December 17, 2010

Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: International Emissions Trading Association response to the Commodity Futures Trading Commission's Call for Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets, 75 Fed. Reg. 72,816 (Nov. 26, 2010)

Dear Commissioners and Staff,

On behalf of the International Emissions Trading Association (IETA), I am writing in response to the Commodity Future Trading Commission's (CFTC's) call for "Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets," published in the Federal Register on November 26, 2010 (Volume 75, Number 227, Page 72816-72818).

IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 165 member companies include some of the nation's, and the world's, largest industrial and financial corporations—including global leaders in oil & gas, electricity, cement, aluminum, chemical, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, offset project development, legal, and consulting industries. A full list of our members is available on our website at www.ieta.org.

The November 26th Federal Register notice included eleven questions on which the CFTC is seeking public comment. IETA's response to these questions is as follows:

1. Section 750 of the Dodd-Frank indicates that the goals of regulatory oversight should be to ensure that carbon markets are efficient, secure and transparent. What other regulatory objectives, if any, should guide the oversight of such markets?

IETA strongly supports measures to develop carbon markets that are efficient, secure and transparent. However, in the effort to ensure that markets operate in such a manner, regulation must not lose sight of the other crucial factors necessary for markets to add value and be useful. Regulation that achieves those three goals at the cost of significantly reducing the utility of the markets to its participants achieves a hollow victory. To that end, we recommend that the following objectives be given equal priority with efficiency, security and transparency.

First, markets must be liquid to be useful. Regulation that reduces market liquidity is ultimately self-defeating, as it hinders the deployment of capital in the manner most effective for reducing emissions. Liquidity in the market serves to enhance the economic efficiency of this policy goal. Through the recognition of offsets, the carbon market serves to attract private capital towards investments in low carbon technologies, many of which are essential for developing the innovation that will be needed to meet the broader emission reduction policy goals. Liquidity in the markets serves a particularly vital role in bringing more and greater sources of private capital into the market, which enables many of these important offset projects to get off the ground. Increased liquidity and helping to create a market for offset credits is important for the offset market starting at the project stage.

Second, cost of participation must remain low. Regulation that significantly increases costs to market participants of participating in the market is counterproductive.

Third, regulation should not restrict innovation. Transactions desired by and useful to both parties should not be impeded simply because regulation did not contemplate them, or considers them difficult to monitor. Regulations should prohibit, identify and prosecute fraud and abuse, not constrict the universe of transaction types.

One of the great strengths of the US economy has always been its ability to constantly innovate, reduce costs, and provide creative solutions to problems. Well-designed regulation must police the markets for illicit behavior without impairing the markets' ability to deliver constant innovation, engage in customization and solve customers' problems.

2. What are the basic economic features that might be incorporated in a carbon market that would have an effect on market oversight provisions—e.g., the basic characteristics of allowances, frequency of allocations and compliance obligations, banking of allowances, borrowing of allowances, cost containment mechanisms, etc.?

In general, carbon markets operate in a similar manner to other commodity markets. However, there are economic features of carbon markets that are unique. On the whole, these features tend to make fraud and abuse of carbon markets inherently more difficult. Therefore, IETA believes the CFTC can effectively regulate existing and emerging carbon markets within their existing regulatory authority. Specifically, IETA believes that unique regulatory constraints on trading that have been considered in recent legislative proposals, such as limiting market participation or forcing all carbon trading onto exchanges, are inappropriate and unnecessary.

First and foremost, carbon markets are unique since the foundation for the market, carbon allowances, are created by the government in order to meet a clearly defined environmental objective. In this case, the objective is to reduce emissions of greenhouse gases and abate the potential impacts of global climate change. Government climate programs can employ flexible market mechanisms, such as trading as a means to assist regulated entities in achieving

compliance at the lowest possible cost. Essentially, carbon markets decide how to allocate capital most efficiently to meet stated environmental objectives.

Because carbon allowances are government created, they are less subject to market manipulation and it is easier for the government to control their distribution, transfer, and eventual surrender for environmental compliance. This is an important market quality for regulators to consider. The supply and demand factors seen in other commodity markets, such as energy, still exist in carbon markets. However, the government's role in dictating supply is an important characteristic limiting potential extreme market fluctuation and manipulation.

