

Who's In Charge of Carbon Markets?



Allowance trading needs oversight, but don't overdo it.

BY CATHERINE KRUPKA AND SUSAN LAFFERTY

“Cap-and-trade won't work.”

So says the *Los Angeles Times* in a March 10, 2008 opinion.¹ Recalling the state's experience when it deregulated the power markets and how that effort enabled “unscrupulous traders such as Enron to manipulate the market” the newspaper warns, “We could be looking at deregulation *déjà vu*. Carbon-trading markets are easy to manipulate and produce volatile energy prices, and the political influence of business and other lobbies can skew the system to produce unfair outcomes.”²

Although this opinion focuses on California's attempt to manage greenhouse gas (GHG) emissions, federal lawmakers have expressed similar concerns as Congress considers omnibus climate change legislation. Senators Dianne Feinstein (D-Calif.) and Olympia Snowe (R-Maine) have proposed anti-manipulation laws for the emissions markets premised on laws applicable to manipulating securities prices. The Lieberman-Warner Climate Security Act of 2008 (S.3036), the leading federal cap-and-trade proposal, would establish a “Carbon Market Working Group” to ensure the integrity of the emissions allowance markets.

Is the U.S. on the right track when it comes to regulating the emissions markets? Not necessarily.

Anti-Manipulation Proposals

Conventional wisdom is that, due to the distraction of the November elections and the state of the economy, Congress will wait until at least 2009 to enact a federal cap-and-trade program, including any emissions market oversight provisions. Nevertheless, this year's Congressional activity will set the stage, so it's worth focusing now on the debate over how Congress should address concerns about the impact of GHG-reduction efforts on consumer prices,

including the price of energy.

One aspect of the debate is to what extent a market-based cap-and-trade model is vulnerable to market manipulation and whether speculator participation in the emissions markets will raise the price of allowances or make them more difficult for emitters to secure. For example, another *L.A. Times* opinion piece, from May 28, 2007, observes, “Also hoping to profit, honestly or not, would be carbon traders. Large financial institutions would jump into the exchange to collect commissions on carbon trades, just as they do with crude oil and wheat. This presents opportunities for Enron-style market manipulation.”³ An October 2007 Congressional Research Service report made a similar point, noting, “Since there is widespread suspicion that excessive speculation by hedge funds and others has affected energy prices in recent years, the possibility that the price of allowances could also be subject to distortion or manipulation will be a policy concern.”⁴

Why might Congress worry? The sheer size of the carbon markets suggests to some that the ill effects from their manipulation might be considerable. The Congressional Research Service estimates the United States is expected to distribute 5 billion GHG allowances per year, valued at between \$72 to \$122 billion (likely more) as compared to the current SO₂ markets that involve 9 million annual allowances valued at \$4.5 billion.⁵ Thus, introducing some kind of legal safeguards to prevent the potential adverse consequences of “Enron-style manipulation” in the emissions markets might be smart politics. But there also is the danger of unintended consequences if an irrational fear of speculation causes Congress to structure those safeguards in a way that chills the market participation needed to create robust, liquid allowance markets. When weighing these competing goals, Congress has not yet struck the right balance.

Too Many Chefs

Senators Feinstein and Snowe introduced the “Emission Allowance Market Transparency Act of 2007” (S.2423) last December. In a press release accompanying the bill’s introduction, Sen. Feinstein said “the measure is designed to prevent future Enron-like fraud and manipulation in greenhouse gas credit markets.” An individual or entity that violates the statute or the EPA’s regulations would be subject to a fine of \$1 million, up to 10 years in prison (five years more than under the CFTC or FERC anti-manipulation rules), or both, per violation. The bill would not create any private right of action, leaving enforcement to government prosecutors.

The bill would facilitate price transparency in the emissions allowance markets, taking into consideration the public interest, market integrity, fair competition, and consumer protection. The “markets” include “markets for real-time, forward, futures, and options.”

Notwithstanding the broad purpose of the bill, the proposed definition of “emissions allowance” could create unintended oversight gaps. The bill would define an emission allowance as “any allowance, credit, or other permit issued pursuant to any federal law (including regulations) to any individual or entity for use in offsetting the emissions of any pollutant (including any greenhouse gas) by the individual or entity.”

