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Understanding H.R. 2454

Market Oversight

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The major market failures over the past year were largely caused by a combination of excessive risk-taking by market participants, a lack of effective government oversight and/or a lack of jurisdiction over the markets, and a lack of transparency. In addition, the petroleum price spikes in summer 2008 highlighted concerns about manipulation/excessive speculation affecting energy prices. The American Climate and Energy Security Act (the Waxman-Markey bill) includes provisions to address many of these concerns. In addition, the bill includes a subtitle to strengthen regulation of other energy commodities.

Subtitle D– Carbon Market Assurance

The bill makes some fundamental market design choices at the outset:

- Creating a separate regulatory frameworks for the trading of allowances and allowance derivative instruments;
- Including verified offset credits in the definition of "allowances" for the purpose of the market oversight provisions, although the bill excludes initial contracts to fund the development of offset projects;
- Choosing not to restrict who may trade in the carbon market; and
- Allowing multiple registered exchanges to trade allowance-based instruments rather than requiring that all instruments trade on a single platform

The bill articulates a series of standards for oversight of the allowance market. Under the bill, the Federal Energy Regulatory Commission would regulate the allowance market and must promulgate regulations that:

- Prohibit fraud, manipulation, excessive speculation;
- Facilitate compliance with emissions limits;
- Ensure transparency;
- Set position limits and margin requirements, as necessary;
- Create a national market system;
- Limit or eliminate counterparty risks, market power concentration risks, and other risks associated with over-the-counter (OTC) trading;
- Create standards for trading facilities (i.e., exchanges) and clearing organizations; and
- Other requirements necessary to preserve market integrity and compliance[1]

The bill establishes similar requirements for the allowance derivatives market but delegates to the President and an interagency task group the authority to create appropriate regulations. In the event the interagency

[1] HR 2454, § 341(b)(2)&(c)(2).

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task group does not promulgate regulations, the bill includes default rules that:

- Assign jurisdiction over allowance derivative trading to the Commodity Futures Trading Commission;
- Require trading of allowance derivative instruments to take place "on or through" trading facilities (i.e., exchanges) registered with the CFTC as designated contract markets; and
- Set a 10% position limit on allowances derivatives.[2]

In addition to the list of market elements that regulations must address, the legislation also includes detailed enforcement provisions.[3]

The regulation of the allowance market should be relatively straightforward, as there will be one standard, government-issued instrument that trades.[4] The derivative market could potentially be much larger and more complex. The bill provides for over 132 billion allowances over the life of the policy, although less than five billion may be outstanding initially. Additionally, many of the allowances will likely be submitted for compliance during the early years, whether they are purchased at auction or received via free allocation. Therefore, the so-called "float" of outstanding allowances– or allowances that are in circulation at a given time– will be quite small relative to the total number of allowances that will be available through the life of the bill. This will drive demand for derivatives as emitters seek to manage longer-term price volatility and provide certainty to investors. Put another way, the bill would require emitters to take on 38 years of abatement with as few as one vintage year of allowances available to manage risk.

Upon initial review, it appears that the bill includes both the authority and the mandate for the regulator to create an efficient, transparent marketplace. The principles and default rules would address the following market concerns:

- Manipulation/excessive speculation– Position limits restrict the total percentage of allowances that a single investor or group of investors can control and margin requirements establish minimum deposits that must be on hand before purchasing instruments on credit.
- Risk management– The draft addresses counterparty risks (i.e., ensuring that all parties to a contract can meet their commitments) by (1) calling for standards for the operation of registered clearing organizations for trading facilities and (2) requiring the regulator to "limit or eliminate" counterparty risks associated with over-the-counter transactions.
- Transparency– The bill would create a national market system for allowances and derivatives (similar to the SEC model for the equities markets), which would ensure that anyone purchasing allowances would receive the best available price, regardless of where the allowance is purchased. There are also recordkeeping requirements.
- Fraud prevention– The bill includes oversight and enforcement provisions that would cover registered trading facilities, registered clearing organizations, and any person who violates "any rule or order issued by" the regulator.

Because the bill sets forth standards for the market oversight regulations rather than specifying the precise trading, the ultimate effectiveness of the market oversight provisions will depend on the implementing regulations.

Subtitle E– Additional Market Assurance

In a separate subtitle, the bill also amends the regulation of other energy commodities, including coal, crude oil, gasoline, diesel fuel, jet fuel, heating oil, propane, electricity, and natural gas. The bill extends CFTC regulatory power to swaps involving energy commodities and trading on international markets that touch American soils (including electronically), and applies all commodity market reforms to the carbon market.

Under the subtitle, swaps including energy commodities would no long qualify for the bona fide hedging exemption unless they are backed by a physical commodity. Swap dealers and index funds would also have to report market positions to the CFTC. All transactions taking place off of regulated exchanges would have to clear through CFTC-registered clearing organizations.

The requires the CFTC to establish a Position Limit Energy Advisory Group to provide guidance to the CFTC and help

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3 HR 2454, § 341(b)(3)&(f).

4 The bill includes verified offset credits in the definition of an allowance for the purposes of market oversight.

establish limits on the positions any party may hold in aggregate. In doing so, the bill attempts to cut down on the ability of speculators to amass large holding across multiple markets. The bill establishes further market safeguards by limiting credit default swap ownership and banning naked credit default swaps. To provide additional oversight within the CFTC, the bill creates an independent Inspector General of the Commission.

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