Coalition for Emission Reduction Policy
uscerp.org

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Mr. David Stawick
Secretary, Commodity Futures Trading Commission
Three Lafayette Centre
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Re: Comments of the Coalition for Emission Reduction Policy on Adaptation of Regulations to Incorporate Swaps, 76 Fed. Reg. 33,066 (June 7, 2011)

The Coalition for Emission Reduction Policy[1] ("CERP") appreciates the opportunity to file these comments on the Commodity Futures Trading Commission's ("CFTC" or "Commission") recent proposed rule conforming its existing regulations to new provisions of the Commodity Exchange Act ("CEA") enacted in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Dodd-Frank Act").[2]

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 GHG markets and transactions in GHG allowances and 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. CERP has also filed comments on the Commission's proposed clarification of the term "swap" and its interagency study of oversight of current and prospective GHG markets.[3] For more information about CERP, please see www.uscerp.org.

[1] The Coalition for Emission Reduction Policy was previously named the Coalition for Emission Reduction Projects.
[2] Adaptation of Regulations to Incorporate Swaps, 76 Fed. Reg. 33,066 (June 7, 2011).
[3] *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); 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 (filed July 18, 2011); Response of the Coalition for Emission Reduction Projects to the Commodity Futures Trading

CERP's comments on this proposed rule focus on a single issue that is of great importance to the proper functioning of GHG markets: whether forward transactions in environmental commodities (such as GHG allowances and offset credits) can be "physically settled." 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."[4] In its proposed rule, the Commission invited comment on whether the current definition of the term "physical" in the Commission's existing regulations should be modified to explicitly exclude non-physically deliverable commodities (which CERP interprets as a reference to intangible commodities). The Commission further suggested that it would be confusing and contrary to the plain language of the statute to interpret the term "physical" to include intangible commodities. However, the Commission recognized that it may be appropriate to interpret the term "physical" in contexts where the concept directly arises, such as in the trading of environmental commodities. As the Commission noted in its proposal, any modification to the definition of "physical" will have important implications for the scope of the forward contract exclusion provided in the definition of "swap."[5]

CERP understands that the term "physical" is used in a number of Commission regulations,[6] and that different interpretations of that term may be appropriate in different contexts. Accordingly, CERP takes no position on whether the term "physical" should continue to be defined as part of the Commission's generally applicable regulations, or should instead be defined on a rule-by-rule basis as the Commission suggests. Regardless of whether or how the Commission alters Regulation 1.3(ll) in this rulemaking, however, it is *essential* that the Commission expressly recognize that forward contracts that result in *actual delivery* of environmental commodities are "physically settled" for purposes of the new definition of "swaps." 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. Thus, if the Commission amends the definition of "physical" as a result of this rulemaking, it must make clear that forward contracts involving environmental commodities are no less eligible than contracts in tangible commodities for the forward contract exclusion.

As a legal matter, it is true that the phrase "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:

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

[4] 7 U.S.C. § 1a(47)(B)(ii).

[5] 76 Fed. Reg. at 33,069.

[6] *Id.* (noting that the term "physical" is used in 45 different CFTC regulations).

> 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.

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"—can fall within the forward contract exclusion "so long as [it] is intended to be physically settled."[7] Even the CFTC and the Securities and Exchange Commission ("SEC") jointly refer to forward sales of securities as "physically settled" in their separate rule clarifying the definition of "swap."[8] Contrary to the Commission's suggestion that the forward contract exclusion would be "meaningless" if "'physical' included non-physical,"[9] the text itself implies that Congress did view certain transactions involving intangibles as capable of "physical" settlement.

Congress' use of the term "physically settled" in the Dodd-Frank Act was almost certainly not intended to distinguish between intangible and tangible commodities, but was instead intended to distinguish between transactions that result in *actual delivery* of a commodity or security and those that settle in cash. This understanding 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.[10] In the specific context of environmental commodities, the CFTC has as recently as 2008 referred to futures in

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[7] It is also notable that Congress allowed the forward contract exclusion to apply to any "nonfinancial commodity." The definition of "commodity" in the 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.

[8] Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818, 29,831 (May 23, 2011) ("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).

[9] 76 Fed. Reg. at 33,069.

[10] *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).

European Union emission allowances as being "physically settled" when they result in actual transfer of the allowances in the appropriate government registries.[11]

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."[12] Similarly, the SEC 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.[13] These numerous examples demonstrate that the phrases "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. Using the term "physical" in connection with such transactions has not caused confusion or absurd results, as the Commission suggests in the present rulemaking.[14]

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 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."[15] 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.[16]

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

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[11] 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).
[12] OCC, Administrator of National Banks, Interpretive Letter # 1040 at 1-2 (Sept. 2005).
[13] *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).
[14] 76 Fed. Reg. at 33,069. CERP notes that interpreting the term "physical" to refer to *actually delivered* commodities or interests would exclude certain contracts based on bona fide *non-deliverables*—such as interest rates and temperatures (the two examples mentioned by CFTC in the present rulemaking). Thus, the interpretation of "physical settlement" advanced here would not cause the forward contract exclusion to become unreasonably expansive.
[15] http://www.isda.org/publications/pdf/ISDA-Allowance-Forward-Confirmation.pdf.
[16] MCX – Futures Contracts on Canada Carbon Dioxide Equivalent Units, http://www.mcex.ca/products_MCX_en. Note that this contract is scheduled to be delisted from trading on the MCX after June of this year.

of statutory construction is that the technical meaning should be applied absent evidence of intent to the contrary.[17] 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 phrase "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 its proposed rule interpreting the definition of "swaps," 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."[18] 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."[19]

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 need and 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.

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[17] *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)).

[18] 76 Fed. Reg. at 29,828.

[19] *Andersons v. Horton Farms,* 166 F.3d 308, n.14 (6th Cir. 1998) (quoting *Salomon Forex, Inc. v. Tauber,* 8 F.3d 966 (4th Cir. 1993)).

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 the Commission 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 therefore urges the Commission to make clear that forward contracts involving environmental commodities are "physically settled" if they result in actual delivery, just as for forward contracts in tangible commodities. This clarification is necessary and appropriate regardless of whether or how the Commission amends Regulation 1.3(ll) in this rulemaking. As noted above, our position would not preclude the Commission from making other changes to the current definition of "physical" in Regulation 1.3(ll), as the Commission deems appropriate.

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

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