

THE STATUS OF ENVIRONMENTAL COMMODITIES UNDER THE COMMODITY EXCHANGE ACT

*Matthew F. Kluchenek**

This article examines the role of the Commodity Futures Trading Commission (“CFTC”) in regulating transactions in environmental commodities, such as renewable energy certificates (“RECs”), emissions allowances, carbon offsets and carbon credits. The article examines the general role of the CFTC, the types of products subject to the CFTC’s jurisdiction, the basis for and scope of exclusions to the CFTC’s jurisdiction, and how commodity option transactions could be converted into swaps subject to the CFTC’s jurisdiction.

Ultimately, transactions in environmental commodities may qualify for the forward exclusion from the definition of “swap” under the Commodity Exchange Act¹ (“CEA”)—and thus *not* be subject to CFTC regulation—if the transactions satisfy certain requirements, the most important of which is the parties’ intent to physically settle each transaction. Such an exemption, however, is relatively narrow, and the active “trading” of an environmental commodity may jeopardize the use of the exemption.

I. The Role of the Commodity Futures Trading Commission

A. Jurisdiction and Mission of the CFTC

When Congress created the CFTC in 1974, it conferred upon the CFTC “exclusive jurisdiction” over commodity futures and options thereon.² Unless exempted, futures

* Matthew F. Kluchenek is a Partner at Baker & McKenzie LLP, and heads the Firm’s North America Derivatives practice.

¹ Commodity Exchange Act of 1936, Pub. L. No. 74–675, 49 Stat. 1491 (1936) (codified as amended in scattered sections of 7 U.S.C.), replacing the Grain Futures Act of 1922.

² Commodity Futures Commission Trading Act of 1974, Pub. L. No. 93–463, 88 Stat. 1389 (1974) (codified as amended in scattered sections of 7 U.S.C.). The CEA does not define the term “futures” or “futures contract,” but such contracts are generally defined as standardized contracts to buy or sell a

contracts and options thereon must trade on a commodity exchange that has been designated as a contract market—that is, an exchange or market—by the CFTC in order to be legal and enforceable.³ By contrast, spot and forward transactions—in which the parties intend to make or take delivery of a commodity—are not generally subject to CFTC jurisdiction.⁴

Historically, the CFTC’s regulation of trading in environmental commodities has been relatively limited, but the agency has explored the scope of its boundaries with respect to such commodities. For example, while recognizing that other federal agencies may be better equipped to regulate allocation and recordkeeping requirements associated with the trading of such products, former CFTC Chairman Gary Gensler asserted that oversight by the CFTC of environmental commodities would give it additional experience regulating cash emissions contracts, and claimed that, should Congress seek to regulate cash markets for emission instruments, the CFTC would be well suited to carry out that function. According to Chairman Gensler:

In most respects, emissions contract markets operate no differently than the other commodity markets the CFTC regulates. While each contract – such as sulfur dioxide, soybeans, treasury bills or natural gas – presents its own unique challenges, the regulatory scheme is essentially the same. Carbon markets have similarities to several different markets that fall within our regulatory authority. For example, carbon allowances and offsets are similar to agriculture commodities in that there is a yearly “crop” and important programmatic regulations governing the nature of the product. At the same time, carbon contracts have similarities to financial products. For example, government-issued allowances and offset credits would be similar to Treasury-issued debt instruments. Futures contracts on Treasury debt are among the most actively traded CFTC-regulated products.⁵

commodity for a specified price in the future. In a futures contract, only the price and the quantity of the contracts are negotiated; all of the other terms are standardized and not negotiable. Importantly, a futures contract does not involve the sale of a *commodity*, but the sale of a *contract*, which permits the purchaser to buy or sell the commodity (unless the contract is cash-settled). From a statutory perspective, Congress refers to “futures contracts” in the CEA as “transactions involving . . . contracts of sale of a commodity for future delivery.” 7 U.S.C. § 2(a)(1)(A) (2012). The CEA defines “contract of sale” broadly to include “sales, agreements of sale, and agreements to sell.” *See id.* § 1a(13). The term “future delivery” is defined as excluding “any sale of any cash commodity for deferred shipment or delivery.” *Id.* § 1a(27).

