



Comments to the WCI Markets Committee
Regarding Draft Recommendations on Market Oversight
May 3, 2010

The International Emissions Trading Association (IETA) very much appreciates this opportunity to comment on the Market Oversight Draft Recommendations offered by the Markets Committee of the Western Climate Initiative (WCI) on April 1, 2010.

IETA has been the leading voice of the business community on the subject of emissions trading since 2000. IETA supports efforts to address the pressing environmental challenge of climate change, and is dedicated to the establishment of environmentally effective market-based emissions trading systems that generate reductions at least cost to the community.

First and foremost, IETA extends its appreciation for your leadership in working to develop a cap-and-trade program. IETA is dedicated to the establishment of effective market-based trading systems for greenhouse gas emission by businesses that are demonstrably fair, open, efficient, accountable, and consistent across national boundaries. The WCI includes many provisions that would help create a market capable of maximizing both environmental and economic benefits for businesses as well as consumers.

Although IETA strongly believes a national cap-and-trade system is the best means of reducing greenhouse gas emissions in a cost effective manner, IETA commends the WCI for their leadership in working to develop a framework that will both encourage and provide useful lessons in the development of a federal program. Specifically, IETA applauds the WCI's ongoing efforts to thoughtfully consider the needs of a wide variety of carbon market stakeholders by using practical mechanisms that reduce compliance costs while promoting market transparency and effective regulation.

As you continue to revise the WCI, IETA is pleased to share its concerns regarding six of the WCI Markets Committee's twelve recommendations:

1. Require Use of a Central Limit Order Book for Secondary Market Transactions (WCI recommendation 8)
2. Information on Derivatives Positions (WCI 2)
3. Secondary Market Holdings and Transfer Information Disclosed to Public (WCI 11)
4. Do Not Limit Market Participation to Compliance Entities (WCI 5)
5. Treat Compliance Instruments as Commodities for Market Oversight Purposes (WCI 1)
6. Holdings limits (WCI 7)



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1. IETA strongly opposes requiring a central limit order book for secondary market transactions.

IETA appreciates the Markets Committee's intent to maximize transparency and liquidity in secondary markets. Sustaining both conditions is essential for the market to effectively serve its key price discovery role and enable the program to meet its stated environmental objectives at the lowest possible cost. Yet requiring a central limit order book (CLOB) would create an undesirable tradeoff, limiting the market's ability to provide sought-after "clear and immediate price signals": a CLOB is much more likely to hamper market efficiency by reducing liquidity than to help it by encouraging transparency. A better approach is to encourage competition among exchanges so that market participants opt for the best service offerings, rather than to appoint a single CLOB as the monopoly provider.

Forcing all secondary market orders to be reported to a CLOB would likely raise transaction costs and restrict service providers' ability to tailor contracts to client needs; both of these barriers would unnecessarily discourage liquidity.

Mandating a CLOB precludes the availability of custom contracts that many covered entities demand to meet their unique compliance needs. Even in secondary markets, tailored bilateral over-the-counter (OTC) transactions would often be the lowest-cost compliance option, particularly for internal emissions trading between affiliated firms and for high-volume transactions. If a service provider accumulates allowances on behalf of a client, then submits those to the Administrator to meet a compliance obligation in the client's name, is this a transaction that must first be processed in the CLOB? If two parties agree among themselves to transfer X allowances at Y price, how can this deal be preserved using the CLOB? Would each side have to post its intent to buy or sell and hope the "matching engine" creates the deal as envisioned? Could somebody else who has posted a buy or sell order "steal" part of the deal as a function of the matching engine? What if a party would like to transact a larger quantity than is being offered on the CLOB, and can get it done via a bilateral negotiation? All of these issues may impose costs that market participants would not incur if they transacted bilaterally, over the counter.

Requiring even a "soft" CLOB also risks paralyzing innovation and competition from other trading venues. While linkages between markets should be encouraged, forcing all trading onto a single venue via a CLOB would likely hurt the development of vibrant carbon markets. Allowing the emergence of competitive trading platforms is ultimately in the public interest by lowering the costs of the program, enhancing transparency, and raising the level of self-regulatory oversight.

