

May 2014

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### Repository Citation

Leo Mensah, *Missed Opportunity: Excluding Carbon Emissions Markets from Comprehensive Oversight*, 38 Wm. & Mary Env'tl. L. & Pol'y Rev. 795 (2014), <https://scholarship.law.wm.edu/wmelpr/vol38/iss3/8>

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## MISSED OPPORTUNITY: EXCLUDING CARBON EMISSIONS MARKETS FROM COMPREHENSIVE OVERSIGHT

LEO MENSAH\*

It is not very often that a Commissioner on the United States Commodity Futures Trading Commission (“CFTC”) makes a reference to a mythical fire-breathing creature composed of equal parts lion, snake, and goat.<sup>1</sup> One would think that federal regulators spend their time discussing more important issues. On July 10, 2012,<sup>2</sup> when the outspoken Commissioner Bart Chilton made reference to the chimera,<sup>3</sup> he was intending to capture an important regulatory sentiment regarding the progression of comprehensive regulation and the risks of progressing in a step-by-step fashion. The CFTC’s July 10th open meeting was held to provide a final definition for the term “swap”.<sup>4</sup> The opaqueness of the financial swaps market played a large role in the 2008 financial collapse. While a concrete definition would help give certainty to the financial markets, the definition would have wide-ranging effects for the country’s energy trading markets.<sup>5</sup> The CFTC vote resulted in a four-to-one decision

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\* The author would like to thank his family and close friends for always encouraging him to pursue his interests, think critically, and enjoy the journey.

<sup>1</sup> See Transcript, United States of America Commodity Futures Trading Commission, Open Meeting to Consider Final Rule on Further Definition of the Term “SWAP,” Final Rule on the End-User Exception to Clearing, and Proposed Rule to Exempt from Clearing Certain Swaps by Cooperatives (July 10, 2012), [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfs submission/dfs submission11\\_071012-trans.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfs submission/dfs submission11_071012-trans.pdf) [hereinafter CFTC Open Meeting] (stating, “I’m a little concerned that these good forwards, the forwards that had been used for legitimate purposes, are going to morph sort of chimerical. Remember the mythological creature with the lion’s head, the goat’s body and the snake’s tail? They’re sort of going to morph.”).

<sup>2</sup> See generally COMMODITY FUTURES TRADING COMM’N, FINAL RULES AND INTERPRETATIONS I) FURTHER DEFINING “SWAP,” “SECURITY-BASED SWAP,” AND “SECURITY-BASED SWAP AGREEMENT”; II) REGARDING “MIXED SWAPS”; AND III) GOVERNING BOOKS AND RECORDS FOR “SECURITY-BASED SWAP AGREEMENTS,” [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd\\_factsheet\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd_factsheet_final.pdf) (last visited Mar. 31, 2014) [hereinafter FINAL FACTSHEET].

<sup>3</sup> See CFTC Open Meeting, *supra* note 1.

<sup>4</sup> See FINAL FACTSHEET, *supra* note 2.

<sup>5</sup> CFTC Open Meeting, *supra* note 1.

to exempt energy forwards from the swap definition,<sup>6</sup> thereby exempting such transactions from the comprehensive swap rules of the Dodd Frank Act. Commissioner Chilton<sup>7</sup> was the only commissioner who publicly voiced his concern for the exemption.<sup>8</sup>

Commissioner Chilton's concern over the energy forward exemption is more than a fleeting fear, or an overly cautious reaction, because it stems from an important concern. Market manipulation should be an ever-present concern for regulatory agencies. Manipulation or fraud in any form erodes both the confidence of market participants and the integrity of the markets themselves. The alarming events leading up to the financial crisis of 2008<sup>9</sup> lend credence to Commissioner Chilton's concerns about seemingly small regulatory gaps that can be exploited through linguistic and financial gamesmanship.<sup>10</sup> The chimera is composed of several different parts, which makes it difficult to say exactly what it is. The complexity of nearly unclassifiable financial transactions played a prominent role in the 2008 crash.<sup>11</sup> Similarly, energy forward contracts, which are exempt from CFTC regulations, and energy futures contracts, which are regulated by the CFTC, share many similar complex components,<sup>12</sup> and one contract could very easily be made to look like the other. Although energy forwards were excluded because of specific language within the controlling statutes,<sup>13</sup> Commissioner Chilton was worried that, due

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<sup>6</sup> *Id.*

<sup>7</sup> See generally Commissioner Bart Chilton, U.S. COMMODITY FUTURES TRADING COMM'N, <http://www.cftc.gov/About/Commissioners/BartChilton/index.htm> (last visited Mar. 31, 2014) (explaining Commissioner Chilton's background).

<sup>8</sup> See CFTC Open Meeting, *supra* note 1 ("What we're doing in here, and follow me if you will, guys, is we are excluding all forwards. An exclusion is different than an exemption. Yes, an exemption. An exemption is you could still have bells and whistles. So we're exempting you, but you got to report, you got to do this, whatever bells and whistles we determine to put on. And exclusion is you're off the bus. You might say but you just said that the law said that forwards aren't on your bus. So why do you have a problem with it? It's because of the potential chimerical nature of what the forwards could become.").

<sup>9</sup> See FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xv, xvi (Jan. 2011), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>10</sup> See *id.*; see also Gary Gensler, Chairman, Remarks at the CFTC's Role in Cap-and-Trade, IETA Symposium (Nov. 3, 2009) [hereinafter Chairman Gensler IETA Remarks], available at <http://www.cftc.gov/pressroom/SpeechesTestimony/opagensler-17> ("Last year's [2008] crisis highlighted all too well how opaque markets can threaten the financial system and the American public. There has neither been transparency to the public nor to the regulators in these markets.").

<sup>11</sup> See Chairman Gensler IETA Remarks, *supra* note 10.

<sup>12</sup> See *infra* note 59.

<sup>13</sup> See CFTC Open Meeting, *supra* note 1.

to a language loophole, energy transactions could be subject to manipulation if they were set up as a forward, even though in reality, the contract was closer to a future contract.<sup>14</sup> Such a scheme might allow financial entities to escape the purview of comprehensive CFTC regulations.

On a broader level, Commissioner Chilton was concerned with the CFTC's process of excluding energy forwards and the ramifications that excluding energy forwards would have on the CFTC's regulatory framework.<sup>15</sup> Specifically, he was concerned that the CFTC might be giving too much room to energy markets by completely excluding them from the comprehensive regulations of The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),<sup>16</sup> and CFTC oversight,<sup>17</sup> instead of examining the regulatory needs of energy markets and then determining the appropriate steps to take. Another option, which was not fully discussed at the hearing, would have been to keep the markets under the purview of the CFTC and provided a narrow exemption.<sup>18</sup> Upon looking at each market, the CFTC could get a better understanding of the markets' susceptibility to manipulation and overall risk profile. However, by excluding energy forwards, the CFTC may have relinquished regulatory control over industries where their comprehensive oversight is necessary.<sup>19</sup> The active and proposed carbon markets in the United States provide a pertinent example of an energy market that will suffer as a result of the overly broad CFTC exclusion. These markets are an example of the concerns raised by Chilton and it is the focus of this Note that the carbon trading markets are exactly the type of market that requires CFTC oversight to function properly.

When the CFTC adopted its final swap definition, it excluded carbon forward transactions from comprehensive CFTC regulation,<sup>20</sup> and by doing so it incorrectly ceded control of a market that should rightfully be regulated by the CFTC. The decision was not made in a vacuum. At best, when choosing to exclude the carbon forwards markets from CFTC

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<sup>14</sup> *Id.* (describing how the contracts might not be delivered).

<sup>15</sup> *Id.*

<sup>16</sup> *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376.

<sup>17</sup> *Id.*

<sup>18</sup> Chairman Gensler IETA Remarks, *supra* note 10 (Gensler echoed these sentiments in 2009, stating that "[i]f Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow.").

<sup>19</sup> *Id.* (stating, "I believe that comprehensive regulation of OTC derivatives is a critical component of a well functioning emissions trading market as well.").

