July 22, 2011

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

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F ST, NE
Washington, DC 20549-1090

Subject: CFTC/ SEC File No. S7–16–11

Re: International Emissions Trading Association response to the Commodity Futures Trading Commission's and Security and Exchange Commission's Joint Proposed Rules and Interpretations regarding "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping"; Federal Register, Vol. 76, No. 99 (May 23, 2011)

Dear Commissioners and Staff,

On behalf of the International Emissions Trading Association (IETA), I am writing in response to the Commodity Futures Trading Commission's (CFTC's) and Security and Exchange Commission's (SEC's) proposed rules regarding "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping", published in the Federal Register on May 23, 2011 (Volume 76, Number 99, Pages 29818-29900).

IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 155 member companies include some of the nation's, and the world's, largest industrial and financial corporations—including global leaders in oil & gas, electricity, cement, aluminum, chemical, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, offset project development, legal, and consulting industries. A full list of our members is available on our website at www.ieta.org.

The Joint Notice of Proposed Rulemaking (JNOPR) published on May 23, 2011 in the Federal Register provided proposed rules and interpretations of Product Definitions for swap transactions. The JNOPR includes clarification of the Forward Contract Exclusion, and under this section the CFTC and SEC ask the following set of questions:

> "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?"[1]

IETA's response to these questions is as follows:

1. **The Forward Contract Exclusion from the swap definition should apply to environmental commodities such as emissions allowances, carbon offsets/credits, and renewable energy certificates.**

As amended by the Dodd Frank Act, the Commodity Exchange Act defines the term "swap" to exclude "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."[2] The CFTC further clarified this so-called "forward contract exclusion" in the May 23rd JNOPR, stating that forward contracts for nonfinancial commodities are commercial merchandising transactions under which the primary purpose of the contract is to transfer ownership of the commodity, not to solely transfer price risk of the underlying commodity. [3]

IETA believes that trades of environmental commodities such as carbon allowances and offsets, emissions allowances, and renewable energy certificates (RECs) are non-financial commodities and should qualify for the forward contract exclusion. Similar to energy commodities such as natural gas or electricity, environmental commodities can be transferred from one party to another, and typically are transferred with the purpose of using the commodity for compliance under a specific regulatory program or voluntary obligation.

Carbon allowances and SO2 and NOx emissions allowances are essentially rights to emit a set quantity of emissions. These rights, known as allowances, are generated and distributed by a Federal or state governmental agency and 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, with the purchasing party obtaining the allowances to use for compliance with environmental regulations.

Carbon offsets are credits granted by a state or regional governmental body or an independent standards organization for activities verified to have reduced concentrations of greenhouse gases. Offset credits are issued in the form of serial numbers, which represent the physical ownership of the credits. These credits are placed in electronic accounts, and may be transferred electronically between account holders, with the purchasing entity using the offsets to meet a regulatory mandate or voluntary commitment to reduce greenhouse gas emissions.

Renewable energy certificates are issued by state authorities or an independent standards organization in an amount equal to the generation of electricity from a qualifying renewable energy facility. These RECs are, again, issued in the form of serial numbers, which represent the physical ownership of the credits. These credits are placed into the electronic accounts of

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[1] **Federal Register**, Vol. 76, No.99, May 23, 2011, Page 29832
[2] Commodity Exchange Act, Section 1a(47)(B)(ii).
[3] **Federal Register**, Vol. 76, No.99, May 23, 2011, Page 29828

facilities producing the renewable energy, and may be transferred between account holders. The purchasing entity can use the RECs for compliance with an obligation to sell a certain percentage of renewable energy. This obligation is met by "retiring", or consuming, a certain number of RECs in a given time period.

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. This study, known as the "Section 750 study", supports IETA's assertion that environmental commodities can be and are routinely transferred among parties, resulting in physical deliveries that would satisfy the CFTC's requirements under its forward contract exclusion.

The Section 750 study distinguishes between the "primary" carbon market, in which allowances or offsets are produced by specific actions (i.e., actions to lower emissions at a specific facility) or distributed by the government through direct allocation or auction to market entities, and the secondary market in which the commodities are bought and sold after their initial entry into the market. As the study states, the secondary market, "…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."[4]

The Study goes on to explain:

> "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."5

IETA agrees with this analysis of the carbon market, which correctly asserts that spot transactions and, more importantly for this discussion, secondary market forward contracts primarily provide for the transfer of ownership of the allowance or offset credit. Therefore, the forward contract exclusion can apply in these circumstances, as implied by the findings of the Section 750 study.

Furthermore, IETA believes the structure and nature of transactions in the carbon market are identical in nature to those in other emissions markets, such as SO2 and NOx allowance trading markets under the Clean Air Act, and in state-administered trading markets for renewable energy certificates (RECs).

IETA also believes the premise contained within the Section 750 study that carbon allowances and offsets can be physically transferred among counterparties, thus making the trades eligible for the forward contract exclusion, should also be applied to other environmental commodities such as SO2 and NOx emission allowances and RECs.

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[4] "Report on the Oversight and Existing and Prospective Carbon Markets", Interagency Working Group for the Study on Oversight of Carbon Markets, January 18, 2011, Page 42.
[5] Ibid.