³ *Id.* § 6(a).

⁴ *See* *Dunn v. CFTC*, 519 U.S. 465, 472 (1997) (noting that forward contracts are agreements in which participants “anticipate the actual delivery of a commodity on a specified future date,” while spot contracts are “agreements for purchase and sale of commodities that anticipate near-term delivery”).

⁵ *Global Warming Legislation: Carbon Markets and Producer Groups Before the S. Comm. on Agriculture, Nutrition, and Forestry*, 111th Cong. 3 (2009) (statement of Gary Gensler, Chairman,

Ultimately, Congress did not accept Chairman Gensler’s invitation, but did mandate the formation, via the Dodd-Frank Wall Street Reform and Consumer Protection Act⁶ (“Dodd-Frank Act”), of an inter-agency working group to study the oversight of existing and prospective carbon markets.⁷

B. Dodd-Frank Act

In 2010, Congress enacted the Dodd-Frank Act, which adopted sweeping changes to how the markets in the U.S. for over-the-counter derivatives, and the participants in those markets, are regulated. Many of those changes were implemented by amending the CEA. Through the Dodd-Frank Act, Congress issued a general directive to the CFTC of having as many “swaps” as possible cleared by regulated clearing entities in order to reduce “systemic risk” to the financial markets, and as many “swaps” as possible traded on regulated exchanges, or on or through other regulated entities, in order to increase transparency in the markets.⁸ The Dodd-Frank Act thus makes it unlawful for a person⁹ to enter into a “swap” without complying with the CEA and the numerous rules promulgated by the CFTC.¹⁰

The Dodd-Frank Act was important to the environmental commodity market in two respects, both of which are discussed more fully below: 1) it provided and confirmed the basis for excluding environmental commodities from the definition of “swap” and thus from regulation by the CFTC; and 2) it created the inter-agency working group to study the markets.

C. The Definition of “Swap”

1. Dodd-Frank Act

The cornerstone of commodity futures trading regulations under the Dodd-Frank Act is the definition of “swap.” Generally, if a transaction involves a swap, regulation follows. The Dodd-Frank Act contains a broad definition of “swap” that encompasses most transactions that *transfer financial risk* from one party to the other party.¹¹ The

Commodity Futures Trading Comm’n).

⁶ Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

⁷ See Dodd-Frank Act § 750.

⁸ See 7 U.S.C. §§ 2(h)(1)(A), 2(h)(8)(B).

⁹ Under 7 U.S.C. § 2(e), each counterparty to a swap transaction that is not executed on or pursuant to the rules of a designated contract market is required to be an “eligible contract participant,” or “ECP.” The definition of ECP is set forth in 7 U.S.C. § 1a(18), and 17 C.F.R. § 1.3(m) (2014).

¹⁰ See, e.g., 7 U.S.C. §§ 2(h), 2(h)(8)(B).

¹¹ See 7 U.S.C. § 1a(47)(A).

definition of swap specifies several categories, including:

- Options, including puts, calls, caps, floors and collars;
 - Event contracts;
 - Swap structures in which a fixed payment is exchanged for a floating payment on one or more scheduled dates, with payments linked to the value or level of one or more rates, currencies, commodities, quantitative measures or other financial or economic interests, and which transfers risk associated with a future change in the value or level of the foregoing between the parties without also conveying a current or future ownership interest in an asset; and
 - Instruments that become commonly known to the trade as swaps or by more specific names linked to an underlying commodity or financial measure.¹²
2. *The CFTC's Further Definition of "Swap"*

In July 2011, the CFTC and the SEC adopted joint final rules further defining the term “swap” and other terms in the Dodd-Frank Act (“Product Release”).¹³ The Product Release provides important guidance on the classification of various types of derivative instruments. These classifications determine whether the instruments are subject to regulation by the CFTC or the SEC (or both) or whether they fall outside of either agency’s general regulatory authority under the CEA, as amended by the Dodd-Frank Act.¹⁴ As discussed below, the Product Release examines whether environmental commodities may be subject to federal regulation by the CFTC and the basis for any exemption.