Putting in place a "hard" CLOB would prohibit exchanges to compete for market share. Experience in other commodity and equity markets has shown that exchanges will compete on the following levels:

- a. Price: competition among trading platforms leads to lower fees for clearing and trade execution services. Instituting a CLOB will eliminate competitive pressures to



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reduce fees, and thereby increase transaction costs. In the end, consumers within WCI states and provinces will bear the increased costs for compliance.

- b. Efficiency: where competition among trading platforms has been embraced, it has led to a more efficient marketplace. Exchanges will compete not only on the basis of cost, but also to provide the most efficient transactional marketplace. This has led to innovations in electronic trading and trade matching technologies. The result in many existing commodity markets is greater speed of transactions, lower transaction costs, and fewer trade execution errors. A CLOB would not induce the same competitive pressures to constantly upgrade technology or generally improve transaction efficiencies.
- c. Product Innovation: trading platforms also compete to meet the product needs of market participants. Markets tend to evolve over time, expanding the number of counterparties and developing more effective means to manage and hedge risk. Trading platforms that are most adaptive to the demands of the market tend to win the liquidity. As such, competitive exchanges are more responsive to developing new products and risk management tools, which lowers risk to counterparties and lowers transaction costs.
- d. Security: perhaps most important, the establishment of a CLOB would make the WCI markets less secure and more open to fraud and market abuse. Today, trading platforms, and particularly exchanges, compete to be the most secure marketplace. Certain exchanges are designated self-regulatory organizations, creating and enforcing rules that adhere to CFTC guidelines. Allowing multiple exchanges encourages each one to differentiate itself based on its ability to create and maintain a fair marketplace free from fraud. There is no such incentive for a CLOB to compete on the basis of market security, and as such leaves it susceptible to fraud and market abuse.

It is worth noting that a CLOB was considered for the equity markets by the SEC ten years ago and was ultimately rejected, largely for these same reasons.

Through the draft recommendations and comments at stakeholder meetings, some WCI officials have also made it clear that an impetus for considering a CLOB is to ensure market fairness. Specifically, some officials believe the CLOB would be an effective vehicle to level the playing field between large compliance entities and financial players and smaller compliance entities.

Unfortunately, instituting a CLOB to address these issues could very well be creating a solution in search of a problem. The experience of IETA members in global carbon markets has not only shown that small compliance entities have no difficulty gaining access to the market or in finding pricing information, but most have benefitted from transacting for their modest needs in the OTC markets.

The European Union's Emissions Trading Scheme caps emissions from tens of thousands of sources – many of them small or medium sized enterprises. The EU carbon market is now five years old, and most smaller compliance players forgo day-to-day participation in the market, given their modest needs. Many simply turn to the bank with which they have an



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existing relationship to manage their compliance risk. Still others will enter the market on an intermittent basis (often once a year or once a compliance period) and buy whatever allowances they need to meet compliance. Often these actors find that the costs of carbon regulation relative to their overall business is not significant, so it is more efficient to meet a compliance objective promptly in one purchase rather than to trade actively throughout the year to get better average pricing.

WCI will likely have a similar profile of end users, and therefore should experience similar behavior. IETA does not believe the costs and risks of setting up a CLOB can be justified to address perceived market "fairness" concerns that may never materialize.

Perhaps the most important reason for not moving forward with a CLOB is that the market simply doesn't need one. There are multiple exchanges, electronic trading platforms, and a host of over-the-counter brokers waiting to provide the essential market services the WCI envisions for the CLOB. Furthermore, the WCI can achieve its stated goals of creating a transparent and fair marketplace by simply instituting robust transaction reporting standards for both the OTC and exchange traded markets.

For these reasons, IETA urges the WCI Markets Committee to adopt option "D" under section 4.3.2.2 of the draft recommendations: Allow OTC transactions without use of a central limit order book.

2. IETA agrees that maintaining an appropriate level of transparency regarding OTC derivatives transactions promotes an efficient market and reduces the possibility for market manipulation.

A framework that provides robust disclosure of all OTC transactions to the regulator and preserves access to OTC markets for regulated entities can achieve the same degree of transparency to the regulator and market as forcing all transactions onto exchanges, and it does so at much lower cost to the economy and individual ratepayers.

IETA appreciates the importance WCI places on the issue of reporting information on derivatives positions, and we encourage WCI to pursue such policies that not only achieve the proper level of transparency but also help sustain a sufficient level of market liquidity. It is no doubt difficult to achieve an appropriate balance between these two concerns, but doing so will ensure that a WCI carbon market can operate efficiently and fairly.

