10] See http://docs.cpuc.ca.gov/WORD_PDF/FINAL_DECISION/129517.pdf

[11] See https://www.efis.psc.mo.gov/mpsc/Filing_Submission/DocketSheet/docket_sheet.asp?caseno=EX-2010-0169&pagename=case_filing_submission_rst.asp

[12] See http://www.michigan.gov/documents/mpsc/2007-SNB-0213_254495_7.pdf See section 39(2).

[13] See http://www.nmprc.state.nm.us/renewable.htm

[14] See: http://www.ccfe.com/ccfeContent.jsf?id=4565857

[15] See: http://www.ccfe.com/ccfeContent.jsf?id=4565857

The requirements of a voluntary end-user may be equally as rigid. Like legislators, many end users desire to support resources in their home-state or region, or may have preferences for a particular technology to the exclusion of other technologies. These preferences allow customers to make targeted marketing claims for maximum impact. For example:

- Some voluntary buyers desire to claim "we purchase renewable energy"
- other buyers desire to claim "we purchase wind energy"
- other buyers desire to claim "we purchase *Midwest* wind energy"
- other buyers desire to claim "we purchase *Illinois* wind energy,"
- and still others desire to claim "we purchase wind energy from the Acme wind farm."

For all of these consumers, the OTC market enables them to purchase the product which earns them the maximum value at their price threshold, and helps to differentiate themselves from their competitors. The voluntary REC contract traded on the CCFE is based upon the most generic national REC eligibility requirements under the Green-e Energy National Standard. The CCFE voluntary REC contract does not allow the buyer to specify the region, state or facility from which they desire to purchase RECs. As with compliance RECs, one size does not fit all.

2. Carbon Offsets

Like the market for RECs, Carbon Offsets are principally traded in the OTC market. Exchange trading for Carbon Offsets is limited due to the lack of liquidity in the exchange traded products.[16] As with RECs, Carbon Offset buyers who wish to purchase a custom product must transact in the Over the Counter market.

D. Settlement/Delivery under REC and Carbon Offset Agreements

1. RECs

RECs can be delivered from the Seller to the Buyer over one of the many regional tracking systems, or via a contractual attestation. Transfer over a tracking system requires that both parties have an account with the tracking system over which the RECs are traded. The tracking system assigns a certificate with a unique serial number to the generator, who then transfers the certificate from its account on the tracking system to the buyer's account.[17] The buyer then has exclusive ownership of the REC and may "retire" the REC, which permanently removes it from circulation, or the buyer may transfer the REC to a third party. The tracking system only assigns one certificate per REC, preventing double sales of the REC. Compliance market regulators

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[16] See Order Finding that the Carbon Financial Instrument Contract Offered for Trading on the Chicago Climate Exchange, Inc. Does Not Perform a Significant Price Discovery Contract. Federal Register Vol. 75, No. 85, 23686-23690 May 4, 2010.

[17] There are nine tracking systems in the United States: ERCOT, M-RETS, MI-RECS, NARR, NC-RETS, NEPOOL, NYSERDA (in development), PJM-GATS, and WREGIS.

typically require that RECs be transferred via a tracking system. There is a limited ability to transfer RECs between tracking systems because each tracking system is associated with a distinct jurisdiction within a regional electric grid, and the REC eligibility requirements vary by jurisdiction.

Parties who do not have accounts with a tracking system, who wish to transact for RECs in the voluntary market, are permitted to transfer RECs via a contractual attestation in which they attest that the REC has met the eligibility requirements necessary for certification with the required standard. After the seller's delivery of the attestation, and the meeting of any other contractual requirements, the buyer owns title to the REC.

Whether RECs are transferred over a tracking system, or a contractual attestation, title to the REC passes at a clear point in time. In all scenarios, exclusive title to the REC, and all of the rights which are contained in the title to the REC, are transferred from the seller to the buyer.