<sup>20</sup> *See* FINAL FACTSHEET, *supra* note 2.

regulation, the CFTC incorrectly analyzed the risks associated with the carbon markets,<sup>21</sup> as reported by internal CFTC investigations and other studies readily available to the Commission. At worst, the CFTC ignored the warnings that were set forth in the carbon market report,<sup>22</sup> and ceded control over a market that is susceptible to rampant manipulation.<sup>23</sup>

The Carbon Market Report that was submitted by the Carbon Market Working Group (“Working Group”)<sup>24</sup> was conducted under the authority of the Dodd-Frank Act for the purpose of determining whether further regulation was necessary for the proper functioning of current and proposed carbon markets.<sup>25</sup> Because of its specific purpose and extensive analysis, the carbon market report and its standard of evaluation should have been treated as a persuasive, if not controlling, report. The thorough analysis of the risk profile of the carbon market, and the evaluation of regulatory oversight for other similar emissions markets, provides a compelling rationale that contradicts the CFTC’s exclusion. The Working Group’s recommendation that the CFTC should regulate carbon markets should have been controlling. The CFTC was wrong to adopt a final swap definition that excluded the carbon market from its regulation because the CFTC fallaciously assumed that lack of manipulation now means that such manipulation will not exist in the future. The current and proposed carbon markets in the United States are susceptible to fraud despite their current level of regulations,<sup>26</sup> and the Dodd-Frank Act could have taken steps to rectify current regulatory oversight issues, and prevent problems in the future; however, the exclusion foregoes the

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<sup>21</sup> See INTERAGENCY WORKING GROUP FOR THE STUDY ON OVERSIGHT OF CARBON MARKETS, REPORT ON THE OVERSIGHT OF EXISTING AND PROSPECTIVE CARBON MARKETS 3-4 (2011) [hereinafter REPORT ON OVERSIGHT OF CARBON MARKETS], available at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy\\_carbon\\_011811.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf).

<sup>22</sup> *Id.*

<sup>23</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-851R, COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM: CARBON TRADING: CURRENT SITUATION AND OVERSIGHT CONSIDERATIONS FOR POLICYMAKERS 3-4 (2010) [hereinafter CARBON TRADING: CURRENT SITUATION AND OVERSIGHT CONSIDERATIONS FOR POLICYMAKERS], available at <http://www.gao.gov/new.items/d10851r.pdf> (describing the types of manipulation that could occur within the markets).

<sup>24</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21 (introductory letter from Chairman Gensler to Speaker John Boehner).

<sup>25</sup> *Id.* at 3-5.

<sup>26</sup> See *id.* at 20, 21, 24. See generally JOSHUA SCHNECK & JONAS MONAST, DUKE NICHOLAS INST., FINANCIAL MARKET REFORM AND THE IMPLICATIONS FOR CARBON TRADING, NIR 11-01 (2011), available at <http://nicholasinstitute.duke.edu/sites/default/files/publications/financial-market-reform-implications-carbon-trading-paper.pdf>.

opportunity that the government had to effectively regulate current and future carbon emissions markets within the United States.<sup>27</sup>

#### ROADMAP

This Note will expand upon the concerns that were raised by Commissioner Chilton by examining the adverse effects that the final definition will have regarding the carbon markets in the United States, and provide examples of the chimerical financial transactions that occur in the carbon cap and trade markets. Specifically, the Note will argue that proper application of the standard of review, established by the Working Group,<sup>28</sup> requires the CFTC to regulate the cap and trade markets, and by not regulating the markets the Commission underestimated the susceptibility of carbon markets to manipulation. The decision also undermines the purpose and effectiveness of the carbon markets.

The Working Group standard employs a balancing test as well as a comparative approach.<sup>29</sup> In order to properly understand the standard of review and the implications of the CFTC's decision, the Note will discuss the origin and purpose of the carbon cap and trade markets, including their current regulatory scheme. This Note will also discuss the specific provisions of the Dodd-Frank Act that affect the carbon markets and the statutory authority of the Working Group. By highlighting the important policies that drove the creation of the Act, this Note will show how those policies support a regime that would subject carbon forwards to CFTC regulation. In order to properly understand how to apply the standard (or how it was misapplied in this case), this Note will also juxtapose the carbon emissions market with the regulatory schemes employed by other emissions markets. In conclusion, this Note will discuss the implications that the CFTC decision has for the carbon markets in the United States, and will also look at the options available to correct the mistake.

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<sup>27</sup> See CARBON TRADING: CURRENT SITUATION AND OVERSIGHT CONSIDERATIONS FOR POLICY-MAKERS, *supra* note 23, at 2 ("Under the Commodity Exchange Act (CEA) carbon emissions are considered to be an 'exempt commodity.' Before Congress amended the CEA in the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act, Pub. L. No. 111-203), derivatives on exempt commodities were eligible for limited oversight by the primary U.S. commodities regulator, CFTC. They could be traded between qualified parties on an over-the-counter (OTC) basis generally free from CFTC regulation. CFTC's authority over such trading was limited to instances in which CFTC suspected fraud or manipulation.").

<sup>28</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 49–51.

<sup>29</sup> *Id.*

The CFTC can assert jurisdiction over carbon emissions to prevent manipulation and fraud.<sup>30</sup> Since it made the decision to exclude the carbon markets, the CFTC must have come to the conclusion that there was little to no risk of manipulation or fraud, but this is an erroneous conclusion. Proper application of the balancing test and comparative approach makes it clear that the CFTC misapplied the standard of review when it exercised its judgment to exclude United States carbon markets from its oversight. By applying the standard of review that was established by the Working Group, and by looking at the purpose of the Dodd-Frank Act in conjunction with the shortcomings of the current regulations for the carbon emissions market, this Note will argue that the CFTC erred in its decision, and if steps are not taken to rectify the mistake, the decision will have a negative impact on the functioning of the current and future carbon emissions markets.

## I. CARBON MARKETS AND THEIR PIVOTAL ROLE IN REDUCING EMISSIONS

### A. *Responding to the Greenhouse Crisis*

Coordinated global efforts to reduce the emission of greenhouse gases came to a head with the negotiation of the United Nations Framework Convention on Climate Change (“UNFCCC”) at the United Nations Conference on Environment and Development (“UNCED”), also known as the Earth Summit.<sup>31</sup> One of the major subsequent developments of the Earth Summit was the Kyoto Protocol,<sup>32</sup> an agreement between many of the world’s industrialized countries to reduce greenhouse gas emissions.<sup>33</sup>

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<sup>30</sup> See CARBON TRADING: CURRENT SITUATION AND OVERSIGHT CONSIDERATIONS FOR POLICYMAKERS, *supra* note 23, at 31.

<sup>31</sup> See generally Laurence Boisson de Chazournes, *The Human Impact on Climate Change*, UNITED NATIONS AUDIOVISUAL LIBR. INT’L L., May 9, 1992, at 1, available at [http://legal.un.org/avl/pdf/ha/ccc/ccc\\_e.pdf](http://legal.un.org/avl/pdf/ha/ccc/ccc_e.pdf) (“Global warming, which is the increase in global average temperature in the course of the twentieth century, is mostly due to the increase of atmospheric greenhouse gas (GHG) concentrations caused by human activity; these anthropogenic emissions have increased by 70 per cent between 1970 and 2004.”).

<sup>32</sup> See generally *Kyoto Protocol*, U.N. FRAMEWORK CONVENTION ON CLIMATE CHANGE, [https://unfccc.int/kyoto\\_protocol/items/2830.php](https://unfccc.int/kyoto_protocol/items/2830.php) (last visited Mar. 31, 2014) [hereinafter *Kyoto Protocol*] (“The Kyoto Protocol is an international agreement linked to the United Nations Framework Convention on Climate Change. The major feature of the Kyoto Protocol is that it sets binding targets for 37 industrialized countries and the European community for reducing greenhouse gas (GHG) emissions.”).

<sup>33</sup> *Id.* (describing the purpose of the Kyoto Protocol).