On the one hand, the reference to any allowance “issued pursuant to any federal law” would appear to cover allowances for non-GHG emissions like SO₂, thus broadening the scope. On the other hand, this same language would exclude some important types of allowances and other certificates, credits or offsets, such as those traded in the voluntary, state, and international markets, or federal allowances that an emitter holds for uses other than offsetting its emissions. It also would exclude allowances that Congress issues to non-

emitting entities, such as states and localities, non-profits and possibly distribution utilities.

It also isn’t clear whether the definition would apply to allowances traded in the secondary markets. For example, the federal government might issue an allowance to an emitter so that it can offset its pollution emissions, and this allowance would be covered. However, none of the GHG legislation currently being considered would require a receiving entity to use an allowance only to

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reduce its emissions. Indeed, that would be anathema to a cap-and-trade program, which is designed to give emitters flexibility to choose how to manage emissions compliance, including by selling the allowance for cash. Once an allowance leaves the initial recipient’s possession, it is no longer held by the entity contemplated by the definition of a regulated allowance, and might not fit the definition in the Feinstein-Snowe legislation.

Dueling Agencies

To address market manipulation in the emissions markets, the Feinstein-Snowe bill would make the following emissions trading activities unlawful:

■ To knowingly provide the EPA or its delegates any false information relating to the price or quantity of emission allowances sold, purchased, transferred, banked or borrowed by the individual or entity, with the

intent to fraudulently affect the data being compiled by the EPA or other entity gathering information for the EPA.

■ Directly or indirectly, to use in connection with the purchase or sale of an emission allowance any manipulative or deceptive device or contrivance, within the meaning of section 10(b) of the Securities Exchange Act of 1934, in contravention of such rules and regulations as the EPA may prescribe to protect the public interest or consumers.

■ To cheat or defraud, or attempt to cheat or defraud, another market participant, client, or customer.

The EPA also would be required to monitor trading to prevent false reporting, manipulation, and fraud.

These provisions beg a series of questions. Would the law cover the emissions-trading landscape? The answer is that it depends on what Congress is trying to achieve. Reading the plain text of the statute, it would give the EPA authority over activities related to “emissions allowances” the federal government would issue to entities using them to reduce their pollution emissions. But the anti-manipulation provisions wouldn’t apply to any other allowances trading throughout the United States and internationally, and wouldn’t apply to market participants other than emitters that were the initial recipients of the allowances.

The second question is whether 10b-5 is the appropriate standard for regulating the emissions-trading market, and the answer is no. Congress seems fixated on using 10b-5 as a model for anti-manipulation statutes. For example, it adopted this standard in the anti-manipulation laws related to FERC’s regulation of the wholesale natural gas and power markets.⁶ But this reliance is misplaced. 10b-5 is an anti-fraud statute that generally applies when there is a duty to disclose (*e.g.*, when a statute

requires disclosure, when an insider trades on non-public information, or where a fiduciary or other relationship or trust exists). At this time, there is no duty to disclose in the emissions-trading regime. A more appropriate model would be CFTC's manipulation provisions, because they address the activity that seems to be of concern to Congress by making it a felony for "Any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery ... or to corner or attempt to corner any such commodity."⁷

Third, what constitutes an action "in connection with the purchase or sale of an emission allowance?" Drawing from the CFTC and FERC debate in the *Amaranth* enforcement cases, the "in-connection-with" language likely will create regulatory uncertainty over who regulates what. In the Energy Policy Act of 2005, Congress used the same "in-connection-with" phrase to frame the scope of FERC's authority to pursue evidence of manipulation in the power and natural gas industries. When investigating Amaranth's alleged manipulation of the natural gas markets, FERC read broadly the "in-connection-with" language to allow it to take enforcement action against Amaranth even though Amaranth's activity was in the futures markets. FERC argued Amaranth's activities related to the NYMEX natural gas futures contract adversely impacted the physical markets because natural gas futures contract prices serve as a significant benchmark for prices in physical natural gas. FERC's action has made it difficult for market participants to understand where FERC's exclusive jurisdiction ends and the CFTC's exclusive jurisdiction begins.⁸ Worse, it's created in-fighting between the two agencies.⁹

The Feinstein-Snowe bill runs the risk of enabling the same turf battle to occur among the CFTC, FERC and the