For regulators within WCI member states and provinces, gaining transparency into derivatives transactions provides them access to important information on prices for WCI compliance instruments. This information can be used to effectively monitor the economic impacts of the WCI program on the regional economy and the complying entities, as well as assess the environmental benefits of the program relative to its costs. In addition, reporting of derivative price information can also help regulators guard against market manipulation by alerting them to irregular moves in market price relative to presumed supply and demand dynamics.



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Reporting of derivatives transactions will also provide regulators with a view of the accumulated positions of various types of market participants. This information can be used to analyze relative market power of individual market participants and protect against market abuse.

WCI is also considering what types of transactional information, if any, should be made available to the public. To be sure, the price of carbon within WCI is likely to be of little interest to the general public. Rather, carbon market information would be of value to compliance entities, other market participants, and non-governmental organizations with interest in the operation of the program. Considering this, IETA recognizes the benefits of providing a measure of public transparency in the WCI, particularly as it pertains to aggregate market price and trade volume.

IETA is in agreement with the WCI's assessment of the importance of the collection and public disclosure of some information relative to derivative positions in WCI compliance instruments. However, it is crucial to determine what types of trade information are most appropriate and useful for regulators and what subset of this information should be shared with the public.

IETA believes WCI regulators would benefit from the receipt of the following information on derivative transactions:

- **Trade Structure:** Information on the underlying commodity (i.e. allowance or offset), structure of the trade, and the term of the transaction.
- **Price:** Information on the agreed upon price for the derivatives transaction.
- **Volume:** Information on the amount of the compliance instrument bought or sold in the transaction.
- **Counterparties:** Names of counterparties, including delineation of the buyer and the seller.
- **Time of Transactions:** Time of day of the transaction, in order to provide the regulator with the proper sequencing of the transaction relative to other similar transactions in the market.
- **Open Contracts on Regulated Exchanges:** Daily reporting of open interest in all regulated exchanges for relevant contracts for specified compliance instruments.

IETA believes it is appropriate to provide regulators with access to the above set of derivative trade information on a daily basis. As the WCI has pointed out, there is a balance between the need to have current information, the ability of the regulator to access and analyze this data in a timely fashion, the cost to the regulator for establishing a transaction reporting system and provide monitoring services, and the costs to counterparties and intermediaries in the market to reporting the above transaction data points.

IETA asserts that the regulatory imperative to receive the above information for oversight purposes outweighs many of these concerns, as long as the reporting of derivative trade information can be done in a manner that does not become cost prohibitive, negatively



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impact market liquidity, and commercially disadvantage market participants. *(We discuss below in more detail our views on how this information should be collected.)*

IETA also believes the disclosure of certain classes of information is also appropriate for distribution to the public in the interest of fostering market transparency. The information that could be provided to the public includes:

- **Aggregated Price:** Daily weighted average price for a given contract for a specified compliance instrument.
- **Aggregated Trading Volume:** Cumulative number of tons traded for a given contract for a specified compliance instrument. This information is reported at the end of each trading day.
- **Open Contracts on Regulated Exchanges:** Daily reporting of open interest in all regulated exchanges for relevant contracts for specified compliance instruments.

Clearly, IETA is recommending WCI regulators receive a broader set of transaction data from market participants than what is made available to the public. The arguments for this tiered approach to market transparency are two-fold.

First, certain transaction information should be withheld from the public to protect the trading positions and trading strategies of individual market participants from the public. Most participants in the WCI carbon market would consider their positions, and therefore their underlying trading strategies, to be proprietary and therefore protected from transparency to competitors in the marketplace. A lack of protection in this regard would surely discourage the participation of various classes of counterparties in the WCI market. Limits on the participation of counterparties in the market – whether imposed by regulators or the unintended result of regulatory actions – will negatively impact market liquidity and ultimately drive up the costs of compliance.

Second, and perhaps more important, it is in the public interest to restrict public access to certain derivatives transaction information. Specifically, the listing of the counterparties to each trade would allow the public to discern the market holdings of each market participant. This would be especially detrimental to entities that trade in the carbon derivatives market as a means to achieve compliance. For example, if the market is fully aware that a compliance entity is substantially short of its obligation to turn in allowances or offsets equal to its actual emissions, market participants can anticipate this compliance entity must buy in the market at virtually any price to meet compliance. This could lead to market activity that drives up the cost of compliance instruments for the compliance entity in need of allowances. The result is a buyer motivated by compliance to purchase at elevated price levels, and this cost will ultimately be borne by the public.