The adoption of the Kyoto Protocol was hailed by some of those involved as one of the greatest achievements of international diplomacy in the late twentieth century,<sup>34</sup> and in order to effectuate the goal of the UNFCCC,<sup>35</sup> the Kyoto Protocol suggests several different methods for countries to manage their greenhouse gas emissions.<sup>36</sup> The United States is one of the largest producers of greenhouse gases,<sup>37</sup> and as a response to the Kyoto Protocol, the United States—along with several other countries—implemented many different programs focused on bringing greenhouse gas emissions in line with the agreement.<sup>38</sup>

The carbon cap and trade system is one of the carbon reducing mechanisms that United States implemented to reduce its greenhouse emissions.<sup>39</sup> Over the course of its introduction and implementation, the cap and trade system has proven to be largely effective.<sup>40</sup> “The International Energy Agency said the U.S. has cut carbon dioxide emissions more than any other country over the last six years.”<sup>41</sup> Total United States carbon emissions from energy consumption peaked at about six billion metric tons in 2007.<sup>42</sup> Since 2007, United States emissions have dropped to levels similar to the emissions that occurred in 1990.<sup>43</sup> The Energy Agency has projected emissions for this year to be around 5.2 billion tons.<sup>44</sup>

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<sup>34</sup> See generally Michael Grubb, *Kyoto and the Future of International Climate Change Responses: From Here to Where?*, 5 INT’L REV. ENVTL. STRATEGIES 1 (2004).

<sup>35</sup> See Boisson de Chazournes, *supra* note 31, at 1 (“[The] stabilization of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system.”).

<sup>36</sup> See *Kyoto Protocol*, *supra* note 32 (stating that “[u]nder the Protocol, countries must meet their targets primarily through national measures. However, the [Kyoto] Protocol also offers them an additional means of meeting their targets by way of three market-based Mechanisms. The Kyoto mechanisms are: International Emissions Trading; Clean Development Mechanism (‘CDM’); Joint implementation (‘JI’). The mechanisms help stimulate green investment and help Parties meet their emission targets in a cost-effective way.”).

<sup>37</sup> See *Global Greenhouse Gas Emissions Data*, EPA, <http://www.epa.gov/climatechange/ghgemissions/global.html> (last visited Mar. 31, 2014).

<sup>38</sup> See *International Climate Partnerships*, EPA, <http://www.epa.gov/climatechange/EPAactivities/internationalpartnerships.html> (last visited Mar. 31, 2014).

<sup>39</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 4–6; MARK JICKLING & LARRY PARKER, CONG. RESEARCH SERV., RL34488, REGULATING A CARBON MARKET: ISSUES RAISED BY THE EUROPEAN CARBON AND U.S. SULFUR DIOXIDE ALLOWANCE MARKETS, at intro. (2008).

<sup>40</sup> See Kevin Begos, *CO<sub>2</sub> Emissions in US Drop to 20-Year Low*, AP IMPACT (Aug. 16, 2012, 10:39 PM), <http://bigstory.ap.org/article/ap-impact-co2-emissions-us-drop-20-year-low>.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

Although the carbon cap and trade system in the United States has been successful at curbing carbon emissions,<sup>45</sup> the system is not perfect. As will be discussed later in this Note, there are several threats that could significantly impact the functionality and efficiency of the cap and trade system,<sup>46</sup> thereby turning this productive emissions reduction strategy into a floundering and inefficient method of climate control. Because this is a relatively new system, it makes sense to think that much of the change has been capturing the low hanging fruit. Now that the easy changes have occurred, any problems that went unnoticed will only be magnified.

*B. Structure and Size of Carbon Markets in the United States*

A closer look at structural mechanisms of the cap and trade system will make it easier to understand and elucidate the concerns over the CFTC's exclusion of the markets from their regulatory oversight.<sup>47</sup> The carbon cap and trade system works by setting a limit on the amount of greenhouse gases that regulated entities are allowed to emit.<sup>48</sup> The mechanisms that make the system effective rely on companies acting in a rational fashion by providing financial incentives to reduce emissions. Regulated entities are provided with emissions allowances that determine the "cap" on their emissions.<sup>49</sup> These emissions allowances, or certificates, are distributed to firms through an auction system or another allocation process.<sup>50</sup>

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<sup>45</sup> *See id.*

<sup>46</sup> *See* CARBON TRADING: CURRENT SITUATION AND OVERSIGHT CONSIDERATIONS FOR POLICY-MAKERS, *supra* note 23, at 2 (stating, "carbon product trading poses various risks and challenges that were similar to those found in other commodity markets. For example, carbon products pose market risk, which is the exposure to losses from changes in product prices. Similarly, carbon product markets face the risk of potential manipulation and fraud. Although no fraud involving carbon products has been identified in the United States since 2001, carbon products traded in Europe have been part of several fraudulent activities, including those involving value-added tax violations. Carbon markets could be significantly affected by political or regulatory changes after implementation of any U.S. cap-and-trade program, but market observers noted that this risk could be mitigated by including elements in the program that increased certainty of its duration and features.").

<sup>47</sup> CFTC Open Meeting, *supra* note 1.

<sup>48</sup> PEW CENTER ON GLOBAL CLIMATE CHANGE, CARBON MARKET DESIGN AND OVERSIGHT: A SHORT OVERVIEW 1 (2010) [hereinafter CARBON MARKET DESIGN AND OVERSIGHT], available at <http://www.c2es.org/docUploads/carbon-market-design-oversight-brief.pdf>.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

The second component of the cap and trade system is an effective market for trading surplus allowances.<sup>51</sup> “Trading provides regulated firms the flexibility either to reduce their own emissions and sell excess allowances, or to buy extra allowances they need from other firms. . . .”<sup>52</sup> One of the reasons that a cap and trade system is preferred, as opposed to other traditional forms of regulation, is that it allows for emissions reductions at the lowest possible cost by incentivizing regulated entities to reduce their emissions.<sup>53</sup> Thus far it seems like incentives have been properly aligned. The goal for companies is to reduce their costs, and the benefit of the cap and trade system is that the cost of emissions is tied to a price that companies can work around. However, “as both the cap and the number of available allowances is reduced over time . . . the price of [greenhouse gas emissions] will rise and create a continuing incentive for firms to find new ways to reduce their emissions”<sup>54</sup> or find ways to reduce the prices they pay for their allowances. This system of incentives will also allow for a reduction in regulatory costs over time, while simultaneously avoiding costs that are associated with traditional regulation and compliance programs.<sup>55</sup> But the reduction in the cap and the increase in price also changes the incentives of participating companies. The incentives change depending on the number of allowances that are available. At one end of the spectrum allowances are numerous and the market is robust. At the other end of the spectrum allowances are scarce and costs of emission are high. Rationality points to the idea that at the high cost level, incentives to cheat will increase as companies seek to find ways to lower their costs. It is difficult to pinpoint exactly where the current markets are on this spectrum, but the goal of the cap and trade program is to slowly reduce overall allowances; therefore, if the program is successful, it will eventually enter into the high cost end of the spectrum.

*C. The Importance of a Well Functioning Market*

The carbon cap and trade system consists of an effective system for creating allowances, but in order for the system to function properly

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<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 2, 3; *see also* REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21 (describing various methods to reduce carbon emissions).

<sup>54</sup> *See* CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 2.

<sup>55</sup> *Id.*

and achieve the economic incentives that make it a favorable reduction mechanism, there must also be an effective market for trading allowances.<sup>56</sup> With respect to the markets, CFTC regulation is fundamental to the success of the emissions reduction program.

Because the trading function of the cap and trade program relies on markets, it is critical that such market transactions are effectively regulated.<sup>57</sup> “To the extent that the market cannot be manipulated or distorted, it can best be used for the purpose it was created—to reduce GHG emissions at the least possible cost to the economy.”<sup>58</sup> Lack of regulation weakens the integrity of current and prospective markets because it paves the way for manipulation and fraud.<sup>59</sup> Manipulation and fraud have the effect of distorting market prices.<sup>60</sup> A cap and trade system operating in a market that sends inefficient price signals to its participants is less likely to incentivize participants to take appropriate actions regarding their carbon emissions.<sup>61</sup>

#### *D. Scope of Market Transactions*

As the allowances in the carbon cap and trade market are reduced over time, the prices of such allowances will likely increase. The theory underlying the cap and trade system is that as the allowances are reduced companies will reduce their emissions as well, but by exempting the carbon forward contracts that will be traded in the secondary market, the CFTC has allowed for a minor loophole that could be exploited by companies seeking alternative means of working within the cap and trade system. The fear is that language within the current regulations will allow traders to slip between the regulatory oversight depending on what type of derivative contract they use as if one contract is truly less open to manipulation and fraudulent activity. However, both carbon forward contracts and carbon futures contracts are open to manipulation that could distort the efficiency of the cap and trade markets.

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<sup>56</sup> *Id.*

<sup>57</sup> See Gary Gensler, Chairman, Testimony Before the U.S. Senate Comm. on Agric., Nutrition & Forestry (Sept. 9, 2009) [hereinafter Chairman Gensler Testimony], available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement090909>.