Carbon markets require regulated entities to surrender allowances (or at times offsets) equal to their total emissions to fulfill environmental compliance obligations. This true up period has ranged from one to three years, making the market less susceptible to volatile price swings. Contrast this with the power markets where the market is subject to swings in price everyday and there is a corresponding need to provide power to customers on a continual basis. The risk of price volatility in carbon markets having a systemic impact on the economy is tempered by this design feature, and should be considered by regulators of future markets.

Carbon markets also operate under an extremely efficient delivery mechanism. As opposed to energy commodities that are delivered by pipelines, tankers, and power transmission lines, carbon allowance markets have no delivery constraints. Allowances are issued by the government and either auctioned or distributed directly to emitters. Each carbon allowance is held in an electronic registry that facilitates transfer and, ultimately, retirement. The ability for any party to take physical delivery with little burden other than an account at a registry lowers the barriers to entry for participants and eliminates delivery bottlenecks that can impact price volatility.

Carbon markets also tend to have the unique element of being tied to long-term compliance obligations. Global warming is a challenge that requires sustained effort to control greenhouse gas emissions. Correspondingly, legislation to address climate change has contemplated compliance periods lasting several decades. The reason for such long-term certainty is to motivate the market to deploy the vast amount of capital necessary to transition to a low-carbon economy. Necessarily, the hedging of this massive amount of investment must also be long-term. The over-the-counter carbon market is an effective and efficient venue for executing such long-term hedges. Regulators should consider this dynamic when considering the role of the over-the-counter (OTC) market for carbon trading.

Another unique element of carbon markets, and one that is typically part of any carbon cap-and-trade program, are provisions for cost containment. The control of carbon emissions can have a direct and profound impact on the economy by potentially raising the cost of energy across all segments. Therefore, policy makers often incorporate elements to control costs into carbon market design.

The most popular of these mechanisms is offsets, essentially the transfer of capital to a non-compliance entity to fund emissions reductions. Using the efficiency of markets, capital will flow to those entities able to reduce carbon emissions at the lowest cost, thereby lowering the costs for all participants in the program.

By their nature, offsets involve the participation of entities not normally involved in markets. Often these are small- to medium sized entities such as farmers, small landfill owners, foresters, and renewable energy developers. They contract with investors to generate carbon credits, which can be sold in the market and used for compliance. These contracts are highly differentiated and customized to account for large variabilities in risk and capital needs.

Any offset contract generally implies the promise of delivery at some point in the future. Thus, offset contracts, as with many transactions in the carbon markets, should be viewed as falling within the scope of the forward contract exclusion under Dodd-Frank. Additionally, the CFTC should well consider the bespoke nature of these contracts. They cannot be listed on an exchange, and must be structured in the OTC market. Furthermore, regulators should consider the impacts margin requirements for primary carbon project developers would have on project creation and corresponding liquidity in offset supply.

Moreover, the contracts between iron ore producers and iron smelters that are a key condition precedent for the production of iron are not subject to regulation by the CFTC, as they qualify as either spot or forward contracts. The same is true with respect to spot and forward contracts for the delivery of bauxite and aluminum. Contracts for trading iron or aluminum are subject to regulation, but contracts with respect to key inputs into their production are not.

Emission offsets exhibit a similar dynamic between the project developer and the ultimate buyer or financial intermediary. Allowing so-called “offset creation contracts” to be executed OTC is essential to allowing project developers (many of whom are thinly capitalized) to implement emission reductions, generate offset credits and bring them to market. Once an emission offset is issued by the environmental regulator, it should be subject to the regulation applicable to emission allowances.

It should also be noted here that the OTC market plays a vital role in the development of carbon markets and their continued ability to enable companies to reach compliance at the lowest overall cost to the economy. The OTC market is essential in the early stage of development for carbon markets, providing a venue for trading that ensures transparency and liquidity at times of low volume and with relatively few market participants.

The OTC market also provides the appropriate venue for innovation in market-based risk management tools. Although many of these products may eventually migrate to an exchange environment, their initial liquidity is only to be found in OTC markets, where end users and

experienced intermediaries can innovate to control compliance costs to consumers. As stated above, the OTC market is also the best venue for the structuring of long-term carbon price hedges for large-scale capital investments.

3. Do the regulatory objectives differ with respect to the oversight of spot market trading of carbon allowances compared to the oversight of derivatives market trading in these instruments? If so, explain further.