With an understanding of what types of derivatives trade information that should be reported to the regulator (and made available to the public), the next question is how to ensure WCI regulators are able to efficiently and cost-effectively collect this information.



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IETA strongly advocates for a system of reporting that provides regulators with the requisite level of trade data, while not contributing significantly to transaction costs for market participants. Perhaps the simplest means for reporting transactions is to leverage the availability of information from the most actively traded carbon products on exchanges.

In our experience in other carbon markets (i.e. EU ETS and RGGI), trading tends to migrate toward the liquidity, efficiency, and financial clearing available through regulated exchanges. Each existing carbon market began in the over-the-counter (OTC) market. But as these markets matured and new counterparties entered the market, certain types of transactions became standard and liquidity for these trades largely transitioned to exchanges.

Over time as carbon markets mature, transactions conducted solely in the OTC market – and therefore not cleared through an exchange – tend to be customized, complex, and non-standard. As such, trade information from these transactions is of less use to regulators, as it is difficult (if not impossible) to put these transactions in the context of more standard and liquid market activity.

IETA has no reason to believe that a market for WCI compliance instruments would evolve in a different manner. Understanding this fundamental basis for the evolution of carbon markets, IETA recommends WCI regulators initiate their market oversight of the region's carbon markets with the acquisition of trade information from the leading exchanges and clearinghouses – the equivalent of option “B” on page 12 of the Markets Committee draft recommendations (“Collect on an ongoing basis information on derivatives positions from some entities, e.g., registered intermediaries.”). As long as this authority is limited to the states' collecting the same information as the CFTC, the additional cost should be minimal; IETA sees no reason why the states would need information beyond that required by the CFTC. Further, this is likely to provide an efficient means of transaction data acquisition and to result in less time to establish a trade reporting infrastructure to be used by regulators in WCI member states and provinces.

This “walk before run” strategy would be cost-efficient to establish and easy for regulators to analyze. WCI regulators can continue to monitor market activity and assess any informational market needs over and above those provided by exchanges.

As a means for acquiring this transaction information from exchanges, IETA strongly recommends WCI regulators establish an agreement with Federal regulators (in this case the CFTC) to provide for the flow through of trade reporting data from the Commission. This approach allows WCI regulators to leverage the existing reporting infrastructure established by federal regulators, reducing implementation costs and ensuring standardization of trade data. In addition, it would benefit market participants by maintaining one standard for reporting of trade information, rather than forcing regulated exchanges, financial intermediaries, or other market participants to adhere to differing reporting standards on a Federal and WCI member level. This latter scenario would inevitably lead to higher transaction costs and therefore higher costs of compliance for the WCI program.



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Page 12 of the draft recommendations also lays out four options for disclosure of derivatives market information. With the foregoing in mind, IETA would prefer option "C" ("Disclose derivative positions aggregated to a level similar to the CFTC Commitments of Traders Reports"), believing that it would be inadvisable for states to have disclosure requirements that are inconsistent with a federal requirement. There is some risk that if states disclose much more information than the CFTC it would create an incentive to "game" the system through arbitrage of the information disparity. The disclosure system should not facilitate this type of regulatory arbitrage.

IETA believes that mandating stringent disclosure requirements of all OTC transactions to the regulator and market-relevant information to the public will achieve the important policy objectives of creating transparency and combating fraud and manipulation, yet not impose substantial additional costs on offset project developers and regulated entities.

3. IETA supports appropriate public disclosure of secondary market holding and transfer information.

IETA supports regular and prompt release of aggregated data as a means to ensure market transparency, discourage impropriety and promote equal footing for market participants of all sizes. Regarding information on individual positions and transactions, there is a tension between the public benefits of transparency and the legitimate needs of businesses to protect proprietary information regarding their holdings, needs and activity levels. Therefore, release of information on individual transactions or specific company data must be treated more cautiously. At a minimum, such data should be released without specifying companies involved. Even then, care must be taken so that the data released is truly anonymous, and is not obviously attributable to the specific company that is its source even if the company goes unnamed. Among other options, this suggests that such individual data may need to be released after a substantial lag.