<sup>58</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 2.

<sup>59</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 20, 24; CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 6.

<sup>60</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 24.

<sup>61</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 4.

As the carbon allowances are reduced, derivative trading will become an increasingly important mechanism to hedge against risk because “[e]mitters in a cap-and-trade system, such as utilities, will have concerns about both the volatility and the future direction of allowance prices, and some will likely look to derivatives as a way to minimize (or *hedge*) these concerns.”<sup>62</sup> Hedging is a financial strategy that seeks to reduce the financial risk of a transaction by taking a counterbalancing position that will offset any losses that occur in the initial transaction. Hedging, if employed correctly, allows market participants to reduce their potential losses in any given transaction.<sup>63</sup> “For example, if a [utilities] firm believes it will need additional allowances in the future and the price at that time will be higher, it might want to purchase allowance futures [in order to avoid incurring the higher future price].”<sup>64</sup>

This leads to several types of derivative transactions that will play a central role in the carbon trading market. This type of secondary trading will be a crucial strategy employed by companies when the emissions allowances are reduced. The forward contract and the future contract are methods used for hedging against the risk of price volatility. The features of these secondary market hedging contracts are nearly identical, with the primary difference being that one contract requires physical delivery of the commodity.

A forward contract is:

A privately negotiated, individualized cash transaction in which a commercial buyer and seller agree upon delivery of commodity at a future date. A price may be agreed upon in advance, or there may be agreement that the price will be determined at the time of delivery.<sup>65</sup>

A futures contract is:

A standardized contract involving an established quantity of an underlying asset (e.g., an allowance) that will be physically delivered or settled for cash at a known future date. The price is determined through the bid and offers that are made on trading platforms such as regulated

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<sup>62</sup> *Id.* at 3 (emphasis in original).

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

exchanges and the price is established at the initiation of the contract. Futures contracts are cleared through a designated derivatives clearinghouse. . . .<sup>66</sup>

Both the forward and futures contract are used for the purpose of buying a certain asset commodity at a specific price at a certain time. In the carbon markets, they would be used when one company estimates that the prices for allowances will increase and chooses to lock in the current price. The primary differences between the two contracts are that the futures contract is guaranteed through a clearing house and is typically a standardized contract. The forward contract is different in that it is done off of an exchange, and the contract is typically individualized and not as rigid as a futures contract. The problem is that because the forward contract can be individualized, two parties could easily create an off exchange forward contract that has all of the characteristics of a futures contract and escape the purview of the CFTC regulation. That is the essential impact of exempting forwards from the swap definition.

The essential aspect of swaps, as they were defined at the CFTC hearing is that they are, "transaction[s] between parties that involve[] an exchange of allowances (or offsets) or other cash-flows in order to maximize revenue or minimize financing costs for each party."<sup>67</sup> While a swap contract will typically involve periodic payments, a forward contract will involve a single payment upon the delivery of the underlying asset. The forward contract could be set up to look like a swap and require periodic payments. With forward contracts occurring off of exchanges and outside the CFTC swap regulations, they will lack transparency and be more susceptible to manipulation and fraudulent activity. In a market "accurate price signals are the most efficient transmitters of economic information, as they indicate when supply is either low or high, when demand is robust or weak, and when firms should take notice of longer-term trends."<sup>68</sup> Therefore it is critical that the market works as efficiently as possible.<sup>69</sup> As a natural extension of its regulatory power, the CFTC should regulate the carbon forwards market because it is empirically clear that as allowances are reduced and incentives are changed market participants will seek ways to reduce their costs in any way possible.

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<sup>66</sup> *Id.*

<sup>67</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 4.

<sup>68</sup> *Id.*; see also REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21; Chairman Gensler Testimony, *supra* note 57.

<sup>69</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 7, 20; Chairman Gensler Testimony, *supra* note 57.

*E. Concerns That Existed Before the CFTC Exclusion*

There are several threats to the market that could significantly impact the functionality and efficiency of the market.<sup>70</sup> Manipulation and excessive speculation reduce the effectiveness of the system and undermine the goals of the Kyoto Protocol.

Efforts to address excessive speculation, price manipulation, and fraud in recent climate bills include specific prohibitions on manipulation and fraud, position limits, limits on the types of instruments that may be traded and where trading may take place, limits on the short selling of regulated allowances, reporting requirements, and restrictions on market participation.<sup>71</sup>

Transparency of carbon markets is critical to providing market participants with accurate price signals that keep the markets operating efficiently, and recent climate bills have instituted several requirements to reach this goal. Provisions within these bills seek to increase transparency by forcing certain transactions to go through an exchange that would clear the contracts. Certain provisions also require increased record keeping and reporting requirements for market participants, and other measures go as far as suggesting the creation of a national market or automated quotation system for the carbon allowances.<sup>72</sup> These proposed measures that seek transparency share the goal of limiting excessive price volatility, which occurs as a result of over speculation.<sup>73</sup> However, the swap definition undermines these goals because it allows for the forward contracts to remain off exchanges, thereby reducing the transparency of the carbon forwards markets.

*F. Oversight That Existed Before the CFTC Exclusion*

The emissions reduction program is critically dependent on a well-functioning market, and a well-functioning market is critically dependent on being free from price distorting activities such as fraud and manipulation. Understanding the current concerns about the carbon markets puts us in a position to properly understand what should have occurred

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<sup>70</sup> See generally Boisson de Chazournes *supra* note 31; REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21; Chairman Gensler Testimony, *supra* note 57.

<sup>71</sup> See generally Boisson de Chazournes *supra* note 31; REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21; Chairman Gensler Testimony, *supra* note 57.

<sup>72</sup> See SCHNECK & MONAST, *supra* note 26, at 3.

<sup>73</sup> *Id.*

at the CFTC exclusion hearing,<sup>74</sup> and lends credence to the concerns raised by Commissioner Chilton.<sup>75</sup> Up to the time of the final swap definition, the trend within the regulatory statutes was toward providing greater oversight. "The majority of climate bills expand regulators' jurisdiction over allowance and derivative markets. Some bills include specific definitions of the kinds of financial instruments subject to regulatory oversight, while others rely on subsequent rulemaking by regulator(s) to define regulated instruments."<sup>76</sup>

The Waxman-Markey ACES bill (H.R. 2454) creates distinct oversight regimes for allowances and derivatives. The bill instructs FERC to develop and implement regulations for oversight of the regulated allowance cash market. At the same time, an interagency working group would develop and recommend to the President proposals for regulating the allowance derivative market. However, the default rule in the bill would assign oversight of this market to the CFTC. The Boxer-Kerry bill (S.1733) included only placeholder language for market oversight, while the Carbon Market Oversight Act proposed by Senators Feinstein and Snowe (S.1399) lays out a comprehensive regulatory framework.<sup>77</sup>

The expansion of the emissions markets, the incentives of market participants, and the growing importance of derivative trading raise legitimate reasons for maintaining regulatory control of the carbon emissions markets with the CFTC. These reasons, which contradict the final swap definition adopted by the CFTC, have been echoed in several environmental bills. "While the Markey bill initially proposed creating an Office of Carbon Market Oversight at the Federal Energy Regulatory Commission (FERC), subsequent bills demonstrate an emerging consensus that the Commodity Futures Trading Commission (CFTC) is best equipped to regulate emissions markets."<sup>78</sup>

Oversight provisions in some bills could be interpreted to cover transactions involving the development of offset projects (i.e., contract

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<sup>74</sup> FINAL FACTSHEET, *supra* note 2.

<sup>75</sup> See CFTC Open Meeting, *supra* note 1.

<sup>76</sup> SCHNECK & MONAST, *supra* note 26, at 3.

<sup>77</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 7.

<sup>78</sup> SCHNECK & MONAST, *supra* note 26, at 3.

sales before a government authority certifies the offset credit as a compliance instrument). “Carbon market bills address the concern by exempting a narrowly defined category of contracts from exchange and clearing requirements or allowing the regulator to determine which financial instruments are subject to the exchange trading and clearing requirements.”<sup>79</sup> Commissioner Gary Gensler recognized the legitimacy of these concerns when he commented at the International Emissions Trading Association during the 2009 Fall Symposium.<sup>80</sup>

Unlike futures contracts, which are cleared on an exchange, forwards contracts would not be subject to the same level of oversight; therefore there is less transparency and a greater risk of fraud and manipulation that would undercut the goals of the carbon cap and trade system.

