# Amid Derivatives Reform, Federal Regulators Contemplate Future Regulation of Carbon Markets

November 30, 2010

The U.S. Commodity Futures Trading Commission (CFTC) has issued a Notice and Request for Comment on a study regarding the oversight of existing and prospective carbon markets. Although carbon markets are currently far removed from the frenzy of activity surrounding the CFTC's rapid expansion into the over-the-counter derivatives markets, decisions made now may define how carbon and other environmental products and markets are regulated in the future.

On November 19, 2010, amid the flurry of rulemaking activity associated with implementing the many provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the U.S. Commodity Futures Trading Commission (CFTC) quietly issued a Notice and Request for Comment on a study regarding the oversight of existing and prospective carbon markets (Carbon Market Notice). The announcement came on a particularly busy day when the Commission voted to issue four other Notices or Advance Notices of Proposed Rules called for by the Dodd-Frank Act. The announcement initially received little attention, but may prove to be significant. Although carbon markets are currently far removed from the frenzy of activity surrounding the CFTC's rapid expansion into the over-the-counter derivatives markets, decisions made now may define how carbon and other environmental products and markets are regulated in the future.

## Interagency Working Group Considers Future Regulation of the Carbon Markets

Section 750 of the Dodd-Frank Act requires the CFTC to assemble an interagency working group for the purpose of conducting a study on the oversight of existing and prospective carbon markets (including both spot and derivatives markets). In addition to the CFTC, the working group is composed of representatives from the U.S. Department of Agriculture, the U.S. Department of the Treasury, the U.S. Securities and Exchange Commission, the U.S. Environmental Protection Agency (EPA), the Federal Energy Regulatory Commission (FERC), the Federal Trade Commission and the U.S. Energy Information Administration. Although the Dodd-Frank Act designated the CFTC to head the interagency group, previous legislative proposals had considered giving authority over the carbon markets, in whole or in part, to various other federal agencies, including the EPA and the FERC. Accordingly, a threshold question not directly addressed in the Carbon Market Notice is which regulator (or regulators) should be charged with overseeing the potentially vast market for carbon products and derivatives.

The Carbon Market Notice poses 11 specific questions, including the following:

- Other than the general goal of achieving "efficient, secure, and transparent" markets for carbon products, what other regulatory objectives should guide the oversight of such markets?
- What are the basic economic features that might be incorporated into a carbon market that would have an effect on market oversight? For example, are allowances freely tradable (and if not, to what extent is trading restricted), are there limitations on banking or borrowing allowances, and will the market be subject to a price cap or some other cost containment mechanism?
- Do the regulatory objectives differ with respect to the oversight of spot versus derivatives markets for carbon products?
- Is further congressional action necessary to achieve the desired regulatory objectives for oversight of the carbon markets, or is existing legislation, including the Commodity Exchange Act and other relevant federal statutes, sufficient?
- What type of reporting requirements are necessary to allow for adequate oversight of carbon markets? Should reporting requirements differ depending on the type of market participant?
- To what extent is a unified regulatory oversight program that oversees activity in both spot and derivatives carbon markets desirable?
- To what extent should a U.S. regulatory program for carbon markets interact with comparable international regulatory programs?
- To what extent are experiences in regional carbon markets (*e.g.*, the Regional Greenhouse Gas Initiative) or other environmental markets (*e.g.*, markets for $SO_2$ and $NO_x$ emissions allowances) instructive?

## U.S. Carbon Markets Are Likely to Continue to Grow

Although the Chicago Climate Exchange recently announced plans to conclude its voluntary carbon program, activity in some state and regional carbon markets is accelerating in the absence of a federal program. For example, in late October 2010, California released its blueprint for a market system to curb greenhouse gases within the state. Notably, this program survived a ballot initiative that threatened to postpone its implementation indefinitely. Similarly, two coalitions of state (and provincial) governments—the Western Climate Initiative and the Midwestern Greenhouse Gas Reduction Accord—are expected to follow the Regional Greenhouse Gas Initiative by moving substantially closer to bringing new regional carbon markets online within the next 24 months.

Even though a federal cap-and-trade program is unlikely in the next two years, forward-looking regulators and market participants should begin to prepare now for the new regulatory regime because carbon markets in the United States (and government oversight of those markets) are likely to continue to develop and grow.

The CFTC's interagency working group is required to submit a report including recommendations to Congress on or before January 17, 2011. Comments to the Carbon Market Notice are due on or before December 17, 2010.