II. The Forward Exclusion

A. Generally

Since its inception in 1936, the CEA has excluded so-called “forward contracts” from federal regulation. The CEA defines the term “forward contract” by excluding such contracts from the term “future delivery”—i.e., from the definition of futures contracts. The operative provision provides that “‘future delivery’ does not include any sale of any cash commodity for *deferred* shipment or delivery.”¹⁵ This language provides the basis for the so-called “forward exclusion,” which refers to the exclusion of forward contracts

¹² *See id.*

¹³ 77 Fed. Reg. 48,208 (Aug. 13, 2012).

¹⁴ *See id.*

¹⁵ 7 U.S.C. § 1a(27) (emphasis added).

from regulation under the CEA and the jurisdictional auspices of the CFTC.¹⁶

Notably, the Dodd-Frank Act amended the CEA to add a forward exclusion to the definition of “swap.”¹⁷ The exclusion applies to “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.”¹⁸ To fall within the exclusion, a transaction must include the following three components:

- a nonfinancial commodity,
- deferred shipment or delivery of the nonfinancial commodity, and
- an intent to physically deliver the nonfinancial commodity.

The CFTC has stated that it intends to interpret the forward exclusion for nonfinancial commodities in the “swap” definition in a manner consistent with its historical interpretation of the existing forward exclusion with respect to futures contracts.¹⁹ The CFTC’s historical interpretation has been that forward contracts are “commercial merchandising transactions,” the primary purpose of which is to transfer ownership of the commodity and not to transfer solely its price risk.²⁰

B. Nonfinancial Commodities

¹⁶ The “forward exclusion” has a lengthy history, originating in the Futures Trading Act of 1921 (“FTA”), Pub. L. No. 67-66, ch. 86, 42 Stat. 187 (1921) (held unconstitutional by *Hill v. Wallace*, 259 U.S. 44 (1922)). As proposed by Congress, the FTA sought to impose a tax on futures contracts—a term not defined in the FTA. During the bill’s Congressional hearings, however, farmers expressed concern over the possible taxation of forward transactions, which farmers replied upon as a critical commercial hedging tool. *See Hearing on H.R. 5676 Before the S. Comm. on Agriculture and Forestry*, 67th Cong. 8-9, 213-14, 431, 462 (1921); *CFTC v. Co Petro Mktg. Group*, 680 F.2d 573, 577 (9th Cir. 1982). In response, the Senate added a provision to the FTA that excluded from the definition of “future delivery” “any sale of cash grain for deferred shipment or delivery.” *See* Pub. L. No. 67-66, 42 Stat. 187. According to the Senate report, the “addition was made in order that transactions in cash grain when made for deferred shipment or delivery, would not fall within the provisions for taxing imposed in Section 4 of the bill.” S. REP. NO. 212, at 1 (1921). In discussing the scope of the provision, Senator Capper, the bill’s sponsor, made clear that “the bill does not concern itself at all with the sale or purchase of actual grain, either for present or future delivery. The entire business of buying and selling actual grain, sometimes called ‘cash’ or ‘spot’ business, is expressly excluded. It deals only with the ‘future’ or ‘pit’ transaction, in which the transfer of actual grain is not contemplated.” 61 CONG. REC. 4762 (1921) (statement of Sen. Capper). The cash forward exclusion was carried forward without change into the Grain Futures Act of 1922, Pub. L. No. 67-331, § 2(a), ch. 369, 42 Stat. 998 (1922), which replaced the FTA, and thereafter was incorporated into the CEA, 7 U.S.C. § 1a(27). The language remains unchanged from inception through today.

¹⁷ *See id.* § 1a(47)(B).

¹⁸ *Id.* § 1a(47)(B)(ii).

¹⁹ *See* 77 Fed. Reg. at 48,227.

²⁰ *See id.* at 48,235 (“[A] transaction entered into by a consumer cannot be a forward transaction.”).

In the Product Release, the CFTC interpreted the scope of the term “nonfinancial commodity” in the forward exclusion. According to the CFTC, a “nonfinancial commodity” is a “commodity that can be physically delivered and that is an exempt commodity or an agricultural commodity.”²¹ Exempt commodities, including energy commodities, metals and agricultural commodities, are nonfinancial by nature.