2. Environmental commodities can be physically settled.

The CFTC's/SEC's question relative to the nature of environmental commodities in the swap definition JNOPR questions whether these commodities can be "physically settled" because they are not tangible commodities in that they "lack a physical existence other than on paper." In other words, one cannot touch it, as you could oil or coal, or consume in a material way, such as electricity or natural gas.

The CFTC/ SEC appear to assert that environmental commodities lack a physical existence and, as a result, cannot be physically settled. However, IETA maintains that when determining the ability to physically settle environmental commodity transactions, tangible does not equal physical.

A physically settled commodity is one that is <u>not</u> 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.

An apt comparison can be drawn to transactions in other intangibles, such as intellectual property rights or broadcasting licenses, where the buyer is certainly expecting a physical settlement, allowing him or her to derive the value embodied in those intangibles.

More germane to the regulation of trades of environmental commodities and their potential qualification for the forward contract exclusion is how they are transacted, and for what purpose.

As discussed above, environmental commodities are produced either by governments for use in meeting particular environmental objectives (i.e. reducing greenhouse gas emissions or controlling emissions that contribute to acid rain or ground-level ozone), or by companies engaging in a specific economic activity (i.e. taking action to emit fewer greenhouse gases or generating electricity from a renewable energy facility). Implied in the act of production of environmental commodities is the need by another party to consume it.

This relationship between supply and demand is similar to oil or natural gas markets, where these commodities are produced for the benefit of entities to consume in their refineries or power plants. Consumption in environmental markets is in the form of retirement of allowances, offsets, or RECs on a registry for either compliance with environmental obligations or to meet voluntary environmental objectives.

This activity of consuming environmental commodities compels physical settlement, and can be easily distinguished from cash settlement typical of swap and futures transactions executed for the purpose of hedging risk. Consumption of environmental commodities is for compliance with legal or voluntary environmental obligations, a purpose that simply cannot be met with cash.

IETA reiterates the ability for environmental commodities to be physically settled, and urges the CFTC to preserve the eligibility of these commodities for the forward contract exclusion.

3. **Applicability of the Forward Contract Exclusion would not result in transactions falling outside of the Dodd-Frank Act that should otherwise have been included within DFA jurisdiction.**

IETA believes the applicability of the forward contract exclusion to environmental commodity markets will not cause transactions that should be subject to the swap regulatory regime to fall outside of the Dodd-Frank Act.

As stated above, contracts for the delivery of environmental commodities are made for physical delivery and are typically conducted for the purpose of transfer of ownership, not managing price risk. Therefore, these transactions would properly fit within the forward contract exclusion under the Dodd-Frank Act. However, the exclusion of forward contracts for environmental commodities will not impact Dodd-Frank Act jurisdiction of other types of transactions involving those or other commodities, any more than application of the forward contract exclusion to any other commodity, such as oil or corn, would impact the Dodd-Frank Act jurisdiction of other types of transactions involving those or other commodities.

It should be noted that certain types of environmental commodity transactions are already under the jurisdiction of the CFTC, or soon will be with the implementation of the Dodd-Frank Act. For example, futures contracts for SO_2 and NO_x allowances and certain carbon allowances are traded on listed futures exchanges, or designated contract markets (DCMs). The Chicago Climate Futures Exchange (CCFE) and the GreenExchange are both DCMs and both list futures contracts for emissions and carbon. The CCFE also lists several REC futures contracts.

The CFTC has oversight of the operations of these DCMs, and therefore the contracts listed on these exchanges. As such, trading in environmental commodity futures contracts are subject to CFTC jurisdiction under the Commodities Exchange Act.

Although most environmental commodity markets are nascent in nature and less developed than energy and many other commodity markets, swaps and options trading of environmental commodities does occur in limited circumstances. For example, physically settled options are actively traded in emissions markets and traded with limited liquidity in carbon markets. IETA anticipates that as these markets mature, counterparties seeking to manage price risk will increasingly turn to swap and option contracts, and liquidity in these products will increase across all product areas.

The CFTC has clear jurisdiction over swap and options contracts under the Dodd-Frank Act[6], and IETA anticipates that the CFTC will exercise its authority over trading in these products.

The Interagency Working Group that authored the Dodd-Frank Act Section 750 study agrees. The report states, "The current legal framework for oversight of derivative markets, as enhanced by the Dodd-Frank Act when it becomes effective in July 2011, will provide for robust and effective oversight of carbon derivatives markets and closely linked derivative markets, such as those based on energy commodities."[7]

IETA is confident that a clear understanding of environmental commodities and their qualification as non-financial commodities that can be physically transferred among counterparties will lead the CFTC to the proper regulatory oversight of these markets. In the instance of contracts for physical delivery of environmental commodities for commercial merchandising purposes, IETA believes the CFTC should apply the forward contract exclusion. For swaps and options products, the CFTC has specific authority under the Dodd-Frank Act to regulate these products.

Thank you for considering IETA's comments. Please do not hesitate to contact our US Director, David Hunter, in IETA's Washington, D.C. office, with questions or for further information.

Sincerely,

Henry Derwent
President and CEO

[6] CEA, Section 1a(47)(A).
[7] "Report on the Oversight and Existing and Prospective Carbon Markets", Page 51.