For a carbon cap and trade system to effectively achieve the goal of reducing carbon emissions it must be supported by regulations that allow both the distribution of allowances and the markets on which those allowances will trade to function effectively. “A well-designed policy should include effective means to prevent excessively high prices (a political as well as economic question), extreme price volatility, and it should include oversight provisions to prevent market manipulation, irresponsible risk-taking, and other problems.”<sup>81</sup> Therefore, as CFTC Commissioner Gensler previously reported, it makes sense that the CFTC would employ its considerable experience to protect the growing carbon emissions markets.<sup>82</sup>

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<sup>79</sup> *Id.*

<sup>80</sup> See Chairman Gensler IETA Remarks, *supra* note 10 (“I believe that comprehensive regulation of OTC derivatives is a critical component of a well functioning emissions trading market as well. As Congress moves forward with potential cap-and-trade legislation, I believe it should fully regulate the expanded carbon trading markets—including the futures market, the OTC market and the cash market—without exception. Ensuring transparency, protecting the price discovery function and addressing financial risk are every bit as critical for emissions markets as other markets.”)

It is crucial to ensure that carbon markets function smoothly, efficiently and transparently. Effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. There are six regulatory components of carbon markets that I believe should be considered:

1. Standard setting and allocation;
2. Compliance with emissions caps and offset requirements;
3. Recordkeeping and maintaining a registry;
4. Overseeing the trade execution system;
5. Overseeing clearing of trades; and
6. Protecting against fraud, manipulation and other abuses.”).

<sup>81</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 2.

<sup>82</sup> See Chairman Gensler IETA Remarks, *supra* note 10 (“The markets should benefit from the protections that we currently have against fraud, manipulation and other abuses as

## II. APPLYING THE WORKING GROUP TO THE CFTC DECISION EXCLUSION

### A. *Purpose of the Working Group*

The CFTC decision to exclude carbon market transactions from the swap definition was not made in an informational vacuum. There were several reports that expressed the concerns raised by Commissioner Chilton.<sup>83</sup> One such report, which should have been a pivotal part of the decision making process, was presented by the CFTC's own interagency group. "Section 750 of the [Dodd-Frank Wall Street Reform and Consumer Protection] Act established an interagency working group to 'conduct a study on the oversight of existing and perspective carbon markets to ensure efficient, secure, and transparent carbon markets, including oversight of spot markets and derivative markets.'<sup>84</sup>

The study accomplishes several things. It provides an analysis of the structure of carbon markets, regulatory oversight of carbon markets, and methods used to achieve regulatory goals. It examines the existing and perspective carbon markets and the economic features of carbon markets that are relevant for analysis of oversight provisions. Finally, it offers recommendations for effective oversight of carbon markets.<sup>85</sup>

The group has four overarching objectives that guide its recommendations.<sup>86</sup> The guiding objectives are: facilitating and protecting price

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directed by the Commodity Exchange Act coupled with any new protections Congress is considering for the OTC derivatives markets. We also must ensure that all transactions in both the carbon futures and cash markets are promptly reported and that a central registry is updated at least on a daily basis. With immediate registry of trades, it will be easier for regulators to identify manipulation in the markets. It is important that companies are able to make long-term capital commitments and hedge their long-term price risk of carbon emissions allowances. That is why it is critical to get the regulatory oversight right of both the futures markets and the over-the-counter markets that may develop out of a cap-and-trade program.").

<sup>83</sup> CFTC Open Meeting, *supra* note 1.

<sup>84</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 3 ("The interagency group is composed of the following members or designees: the Chairman of the Commodity Futures Trading Commission (CFTC), which serves as the Chairman of the interagency group, the Secretary of Agriculture, the Secretary of the Treasury, the Chairman of the Securities and Exchange Commission (SEC), the Administrator of the Environmental Protection Agency (EPA), the Chairman of the Federal Energy Regulatory Commission (FERC), the Chairman of the Federal Trade Commission (FTC) and the Administrator of the Energy Information Administration (EIA).").

<sup>85</sup> *Id.* at 22–24.

<sup>86</sup> *Id.*

discovery in the carbon markets, ensuring appropriate levels of carbon market transparency, allowing for appropriate, broad market participation, and preventing manipulation, fraud, and other market abuses.<sup>87</sup> These guiding objectives are in line with the policy goals of the Dodd-Frank Act,<sup>88</sup> but stand in direct contrast to the final swap definition adopted by the CFTC. It makes for poor regulation when the Commission decides to ignore or misinterprets the very group that was gathered to give them information on the market. It is even more egregious when one considers that one of the participants in the study was the CFTC chairman, and the specialists assembled to conduct the report are highly knowledgeable about the state of the market and the effect of regulations.

The Working Group establishes that one of the primary benefits of a carbon market is the cost effectiveness of a marketplace that sets the price for offsets, and also allows the efficient distribution of such offsets.<sup>89</sup> This benefit would clearly be reduced if the markets were subject to price skewing, manipulation, or market fraud.<sup>90</sup> The group notes that “[f]or markets to operate effectively, it is important that they are free of manipulative and fraudulent activities. In both cases such activity tends to distort prices, leading to decisions by market participants and end-users that are not economically efficient.”<sup>91</sup> As discussed earlier, economic inefficiency has the potential to undermine the entire goal of the cap and trade system.<sup>92</sup>

### *B. The Working Group’s Standard of Review*

In determining whether it makes sense for the CFTC to regulate the Carbon Markets, the Working Group smartly employed both a balancing test based on factors specific to the Carbon markets and a comparative approach based on the regulatory scheme of similar emissions markets.<sup>93</sup> The Working Group largely bases the economic analysis of regulatory oversight by comparing the carbon emissions market to the markets for sulfur dioxide and nitrogen dioxide.<sup>94</sup> The Working Group notes:

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<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* 21, at 7–8.

<sup>90</sup> *See id.*; Chairman Gensler Testimony, *supra* note 57; CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48.

<sup>91</sup> REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 24.

<sup>92</sup> *See* Chairman Gensler Testimony, *supra* note 57.

<sup>93</sup> REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 30.

<sup>94</sup> *Id.* at 10.

In most respects, emissions markets operate no differently than markets for other commodities . . . . This suggests that the same principles that guide the development of market oversight provisions for other markets should do so for carbon markets, [and] the basic features that are generally necessary to facilitate efficient, transparent, and secure markets (e.g., robust participation, liquidity, information, and effective oversight) are also needed for carbon markets. The general tradeoffs that should be considered in establishing the regulatory framework for carbon markets are the same as are present in other markets.<sup>95</sup>

With respect to other commodities, the role of regulators is not only to make sure that such oversight provisions are in place, but also to make sure that such provisions are effective, and facilitate the underlying policy goals.<sup>96</sup>

Carbon product trading poses various risks and challenges that were similar to those found in other commodity markets. For example, carbon products pose market risk, which is the exposure to losses from changes in product prices. Similarly, carbon product markets face the risk of potential manipulation and fraud.<sup>97</sup>

### C. *Comparison to Sulfur Dioxide and Nitrogen Dioxide Markets*

In making its recommendation, the Working Group compares the regulatory scheme of the carbon market to the framework employed by both the sulfur dioxide and nitrogen dioxide emissions markets.<sup>98</sup> The comparison is appropriate because the emissions programs share similar goals

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<sup>95</sup> *Id.* at 30.

<sup>96</sup> *See id.* at 21 (“The objective of market oversight is to ensure that price determination in a market is accomplished efficiently, fairly, and openly so as to reflect the forces of supply and demand. To accomplish this, regulators often focus on four areas of concern that potentially influence how well a market functions. These are facilitation of price discovery, market transparency, optimal market participation, and prevention of manipulation, fraud and other abuses.”).

<sup>97</sup> *See* CARBON TRADING: CURRENT SITUATION AND OVERSIGHT CONSIDERATIONS FOR POLICY-MAKERS, *supra* note 23, at 2.

<sup>98</sup> REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 4.

of lowering emissions,<sup>99</sup> and both programs seek to accomplish their goals through a cap and trade program.<sup>100</sup> Because of the similarities between these markets, the logical conclusion points towards CFTC regulation.

