Executive Summary

The Western Climate Initiative is a collaboration of seven US states and four Canadian provinces to reduce greenhouse gas emissions, including the design and implementation of a cap-and-trade program. The WCI is working through five committees, including the Markets Committee, to complete tasks and deliverables for implementation. Recommendations on oversight of markets for greenhouse gas allowances and offset certificates (“compliance instruments”) is among the Markets Committee’s tasks. This document provides draft recommendations on market oversight. Following public comment and continued work by the Markets Committee, the Committee will issue Final Recommendations.

The Markets Committee has used a variety of sources of information in developing its recommendations, including published reports, presentations, stakeholder comment, contact with market participants and regulators, and contracting with outside advisers. It adopted principles to guide its work and recommendations.

The Markets Committee has identified twelve items as the tools or decisions WCI Partner jurisdictions can use or make to establish effective oversight of compliance instruments. The Draft Recommendations are:

1. Treat Compliance Instruments as Commodities for Market Oversight Purposes
2. Information on Derivatives Positions
3. Treat Allowances and Offset Certificates Identically for Market Oversight Purposes
4. Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System
5. Do Not Limit Market Participation to Compliance Entities
6. Require Registration of Intermediaries as Market Professionals
7. Holdings Limits
9. Require Reporting of Beneficial Ownership
10. Information Required for Compliance Instrument Transfer
11. Secondary Market Holdings and Transfer Information Disclosed to Public
12. Market Monitoring

In many cases, the Draft Recommendations are interrelated, and changing one could change another. Importantly, the first Draft Recommendation implies the adoption of an existing framework for regulating compliance instrument derivatives. Consequently, Draft Recommendations 3 – 12 are primarily focused on secondary markets.

In considering Draft Recommendations, the Markets Committee recognized and attempted to weigh a number of factors that were often difficult to predict and sometimes were in competition. These included transparency, market liquidity, allowing markets to evolve, adopting best practices and lessons from more mature markets, leadership, resource demands on jurisdictions and participants, unique characteristics of markets for compliance instruments, and enforceability. The Committee believes that the resulting Draft Recommendations describe policies that will enhance the ability of the cap-and-trade program to contribute to greenhouse gas emissions reductions at relatively low cost, provide regulatory oversight, and promote market participant confidence. The Committee welcomes comment on the Draft Recommendations individually and collectively, and in particular on:

A. Whether the tools available to WCI Partner jurisdictions for market oversight have been completely and correctly identified;
B. Whether the Draft Recommendations would correctly maximize the environmental and economic benefit to the public and support WCI’s Principles of Market Oversight;
C. Whether the Committee should recommend collection of derivatives position information from market participants, including on over-the-counter derivatives; and if so, what of that information to disclose to the public; and
D. The Draft Recommendation to require secondary market trades to use a central limit order book.
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1 Purpose and Background

The Western Climate Initiative (WCI) is a cooperative effort of seven U.S. states and four Canadian provinces that are collaborating to identify, evaluate, and implement policies to reduce greenhouse gas (GHG) emissions, including the design and implementation of a regional cap-and-trade program. The WCI began in February 2007 with the governors of Arizona, California, New Mexico, Oregon, and Washington, who have since been joined by the premiers of British Columbia, Manitoba, Ontario, and Quebec, and the governors of Montana and Utah. Participation in the WCI reflects each Partner jurisdiction’s strong commitment to identifying, evaluating, and implementing collective and cooperative actions to address climate change.

In September 2008, the Partner jurisdictions released the final “Design Recommendations for the WCI Regional Cap-and-Trade Program.” The first compliance period for the cap-and-trade program will begin January 1, 2012, covering GHG emissions from electricity generation (including emissions associated with imported electricity), combustion at large industrial and commercial facilities, and industrial process emissions for which adequate measurement methods exist. Starting in 2015, the program’s coverage expands to include transportation fuels in addition to residential, commercial, and small industrial combustion. Thus, by 2015 the cap-and-trade program will cover almost 90% of GHG emissions in the Partner jurisdictions.

In February 2009, the Partner jurisdictions released the WCI 2009 – 2010 Work Plan, describing the approach to implementing the Design Recommendations. The WCI is working through five committees: Offsets, Reporting, Complementary Policies, Cap Setting and Allowance Distribution, and Markets. The Work Plan describes the tasks and deliverables for each committee. The purpose of one of the Markets Committee’s tasks, “market oversight,” is to recommend measures to ensure that the allowance and offset certificate trading market is organized properly to operate reliably and prevent or minimize manipulation. This task was included in the work plan based on the consensus among WCI Partner jurisdictions on the need to provide effective oversight to assure an efficient and transparent carbon market.