No, the regulatory objectives are essentially the same. Spot and derivatives markets will both play a critical role in accurate price discovery and risk management in any future carbon market. As a result, the regulatory objectives of minimizing, detecting and punishing market manipulation and providing transparency to market participants are the same in both the spot and derivative markets. In addition, an important objective in environmental markets is to make environmental compliance easy, whether using spot markets or derivative products.

Even though the oversight objectives are the same, the regulatory focus may differ in practice due to the nature of the two market segments. For example, jurisdictions in Europe typically focus market oversight more intently on derivatives markets than spot markets. European regulators maintain the right to intervene in either market segment with the same tools. However, they choose to impose fewer regulatory measures on spot markets so as to encourage participation, enhance liquidity and promote environmental compliance. They focus regulation of spot markets on the licensing and oversight of exchanges, where many allowance transactions flow naturally, but there is typically no training, licensing or registration requirement for buyers and sellers. On the other hand, given the complex and illiquid nature of many carbon derivatives products, regulators apply training and licensing requirements on participants in such transactions – including the buyers, sellers, exchanges and OTC intermediaries.

In IETA's view, this has worked reasonably well for market participants in Europe. It mirrors the approach to oversight of energy markets in those jurisdictions, making compliance across related markets straightforward. Since much of the participation in spot markets is naturally undertaken by covered entities seeking to meet environmental compliance obligations, it is appropriate for market regulators to make participation (and environmental compliance) easy. The regulator monitors spot markets and makes clear to participants that it may choose to take additional action if events unfold that warrant intervention. Since derivates transactions are more customized, less liquid and more difficult to trade on exchanges, regulators have applied more safeguards, such as training and licensing.

4) Are additional statutory provisions necessary to achieve the desired regulatory objectives for carbon markets beyond those provided in the Commodity Exchange Act, as amended by the Dodd-Frank Act, or other federal acts that may be applicable to the trading of carbon allowances?

We do not believe that carbon markets are different from other energy commodity markets in any way that suggests they need a materially different regulatory structure, nor that any additional statutory provisions are required for the CFTC to implement an appropriate, comprehensive regulatory scheme. To the extent that there are differences in markets for emissions allowances and related instruments, those differences actually suggest that emissions markets are less susceptible to fraud and manipulation than markets for other energy commodities.

The key difference that makes this so is that the underlying commodity, the emission allowance, has no locational component. Historically, many, perhaps most manipulation schemes have relied, at least in part, on physical logistics components. For example, deliberately over-scheduling electric transmission lines, or natural gas pipelines, or otherwise relying on restrictions on the ability of the infrastructure to move the underlying commodity from where it is to where it is desired. There is no physical logistic component to emissions allowances, removing one of the major components, and hence opportunities, for manipulation.

In the entire history of the program, we are unaware of so much as an allegation of fraud or manipulation in the market for US SOx and NOx allowances. Additionally, we are unaware of any entity that has advocated that additional statutory authority is necessary for the CFTC to regulate the SOx and NOx markets, and we do not see a material difference between these markets and carbon markets.

For all these reasons, we believe that it is logical to assume that carbon markets will actually be one of the easier markets to police among its emissions and energy commodity peer group. Therefore, the CFTC has all the statutory authority it needs to thoroughly and effectively regulate carbon markets.

5) What regulatory methods or tools would be appropriate to achieve the desired regulatory objectives?

Rather than focus on "specific tools," we recommend that the CFTC develop its carbon market program around a reporting and monitoring program, using principles-based regulation rather than detailed, prescriptive rules. By gathering and reviewing data on inventories and transactions, and following up on unusual or suspicious patterns with more detailed, individually focused inquiries, we believe the CFTC will best serve the goals articulated in our answer to question #1.

With regard to purchase and position limits specifically, we are not opposed to them as a matter of philosophy, but we do believe that the CFTC should hold the possibility of setting such limits in reserve, rather than putting them in place as part of the "Day 1" rules. In

particular, when thinking about start-up markets, the most likely scenario is initial participation by relatively few participants at the beginning. If this is in fact the case, it may be almost impossible for them NOT to hold or purchase relatively large portions of the total allowances in circulation. This circumstance should be kept in mind when evaluating the possible use of holding or purchase limits. IETA believes implementing any such limits should take place only after identifying a specific problem that is occurring for which limits would be a clear solution. Pre-emptive limits based solely on concerns about potential undue concentration are not justified.