The requirement that a commodity be able to be physically delivered is designed to prevent market participants from relying on the forward exclusion to enter into swaps based on indexes of exempt or agricultural commodities outside the bounds of the Dodd-Frank Act and settling them in cash, which the CFTC believes would be inconsistent with the historical limitation of the forward exclusion to commercial merchandising transactions.²²

C. Intangible Commodities

The CFTC has interpreted the term “intangible commodity” to qualify as a nonfinancial commodity so long as “ownership of the commodity can be conveyed . . . and the commodity can be consumed.”²³ The CFTC has emphasized that, for an intangible commodity to qualify for the forward exclusion, there must be an intent to physically settle the transaction.²⁴ As discussed in greater detail below, an example of an intangible nonfinancial commodity that qualifies under this interpretation is an environmental commodity that can be physically delivered and consumed (e.g., by emitting the amount of pollutant specified in the allowance).²⁵

D. Deferred Delivery

An essential element of a forward contract is that the delivery of the nonfinancial commodity is *deferred*.²⁶ Delivery is typically deferred for commercial convenience or necessity.²⁷

To the extent that a transaction results in immediate or near-immediate delivery of the commodity, the contract is likely to be characterized as a “spot” transaction. The CEA

²¹ *Id.* at 48,232. The CEA defines an “exempt commodity” as “a commodity that is not an excluded commodity or an agricultural commodity.” 7 U.S.C. § 1a(20). The CFTC defines the term “agricultural commodity” in Rule 1.3(zz). *See* 76 Fed. Reg. 41,048, 41,056 (Jul. 13, 2011).

²² *See* 77 Fed. Reg. at 48,232.

²³ *See id.* at 48,233 (emphasis added).

²⁴ *See id.*

²⁵ *See id.*

²⁶ *See* 7 U.S.C. § 1a(27).

²⁷ *See* 77 Fed. Reg. at 48,228.

excludes “spot” or “cash” transactions from the CFTC’s jurisdiction.²⁸ The CFTC staff has defined a spot transaction as one where immediate delivery of and payment for the product are expected on or within a few days of the trade date.²⁹

According to the Sixth Circuit, “because the CEA was aimed at manipulation, speculation, and other abuses that could arise from the trading in futures contracts and options, as distinguished from the commodity itself, Congress never purported to regulate ‘spot’ transactions (transactions for the immediate sale and delivery of a commodity) or ‘cash forward’ transactions (in which the commodity is presently sold but its delivery is, by agreement, delayed or deferred).”³⁰ Accordingly, transactions in environmental commodities on a spot basis would not be subject to the CEA.

E. Intent to Deliver

Because a forward contract is a commercial merchandising transaction, intent to deliver has been the critical element of the CFTC’s analysis of whether a particular contract is a forward contract.³¹ In assessing the parties’ delivery intent, the CFTC has applied a “facts and circumstances” test in which the CFTC “reads the ‘intended to be physically settled’ language . . . to reflect a directive that intent to deliver a physical commodity be a part of the analysis of whether a given contract is a forward contract or a swap, just as it is a part of the CFTC’s analysis of whether a given contract is a forward contract or a futures contract.”³²

A good example of the line of cases interpreting the intent to deliver requirement is *CFTC v. Co Petro Mktg. Group, Inc.*³³ In 1982, the Ninth Circuit considered a claim by the CFTC that Co Petro, an operator of retail gasoline outlets and a petroleum broker, was

²⁸ See COMMODITY FUTURES TRADING COMM’N, DIV. OF TRADING & MARKETS, CFTC LETTER NO. 98-73 (Oct. 8, 1998) (stating the CEA “does not provide the Commission with jurisdiction over true ‘spot’ transactions”).

²⁹ See *id.* (“In a spot transaction, immediate delivery of the product and immediate payment for the products are expected on or within a few days of the trade date.”).

³⁰ *CFTC v. Erskine*, 512 F.3d 309, 321 (6th Cir. 2008).