EPA related to emissions-allowance trading. First, FERC's expansive interpretation of its enforcement authority might cause it to believe that any emissions-allowance manipulation is sufficiently connected to wholesale power or natural gas to give FERC jurisdiction. Second, notwithstanding a provision stating that the bill would not abrogate the CFTC's jurisdiction, the bill still would give the

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EPA authority over markets that have long been within the exclusive jurisdiction of the CFTC (*i.e.*, futures). For example, the Chicago Climate Exchange and NYMEX already offer emissions allowance futures, options and swaps contracts subject to CFTC oversight. Third, the bill does not make the EPA's jurisdiction exclusive. The Senators might want concurrent jurisdiction to ensure no manipulation slips through the cracks. However, to remove the potential confusion and wasted compliance costs created by dueling agencies, it would be more productive to make it clear that only one agency has anti-manipulation authority over the emissions-trading markets. That agency should be the CFTC. Which leads to the next question: Does the EPA have the expertise to enforce the law? Again the answer is no. The EPA has substantive expertise on environmental issues and the SO₂ allowance program it administers. However, understanding

environmental compliance is only one piece of the puzzle. Understanding how markets work is at least as important, and the EPA hasn't proven itself particularly apt in this regard. The CFTC appears to be better equipped to regulate the emissions trading markets. It understands the defined markets (*i.e.*, real-time, forward, futures, and options), and is experienced with the trading platforms on which allowances trade (*e.g.*, NYMEX, CCX), including as a regulator of SO₂ futures and derivatives trading today. The CFTC has an enforcement staff that could be trained to cover U.S. GHG emissions-allowance trading, while the EPA does not. The CFTC also has cooperation agreements with foreign regulators that would help address the international nature of the emerging carbon markets. Finally, the CFTC is familiar with at least some of the industries that will be covered, including the energy sector. So bringing the CFTC up to speed appears to be the easiest, most logical solution.

Should Congress give more than one federal agency enforcement authority over manipulation of the emissions allowance markets? No, only one agency at a time should be regulating emissions-allowance activity. It might make sense for the EPA to have enforcement authority over fraud and manipulation that occurs during the process it would follow to assess GHG emissions and distribute allowances, but the EPA shouldn't regulate emissions-allowance trading once it has distributed those allowances. If it wants to regulate emissions-allowance trading, Congress should pass the oversight baton to the CFTC by expressly stating that neither FERC nor the EPA have jurisdiction over manipulation in those trading markets.

Devilish Details

Under the bill, the EPA would issue regulations that provide for the timely dissemination of allowance price and

availability data to the EPA, state regulators, market participants, and the public. The EPA could gather the information or hire someone to gather and disseminate the information for it. The EPA must consider the degree of relevant price transparency provided by price publishers and trade processing services in existence when the bill is enacted.

Congress should consider changing the transparency provisions to give the EPA (or preferably the CFTC) the discretion to gather data if the market itself, through such entities as Bloomberg, Platts, or various trading platforms, doesn't publish allowance data. The legislation also should consider that extensive information on emissions allowances will be lacking "when this bill is enacted" because federal GHG allowances won't exist until Congress enacts climate change legislation and the EPA implements the program. Thus, the bill's language needs to adjust the timing for assessing whether there is adequate data available from public sources.

Proposed position limits and accountability rules also need some clarification. Senators Feinstein and Snow would require the EPA to adopt position limits or accountability rules for speculators on the transaction quantities that an entity is allowed to conduct, and the positions the entity is eligible to hold, in any emission allowance market or any federal emission-allowance auction. The bill also would create an exception for a transaction or position that is a *bona fide* hedging transaction or position. The EPA would issue regulations defining the term "*bona fide* hedging transaction or position."

Although the EPA would be required to consult with the CFTC, FERC and FTC in implementing these requirements, the CFTC clearly has more experience than any of the other agencies in establishing and enforcing position limits and hedge exemptions, and thus it should be given the task for the carbon

markets.¹⁰ Congress also should consider allowing exchanges to assist with oversight, including by letting them set position limits or accountability rules, as is currently done under the CFTC's regulations.