Again, considering the history of the NOx and SOx allowance markets to be a good, instructive model, there has been no undue concentration of ownership in that market to date. This fact suggests that there is no particular reason to be concerned about undue concentration in carbon markets. Another factor arguing against the need for position limits is the existence of "offset credits," which will largely be fungible with allowances. In addition to providing some "substitutability," there will be some ability to increase supply of offset credits in response to high prices, unlike with allowances. For all these reasons, position limits do not appear to be justified at the onset of the program.

6. What types of data or information should be required of market participants in order to allow adequate oversight of a carbon market? Should reporting requirements differ for separate types of market participants?

IETA supports broad and timely disclosure to regulators. To that end, IETA supports:

- comprehensive oversight of dealers and major swap participants including training and licensure requirements;
- daily reporting requirements for all transactions (including OTC derivatives) to the CFTC;
- reporting requirements to the CFTC should include:
    - time of transaction for exchange trades, and date of transaction for OTC trades,
    - traded product and term,
    - price, noting complexities inherent in carbon transactions[1],
    - counterparty information, and
    - position reporting for dealers and major swap participants (as defined by the CFTC).
- daily release to the public of aggregated price and volume information on OTC and exchange-traded derivatives by the CFTC.

[1] Price reporting will be complex. Many derivative transactions are done on a "bundled" basis meaning they address more than one commodity such as natural gas and carbon where the prices set for each may be related. In addition, many bundled transactions do not necessarily contain a specific fixed price but rather may index the carbon price against a certain reference benchmark. As a result, CFTC needs to be alert to these distinctions.

Generally, IETA believes that reporting requirements should be the same for all classes of market participants. From the perspective of ensuring transparency and fairness, there are no relevant distinctions to be drawn among those different classes. However, it may be appropriate to allow exemptions for classes of smaller participants who are not taking market positions that would create material risks of fraud, market manipulation or excessive speculation – particularly those involving entities seeking to meet environmental compliance obligations.

7. To what extent is it desirable or not desirable to have a unified regulatory oversight program that would oversee activity in both the secondary carbon market and in the derivatives markets?

To the extent that "unified regulatory oversight program" means integrated oversight of the different parts of the carbon market, IETA strongly supports a single regulatory regime for both the "secondary carbon market" and derivatives market and between possible state and federal carbon markets. An important element of harmonized systems would include an identical or compatible reporting format that allows market data to be seamlessly disclosed, viewed and analyzed. While market participants would certainly benefit from harmonized disclosure, the comparability of data would benefit regulators as well.

To the extent the question is directed at another issue, IETA would like to reserve its right to amend its answer.

8. To what extent, if any, and how should a U.S. regulatory program interact with the regulatory programs of carbon markets in foreign jurisdictions?

IETA supports the CFTC's coordination and harmonization with regulatory programs in foreign jurisdictions. Carbon markets are likely to be global and share participants and product attributes across national boundaries. In addition, there is the possibility of linkage between a U.S. carbon program and those in foreign jurisdictions, making regulatory coordination beneficial. IETA supports the harmonization of market oversight rules across jurisdictions, to the extent this is feasible and practical.

9. What has been the experience of state regulators in overseeing trading in the regional carbon markets and how would that instruct the design of a federal oversight program?

While IETA is not itself a state regulator, our members participate in all regional carbon markets. IETA, as a representative for its members, is also a stakeholder in market design and rulemaking forums hosted by various state governments and relating to the development of state and regional carbon markets.

As such, IETA is able to assess various experiences of state regulatory authorities in relation to the trading markets developed around their carbon programs. The Regional Greenhouse Gas Initiative (RGGI) is the only U.S. carbon market in current operation (although there is currently pre-compliance trading underway in California in anticipation of that state's carbon trading program set to launch in 2012). State officials in RGGI have opted for what appears to be a bifurcated approach to market regulation.

The individual states in RGGI are responsible for the creation of carbon allowances and their distribution to the market. The RGGI states are also responsible for environmental compliance under their program. While RGGI conducts rigorous monitoring of its allowance auctions and underlying carbon markets, RGGI states do not oversee trading activity relating to their carbon markets. It is our understanding that oversight of carbon trading markets for the protection against fraud and market manipulation is the sole authority of the CFTC.

IETA is not aware of any problems with market oversight under RGGI's system. IETA also believes the ability for state regulators to rely on federal regulators for the effective oversight of carbon trading activities, especially under the anticipated reforms of the Dodd-Frank Act, is the most cost-effective and efficient means of carbon market regulation.