³¹ The CFTC observed in its decision in *Wright* that “it is well-established that the intent to make or take delivery is the critical factor in determining whether a contract qualifies as a forward.” *Wright*, CFTC Docket No. 97–02, 2010 WL 4388247 at *3 (Oct. 25, 2010).

³² Further Definition of “Swap,” “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Securities Act Release No. 9204, Exchange Act Release No. 64372 [FSLR Transfer Binders—2002 to Current] Fed. Sec. L. Rep. (CCH) ¶ 89,429 (April 29, 2011). See also *Andersons, Inc. v. Horton Farms*, 166 F.3d 308, 318-17 (6th Cir. 1998) (“The purpose of this ‘cash forward’ exception is to permit those parties who contemplate physical transfer of the commodity to set up contracts that (1) defer shipment but guarantee to sellers that they will have buyers and vice versa, and (2) reduce the risk of price fluctuations.”).

³³ 680 F.2d 573, 576 (9th Cir. 1982).

unlawfully selling off-exchange futures contracts, under which Co Petro sold petroleum “at a fixed price for delivery at an agreed future date,” but “did not require its customer to take delivery of the fuel.”³⁴ As explained by the Ninth Circuit, the customer could designate Co Petro, at a future date, to sell the fuel on its behalf and not take delivery of the fuel. If the cash price rose during the interim period, Co Petro would remit to the customer the difference between the original purchase price and the subsequent sale price. If the cash price decreased, Co Petro would deduct from the customer’s deposit the difference between the purchase price and the subsequent sale price and remit the balance of the deposit to the customer.³⁵

The CFTC alleged that these transactions constituted transactions in futures and thus were required to be traded on an exchange subject to CFTC jurisdiction. In response, Co Petro contended that the CFTC did not have jurisdiction over the transactions because they constituted forward contracts and were thus expressly excluded from the CEA.³⁶

Based upon the CEA’s legislative history, the Ninth Circuit concluded that Congress intended “that a cash forward contract is one in which the parties *contemplate* physical transfer of the actual commodity.”³⁷ In finding that the parties to the Co Petro agreements did not contemplate actual delivery in the future, the court of appeals held that the forward contract “exclusion is unavailable to contracts of sale for commodities which are sold merely for speculative purposes and which are not predicated upon the expectation that delivery of the actual commodity by the seller to the original contracting buyer will occur in the future.”³⁸

Importantly, subsequent book-outs or alternative settlement methods generally will not alter the original character of the agreement as a commercial merchandising transaction so long as the original agreement contemplated physical delivery of the

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 576-77.

³⁷ *Id.* at 578 (emphasis added).

³⁸ *Id.* at 579. However, while most courts have adopted the CFTC’s reasoning, in *CFTC v. Zelener*, 373 F.3d 861, 865 (7th Cir. 2004), the Seventh Circuit (and several lower courts) disregarded any intent or physical delivery consideration. Rather, the Seventh Circuit held that the relevant inquiry was whether the transaction involved “a sale of the commodity,” in which case it would be deemed to be a forward contract, or whether the contract was “a sale of the contract,” in which case it would be considered a futures contract. As a proxy for such an inquiry, the court looked to whether the contract was fungible or, absent fungibility, whether the seller promised to allow the buyer to enter into an offsetting contract on demand. If either condition applied, the contract would be regarded as a futures contract. *Id.* at 868. Nonetheless, the CFTC has continued to adhere to the intent to deliver requirement, as evidenced in the Product Release and subsequent CFTC enforcement actions.

commodity.³⁹ In addition, the presence of certain provisions such as liquidated damages and renewal or evergreen provisions does not necessarily render an agreement ineligible for the forward exclusion.⁴⁰

III. Environmental Commodities

A. Interagency Working Group's Carbon Oversight Study

Prior to the issuance of the Product Release, the Interagency Working Group for the Study on Oversight Carbon Markets ("Interagency Working Group"), led by the CFTC, issued a report on the oversight of existing and prospective carbon markets ("Carbon Report"), fulfilling a requirement established in the Dodd-Frank Act.⁴¹