2. Carbon Offsets

Similar to RECs, Carbon Offsets may be settled through delivery over a registry, or via a contractual attestation. Registries are the carbon offset equivalent of the REC tracking system. The registry assigns a certificate with a unique registry number to the generator of the carbon offset. The generator then transfers the carbon offset to the buyer's account on the registry. Once a carbon offset has been retired, it is no longer able to be transferred.

Carbon Offsets may also be transferred via a contractual attestation.

Whether Carbon Offsets are transferred over a registry or a contractual attestation, title to the Carbon Offset transfers when the buyer receives delivery of the Carbon Offset over the registry, or via the contractual attestation.

E. Existing Oversight of Environmental Commodity Markets

1. RECs

a. Compliance RECs

State RPS statutes designate oversight entities which have the responsibility for certifying that RECs used for compliance are generated by appropriate facilities, and that they have a clean chain of title leading to the end user. These regulators have the authority to administer the RPS and sanction parties who violate RPS rules. These regulators (generally state public utilities commissions) have a long history of regulating utilities and other compliance entities, and are highly vested in preventing market abuses in order to deliver the maximum benefits and protection to each state's consumers and other stakeholders.

b. Voluntary RECs

Through their Green-e Energy program, the non-profit Center for Resource Solutions ("CRS") is the primary certifier of RECs sold in the United States. CRS audits the entire contract chain – from generator to end-use buyer – of voluntary purchases of RECs to ensure that (a) the RECs meet the requirements of the Green-e Energy National Standard and (b) consumers are protected and receive adequate information about their REC purchase.

Over two thirds of United States voluntary renewable energy retail transactions were Green-e Energy certified in 2010. Green-e Energy certified 27 million MWh of voluntary renewable energy sales in 2009, which includes both retail and wholesale-level transactions, and unaudited figures for 2010 show an expected increase of close to 20% over 2009 certified sales.

2. Carbon Offsets

a. Compliance Carbon Offsets

As with RPS', cap and trade programs are regulated at the state level by the governing body selected by the legislature. These governing bodies are responsible for program oversight, rules, and enforcement. The two largest cap and trade regimes for greenhouse gasses are the Regional Greenhouse Gas Initiative[18] and the newly enacted California cap and trade program administered by the California Air Resources Board.[19]

b. Voluntary Carbon Offsets

There are several consumer-protection organizations which verify voluntary carbon offsets in the United States. Examples of such organizations are Green-e Climate, which is operated by CRS,[20] the Voluntary Carbon Standard,[21] and the Climate Action Reserve.[22] These groups ensure that Carbon Offsets verified under their respective protocols meet all protocol requirements.

III. Forward Contract Exclusion

In Question 32 of the NOPR the Commission asked: "**Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates?"**

In Question 31 of the NOPR, the Commission asked: **"Should the Commissions provide guidance regarding the scope of the term "non-financial commodity" in the forward contract exclusion from the swap definition? If so, how and where should the Commissions draw the line between financial and nonfinancial commodities?**

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[18] http://www.rggi.org/
[19] http://www.arb.ca.gov/cc/capandtrade/capandtrade.htm
[20] http://www.green-e.org/getcert_ghg.shtml
[21] http://www.v-c-s.org/
[22] http://www.climateactionreserve.org/

Commodity Exchange Act ("CEA") § 1a(47)(B)(ii) as amended by Dodd-Frank provides an exemption from the swaps definition for "any sale of a *nonfinancial commodity* or security for deferred shipment or delivery so long as the transaction is *intended* to be *physically settled.*"

Questions regarding financial commodities are related to questions regarding the forward contract exclusion, therefore 3Degrees will address question 31 of the NOPR in tandem with the portions of question 32 which reference the forward contract exclusion.

A. Financial and Nonfinancial Commodities

3Degrees urges the Commission to clarify the terms "financial commodity" and "non-financial commodity" through definitions in order to grant market participants clarity as to whether their transactions will be eligible for the forward contract exclusion. Without definitions, market participants will be forced to wait for the Commission and courts to define what a financial commodity is in a piecemeal fashion, and some market participants will have their expectations frustrated by unanticipated Commission or court determinations.