The regulatory framework for the nitrogen dioxide and sulfur dioxide is split among multiple regulatory agencies. “[T]he EPA currently issues allowances on sulfur dioxide and nitrogen dioxide under the Acid Rain [Program].”<sup>101</sup> The acid rain program was one of the first emissions programs to depart from the typical compliance programs and move to a cap and trade system.<sup>102</sup> The NO<sub>x</sub> trading program also follows the cap and trade system to allow for a flexible and market based approach to reducing emissions.<sup>103</sup> The Nitrogen program was implemented in 2003 in an effort to reduce the emissions from large power plants and other large emitters.<sup>104</sup>

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<sup>99</sup> See *Acid Rain Program*, EPA, <http://www.epa.gov/airmarkt/progsregs/arp/> (last visited Mar. 31, 2014) [hereinafter *Acid Rain Program*] (“The overall goal of the Acid Rain Program is to achieve significant environmental and public health benefits through reductions in emissions of sulfur dioxide (SO<sub>2</sub>) and nitrogen oxides (NO<sub>x</sub>)—the primary causes of acid rain.”); *Acid Rain Program Basic Information*, EPA, <http://www.epa.gov/airmarkt/progsregs/arp/basic.html> (last visited Mar. 31, 2014) (“The Clean Air Act Amendments of 1990 set a goal of reducing NO<sub>x</sub> by 2 million tons from 1980 levels. The Acid Rain program focuses on one set of sources that emit NO<sub>x</sub>, coal-fired electric utility boilers. As with the SO<sub>2</sub> emission reduction requirements, the NO<sub>x</sub> program was implemented in two phases, beginning in 1996 and 2000.”).

<sup>100</sup> *SO<sub>2</sub> Reductions and Allowance Trading Under the Acid Rain Program*, EPA, <http://www.epa.gov/airmarkt/progsregs/arp/s02.html> (last visited Mar. 31, 2014).

<sup>101</sup> Chairman Gensler Testimony, *supra* note 57.

<sup>102</sup> *Acid Rain Program*, *supra* note 99 (“The Acid Rain Program represents a dramatic departure from traditional command and control regulatory methods that establish specific, inflexible emissions limitations with which all affected sources must comply. Instead, the Acid Rain Program introduces an allowance trading system that harnesses the incentives of the free market to reduce pollution. Under this system, affected utility units are allocated allowances based on their historic fuel consumption and a specific emissions rate. Each allowance permits a unit to emit 1 ton of SO<sub>2</sub> during or after a specified year. For each ton of SO<sub>2</sub> emitted in a given year, one allowance is retired, that is, it can no longer be used.”).

<sup>103</sup> *Acid Rain Program*, *supra* note 99.

<sup>104</sup> *NO<sub>x</sub> Budget Trading Program/NO<sub>x</sub> SIP Call, 2003–2008*, EPA, <http://www.epa.gov/airmarkets/progsregs/nox/sip.html> (last visited Mar. 31, 2014) (“In 2003, EPA began to administer the NO<sub>x</sub> Budget Trading Program under the NO<sub>x</sub> State Implementation Plan, also known as the ‘NO<sub>x</sub> SIP Call.’ The NO<sub>x</sub> Budget Trading Program (NBP) was a market-based cap and trade program created to reduce emissions of nitrogen oxides (NO<sub>x</sub>) from power plants and other large combustion sources in the eastern United States. NO<sub>x</sub> is a prime ingredient in the formation of ground-level ozone (smog), a pervasive air pollution problem in many areas of the eastern United States.”).

For both the sulfur and nitrogen dioxide cap and trade markets the trading portion is regulated by the CFTC, while the distribution of the allowances are controlled by EPA and other regulators.<sup>105</sup> The CFTC regulates both sulfur and nitrogen due to a combination of statutory authority and because these markets fall under the natural purview of the financial regulators.<sup>106</sup> The controls and goals of the sulfur and nitrogen markets have many of the same goals as the carbon cap and trade program.<sup>107</sup> Where the CFTC has the expertise it should regulate the markets, and despite the differences between emissions markets and other commodities markets,<sup>108</sup> the reasoning for CFTC oversight echoes the sentiments expressed by CFTC Gary Gensler regarding the carbon markets<sup>109</sup> and still points toward CFTC regulation.

The cap and trade program for sulfur emissions also provides a strong example of how a carbon market should be regulated, because, like the nitrogen dioxide market, it has many similarities to the carbon emissions program, and when one extends the reasoning that was employed for the sulfur and nitrogen markets it points toward CFTC oversight.

For the sulfur and nitrogen markets, EPA has traditionally had oversight of the distribution, auctioning, and transference of the emission allowances. This is the part of the cap and trade system that EPA and other environmental regulators have the expertise to manage. With respect to the markets on which the sulfur and nitrogen emissions allowances trade, the environmental regulators are not responsible for their oversight, because they lack the technical expertise. EPA also lacks the price reporting mechanism that provides transparency for emissions

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<sup>105</sup> See generally CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48; Chairman Gensler Testimony, *supra* note 57.

<sup>106</sup> See CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 6.

<sup>107</sup> See REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21; Chairman Gensler Testimony, *supra* note 57.

<sup>108</sup> See JICKLING & PARKER, *supra* note 39, at 20 (“In a 2005 Interpretive Letter approving physically settled emission derivatives transactions, the Office of the Comptroller of the Currency, Administrator of National Banks, states that physical settlement of emission allowances do not pose the same risk as other physical commodities: The proposed emissions derivatives transactions [e.g., futures, forwards, options, swaps, caps, and floors] will be linked to three emission allowance markets: the U.S. SO<sub>2</sub> (Sulfur Dioxide) and NO<sub>x</sub> (Nitrogen Oxide) markets and the European Union’s CO<sub>2</sub> (carbon dioxide) market. These emissions markets are volatile and price fluctuates considerably. Market participants manage price risk through the use of derivative structures, such as forwards, futures, options, caps and floors. These derivatives are generally physically settled, because the current emissions market is primarily physical in nature. . . .”).

<sup>109</sup> See Chairman Gensler Testimony, *supra* note 57.

market transactions. This is one of the primary reasons why the CFTC provides oversight for the trading of sulfur emissions.<sup>110</sup>

EPA does not regulate the trading portion of the cap and trade system because it lacks the expertise. Because of the similarities between emissions contracts and other commodities, the emissions programs fall under the natural purview of CFTC regulation. CFTC Commissioner Gary Gensler felt that:

In most respects, emissions contract markets operate similarly to other commodity markets the CFTC regulates. While each contract—such as sulfur dioxide, wheat, treasury bills or natural gas—presents its own unique challenges, the regulatory scheme is essentially the same. The Commission has thorough processes to ensure that exchanges have procedures in place to protect market participants and ensure fair and orderly trading, that products are designed to minimize potential manipulation and that exchanges comply with the law and regulations.<sup>111</sup>

In addition to their regulatory expertise regarding commodity exchanges, the Commission also has the adequate staff and compliance mechanism in place to monitor and enforce these exchanges and the market participants. Because the Commission has the authority to set position limits for market participants, and monitor the markets for signs of manipulation,<sup>112</sup> it should not have elected to exempt carbon forwards from its oversight.

The similarities between the sulfur, nitrogen, and carbon emissions markets make CFTC control of carbon markets a natural extension of its regulatory power.

There are two main trends that are reflected in both the carbon and sulfur emissions market.<sup>113</sup> One of the similarities is a trend toward increasing market participation from parties not directly related to the carbon market.<sup>114</sup> Another similarity is the increasing use of complex

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<sup>110</sup> See CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48.

<sup>111</sup> Chairman Gensler IETA Remarks, *supra* note 10.

<sup>112</sup> *Id.*

<sup>113</sup> See JICKLING & PARKER, *supra* note 39, at 1.

<sup>114</sup> *Id.* at 27 (“First, there is a trend toward more diverse, non-traditional participants in the Title IV market. Like the Title IV market, the economic importance of a carbon market will likely draw in entities not directly affected by the reduction requirements, such as financial institutions. The motivations of these entities may be equally diverse, including facilitating projects involving the need for allowances, portfolio balancing, and profits earned through intermediary fees or proprietary trading.”).

financial devices to manage the risk associated with allowances through hedging and other secondary trading activity.<sup>115</sup> These trends are also present in the carbon markets. The similarities between the three emissions markets lead to one conclusion. The CFTC should, at the very least, manage the market for trading carbon emissions. It has both the statutory authority to do so, and has the benefit of experience when it comes to managing regulatory oversight of emissions markets. The main difference between the sulfur and carbon markets is the volume of emissions produced by a single industry,<sup>116</sup> but this difference only highlights the crucial role that the CFTC would play in protecting the integrity of the carbon markets.

