THE COMMERCIAL ENERGY WORKING GROUP

PROPOSED STATEMENT OF PURPOSE
REPORT ON GUIDING PRINCIPLES FOR CARBON MARKET DESIGN
PREPARED BY THE CFTC ENERGY AND ENVIRONMENTAL MARKETS COMMITTEE

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INTRODUCTION

The Commodity Futures Trading Commission ("**Commission**" or "**CFTC**") has addressed the issue of carbon markets and climate risk on various occasions. In 2011, the Commission participated in the Interagency Working Group for the Study on Oversight of Carbon Markets ("**Interagency Working Group**"). The Interagency Working Group, led by then-CFTC Chairman Gary Gensler, was also composed of the following members: the Secretary of Agriculture; the Secretary of the Treasury; the Chairman of the Securities and Exchange Commission; the Chairman of the Federal Energy Regulatory Commission ("**FERC**"); the Chairman of the Federal Trade Commission; the Administrator of the Environmental Protection Agency; and the Administrator of the Energy Information Administration. In January 2011, the Interagency Working Group issued the *Report on the Oversight of Existing and Prospective Carbon Markets* ("**2011 Report**"), which was required by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), and provided an analysis of the then-current, complex web of regulatory oversight of carbon markets.

More recently, the Commission touched on the issue of carbon pricing as part of a report issued in September 2020 by the Climate-Related Market Risk Subcommittee of the CFTC's Market Risk Advisory Committee ("**MRAC**") entitled "Managing Climate Risk in the U.S. Financial System" ("**2020 MRAC Climate Report**").[1] While recognizing the centrality of carbon pricing to regulatory strategies designed to manage climate risk, the 2020 MRAC Climate Report advanced a set of recommendations that more broadly focused on efforts to address climate-related financial market risk.

Existing programs directed at the reduction of carbon emissions involve a complex mixture of various forms of state and federal regulation that, include, but are not limited to market-oriented approaches. Market-oriented approaches have been recognized as an effective, cost-efficient way to incentivize the reduction of carbon emissions consistent with legislatively or regulatory imposed emission targets. These approaches primarily include mandatory (compliance) and voluntary emissions trading systems ("**Cap and Trade Model**"). Increasingly, there has been a push to incorporate externally-determined (*i.e.,* regulatory) carbon costs into the price of physical energy and other commodities ("**External Carbon Pricing Model**"). Examples of market-oriented approaches to carbon reductions that are currently in effect include, but are not limited to, the following:

- Existing Cap and Trade Model programs, like the Regional Greenhouse Gas Initiative ("**RGGI**") and Western Climate Initiative ("**WCI**").

- Low-Carbon Fuel Standard ("**LCFS**") programs, including the Transportation and Climate Initiative ("**TCI**").

[1] CFTC Press Release, CFTC's Climate-Related Market Risk Subcommittee Releases Report (Sept. 9, 2020), https://www.cftc.gov/PressRoom/PressReleases/8234-20.

- State renewable portfolio standards with associated renewable energy credit markets ("**RECs**") and state-adopted emission limitation regulations (*e.g.,* Massachusetts).

- Voluntary Carbon Markets, such as the carbon offset markets.

- FERC's Policy Statement on Carbon Pricing in Organized Wholesale Electricity Markets.[2]

As the physical, financial and transitional risks to the U.S. economy related to climate change appear to reach an inflection point, some form of legislative or regulatory action to address climate risk at the federal and state level appears to be increasingly likely. This inflection point is also reflected by efforts in the corporate sector to voluntarily reduce carbon emissions pursuant to formalized ESG initiatives. Absent federal legislation implementing a unified, national carbon policy, it is likely that, in addition to existing approaches designed to facilitate the reduction of carbon emissions, new products and markets will be created.

Physical, cash markets for carbon allowances and off-sets and markets for derivatives subject to the Commission's jurisdiction under the Commodity Exchange Act ("**CEA**") are closely price-linked. This linkage is perhaps closer and better correlated than in the case of derivatives and physical commodities. In addition to being used for direct emission reduction purposes (*i.e.,* physically-delivered carbon futures), carbon derivatives also play an important function in enhancing liquidity and facilitating price discovery, as well as managing price risk exposure, in secondary cash markets for carbon allowance and offset.

