



July 22, 2011

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Comment to 76 Fed. Reg. 29818 (May 23, 2011); 76 Fed. Reg. 33066 (June 7, 2011)
Submitted via CFTC website

Dear Mr. Stawick,

Friends of the Earth is pleased to provide comments on Question 32: *Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?*

While forward contracts may be most strongly associated with the delivery of commodities for commercial merchandising transactions, in the carbon markets, forward contracts can be easily used by financial speculators. Since there are no costs associated with making or taking delivery of carbon, no cost to store it, and no delay in delivering it, **a forward contract exclusion for carbon may allow financial speculators to use the exclusion to escape regulations otherwise required by the Dodd-Frank Act.** The intangible nature of carbon makes it much easier for speculators or those simply seeking to hedge carbon price risk to take delivery of the carbon itself rather than enter into a derivatives transaction; this is especially true for carbon trading regimes which allow borrowing, banking, and other measures to ensure that carbon commodities are “valid” (able to be surrendered for compliance purposes) for a longer period.

Thus, while it may be possible to “physically settle” a carbon forward contract through the provision of carbon allowances or credits, carbon is indeed different from other physical commodities. The CFTC’s January 2011 report, *Report on the Oversight of Existing and Prospective Carbon Markets*, (“Report”) acknowledged that “Various characteristics of carbon market suggest the need to consider whether additional regulation is necessary for primary and secondary carbon allowance and offset markets.” The forward contract exclusion is a good example of how carbon should be regulated differently; **Friends of the Earth recommends that the CFTC not include carbon in the forward contract exclusion.**

Rather, we believe that all trading of carbon emissions allowances, offsets, credits and related instruments and products, including options, swaps and derivatives, should be

standardized and conducted on open, transparent and regulated exchanges. Unlike other commodity markets, which arose to serve the economic interests of buyers and sellers, carbon markets are created from legislative fiat and should be held to the highest standards of environmental and market integrity.

The Report concluded that the CFTC should be guided by several objectives when promulgating rules governing carbon markets, including the objectives of facilitating and protecting price discovery, and ensuring appropriate levels of carbon market transparency. These regulatory objectives apply to all markets, but they are particularly critical for carbon in order for cap and trade systems to fulfill their public policy function. Exchange trading is the best way to provide for transparency and price discovery, and **exempting certain carbon transactions from exchange trading would reduce the ability of the CFTC, market participants, and interested parties to benefit from critical pre- and post-trade data.** Such data includes information on the provenance of carbon offsets, ownership distribution throughout the carbon markets, the total supply of offsets and allowances in circulation presently and in the future, etc.

Finally, Friends of the Earth believes that this exclusion, if granted, will be mostly likely used by offset traders, as carbon allowances are by nature standardized and well-suited to exchange trading. As discussed in other analyses,¹ offsets are more likely to be at risk for fraud, corruption and gaming. Relative to allowances, they carry more inherent financial risk, due to factors such as performance risk (that the project may not result in the intended amount of carbon dioxide reductions), registration risk (that the project may not be properly registered), issuance risk (that the project may not receive carbon credits), reversal risk (that carbon emissions may be released back into the atmosphere after crediting), etc. In addition, some offset types are more likely to create harmful environmental and social impacts. Although many of these problems are best addressed through robust carbon market design, offset protocols, and anti-corruption standards, these measures should be buttressed by transparency at all levels, including trading.

For the abovementioned reasons, we encourage the CFTC to not include carbon in the forward contract exclusion. We are grateful to the Commission for considering these views.

Sincerely,

A handwritten signature in black ink, appearing to read "Michelle Chan", with a horizontal line extending to the right.

Michelle Chan
Director, Economic Policy Programs

¹ See Friends of the Earth, *Smaller, Simpler and More Stable: Designing Carbon Markets for Environmental and Financial Integrity*, Sept 2009 at <http://www.foe.org/sites/default/files/CarbonMarketsReport.pdf>