*D. Balancing the Dodd-Frank Act with the Exemption*

The Working Group believes that the Dodd-Frank Act will achieve comprehensive oversight of the carbon derivative market;<sup>117</sup> however, the Working Group makes the distinction between primary and secondary carbon derivative markets and how they will be affected by the implementation of Dodd-Frank. “[P]rimary and secondary carbon allowance and offset

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<sup>115</sup> *Id.* (“Second, there is trend in the Title IV market toward using financial instruments to manage allowance price risk. This trend is partly the result of the regulatory uncertainty introduced in the allowance market by difficulty EPA is having with the Clean Air Interstate Rule (CAIR). Given the greater economic stakes involved in a carbon market, this trend toward more sophisticated financial instruments is likely to emerge early as a hedge against price uncertainty. The emergence of entities well-versed in the use of these instruments may reinforce the trend and make options, collars, strangles, and other structures as common in the allowance market as they are in other commodity markets.”).

<sup>116</sup> *Id.* at 22 (“reduction scheme, there are several important differences. For example, the Title IV program involves up to 3,000 new and existing electric generating facilities that contribute two-thirds of the country’s SO<sub>2</sub> and one third of its nitrogen oxide (NO<sub>x</sub>) emissions (the two primary precursors of acid rain). This concentration of sources makes the logistics of allowance trading administratively manageable and enforceable with continuous emissions monitors (CEMs) providing real time data. However, greenhouse gas emissions are not so concentrated. In 2005, the electric power industry accounted for about 33% of the country’s GHG emissions, while the transportation section accounted for about 28%, industrial use about 19%, agriculture about 8%, commercial use about 6%, and residential use about 5%. Thus, small dispersed sources in transportation, residential/commercial and agricultural sectors, along with industry, are far more important in controlling GHG emissions than they are in controlling SO<sub>2</sub> emissions. This diversity multiplies as the global nature of the climate change issue is considered, along with the multiple GHGs involved. Thus, a carbon market is like to involve far greater numbers of affected parties from diverse industries than the current Title IV program.”).

<sup>117</sup> REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 50–51.

markets will not be subject to the same comprehensive oversight as derivative markets. Various characteristics of carbon market suggest the need to consider whether additional regulation is necessary for primary and secondary carbon allowance and offset markets.”<sup>118</sup>

Based on the cost of implementing regulations and the costs of foregoing Dodd-Frank regulations, the Working Group recommended to:

1. 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. 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.
2. Ensure that appropriate oversight mechanisms are in place for primary and 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.<sup>119</sup>

The recommendations provide a strong case for including carbon markets in the swap definition, and the actions taken by the United States Commodity Futures Trading Commission are directly contrary to such recommendations.<sup>120</sup> The recommendation is important because the group must have had access to all or most of the CFTC budgetary information and cost benefit analysis. The interagency group’s recommendation is also supported by Commissioner Gary Gensler’s 2009 report, in which he states his belief that the CFTC has the expertise to manage the trading portion of the cap and trade system.<sup>121</sup>

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<sup>118</sup> *Id.* at 51. *But see* JICKLING & PARKER, *supra* note 39, at 31 (“Spot market trades, which would not come under regulation under current securities or commodities law, are another area where abuses could arise from information asymmetries between large, sophisticated traders and smaller firms that rarely use the market. The potential for abuse, however, would be greatly reduced if current price data were easily available to all market participants.”).

<sup>119</sup> REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21, at 51.

<sup>120</sup> *See* CFTC Open Meeting, *supra* note 1.

<sup>121</sup> *See* Chairman Gensler Testimony, *supra* note 57.

*E. Dealing with Shortcomings and Exceptions to Dodd-Frank*

Although the Dodd-Frank Act would not have perfected the regulations, it would certainly have made them stronger for existing and prospective markets.<sup>122</sup> While there is significant overlap between current laws the Dodd-Frank regulations, there are still areas that are left unanswered by both Dodd-Frank and the current laws governing the carbon markets. The areas that are left unresolved include: regulation of the spot market, regulation of end-user transactions, regulation of offset credit transactions, and limitations on carbon market participation.<sup>123</sup> Even with the shortcomings of the Dodd-Frank Act, and taking into regard the issues that would still surround the carbon emissions markets, the benefit to market integrity far outweighs any potential costs.

During the voting on the final swap definition, Bart Chilton recognized the potential problems with the sweeping exclusion.<sup>124</sup> An exclusion differs from an exemption in that when there is an exemption it can be limited and narrow while still maintaining adequate protections and “bells and whistles.”<sup>125</sup> With an exclusion, the Commission does not have the same power to attach conditions. Commissioner Chilton feared “the creation of some chimerical product that is a forward yet has embedded as part of the contract a commodity option . . .”<sup>126</sup> when such an option should be under the CFTC regulation.

Commissioner Chilton’s comment suggests one of the possible alternatives that could have been taken by the United States Commodity Futures Trading Commission. By including carbon derivatives (amongst other energy derivatives) in the definition of swaps, the Commission would then be free to offer exemptions to carbon markets if it determined such exemptions were necessary or appropriate.<sup>127</sup> This would allow for an individual assessment of the risk profile for each market, rather than treating all markets the same with the broad based exclusion. Although

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<sup>122</sup> See SCHNECK & MONAST, *supra* note 26, at 4 (describing the major issues that remain unresolved by the Dodd-Frank Act including: regulation of the allowance (spot) market, regulation of end-user transactions, regulation of offsets credit transactions, limitations on carbon market participation).

<sup>123</sup> *Id.* at 4.

<sup>124</sup> CFTC Open Meeting, *supra* note 1.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> See *id.*; REPORT ON OVERSIGHT OF CARBON MARKETS, *supra* note 21.

this might increase the cost to the CFTC, as noted in the prior section, the benefit outweighs the additional cost.

The United States Commodity Futures Trading Commission has the authority to amend the definition.<sup>128</sup> This is especially important considering that there is the potential for additional carbon markets to come into existence.<sup>129</sup> The head of the CFTC, Commissioner Gary Gensler, held a similar view regarding exemptions prior to the CFTC SWAP definition.<sup>130</sup> Gensler felt that “[i]f Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow,”<sup>131</sup> but the current swap definition that exempts forwards is the opposite of Gensler’s view.

*F. Further Justification for the Balancing Test and CFTC Regulation*

As part of the balancing test, the CFTC should take into account the potential for abuses that may arise in a carbon market not subject to extensive regulatory oversight.<sup>132</sup> Although there have not been any significant instances of manipulation in the carbon emissions markets, the potential for abuse in the carbon markets is substantiated by the abuses that have occurred in other energy markets as a result of deregulation.<sup>133</sup>

The most noteworthy and infamous example of manipulation that occurred at Enron. Although much of the fraud was the result of faulty accounting practices, the deregulation of the California energy markets laid the groundwork for Enron’s market manipulating practices. “The Commodity Futures Modernization Act of 2000 deregulated the market for energy futures,” and created the Enron Loophole.<sup>134</sup> This deregulation

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<sup>128</sup> See CFTC Open Meeting, *supra* note 1.

<sup>129</sup> See SCHNECK & MONAST, *supra* note 26, at 4.

<sup>130</sup> See Chairman Gensler IETA Remarks, *supra* note 10.

<sup>131</sup> *Id.*

<sup>132</sup> JICKLING & PARKER, *supra* note 39, at 1 (“Regulation of [secondary] emissions trading would have to consider two kinds of fraud and manipulation: fraud by traders or intermediaries against other investors, and sustained price manipulation, which is harmful not only to market participants, but potentially to consumers and the economy.”).

<sup>133</sup> *Id.* at 26 (describing what types of manipulation are likely to occur: “[t]he degree to which fraud on the unwary could be a problem depends on how many and what kinds of traders are attracted to the market.”).