Congress did not provide specific guidance on how the term financial commodity should be defined, however 3Degrees believes that Congress considered financial commodities to be a subcategory of derivatives which are traded solely for the purpose of risk shifting, and based upon "financial" indices, rates, and instruments of indebtedness.

The United States Senate Permanent Subcommittee on Investigation "Wall Street And The Financial Crisis: Anatomy of a Financial Collapse Report dated April 13, 2011 (the "Levin-Coburn Report") was drafted for the purpose of determining the causes of the 2008-2009 financial crisis. The Levin-Coburn Report called out collateralized debt obligations, mortgage backed securities, and credit default swaps as playing a large role in the financial crisis.

In Section 1a(47)(A)(iii)(I-XXII) Congress specifically listed the instruments it most intently wanted to regulate as swaps. Among the instruments listed are credit default swaps, and debt swaps, which are the functional equivalent of the instruments identified by the Levin-Coburn Report. These instrumnets were specifically included in the swaps definition because Congress believed they were in part to blame for the financial crisis. These instruments, and the other instruments Congress included in its swaps definition have in common the fact that they are solely for the purpose of risk shifting.

Risk shifting transactions executed using derivatives have many legitimate purposes, and may be eligible for exemptions under other provisions, such as the end user exemption, however Congress did not intend for these derivative transactions to benefit from the forward contract exemption. 3Degrees' recommends the Commission to narrowly define the forward contract exemption in a manner which prohibits these instruments from qualifying for the forward contract exemption, while allowing other commodities to benefit from the forward contract exemption.

In its definition of "swap" there are several instances where Congress incorporated a list of derivatives on indices, rates, and instruments of indebtedness which it sought to specifically regulate as swaps. Under Dodd-Frank's definition, the term "swap" means any agreement, contract, or transaction—

> §1a(47)(A)(i) "that is…an option…based on the value of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, <u>or other financial</u> or economic interests or property of any kind"
>
> § 1a(47)(A)(ii) that "provides for the purchase sale or delivery…that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated <u>with a potential financial</u>, economic, or commercial consequence"
>
> "§ 1a(47)(A)(iii) that provides on an executor basis for the exchanges…of 1 or more payments based on teh value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measure, <u>or other financial</u> or economic interests…"
>
> § 1a(47)(D) "security-based swap" includes any agreement…based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, <u>other financial</u> or economic interest…"

The references to instruments based upon other financial or economic interests implies that Congress considered the instruments prior to the "*or other*" to be financial. Most of these financial interests derive their value from the movement of some variable index or rate neither of the parties controls. The index or rate is merely a number, the relative value of which determines which party must make the payment to the other. When Congress listed the various financial interests in the swaps definitions, it was describing the types of derivatives it seeks to regulate. Commodities based upon these financial interests are the ones Congress sought to regulate as swaps, even if they would otherwise fall within the forward contract exemption.

The term "financial interest" is broad and can mean vastly different things to different people. In order to give market participants appropriate guidance in determining whether they are transacting in financial commodities, the CFTC should define the commodities which are covered by the term financial commodity. In interpreting Congressional intent, care must be taken to not regulate commodities over which Congress did not grant the CFTC jurisdiction, therefore the CFTC should define financial commodities within the confines of the financial interests Congress sought to specifically regulate as swaps.

1. Proposed Definitions for Financial Commodity and Non-Financial Commodity

3Degrees proposes the following definition of financial commodity:

> "A Financial Commodity is a commodity intended to be settled solely with a cash payment or the entering of an offsetting transaction, the amount of which is determined according to the price of an index, commodity, security, currency, quantitative measure, rate, or instrument of indebtedness, without also conveying a future direct or indirect ownership interest in an asset."

This definition borrows from the swaps definitions the types of interests Congress considered to be financial, and incorporates them into the financial commodity definition. By limiting the definition to only financial interests specifically identified by Congress, it avoids jurisdictional overreach.