The Commercial Energy Working Group ("**CEWG**") proposes for internal discussion by Energy and Environmental Markets Advisory Committee ("**EEMAC**") the establishment of a subcommittee charged with assignment of preparing a report setting forth guiding principles for the design of markets for the independent trading of carbon allowances and offsets (*i.e.,* secondary, non-compliance markets).[3] The CEWG recognizes complexity of this topic and that industry groups and task forces are actively considering proposed carbon market designs.

However, the CEWG believes that this proposal is distinguishable from other carbon market efforts. Specifically, as envisioned by the CEWG, the report would focus on the inextricable link between secondary cash markets for emission allowances and offsets and derivative markets. The sponsorship of such a report by EEMAC (or a subcommittee thereof) would be appropriate given the Commission's jurisdiction over derivative markets and its expertise as a "market regulator." The report is intended to provide a guidepost for facilitating fair and orderly trading in carbon markets by promoting uniformity and consistency between the design of secondary, cash and related derivative markets for carbon allowances and offsets.

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[2] *See e.g., Federal Energy Regulatory Commission,* Policy Statement on Carbon Pricing in Organized Wholesale Electricity Markets, Policy Statement, 175 FERC ¶ 61,036 (April 15, 2021)("**FERC Policy Statement on Carbon Pricing**").

[3] The report issued by the Interagency Working Group in 2011 undertook a broad analysis of the regulation and oversight of carbon markets at the time. As noted above, the scope and intent of the proposed statement of purpose is different in that it specifically addresses certain guiding principles that should be considered as part of any market-based approach to implementing carbon policy.

PROPOSED GUIDING PRINCIPLES

With respect to secondary markets for independent trading of allowances and offsets, the CEWG proposes for discussion with EEMAC members whether the following structural elements are appropriate for inclusions as part of any proposed guiding principles on carbon market design:

- *Clear Statement of Jurisdiction*. A clear statement of the appropriate regulatory body's jurisdiction over such markets, including authority to facilitate fair and orderly trading by protecting such markets from fraud, manipulation and other forms of scienter-based market abuses.

- *Identification of Policy Objectives*. Explicitly state the policy objectives of the market and market design, *i.e.,* the achievement of identified mandatory emission reduction targets through a structure that allows for the mitigation of compliance costs and exposure to price risk.

- *Recognized Need to Facilitate Continued Market Development and Liquidity*. Recognition that carbon markets are in their infancy and the imposition of comprehensive regulation on participants transacting in these markets would be cost prohibitive, chill liquidity and result in regulatory arbitrage. However, coordination and information sharing with other regulators at the federal and state level should be strongly encouraged.

- *Benchmark Setting*. Benchmark markets will have different physical settlement requirements and perhaps have delivery from more than one underlying registry. A need for appropriately-tailored governance around benchmark-setting markets exists in order to ensure the integrity of the settlement process. For example, there cannot be a risk of underlying settlement certificates/credits later being invalidated. Given the potential impacts to the secondary market, there must be a market monitor and controls around the primary market.

- *Key Market Design Features*. With respect to secondary markets for independent trading of allowances and offsets, the CEWG proposes for discussion with EEMAC members whether the following design features are appropriate for inclusion in any guiding principles for carbon market design:

    - Registration of market operators and clearing organizations.

    - Onboard process. (*i.e.,* centralized trading platforms and intermediaries should have a mechanism to vet market participants (KYC, money laundering, etc.).

    - Fair and equitable trading practices.

    - Flexible execution.

    - Financial integrity of centralized markets and over-the-counter markets.

    - Public access and minimum eligibility requirements.

    - Information Transparency - pre-trade, post-trade transparency and prices.

- Liquidity (broad participation in markets, including voluntary participation for risk management and speculative purposes, etc.).
- Price discovery.
- Transaction monitoring and trade surveillance, including by self-regulating organizations, such as DCMs.
- Integrated role of derivatives.
- Market integrity and customer protection.
- Cross-border coordination, consistency and deference