These Draft Recommendations are based on the information collected and reviewed by the Markets Committee on market oversight approaches and issues. The information was obtained through several means, including the following:

1 The Design Recommendations and accompanying Background Report can be found at http://westernclimateinitiative.org/the-wci-cap-and-trade-program/design-recommendations.
• The Markets Committee held a stakeholder workshop on market oversight in Seattle, Washington in April 2009. The Committee presented a draft set of principles of market oversight, and a list of questions for discussion with those who attended in person or online.³ Stakeholders were invited to submit written comments.⁴ Stakeholders’ responses guided the Committee’s consideration of issues and the Committee revised the principles of market oversight as set forth below. The principles guided the Committee’s research, analysis, and deliberation, and will continue to do so as the Committee progresses towards final recommendations.

• The Markets Committee made a presentation to the WCI Partners on September 16, 2009, at a public meeting in Toronto, Canada, and invited stakeholder comment at the meeting.

• The Markets Committee made a presentation to the WCI Partners on November 18, 2009, at a public meeting in Santa Fe, New Mexico, and invited stakeholder comment at the meeting.

• The Markets Committee issued a white paper on market oversight⁵ on November 19, 2009, and invited written public comment by December 18, 2009. Eleven parties submitted comments.⁶

• The Markets Committee held a stakeholder call December 2, 2009, to present and discuss the market oversight white paper.⁷

• The Markets Committee made a presentation to the WCI Partners on March 3, 2010, at a public meeting in Vancouver, British Columbia, and invited stakeholder comment at the meeting.

• The Markets Committee held a webinar with the market monitor used by the Regional Greenhouse Gas Initiative (RGGI).⁸

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³ The principles and questions can be found at http://westernclimateinitiative.org/component/remository/func-startdown/25/. Market oversight was one of three tasks for which the Committee developed draft principles for comment; the others were auction design and compliance verification and enforcement.

⁴ Stakeholder comments were submitted to the WCI website, and can be found at http://westernclimateinitiative.org/documents/public-comments/document/2.

⁵ The white paper can be found at the WCI website, at http://westernclimateinitiative.org/component/remository/func-startdown/174/.

⁶ Comments can be found at the WCI website, at http://westernclimateinitiative.org/public-comments/document/13.

⁷ The presentation from the stakeholder call is available on the WCI website, at http://westernclimateinitiative.org/component/remository/Markets-Committee-Documents/Market-Oversight-White-Paper-Presentation/.
• The Markets Committee consulted with U.S., Canadian, state, and provincial regulatory authorities, and received input from European market regulators, potential market participants, trade associations, market infrastructure providers, and other stakeholders.

• The Markets Committee conducted a literature review with the assistance of our task advisor at the Nicholas Institute for Environmental Policy Solutions at Duke University.

Through this process, the Committee acquired substantial knowledge about the types of regulation in place in existing financial markets, the roles of regulators and exchanges, and the scope of existing carbon-related financial products.

In this document, “compliance instrument” refers to either an allowance or an offset certificate, unless otherwise noted. This document builds on the definitions and discussion in the market oversight White Paper without restating them, in most cases.

2 Principles

These principles were adopted with the publication of the white paper on November 18, 2009, and have been modified only to change “allowance” to “compliance instrument” and “offset credit” to “offset certificate” to standardize nomenclature. They serve as guidelines for developing oversight of the compliance instrument and associated derivatives trading markets to assure maximum environmental and economic benefit to the public.

• **Fairness**: All market participants, especially covered entities, have fair and equal access to the market.

• **Efficiency**: The market is designed to operate efficiently so that greenhouse gas (GHG) emission reductions can be achieved at the least cost. An efficient market means that allowance and offset certificate prices reflect supply and demand, and accurately reveal the value of allowances and offset certificates.

• **Effective Oversight**: The design and oversight of the market is effective in preventing or minimizing fraud, manipulation, and speculative excess.

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8 The presentation from the webinar is available at http://westernclimateinitiative.org/component/remository/Markets-Committee-Documents/Monitoring-Emissions-Allowance-Markets/.
• **Transparency and the Reporting and Disclosure of Relevant Information:** Transparency in the design and the operation of the allowance and offset credit market builds and retains public confidence.

  o Reporting of relevant information to regulatory authorities and public disclosure of information has important benefits. It enables regulatory authorities to conduct effective oversight and ensure compliance. It also helps to ensure market efficiency, effective oversight, and compliance and enforcement. The release of information can change the decisions of market participants, which impacts the prices of allowances and offset credits. Timely, accurate, coordinated and consistent release of market-relevant information allows all market participants to have equal access to public information.

  o The reporting and disclosure requirements for compliance, verification and enforcement balance these benefits against the need for entities to protect certain sensitive information. The potential to disclose certain information that could be used to manipulate the market is also considered. This balancing is consistent with applicable law relating to the disclosure of information.