The last clause of the definition, which states "without also conveying a future direct or indirect ownership interest in an asset" is borrowed from and preserves the § 47(A)(iii) exception from the financial interests, those commodities which also convey ownership interests in an asset. The transferring of an ownership interest in an asset is a key difference between the financial commodities and derivatives Congress sought to regulate, and those which it sought to exempt through the 1a(47)(A)(iii) and the forward contract exemption.

This definition of "Financial Commodity" identifies the specific commodities which are financial, thereby providing market participants with the certainty they need in order to transact, and avoids using the term financial commodity as a proxy to expand Commission jurisdiction beyond Congressional intent.

The definition of "Non-Financial Commodity" should be a straightforward definition, which incorporates the definition of Financial Commodity, thereby giving market participants the certainty they need to operate efficiently.

3Degrees proposes the following definition for Non-Financial Commodities:

> "A Non-Financial Commodity is any commodity which is not a Financial Commodity."

This definition will not add additional layers of analysis, and provided that Financial Commodities are appropriately defined, will be easy to apply.

3Degrees' proposed Financial Commodity and Non-Financial Commodity definitions are faithful to Congressional intent and would grant parties the certainty they need in order to be able to transact efficiently in the marketplace.

Environmental Commodity forward transactions involve the transfer of the underlying commodity, and are not based upon the value of an external rate or indices. They are based upon the value the parties place on the underlying commodity. For these reasons, Environmental Commodities when traded in the forward market are Non-Financial Commodities, whether pursuant to 3Degrees definition, or another definitions faithful to Congressional intent.

B. Physical Settlement of Commodities Lacking a "Physical Existence"

In question 32 of the NOPR the Commission asked **"Please…explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)?"**

Like the term "Financial Commodity," the term "Physical Settlement" is a prong of the forward contract exclusion, and needs to be defined and interpreted in a manner which is faithful to Congressional intent, and provides market participants the clarity necessary to efficiently transact.

Congress did not define physical settlement in Dodd-Frank. The Commission has not previously defined the term "physical settlement" and in light of the fact that intent to physically settle is required in order for a transaction to qualify for the forward contract exemption, now is an appropriate time for such a definition.

Commodities contracts can be settled in two ways: physical settlement and financial settlement.[23] In *Co Petro*, the Commission determined that a contract is physically settled if the buyer accepts delivery of the commodity underlying the contract.[24] The Commission cited *Co Petro* in the NOPR, and should also rely upon *Co Petro* to incorporate this definition into the Commodity Exchange Act.

1. Proposed Definitions of Physical Settlement and Financial Settlement

3Degrees proposes the following definitions:

> "Physical Settlement is the settling of contractual obligation through transfer of title to the commodity underlying the transaction, from one party to another."

In order to draw the appropriate contrast, the Commission should define financial settlement as well:

> "Financial Settlement is the settling of contractual obligations through the transfer of cash, or the entering of an offsetting obligation, without the transfer of title to the commodity underlying the transaction."

The reference to "title" to the underlying commodity in these definitions is appropriate because title represents the right to consume the commodity in ways that mere possession of a does not. Having title to a commodity is the essence of owning a commodity, and is the manner in which ownership of a commodity is transferred from one party to another.

These definitions are straightforward, and do not represent a deviation from previous Commission precedent.

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[23] *CFTC v.* Co -Petro *Marketing Group, Inc.,* 680 F.2d 573, 577 (1982).
[24] *CFTC v.* Co -Petro *Marketing Group, Inc.*, 680 F.2d 573, 578 (1982).

2. Commodities lacking a physical existence are able to satisfy the criteria for physical settlement.

Environmental Commodity transactions in practice are settled through the transfer of the commodity underlying the Environmental Commodity transaction. The exchange of the underlying commodity is accomplished through the transfer of title via a tracking system, registry or contractual attestation, in exchange for a cash payment. Title transfer is the linchpin required under Commission precedent.