In its report, the Interagency Working Group recommended that the following four objectives guide the oversight of existing and prospective carbon markets:

- 1) Facilitate and protect price discovery in the carbon markets.⁴²
- 2) Ensure appropriate levels of carbon market transparency.⁴³
- 3) Allow for appropriate, broad market participation.⁴⁴
- 4) Prevent manipulation, fraud and other market abuses.⁴⁵

Based on its study, the Interagency Working Group issued the following recommendations in its report regarding the oversight of existing and prospective carbon markets:

- Rely on the existing regulatory oversight program, as enhanced by the Dodd-Frank Act, for both existing and prospective carbon allowance and offset derivatives markets.⁴⁶
- Ensure that appropriate oversight mechanisms are in place for primary and

³⁹ See 77 Fed. Reg., at 48,227-32.

⁴⁰ *Id.* at 48,240.

⁴¹ See Interagency Working Group for the Study on Oversight of Carbon Markets, *Report on the Oversight of Existing and Prospective Carbon Markets* (Jan. 2011) [hereinafter *Carbon Report*], http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf. The interagency group is composed of the following members: the Chairman of the CFTC, who serves as the group's Chairman, the Secretary of Agriculture, the Secretary of the Treasury, the Chairman of the Securities and Exchange Commission, the Administrator of the Environmental Protection Agency, the Chairman of the Federal Energy Regulatory Commission, the Chairman of the Federal Trade Commission and the Administrator of the Energy Information Administration.

⁴² *Id.* at 49.

⁴³ *Id.* at 50.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* at 51.

secondary allowance and offset markets, reflecting the above objectives and the interdependence of primary, secondary and derivative carbon markets and any unique characteristics or circumstances of such markets.⁴⁷

B. Environmental Commodities Under the Forward Exclusion

Building on the findings and recommendations in the Carbon Report, the CFTC noted in its Product Release that the Carbon Report “suggested that the forward exclusion could apply to agreements, contracts or transactions in environmental commodities” such as emissions allowances, carbon offsets/credits and RECs.⁴⁸ The Carbon Report specifically states:

No set of laws currently exist that apply a comprehensive regulatory regime—such as that which exists for derivatives—specifically to secondary market trading of carbon allowances and offsets. Thus, for the most part, absent specific action by Congress, a secondary market for carbon allowances and offsets may operate outside the routine oversight of any market regulator.⁴⁹

Further, in discussing environmental commodities, the CFTC noted in its release that it:

understands that market participants often engage in environmental commodity transactions in order to transfer ownership of the environmental commodity (and not solely price risk), so that the buyer can consume the commodity in order to comply with the terms of mandatory or voluntary environmental programs. *Those two features—ownership transfer and consumption—distinguish such environmental commodity transactions from other types of intangible commodity transactions that cannot be delivered, such as temperatures and interest rates.* The ownership transfer and consumption features render such environmental commodity transactions similar to tangible commodity transactions that clearly can be delivered,

⁴⁷ *Id.*

⁴⁸ 77 Fed. Reg. at 48,233 n.277. The CFTC chose not to define the term “environmental commodity” because “any intangible commodity—environmental or otherwise—that satisfies the terms of the interpretation [in the Product Release] is a nonfinancial commodity, and thus an agreement, contract or transaction in such a commodity is eligible for the forward exclusion from the swap definition.” *Id.* at 48,233. Regarding a REC, for example, the commission reasoned the “forward sale of a REC transfers ownership of the REC from the producing entity to another entity that can use the REC for compliance with an obligation to sell a certain percentage of renewable energy. Many times, this forward sale takes place prior to the construction of a project to enable developers to secure related project financing.” *Id.* at 48,233 n.285.