• **Administrative Simplicity and Cost:** Proposed rules are designed to be understood and enable entities to have a clear compliance path. Administrative costs and transaction costs are minimized for all parties, consistent with the need to provide effective oversight.

• **Accountability:** All entities involved in the allowance and offset credit market, as either regulators or market participants, are accountable for their actions. The responsibility, authority, and capacity to conduct the necessary oversight and take appropriate action are fully defined for all agencies charged with compliance, verification and enforcement.

• **Conflicts of Interest:** Conflicts of interest between market participants, monitors, and regulators are prevented.

### 3 Stakeholder Comments on White Paper

The Markets Committee received 11 written comments to the white paper. The Committee identified and asked for comment on three key issues, as well as general comment on the content of the white paper.

The first key issue was, “Whether current U.S. and Canadian regulation of commodity markets is appropriate.” Five commenters responded to this issue. In general, the comments favored treating allowances as commodities, rather than construct a new definition or new framework for their regulation. One commenter, however, said that though allowances would fit the
framework for regulation as commodities, oversight of over-the-counter (OTC) derivatives beyond current commodity oversight was needed.

The second key issue was, “Whether to place restrictions on OTC instruments.” Seven commenters responded to this issue. Six commenters recommended not restricting the use of OTC instruments, citing their flexibility and the costs of clearing in exchange transactions. Of those six, three recommended requiring more information on such transactions than is currently reported to regulators. One commenter recommended restricting transactions to exchanges, to reduce complexity and the risk of market manipulation.

The third key issue was, “The appropriate transparency and disclosure requirements.” Five commenters responded to this issue. They said that an appropriate balance of transparency and confidentiality, as well as the costs and benefits of collecting particular data, exists. Three commenters recommended that more information be revealed to regulators than would be made public, and specifically recommended aggregation of data prior to public disclosure. On the December 2, 2009 stakeholder call, some stakeholders requested a specific proposal to respond to. One commenter made specific recommendations on information requirements to restrict the use of inside information.

Commenters made further recommendations to the WCI Partner jurisdictions. Two described recommended roles for a central market monitor. Two requested clarification of the legal authority jurisdictions had over allowance markets, as prerequisites for determining the specific recommendations for oversight. A short discussion of the roles of provincial, state, and federal regulatory authorities is in section 5 of this paper. The Final Recommendations paper will include a more detailed discussion.

Some comments addressed issues outside the scope of the market oversight task, and some commenters took issue with phrasing in the white paper. Two commenters requested a fuller acknowledgement than in the white paper of the possibility and consequences of market manipulation. One commenter requested more information on the risks of low market liquidity, including the risk that liquidity would be harmfully low.

4 Draft Recommendations

The Draft Recommendations presented here incorporate the information the Markets Committee has received and developed on market oversight. Among the general conclusions the Committee reached is that many aspects of oversight are interrelated. In many cases, a Draft Recommendation below depends on the implementation of another Draft Recommendation. For each Draft Recommendation, the Committee has noted these
relationships; if one were to change, others likely would as well. For this reason, the Committee has considered the Draft Recommendations as a package.

Of particular note is Draft Recommendation 1 (Treat Compliance Instruments as Commodities for Market Oversight Purposes). It does not recommend that the Partner jurisdictions implement new restrictions on the trading of derivatives. This influences the discussion of the further Draft Recommendations, especially by narrowing the focus of several to secondary markets.

Second, some of the Draft Recommendations imply or require particular technical capabilities in a cap-and-trade compliance instrument tracking system. Where this is the case, the requirements are discussed with the Draft Recommendation. An electronic tracking system provides complete accounting of compliance units, recording the real-time status of issuance, holdings and transfer of compliance units between accounts, and providing the function to reconcile reported emissions for each compliance period with the compliance entity’s holdings.

4.1 Allowances, Offset Certificates, and Derivatives

4.1.1 Draft Recommendation 1: Treat Compliance Instruments as Commodities for Market Oversight Purposes

4.1.1.1 Background

Commodity cash and derivatives markets are closely linked, and activity in one will affect behavior in the other. Nevertheless, they are different in definition and in legal framework and warrant separate treatment. The market oversight white paper described commodity derivatives and the regulatory framework for them, and the discussion here builds on that.

4.1.1.2 Options

The first of the “key issues” the Markets Committee asked for comment on in the white paper was:

A) Whether cap-and-trade compliance instruments should be treated as commodities, which would place them in the context of a body of existing law and regulation, or

B) Whether to attempt to define compliance instruments in such a way that they would not be commodities, and develop a new body of law and regulation.

4.1.1.3 Evaluation of Options

As described in the market oversight white paper, “Commodities are goods that are interchangeable with other goods of the same type.” Cap-and-trade compliance instruments in the US Acid Rain Program, RGGI, and the European Union Emissions Trading Scheme (EU ETS)
have been treated in many ways as commodities by market participants and regulators. Though they are instruments that will ultimately be used to satisfy legal requirements, as finite resources they have market prices.