<sup>134</sup> See MARK JICKLING, CONG. RESEARCH SERV., RS22912, THE ENRON LOOPHOLE 2–6 (2008).

led to dark markets without transparency, and was described by California State Senator Joseph Dunn as “the greatest fraud ever perpetrated on the American consumer.”<sup>135</sup> Enron’s scams created fake electricity shortages that caused the price of electricity to skyrocket, and caused severe blackouts across the state. In the end, Enron’s scams led to the bankruptcy of a nearly 100 year old energy utility company.<sup>136</sup>

The Enron loophole created by the deregulation of California energy markets allowed over the counter derivatives trading on exempt commercial markets (much like carbon forwards trading on exempt markets) to avoid CFTC regulation, and the results were historically disastrous. The 2008 Farm Bill partially closed this loophole by allowing the CFTC to regulate these trades when it determines that the derivatives play a significant role in price discovery.<sup>137</sup>

Whereas Enron provides an example of energy manipulation in an unregulated market, the “London Loophole” demonstrates that sophisticated parties will use any potential regulatory weakness to their advantage if it aligns with their incentives. The London Loophole was the regulatory gap that allowed foreign speculators to trade certain United States registered commodities on exchanges that were registered in London, thereby avoiding the trading requirements, such as position limits and reporting, that are required of commodities traded on United States exchanges.<sup>138</sup> The CFTC meeting in July 2012 intended to close the “Swaps Loophole.”<sup>139</sup> This loophole allowed large institutional investors to “avoid position limits that would be applicable to direct transactions in the underlying futures.”<sup>140</sup>

With the California market and the potential for a national carbon market, the volume of carbon trading will increase, as will the economic impact or any potential fraud or manipulation. There have already

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<sup>135</sup> See *Examining Enron: Developments Regarding Electricity Price Manipulation in California: Hearing Before the Subcomm. on Consumer Affairs, Foreign Commerce and Tourism of the S. Comm. on Commerce, Sci., & Transp. of the U.S. Senate*, 170th Cong. 2 (2002).

<sup>136</sup> *Id.* at 14.

<sup>137</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 8.

<sup>138</sup> See Senator Carl Levin, Statement on the Close the London Loophole Act (June 12, 2008), available at <http://www.levin.senate.gov/newsroom/press/release/?id=dc568712-730d-4c88-9e8a-a217f7f61fcb>.

<sup>139</sup> See CFTC Open Meeting, *supra* note 1.

<sup>140</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48, at 8.

been examples of abuses in the energy markets,<sup>141</sup> and the risk is compounded by the fact that carbon allowances will be reduced over time.

Due to the murky regulatory provision, it is possible that no single agency would have regulatory oversight of the carbon emissions market. Instead, major energy regulators would form a regulatory patchwork to regulate the markets. Even with a patchwork approach, the CFTC would need to play a pivotal role in regulating the derivative trading and protect the market from fraud and manipulation.<sup>142</sup> Without the oversight of the CFTC, it seems likely that sophisticated parties would be able to take advantage of relaxed regulations and slip between the patchwork scheme of current regulators. The potential for fraud and manipulation stands directly at odds with the CFTC's decision to exclude energy markets.

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<sup>141</sup> See *Excessive Speculation and Compliance with Dodd-Frank Act Before the Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs*, 112th Cong. 1 (2011) (statement of Tyson Slocum, Director, Public Citizen's Energy Program) [hereinafter Tyson Slocum Testimony] (describing abuses in energy trading: "Energy traders like Goldman Sachs are investing and acquiring energy infrastructure assets because controlling pipelines and storage facilities affords their energy trading affiliates an 'insider's peek' into the physical movements of energy products unavailable to other energy traders. . . . *The Wall Street Journal* reported that financial speculators were snapping up leasing rights in Cushing, Ok.11. . . . Armed with this non-public data, a company like Goldman Sachs most certainly will open lines of communication between the affiliates operating pipelines and the affiliates making large bets on energy futures markets. Without strong firewalls prohibiting such communications, consumers would be susceptible to price-gouging by energy trading affiliates.").

<sup>142</sup> See JICKLING & PARKER, *supra* note 39, at 1 ("The Commodities Futures Trading Commission (CFTC) currently oversees the Title IV program and its mission most closely resembles what a regulator of a future carbon market would do, including market surveillance to prevent or detect fraud and manipulation. The major weakness of the CFTC, according to some, is that it lacks resources and the statutory mandate to do its job.

Current derivatives reform proposals would greatly enlarge its regulatory scope. The Securities and Exchange Commission (SEC) is much larger than the CFTC, but it also faces resource and capability issues. While the CO<sub>2</sub> market will resemble commodities markets more closely than securities, SEC has some appropriate regulatory tools applicable to an emissions market.

EPA would likely be responsible for the primary market in allowances. However, EPA lacks experience comparable to that of the CFTC and SEC in regulating trading markets, although the data it gathered in the primary market could be critical to oversight of the secondary market.

Federal Energy Regulatory Commission (FERC) was granted oversight authority over bulk electricity and interstate natural gas markets in 2005. Its experience with market surveillance and enforcement is thus limited in comparison to the SEC and CFTC, and it does not play an active role in overseeing the Title IV market.").

## CONCLUSION

The Dodd-Frank Wall Street Reform and Consumer Protection Act was a direct response to the recession that occurred in the late 2000s.<sup>143</sup> The Act marked the largest and most significant regulation of the financial industry since the great depression, and its sweeping effect impacts nearly all of the financial and regulatory agencies in the United States.<sup>144</sup> The explicit purpose of the Dodd-Frank Wall Street Reform and Consumer Protection Act is to protect consumers and financial markets from manipulation.<sup>145</sup> One of the ways the Act accomplishes this task is by bringing financial swaps—the financial instruments at the heart of the financial crisis—under the regulation of the United States Commodity Futures Trading Commission.<sup>146</sup> The goal of the regulation is to bring greater transparency to the markets so that it will be harder to manipulate,<sup>147</sup> the idea being that transparency will bring about greater efficiency and stability. Other methods of reform include: creating new agencies to monitor financial stability within the country,<sup>148</sup> improving the transparency of financial markets, new participation requirements for market participants,<sup>149</sup> new compliance requirements for financial institutions,<sup>150</sup> and greater protections for investors.<sup>151</sup> The goal clearly is to prevent both systemic risk and manipulation/fraud in the marketplace. The result of the balancing test, comparative test, and result of the potential calamity that could result make it clear that this goal should

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<sup>143</sup> See generally Dodd-Frank Wall Street Reform And Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376.

<sup>144</sup> See Damian Paletta & Aaron Lucchetti, *Law Remakes U.S. Financial Landscape*, WALL ST. J., <http://online.wsj.com/news/articles/SB10001424052748704682604575369030061839958?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052748704682604575369030061839958.html> (last updated July 16, 2010, 12:01 AM).

<sup>145</sup> See generally Dodd-Frank Wall Street Reform And Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376.

<sup>146</sup> *Id.* (Title VII of the act describes the extensive new requirements for over the counter derivatives.).

<sup>147</sup> *Id.*

<sup>148</sup> CARBON MARKET DESIGN AND OVERSIGHT, *supra* note 48.

<sup>149</sup> See generally Dodd-Frank Wall Street Reform And Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (describing the new requirements for participation in the swaps markets).

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

extend to current and future carbon markets. These are all concerns that the CFTC knew about; however, it ignored the Working Group and its recommendation, and by doing so CFTC deregulation has already begun to weaken the carbon markets.<sup>152</sup>

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<sup>152</sup> See Tyson Slocum Testimony, *supra* note 141 (“The Commodity Futures Modernization Act of 2000 deregulated energy trading, undermining CFTC authority over broad swaths of the market and ushering an explosion in volume in unregulated OTC markets and underregulated electronic exchanges, or Exempt Commercial Markets (ECMs)—as evidenced by one such entity, ICE, which operates both as an ECM as an OTC market operator. ICE’s electronic exchange volume increased 826% from 2004 to 2010 (from 35 million contracts to 329 million) and the company’s OTC platform has seen volume grow 976%, from 31 million contracts in 2004 to 333 million in 2010. The bulk of the ‘speculators’ are financial institutions, such as Goldman Sachs, JP Morgan Chase/Bear Stearns, Morgan Stanley and Bank of America/Merrill Lynch. Such firms have turned energy markets into lucrative profit centers for the firms, taking full advantage of the lack of regulatory oversight over their operations to maximize market power and control information.”).