⁴⁹ *Carbon Report, supra* note 28, at 42.

such as wheat and gold.⁵⁰

As a result, the CFTC found that “environmental commodities can be nonfinancial commodities that can be delivered through electronic settlement or contractual attestation. Therefore, an agreement, contract or transaction in an environmental commodity *may qualify for the forward exclusion from the swap definition if the transaction is intended to be physically settled.*”⁵¹

Conversely, as described by an industry participant, to the extent that emissions allowances, carbon offsets/credits and RECs are not physically settled (*i.e.*, consumed), but traded in secondary market fashion like a stock or bond, the forward exclusion would likely not apply to the transaction.⁵² Moreover, the CFTC has stated that, if a contract were to include the right to unilaterally terminate an agreement under a pre-arranged contractual provision permitting financial settlement, the forward exclusion would not apply.⁵³

Importantly, the CFTC *does* have authority over forward contracts under the CEA’s anti-manipulation provisions prohibiting manipulation, making false and misleading statements and omissions of material fact to the CFTC, fraud and deceptive practices, and false reporting.⁵⁴

IV. Commodity Options

A. Generally

⁵⁰ 77 Fed. Reg. at 48,233–34 (emphasis added). The CFTC has previously indicated that environmental commodities can be physically settled. *Id.* at 48,233 n.277.

⁵¹ 77 Fed. Reg. at 48,234 (emphasis added).

⁵² *See id.* at 48,235 n.291 (citing a comment letter explaining that, “unlike a stock or a bond, which can be resold for its cash value, purchasers of environmental commodities intend to take delivery of RECs or carbon offsets for either compliance purposes or in order to make an environmental claim regarding their renewable energy use or carbon footprint”); *see generally*, 77 Fed. Reg. at 48,233-35.

⁵³ *See id.* at 48,235 n.292.

⁵⁴ *See, e.g.*, 7 U.S.C. § 12(d) (directing the CFTC to investigate the marketing conditions of commodities and commodity products and byproducts); *id.* §§ 9, 13b, 13(a)(2), 15 (proscribing any manipulation or attempt to manipulate the price of any commodity in interstate commerce and enabling the CFTC to take action against violators). In particular, the CEA prohibits any person to (i) “use or employ, or attempt to use or employ . . . any manipulative or deceptive device or contrivance”; (ii) “make any false or misleading statement of material fact” to the CFTC or “omit to state in any such statement any material fact that is necessary to make any statement of material fact made not misleading in any material respect”; and (iii) “manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce.” *Id.* § 9(1)-(3); *see also* 17 C.F.R. § 180.1(a) (prohibiting manipulation, false or misleading statements or omissions of material fact, fraud or deceptive practices or courses of business, and false reporting in connection with any swap, or contract of sale of any commodity in interstate commerce).

To the extent that an environmental commodity transaction is structured as either a commodity option or is embedded with a commodity option, the contract may be subject to CFTC regulation. Further, commodity option contracts that function as “trade options” are subject to limited CFTC oversight.

B. CFTC Jurisdiction over Commodity Options

Under the CEA, the CFTC has plenary authority to regulate commodity option transactions.⁵⁵ Commodity options are illegal unless and until the CFTC specifically authorizes them.⁵⁶ The CEA, as amended by the Dodd-Frank Act, defines the term “swap” to include “a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more . . . commodities.”⁵⁷ Options on physical commodities are included in the statutory definition of swap.⁵⁸

Under the CFTC’s part 32 rules, any person is permitted to transact commodity options on or subject to the rules of a designated contract market, while only an eligible contract participant (“ECP”) is permitted to transact commodity options bilaterally or on a swap execution facility.⁵⁹

C. CFTC Jurisdiction over Trade Options

CFTC Rule 32.3 provides an exemption from certain of the swap regulations for trade options on exempt commodities (such as energy and metal commodities) and agricultural commodities (such as grain and soft commodities) if the parties to, and the characteristics of, the commodity options satisfy certain requirements.⁶⁰ In order to be eligible for the trade option exemption, three requirements must be met:

- 1) the offeror of a commodity option must be either an ECP or a commercial market participant;
- 2) the offeree must be a commercial market participant; and
- 3) the commodity option must be intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.⁶¹

While most of the CFTC’s swap rules do not apply to trade options, some rules do

⁵⁵ See 7 U.S.C. § 6c(b).

⁵⁶ See 17 C.F.R. § 32.2.

⁵⁷ See *id.* § 1a(47), amended by the Dodd-Frank Act § 721.

