

Prepared Testimony of

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Hearing on the American Clean Energy and Security Act of 2009
Before the U.S. House Committee on Energy and Commerce

April 24, 2009

Introduction

My name is Carl Royal. I am a member of the Securities and Futures Regulation Practice Group of Schiff Hardin LLP, a general practice law firm with offices located in Chicago, New York, Washington, Atlanta, San Francisco and other cities.

I have over 30 years of experience in the regulation of markets and market participants under the federal securities and commodities laws. In addition to my law firm experience, I spent 14 years at the Chicago Mercantile Exchange, where I served as Senior Vice President and General Counsel.

The Nature of Carbon Markets

In enacting a cap-and-trade program for greenhouse gases, Congress will be establishing the largest environmental market in the world. In many ways this market may look like other markets, but in reality this market differs fundamentally from other commodity markets such as soybeans or gold. The carbon market will trade in allowances whose supply is created by the government, where the supply is limited and decreasing, and the demand for which is driven by industrial users' compliance obligations.

Why have a market in carbon emission allowances? Such a market:

- helps achieve the most environmental good for the least economic cost;
- provides compliance flexibility (avoids one size fits all regulation);
- promotes innovation, which can spur the development of the low-carbon technologies of the future; and
- avoids government getting involved in picking winners and losers.

The carbon market exists solely in order to facilitate the reduction of global warming pollution in the most cost-effective way possible. Its purpose is to achieve a public good, and therefore the public has a strong interest in seeing that the market operates in a way that inspires

public confidence and trust. To put it directly, the market should be set up in a way that limits the kinds of irresponsible behavior and systemic failures that we have seen in financial markets in the last several years. It is essential that Congress erect a regulatory framework that protects the integrity of the market and ensures that the market achieves its environmental purpose. Policy makers will need to design a carbon emissions allowance market that is transparent, that prevents market participants from manipulating prices, and that can resist the development of speculative bubbles that divert prices away from the fundamental drivers of supply and demand.

Fortunately, the good news is that it's perfectly possible for Congress to do.

Key Principles in Market Design

The purpose of the new market will be to establish a trading mechanism for allowances to be priced and traded so that emissions can be reduced in the most cost-effective manner and the product can be a useful tool in emission abatement implementation and planning. Unlike most financial markets, the carbon market should not be viewed primarily as an investing opportunity or a means to facilitate commercial activities. Its regulation should be directed toward ensuring fair and stable pricing of the allowances, albeit with sufficient liquidity to provide an efficient means of trading the allowances. Thus, the regulatory and enforcement focus in a carbon market should be on four overarching objectives:

- First, the trading market should be designed to be as transparent as possible. In particular, trading should take place out in the open, and federal regulators must be able to monitor all trading activity.
- Second, the trading market should be protected from price manipulation and fraud. Price manipulation involves a participant in the market who attempts to create artificial movements in the prices of the allowance products or who imposes a deceit on or abuse of the market. Federal regulators should also prohibit fraudulent activities connected to the market, such as misrepresentations designed to induce a person to buy or sell an allowance.

- Third, regulators should write rules that help maintain fair and orderly markets. The rules of the trading markets should be designed so that no unfair trading advantages are created and that price movements are not distorted or disruptive. This also means that rules and regulations do not contain loopholes that allow some trading activities to occur in an unregulated manner, and that the rules prevent excessive speculation in the market that could lead to price bubbles or excessive troughs.
- Finally, rules and regulations should be designed in such a way as to make their enforcement simple and effective. The rules of the market become meaningless if they cannot be enforced effectively. Regulators should not allow trading activities that they cannot readily monitor or understand, and should design market rules that ease market surveillance and oversight.

Creating a Good Carbon Market Architecture

Because the carbon market is being created de novo, it can be built in a manner that avoids many of the problems that we have seen in markets recently. In my view, a combination of an exchange-only trading requirement, strict limitations (such as position limits and margin requirements) on traders, and tough enforcement provisions can protect the public from the excesses and abuses that have occurred recently in financial markets. This is essential because the environmental purposes of the market are best served by a well-regulated and well-behaved market.

Of particular concern is trading in the over-the-counter (OTC) market. The rationale usually given for OTC trading is that it would enhance financial innovation by allowing market participants (in particular Wall Street banks) more flexibility to devise and trade complex, customized financial tools to manage risks. However, this type of trading has been the source of most of the financial difficulties that we have seen recently. First, because the contracts were between private parties, OTC trading occurred outside of the public eye. Second, the products themselves were often very complicated and contained special terms that made them unlike any other contract. This made them difficult to value because there was no market price to which the contract could be compared. Third, when one party to the contract defaulted, the other party was

often not able to absorb the loss, which potentially could trigger a cascading series of defaults throughout the financial system.