Therefore, IETA believes these experiences highlight the importance of a bifurcated regulatory oversight model, in which appropriate state or federal agencies are charged with environmental compliance and the CFTC is responsible for oversight of corresponding trading activity per their statutory authority.

10) Based on trading experiences in SO2 and NOx emission allowances what regulatory oversight would market participants and market operators, respectively, recommend?

As described at some length in our response to question 5, we believe that the lessons from the SO2 and NOx markets suggest that carbon markets will be less susceptible to fraud and manipulation than markets for other energy-related commodities. One primary reason is that the lack of a physical constraint in the movement of the underlying commodity (the allowance) pre-empts many, if not most manipulation schemes. Carbon markets could also be larger, with more liquidity and broader participation, which should create an even healthier and more competitive market dynamic than SO2 and NOx markets (provided restrictions on market access as proposed by some in Congress are rejected). Furthermore, in the case of carbon markets, the fact that a fungible substitute, the "offset credit" will exist, and the supply of which can be at least partially responsive to high prices, provides an extra safeguard against manipulation schemes. Finally, to our knowledge, there has never been so much as an allegation of a fraud or manipulation scheme in the entire history of the SO2 and NOx markets. Therefore, the available evidence all strongly suggests that the regulatory oversight regime currently applied to the SO2 and NOx markets should suffice for carbon markets.

11. Who are the primary participants in the current primary environmental markets? Who are the primary participants in the current secondary allowance and derivatives environmental markets?"

Primary Markets

Current primary environmental markets host a broad set of counterparties, each with unique responsibilities and functions. They are as follows:

Covered entities: For regulated air markets, such as SO_2, NO_x, and carbon, the core participants in the primary market are typically the companies that emit these gases, and therefore, are mandated to comply with reductions. The markets exist for the emitters to assist them in finding the lowest cost means of compliance. These participants would very likely be qualified as "end users" under the current DFA definition and therefore benefit from the market's hedging efficiencies.

Intermediaries: Primary environmental markets are made more efficient through the participation of market intermediaries, such as banks, marketers, brokers, and, to a limited extent, exchanges. These entities ensure liquidity in primary environmental markets, which is a vital role considering their size relative to other commodity markets. Primary market intermediaries also provide transparency, again an important service for nascent, less-liquid markets.

It should be noted that certain environmental products in the primary market are not (and cannot) be listed and traded on exchanges, whether exempt or designated commodity markets. In particular, the creation of carbon offsets and their sale in the first instance, as stated above, is a highly customized, non-standard market function. As such, they cannot be listed on exchanges, but rather lean heavily on other market intermediaries such as banks, marketers, and brokers for the acquisition of capital and disposition of resulting credits.

Investors: Primary environmental markets are also seen as an attractive investment venue for specialized funds, banks, and some individuals. As is typical in other market commodity markets, these market participants do not have a natural position in the market, nor are they considered "end users." However, they are an important source of market liquidity and investment capital, particularly for carbon offset projects.

Primary Offset Developers/Aggregators: While the CFTC may already have experience in regulating the trading activities of several of the participants listed above, and has even included these types of firms in various market stakeholder groups, the Commission may be less familiar with firms conducting project origination and development activities. As stated above, one of the carbon market's unique features is the offset market.

The sectors involved in offset project development correspond to the methods by which participants outside of regulated sectors can reduce carbon emissions. Therefore, developers are often small- to medium-sized enterprises with small reserves of capital. It is worth noting again that the financial profile of these primary market participants should encourage the CFTC to treat in a sensitive fashion.

Secondary Markets

While there is a large distinction between primary environmental markets and the secondary or derivatives markets, many of the market players are the same. There are notable differences in their roles, market participation, and exposure to risk, however:

Covered entities: This group tends to actively hedge compliance price risk in secondary or derivatives markets.

Intermediaries: Environmental market intermediaries play in even larger role in the secondary or derivatives markets. They provide essential market liquidity and price transparency. OTC markets, assisted by intermediaries such as brokers, still play an important role, but the importance of exchanges as a trading venue is elevated in standardized products and derivatives.

Offset Developers/Aggregators: There is little presence of offset developers in the secondary market. While these entities have a natural hedging position, with their offset supply often locked in long-term sales contracts, many do not use the secondary or derivatives markets to manage risk.

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

Sincerely,

Henry Derwent
President and CEO

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