⁵⁸ See *id.*

⁵⁹ See 17 C.F.R. § 32.3(a)(1)(i).

⁶⁰ 17 C.F.R. § 32.3.

⁶¹ *Id.* § 32.3(a).

apply to each trade option counterparty.⁶²

D. CFTC Jurisdiction over Forward Contracts with Embedded Volumetric or Price Optionality

Under the CFTC's interpretations, a forward contract may be considered a swap because it is embedded with optionality—either volumetric or price optionality. According to the CFTC, a transaction with *volumetric* optionality is a forward contract (i.e., not a swap) if it meets the following seven-part test:

- 1) the embedded volumetric optionality does not undermine the overall nature of the agreement as a forward contract;
- 2) the predominant feature of the agreement is delivery;
- 3) the embedded volumetric optionality cannot be severed and marketed separately;
- 4) the seller of the underlying nonfinancial commodity intends to make delivery of the commodity if the option is exercised;
- 5) the buyer of the underlying nonfinancial commodity intends to take delivery of the commodity if the option is exercised;
- 6) both parties are commercial parties; and
- 7) the exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors or regulatory requirements that are outside the control of the parties.⁶³

Further, the CFTC has stated that a contract embedded with *price* optionality is likely a forward contract (i.e., not a swap) if the option:

- 1) may be used to adjust the forward contract price but does not undermine the overall nature of the contract as a forward contract;
- 2) does not target delivery terms, so that the predominant feature of the contract is actual delivery; and
- 3) cannot be severed and marketed separately from the overall forward contract in which the option is embedded.⁶⁴

⁶² Such applicable regulations include: part 20 (large trader reporting); part 151 (position limits); subpart J of part 23 (duties of swap dealers and major swap participants); sections 23.200 through 23.204 (reporting and recordkeeping requirements for swap dealers and major swap participants); and section 4s(e) of the CEA (capital and margin requirements for swap dealers and major swap participants). *Id.* § 32.3(c)(1)-(5). Each counterparty to a trade option must comply with recordkeeping and reporting requirements under part 45. *Id.* § 32.3(b).

⁶³ Commodity Futures Trading Commission, *CFTC Division of Market Oversight Responds to Frequently Asked Questions Regarding Commodity Options—Commodity Options FAQ* (Sept. 2013), https://forms.cftc.gov/_layouts/TradeOptions/Docs/TradeOptionsFAQ.pdf; see also 77 Fed. Reg. at 48,238-40.

⁶⁴ *Id.*

A contract with an embedded option that satisfies the applicable test(s) will qualify for the forward exclusion and will not be regulated as a swap. As with other transactions, whether price or volumetric options qualify for the forward contract exclusion will be based on overall facts and circumstances.⁶⁵

Ultimately, to the extent that any contracts are deemed to be swaps because of embedded optionality, the full panoply of the CEA's swap regulations would be triggered. In such a circumstance, the contract would be subject to the various clearing, execution, reporting and recordkeeping requirements under the CEA, and the parties to the transactions may be subject to registration, business conduct and numerous other requirements.⁶⁶

⁶⁵ *Id.* On November 20, 2014, the CFTC published a proposed interpretation that would clarify the CFTC's views with respect to forwards with embedded volumetric optionality. *See* 79 Fed. Reg. 69,073 (Nov. 20, 2014). The proposal targets the seventh element of the volumetric optionality test. In this respect, the CFTC would delete the reference to "the exercise or non-exercise" of the option, which would clarify that the focus of this element is on the intent of the parties, rather than the exercise or non-exercise of the option. The proposal would also delete the requirement that the "physical factors or regulatory requirements" be outside the control of the parties. *Id.* at 69,075-76. Thus, if ultimately approved by the CFTC, the seventh factor would read: "The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity." *Id.* at 69,074. If enacted, such language would represent a significant improvement over the CFTC's extant interpretation.

⁶⁶ *See, e.g.*, 7 U.S.C. § 2(a) (recordkeeping and reporting requirements); § 2(h) (clearing mandate); § 2(h)(8) (trade execution mandate); § 6s(h) (business conduct requirements); § 6s(e) (margin and capital requirements).