That is not to say that derivative instruments based on emission allowances are a bad idea. To the contrary, derivative instruments can help companies manage the price risks associated with their need for emission allowances in future years. For example, assume that a company plans to open a new plant in five years. Because the plant is expected to emit a certain amount of carbon, the company knows that it will need to acquire a specified number of emission allowances when the new plant is operational. If the company chose not to use any derivative instrument, it could simply purchase the allowance in the secondary cash market when the new plant becomes operational. However, the company would then be exposed to the risk that the price of purchasing emission allowances might be substantially higher in five years than what the company had budgeted. Alternatively, if the company wished to hedge that price risk, it could purchase a futures contract with a settlement date (i.e., the date when the allowance would be delivered) near the time when the plant is expected to become operational. The price to be paid for the emission allowances in five years would be locked in at the time the futures contract is purchased, thus enabling the company to know what the price will be and to prepare its budget accordingly.

In a carbon market, the needs of regulated emitters are likely to be straightforward in terms of having adequate allowances to meet their compliance obligation and in managing their price risk with futures and options contracts. These products are easily standardized and well-suited to exchange trading. Requiring trading to occur on registered exchanges simultaneously addresses all three of the problems occurring in the OTC market. First, exchange trading maximizes market transparency, because all parties in the market have access to pricing

information in real time, and can see what other traders are doing. Because all trading activity occurs in just a few places and in the public view, it is easier for federal regulators to monitor trading activity and to detect attempts to manipulate prices. Indeed, the exchanges themselves often serve as a first line of defense in monitoring and regulating markets. Second, exchange-traded products have standardized terms that are frequently traded. This makes them easy to understand and easy to price, and it improves market liquidity, which helps to keep the cost low.

Third, the exchange clearing house acts as the central counterparty to traders, i.e., the clearing house in essence provides a performance guarantee to both the buyer and the seller of a cleared contract. This means that buyers and sellers need not worry about each other's creditworthiness; instead, they can rely on the creditworthiness of the clearing house. This is in stark contrast to transactions in OTC derivatives, where a firm needs to monitor closely the credit standing of the other party in order to avoid transactions with a party that might later become insolvent (as happened with Lehman Brothers). When a clearing member enters into a trade on an exchange, it is required to post a certain amount of margin (performance bond) to cover the maximum expected one-day loss the resulting position could incur. The clearing house marks the position held by each clearing member every day to the daily closing market price of each position. If the value of the positions held by a clearing member goes down, the clearing member is required to make a payment (known as variation margin) to the clearing house equal to the decline in the value of its positions. This payment must be made by early the next morning, before the market opens for trading.

The central counterparty system thus provides a high degree of financial integrity. All positions are valued every day based on market prices as determined by a neutral party. If a position's value erodes, there is a daily call for cash. Under this system of daily marking-to-the-

market, a firm cannot hide its losses by pretending that its position has a value equal to its historical book value. This financial discipline would have prevented many of the problems now being faced by banks holding mortgage-backed securities and OTC derivatives that are worth much less than the value attributed to them on the banks' balance sheets.

In addition to requiring that all trading take place on exchanges, the market should be designed to create a structure to set and adjust trading rules and restrictions to prevent market abuses and excesses. There are a number of standard tools that can be used to control market behavior. These include rules on position limits and margin requirements for traders, restrictions on short sales, and limits on trading if prices move dramatically in a given time period. Market regulators should make full use of these tools to dampen volatility, prevent speculative bubbles, and prevent market abuses.

At the same time, regulation should not be so stringent that it chokes off trading interest to the point that market liquidity is hurt. When a market stops being liquid, it is subject to extreme price swings as desperate buyers drive up prices in a bidding frenzy, or panicked sellers try to unload their positions at fire sale prices. Experience in the U.S. commodity futures markets has shown that liquidity can be enhanced when the number of market participants increases. When a market is limited only to commercial participants in the instruments being traded (e.g., farmers and grain elevators in the case of wheat futures, or regulated emitters in the case of emission allowances), trading can become difficult and infrequent because there may not be willing buyers at the same time there are willing sellers. Permitting other participants – variously called “liquidity providers,” “market makers” and “speculators” – into the trading market can smooth out trading activities and thus provide a more liquid market. Thus, a careful

balance needs to be struck between having tough rules that will deter market abuses versus overly strict rules that will discourage legitimate trading activities.

Finally, the market should be designed to ensure that the rules of the carbon market are easily and readily enforced, and that there are significant sanctions for those that violate these rules. There are four essential elements to successful enforcement of the rules of the carbon market. First and foremost, federal regulators must have the commitment and resources to actively and vigorously oversee the market. Congress must also do its part by providing adequate funding for regulatory agencies, and in conducting oversight over carbon market regulators on behalf of the public. Second, market participants should be required to keep sufficient and satisfactory records to enable federal regulators to assemble information about trading activity. This recordkeeping by traders would be in addition to any reporting and monitoring requirements that would be required to be collected by the exchange. Third, regulators need the legal tools and resources to effectively investigate and audit market participants to ensure that all activity is legal. These tools and resources include adequate budget and personnel to conduct investigations, and legal authorities such as subpoena power for records or for witness testimony. Lastly, civil and criminal penalties for violating trading rules in carbon markets need to be sufficiently severe to deter illegal activity. That means that the federal regulator must both zealously investigate and prosecute rules violations, and that the penalties are tough enough to be an effective deterrent.

Thank you for the opportunity to present my views to the committee.