The Interagency Working Group Report on the Oversight of the Carbon Markets "IWG Report" report describe how physical settlement of carbon offsets and emissions allowance occurs. On Page 14 the IWG Report states:

> "the secondary market for allowances and offsets involves those transactions in which allowances and offsets are actually bought and sold following their initial entry into commerce in the primary market. This is in contrast to the derivative markets, which are primarily risk management and price discovery markets where the price of the contract is tied to the price of the allowance and actual transfer of an allowance may not occur. There are two types of secondary cash market transactions, spot transactions and forward contracts. In a spot transaction, one party sells an allowance to another party for immediate delivery of the allowance. In a forward transaction, the parties agree to a price or method to fix a price with delivery of the allowance taking place at a later date. [25]

In the *NORD POOL ASA, Request for No-Action Relief*, the Commission also acknowledged the potential for emissions allowances to be physically settled, stating "NP proposes to make available for direct access its…physically settled Financial European Union (EU) Allowances Contracts…"[26] For all intents and purposes, the Working Group and Commission could have used the same language to describe the physical settlement of REC agreements as well. Based upon precedent and the apparent interpretations of this precedent, Environmental Commodities may be physically settled.

The "lack of physical existence" of some commodities is irrelevant to the ability of a party to effectuate a physical settlement. Environmental Commodities transactions involve the transfer of title and the exclusive rights embodied in title, and therefore are able to satisfy the requirements for a physical settlement.

3. Environmental Commodities forward transactions are *intended* to be physically settled.

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[25] Interagency Working Group for the Study on Oversight of Carbon Markets, *Report on the Oversight and Existing and Prospective Carbon Markets* , Jan. 18, 2011, Page 42.

[26] CFCLTR No. 08-14 (C.F.T.C.), Com. Fut. L. Rep. P 30901 (C.F.T.C.), 2008 WL 4044072 (C.F.T.C).

Having described how Environmental Commodities are physically settled, we must discuss whether Environmental Commodities are *intended* to be physically settled before concluding that Environmental Commodity forward transactions are eligible under the forward contract exclusion.

In its proposed rulemaking, the Commission stated that the "forward contract exclusion from the swap definition for nonfinancial commodities should be interpreted in a manner that is consistent with the Commission's historical interpretation of the forward contract exclusion from the definition of the 'term' future delivery." (NOPR Page 29829) Furthermore, the Commission emphasized that "intent to deliver" is the primary element in evaluating whether the forward contract exclusion applies, and that intent should be evaluated using the Commission's multi-factor approach. (NOPR Page 29829)

To determine whether physical settlement is intended by the parties, the Commission has considered a "facts and circumstances" test.[27] Under *Wright*, which incorporates *Co Petro* and its progeny, the primary factors considered are (1) the parties' ability to deliver and receive delivery; (2) the inherent value of the commodity to the parties; (3) the terms of the contract; and (4) the course of performance of the parties.[28]

The *Wright* facts and circumstances as applied to the settlement of Environmental Commodities make evident that Environmental Commodity forward transactions are intended to by physically settled:

i. Environmental Commodity Counterparties Have The Ability to Deliver and Receive Delivery

Environmental Commodities are goods which are capable of ownership, can be owned by only one party, and are transferred from one party to another via a transfer of title. Title to Environmental Commodities are transferred through a tracking system, registry, or via contractual attestation. The question of whether two individual counterparties are able to deliver and receive delivery will be based on the facts of the individual situation, although generally speaking, because Environmental Commodity contracts require physical settlement of the underlying commodity, and all capable parties have the capacity to receive delivery of a contractual attestation.

ii. RECs and Carbon Offsets have inherent value to end-users

In the Environmental Commodities markets, the right to claim the environmental benefits associated with the generation and consumption of a MWh of renewable electricity or the

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[27] *In re Wright*, CFTC Docket No. 97-02, 2010 WL 4388247 at 3 (CFTC Oct. 25, 2010).
[28] *In re Wright*, CFTC Docket No. 97-02, 2010 WL 4388247 at 3 (CFTC Oct. 25, 2010).