The Lieberman-Warner climate change bill improves on Feinstein-Snowe by establishing a "Carbon Market Working Group" to ensure the integrity of the

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allowance markets. The Group would consist of the EPA administrator, the treasury secretary, the chairs of FERC, the CFTC and the SEC, and any other executive branch official appointed by the president. Taking into consideration the recommendations of the group, the president would delegate to its members and the heads of other appropriate federal entities the authority to adopt regulations for enhancing the integrity, efficiency, orderliness, fairness, and competitiveness of the U.S. emissions-allowance markets. Thus, the Lieberman-Warner bill allows the possibility that the group might see the wisdom of recommending the CFTC be given federal oversight authority for the U.S. emissions trading markets.

The group would focus on efforts that include achieving comprehensive emissions-market oversight and enforcement, including cooperation with other national and international oversight regimes. It also would be charged with recommending efforts aimed at ensuring market transparency and avoiding excessive speculation, thus mirroring certain of the

objectives in the Feinstein-Snowe bill. In addition, the group would be charged with the core principle of ensuring the emissions markets are designed in a manner that prevents fraud and manipulation, including as a result of market power concentration or the abuse of material, nonpublic information.

To achieve these, the working group—in consultation with emissions-market participants, exchanges, clearing entities, the FTC, the Federal Reserve and a variety of other entities—would identify and report on: 1) the major issues related to developing a U.S. emissions market that has integrity and is efficient, orderly, fair, and competitive; 2) any relevant recommendations provided by federal, state, or local governments, organizations, individuals, and entities; and 3) activities (such as market regulation, contingency planning and policy coordination) to carry out those recommendations. Within nine months of enactment, and based on the outcome of the group's activities, the federal agencies to whom the president would have delegated rulemaking authority would promulgate rules to achieve the recommendations of the group and the statute.

Within that same time frame, the EPA administrator also would enter into a memorandum of understanding with the head of each appropriate federal agency that would address regulatory and enforcement coordination, information sharing, and other matters to minimize duplicative or conflicting regulatory efforts. Although a clear statutory allocation of enforcement authority would be the preferred way of avoiding another Amaranth-like debate, the MOU proposal at least provides a forum for attempting to avoid inter-agency conflicts.

In sum, the Lieberman-Warner bill appears to be an improvement over past emissions market oversight proposals, but there remains the possibility that the group approach could (Cont. on p. 64)



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Carbon Markets

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result in a complex, bureaucratic oversight model that protects political fiefdoms at the expense of regulatory clarity and market liquidity. Moreover, until a climate change bill is actually passed, it's also possible Senators Feinstein or Snowe will attempt to substitute their approach for the one included in the Lieberman-Warner bill, or whatever bill the Senate or House considers.

Given all the uncertainties raised by proposed legislation, the key question might not be "who's in charge of carbon markets?" but instead "who isn't in charge of carbon markets?" In its fear of [a repeat of Enron, Congress might be more willing to layer the oversight rather than streamline it by designating the

agency most capable of regulating a new market—the CFTC—as the sole regulator. Even as it becomes clearer that climate change legislation will not pass in 2008, the next Congress could address the oversight conundrum sooner rather than later. ■

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Endnotes:

1. "California's Cap-and-Trade Won't Work," *L.A. Times*, Mar. 10, 2008.
2. id.

3. "Time to Tax Carbon," *L.A. Times*, May 28, 2007.
4. *Air Pollution as a Commodity: Regulation of the Sulfur Dioxide Allowance Market*, Congressional Research Service, RL34235, at 2, Oct. 31, 2007, (the "CRS Report").
5. *CRS Report*, at 21.
6. 16 U.S.C. § 824.
7. CEA Section 9(a)(2), 7 USC § 13(a)(2).
8. See *CFTC v. Amaranth Advisors LLC*, Case No. 07 Civ. 6882 (S.D.N.Y.).
9. Letter to CFTC Acting Chairman Walter Lukken from Senators Dianne Feinstein (D-Calif.), Maria Cantwell (D-Wash.), and Ron Wyden (D-Ore.), dated Sept. 21, 2007: "We believe that a jurisdictional battle between the CFTC and FERC will weaken both Commissions, and could significantly constrain our government's ability to pursue future market manipulation cases under the authority and penalty regime Congress created just two years ago."
10. See CEA Section 4a(a), 7 USC § 6a(a); CFTC Regulation 1.3(z), 17 CFR § 1.3(z).