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LEAD STORIES

Congress eyes OTC trade ban

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Carbon market participants have hit back at proposals in the US Congress that, if passed, would see the emerging federal carbon market operate under strict regulation, with a *de facto* ban on over-the-counter (OTC) trading, as legislators act to prevent Enron-like fraud, manipulation or excessive speculation.

Influential Congressmen Barney Frank and Collin Peterson unveiled an extensive proposal on 30 July to oversee OTC derivatives, which calls for them to be cleared through an approved clearing house and gives regulators the power to prohibit transactions not traded or cleared on exchanges or exempt them from these requirements if, for example, the regulator determines that the contract is not standard enough to clear through an exchange. This would apply to all commodity derivatives, including the expected carbon allowances market.

The US Treasury, on 11 August, published a similar proposal.

“Derivatives have developed a bad name,” said Harold Buchanan, managing partner at environmental investment manager CE2 Capital Partners in California. “When you blame these derivatives, it’s like blaming a knife for a murder.”

An energy and environmental bill passed by the House on 26 June would impose similar restrictions on the OTC carbon market, but would be repealed in favour of the broader oversight measures proposed by Frank and Peterson if they are adopted by Congress. The Senate version will likely include elements of a proposal by Senators Dianne Feinstein and Olympia Snowe, which allows carbon swaps to be regulated, grants full oversight authority for all carbon market trading to the Commodity Futures Trading Commission (CFTC) and requires the agency to set up a clearing house for allowance transactions.

“I would not support a bill unless it had very tough oversight,” leading Democratic Senator Barbara Boxer said.

Carbon market participants support some of the broader themes of the reform measures, but warn that others could hinder the market’s growth.

Buchanan said he could support mandatory disclosure of OTC trades, in a push for transparency, so the CFTC can monitor activity for signs of manipulation without having to disclose that information publicly.

But requiring OTC trades to be cleared on exchange would effectively make it impossible to complete many trades, said David Hunter, US policy director for the International Emissions Trading Association in Washington. “Undue restrictions on the market will drive up costs, and I think that’s what we want to try to avoid,” he said.

Small and medium-size emitters may find the high collateral requirements of the exchanges unaffordable.

Plus, many OTC contracts do not fit within the rigid nature of exchange contracts because they are specifically tailored to meet unique needs and risks, such as cash flow and asset concerns, participants said.

"In the long term, [limitations on OTC trade] will increase transaction costs, decrease liquidity and dramatically increase risk by concentrating more and more market volume in the hands of fewer and fewer intermediaries," said Kedin Kilgore, managing partner at environmental markets advisory firm CO2 Capital in New York.

The impact would be most significant for compliance buyers, who would face higher costs of hedging their carbon exposure and be at a competitive disadvantage compared to jurisdictions that allow more access to OTC derivatives, said Abyd Karmali, a managing director at Bank of America Merrill Lynch and president of the Carbon Markets & Investors Association.

But the limitations on OTC trading are more of an issue for existing energy markets that rely on such instruments, said Jeremy Weinstein, an energy lawyer in Walnut Creek, California who represents utilities and energy marketers.

"The lack of derivative trading in carbon doesn't really bother me that much," he added.

At the heart of the reform movement lies "troubling" presumptions that carbon traders will behave badly and manipulate the market, as the now-defunct Enron did in the electricity markets during the early part of the decade, market experts said.

And for all the alleged harm speculators cause – some observers blame them for the steep climb in oil prices last summer – they provide valuable benefits to the markets, including price transparency and increased liquidity, they said.

"It's interesting that we're talking about cap-and-trade as a solution, but we're saying we really don't trust the trade part," Buchanan said.