emissions reductions from a carbon project, for compliance or voluntary purposes is only granted to the party who retires the Environmental Commodity. These rights provide inherent value to Environmental Commodity buyers. Without title to the Environmental Commodity, the buyer does not receive the benefit, and must either purchase the benefit from another party, or forgo the compliance or voluntary claims. Without the physical settlement of Environmental Commodities, buyers would not receive benefits, and the Environmental Commodity markets would collapse.

iii. Terms of the Environmental Commodity Contracts

Environmental Commodity contracts almost universally require delivery of Environmental Commodities, the failure to do so is an event of default. The event of default exposes the defaulting party to contractual remedies. 3Degrees' cannot speak for other market participants, although to the best of its knowledge, it is rare for a party to execute an Environmental Commodity forward contract which allows for a party to unilaterally terminate an agreement via a pre-arranged contractual mechanism to financially settle the agreement.

iv. Industry Course of Performance

In 3Degrees' experience parties do in-fact deliver Environmental Commodities in satisfaction of contractual terms. This market is one in which parties generate Environmental Commodities, and seek to deliver them to parties who seek to claim the environmental benefits of renewable generation, or emissions reductions. The chain of title for the transfer of Environmental Commodities in thousands of transactions evidence this course of performance. Like in any industry, defaults do happen, although default is generally the result of something going wrong in frustration of a party's intentions.

v. Intention to Physically Settle Conclusion

Based upon the *Wright* test, Environmental Commodity counterparties intend to physically settle, as evidenced by the facts that they are able to physically settle, require physical settlement to meet their needs, contract in a manner which requires physical settlement, and do, in-fact physically settle.

IV. General Application of the Forward Contract Exclusion to Environmental Commodities

In question 32 of the NOPR, the Commission asks: "Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime fall outside the Dodd-Frank Act?"

3Degrees asserts that Environmental Commodities as they are commonly transacted for deferred delivery do not meet the swaps definition, and additionally, would be eligible for the forward contract exclusion even if they did meet the swaps definition.[29]

If Environmental Commodity transactions for deferred delivery do not meet any of the swaps definitions, then these transactions would not need to rely upon the forward contract exclusion. All citations refer to the swaps definitions under the Dodd-Frank Act. In order to streamline the analysis, we have distilled the definitions down to their essence.

Section 1a(47)(A)(i) regulates options on commodities;

Section 1a(47)(A)(ii) regulates derivatives which are financially settled based upon events of commercial or financial consequence;

Section 1a(47)(A)(iii) regulates contracts for differences type transactions in which a cash flow is based upon changes in value for an external rate or index, without the accompanying asset transfer;

Section 1a(47)(A)(iv) regulates transactions commonly known as swaps;

Section 1a(47)(A)(v) regulates security based swaps; and

Section 1a(47)(A)(vi) regulates transactions which are hybrid transactions designed to avoid regulation under the other Dodd-Frank provisions.

Environmental Commodity forward transactions as they have been traded both before and after Dodd-Frank do not meet the criteria of any of sub-definitions (i-iv) on their face. Environmental Commodity forward transactions:

- require physical settlement on the part of the seller, removing them from definition (i);
- are not based upon external events or indicies, removing them from definitions (ii) and (iii);
- are not commonly known as swap, removing them from definition (iv); and
- are not securities, removing them from definition (v).

The criteria for definition (vi) is not met because it would be inappropriate because it would be inappropriate to utilize a catch-all provision for the regulation of Environmental Commodities. Environmental Commodity forward transactions have been in existence since before Dodd-Frank was passed. Congress was aware of Environmental Commodities and chose not to include Environmental Commodity forward transactions within its swaps definition. Congress took great

[29] 3Degrees is not asserting that Environmental Commodities could never be traded in a manner which would meet the swaps definition. Rather, 3Degrees is asserting that Environmental Commodity forward transactions do not meet the definition of swaps.

pains to spell out the transactions it wished to regulate under Dodd-Frank. If Congress wanted to regulate Environmental Commodity forward transactions as swaps, it would have included Environmental Commodity forward transactions within one of its swaps definitions. The purpose of this provision is allow the Commission to prevent parties from evading regulation under the other definitions through the use of structured transactions which operate identically to the instruments defined as swaps, but for technicalities are outside of the definition. Environmental Commodity forward transactions are not such instruments.