For these reasons, IETA recommends daily exchange reports -- such as "commitments of traders" reports employed by some exchanges -- as a reasonable approach to providing useful "real-time" market data without exposing individual company circumstances or strategies.

4. IETA strongly agrees with WCI's recommendation not to limit market participation to compliance entities. Further, IETA believes that carbon market participation should be open to actors in all sectors of the economy.

Prohibiting financial institutions or other sectors from participating would make the market less liquid, less efficient, more volatile and more expensive. Limiting market participation unnecessarily increases overall compliance costs and limits the market's ability to produce a forward price signal.



Forcing non-emitting sectors away from carbon markets would remove a vital source of financing necessary to build new, more efficient and cleaner manufacturing centers and power plants. Full private sector participation, including by financial services providers, will be essential to drive innovation and cost-reductions necessary to both protect the climate and spur economic development and job creation.

Markets must have participants that are willing to “make” a market: participants that will buy and sell readily (i.e. provide liquidity) in order to give the compliance entities in an emissions market the ability to monetize allowances, and thus raise capital at the level required for investment in emission reductions projects. Markets would both allow compliance entities to protect themselves from volatility and provide risk mitigation options for compliance entities’ outside investors. Entities required to reduce emissions are primarily in the power generation or manufacturing business – not finance – and it would appear highly undesirable to make compliance entities undertake risk mitigation strategies on their own behalf as well as on behalf of their investors.

IETA recommends that all participants, including financial institutions, have access to carbon markets. Prohibiting full participation would make the market less liquid, more volatile, and more expensive, increasing overall compliance costs due to decreased market efficiency.

5. IETA supports WCI’s recommendation to treat compliance instruments as commodities for market oversight purposes.

IETA agrees with WCI that the Commodity Futures Trading Commission (CFTC) is best-suited to oversee the carbon market, given its oversight of related energy markets, as well as futures trading in SO₂ and NO_x. The CFTC has the regulatory expertise and skill sets required for overseeing the economy-wide US carbon market that IETA hopes will emerge as the result of important first-moving efforts like those being undertaken by WCI.

The CFTC should be empowered to govern carbon markets with the same set of tools that are used in other markets. These include prompt reporting of trading data by major participants, the ability to establish position limits and margin requirements if needed, training and licensing of market participants, and strong penalties against fraud, false reporting and market abuse.

IETA recommends that for both cash and derivatives markets for carbon commodities, a single regulator, the CFTC, will provide efficient regulatory oversight and clear signals for participants.

6. IETA believes the WCI should carefully determine if there is a need for new rules on holdings limits through close coordination with the Commodity Futures Trading



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Commission and relevant clearinghouses, and that WCI Partner jurisdictions be discouraged from adopting state- or province-level holding limits.

The WCI has raised the issue of establishing a limit on the amount of compliance instruments that may be held by any single or affiliated group of entities. In our experience such "holding limits" are difficult to effectively enforce and can actually impede the proper functioning of a cap-and-trade program, particularly in the early years of the program.

One can assume that WCI is considering these provisions as a means to prevent unacceptable market power by any single market participant. However, it would be very difficult for WCI to determine the most appropriate level of holdings that demonstrate undue market power. In the early years of the program when a limited amount of parties are participating in trading activities, arbitrary limits could be unintentionally breached as early actors acquire allowances or invest in carbon offset projects.

In any case, commodity markets already have in place mechanisms for controlling positions and preventing market manipulation. Clearinghouses, in consultation with the Commodities Future Trading Commission (the CFTC), set position or "holding" limits for commodities traded on futures exchanges. Certainly, clearinghouses can be required to also consult with regulators in WCI Partner jurisdictions on these limits, but setting position limits on a state or province level would be unprecedented and inefficient. Clearinghouses need the flexibility to adjust position limits as the liquidity of the market fluctuates.

IETA recommends that the WCI rely on the relevant clearinghouses to set appropriate holding limits in proper collaboration with the CFTC.

Once again, on behalf of IETA and our 170 member companies, I would like to thank you for providing the opportunity to comment on the WCI and for your attention to these comments. Please do not hesitate to contact me, or IETA's US Director, David Hunter, at hunter@ieta.org, if you have any questions.

Sincerely,

Henry Derwent
President and CEO