If we assume for the sake of argument that Environmental Commodity forward transactions do meet the swaps definition, then Environmental Commodity forward transactions are eligible for the forward contract exclusion which Congress included, for the reasons discussed in prior sections of these comments.

There is not a persuasive basis for regulation of Environmental Commodities as swaps. Environmental Commodities do not pose risks which would justify being singled out for increased regulation. In passing Dodd-Frank, Congress sought to increase regulation on those instruments which caused the financial crisis of 2008-2009, and instruments which pose a systematic threat to the economic system. In contrast:

- There is no evidence that Environmental Commodities caused or significantly contributed to the financial crises.
- Environmental Commodities have not been associated with major scandal or fraud, and are already regulated by State Public Utilities Commissions, the Federal Trade Commission, and the Center for Resource Solutions; and
- the Environmental Commodity markets are too small and insular to have a systematic impact on the financial system in the unlikely event defaults were to occur.[30]

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[30] voluntary renewable energy certificate market was valued at between $110 and $190 million in 2008. Lori Bird, et al., *Green Power Marketing in the United States: A Status Report (2008 Data)*, National Renewable Energy Laboratory, September 2009, available at www.nrel.gov/docs/fy09osti/46581.pdf. In 2009, the regulated carbon markets were valued at $144 billion. Katherine Hamilton, et al., , *Building Bridges: State of the Voluntary Carbon Markets 2010*, Ecosystem Marketplace and Bloomberg New Energy Finance, June 14, 2010, available at http://www.bnef.com/WhitePapers/download/28 In contrast, credit default swaps alone were valued at up to $62 trillion in 2007, based on a gross notional amount from $632 billion in 2001. Shannon D. Harrington and Christine Harper, "Wall Street Shrinks From Credit Default Swaps Before Rules Hit," *Bloomberg*, Nov. 28, 2010, available at http://www.bloomberg.com/news/2010-11-29/wall-street-shrinks-from-default-swaps-as-dodd-frank-rules-hit-speculators.html.

Further, the world derivatives market is worth an estimated $600 *trillion* dollars, Louise Story and James Katner, "Europe Investigating Banks Over Derivatives," *New York Times*, April 29, 2011, available at http://dealbook.nytimes.com/2011/04/29/european-regulators-investigating-banks-over-cds/. The fact that the environmental commodities market is orders of magnitude smaller than the derivatives markets suggests that it could have little impact on the financial stability of the United States.

Regulation of Environmental Commodities forward transactions as swaps under Dodd-Frank would not benefit the producers or consumers of Environmental Commodities. On the contrary, additional regulatory burdens would add costs and frustrate another priority of the federal government, increasing renewable electricity generation. As regulatory costs rise, a greater share of the revenue generated by renewable generators for electricity would be diverted from putting projects in the ground, and towards complying with regulatory burdens. This result would run contrary to the goals of Dodd-Frank, the federal government at large, and the generators and consumers of renewable energy.

Environmental Commodities are nonfinancial commodities traded with the intention of physical settlement, therefore they fall squarely within the forward contract exemption as incorporated in Dodd Frank. It is appropriate to allow Environmental Commodities to benefit from the forward contract exemption.

V. Conclusion

3Degrees is thankful for the opportunity to comment on Dodd-Frank rulemakings, and appreciates the diligence with which the Commission is undertaking its statutory obligations. For the reasons set forth herein, 3Degrees urges the Commission to conclude that Environmental Commodities are not swaps under Dodd-Frank qualify for the forward contract exclusion from the Dodd-Frank swaps definition, and to adopt 3Degrees' proposed definitions to several key terms.

If you have any questions regarding these comments, or would like to discuss the NOPR, please do not hesitate to contact me.

Respectfully Submitted,

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