Whether to treat compliance instruments as commodities for market oversight purposes is a fundamental question in the US especially, because federal law preempts the states from certain regulation of commodity derivatives. By “derivatives” we mean both exchange-traded instruments, such as futures and options contracts, as well as instruments traded over-the-counter. Therefore, determining that compliance instruments are commodities places the responsibility for regulation of their derivatives in the US primarily with the US Commodity Futures Trading Commission (CFTC). The advantages to this include the long history of futures and options regulation, and staff and infrastructure resources at the CFTC. The disadvantages include potentially less control of the non-cash markets by the Partner jurisdictions.

Like energy commodities, compliance instruments could be considered an input to many kinds of economic activity, including production of electricity and use of transportation fuels. In addition to concern that financial manipulation might benefit a few persons at the expense of many, high volatility and higher-than-expected prices in compliance instrument markets have the potential to undermine public support for a cap-and-trade program, which could make achievement of environmental goals more difficult. Partners, therefore, might weigh tradeoffs between transparency, market efficiency, prices, and volatility differently from the legislators and regulators who have established the framework for commodity derivatives regulation.

Participants trading compliance instruments in existing carbon markets have generally treated them as commodities. Many firms that are covered in existing cap-and-trade programs require energy commodities as inputs. As with commodities, compliance instrument prices should reflect market fundamentals, such as economic conditions and industrial production more than the decision of a single firm. (In contrast, the price of a firm’s securities can be linked closely to the business decisions of that firm.)

In its consideration of alternatives to treating compliance instruments as commodities, the Markets Committee found three additional strong arguments not to create an alternative framework. First, the definition of “commodity” in the Commodity Exchange Act\(^9\) is sufficiently broad that it would be difficult to devise a definition of compliance instruments that would not place their derivatives under CFTC regulation in the US. Second, no alternative framework rose up as superior. Third, though the Canadian provinces each have a securities commission that regulate derivatives, in general, because of federal preemption, the US state governments

\(^9\) 7 U.S.C. 1a (4)
retain less authority to regulate national financial markets and, as a result, creating the regulatory capacity for oversight of compliance instrument derivatives traded on national markets could require a significant investment of time and funds.

4.1.1.4 Experience in Existing Environmental Cap-and-Trade Programs
In the US, Acid Rain Program and RGGI compliance instrument derivatives are regulated by the CFTC as commodity derivatives. In the EU ETS, regulation of derivatives is performed by individual countries. That said, most of the exchange-based derivatives activity takes place on the European Climate Exchange, based in London, which is regulated as a commodity derivatives exchange by the UK Financial Services Authority.

4.1.1.5 Draft Recommendation
The Markets Committee recommends that compliance instruments be treated in the same framework and by the same regulators as commodities for the purpose of derivatives regulation. This implies the primacy of the provincial securities commissions and the CFTC in oversight of that aspect of the market. The Committee recommends a close coordination of oversight efforts between agencies of the Partner jurisdictions and US federal regulators.

4.1.1.6 Relationship to Other Draft Recommendations
A discussion on the collection and dissemination of data on derivative positions is included in Draft Recommendation 2 (Information on Derivatives Positions). Some of the data that could be collected is not currently collected by the CFTC or provincial securities commissions, and would then be an exception to the general recommendation that compliance instruments be treated like other commodities.

The remainder of the Draft Recommendations would then apply only to secondary markets in compliance instruments.

4.1.1.7 Requirements of Tracking System
This Draft Recommendation does not imply technical requirements of the tracking system.

4.1.2 Draft Recommendation 2: Information on Derivatives Positions

4.1.2.1 Background
The WCI cap-and-trade program will likely lead to the development of a market for compliance instrument derivatives, as covered entities seek to hedge the cost and availability of compliance instruments in order to meet their compliance obligations. In the United States, regulation of commodity derivative markets occurs at the federal level. In Canada, these markets are regulated at the provincial level. Currently, derivative trading in energy commodity markets
occurs in a variety of venues including regulated exchanges and through private “over-the-counter” (OTC) contracts. Market regulators in Canada and the United States do not track OTC trading of energy-related derivatives as closely as exchange-traded contracts. As a result, it is difficult to track trading activity across the energy derivative markets. Efforts are underway in both countries to reform market regulation, in part because of concerns that OTC opacity allows for undetectable manipulative behavior or drives speculative bubbles. These efforts may increase surveillance of OTC trading but the likely outcome is unclear.

### 4.1.2.2 Options

The Markets Committee identified the following options regarding collection of information on derivative positions:

- **A.** Collect on an ongoing basis information on derivative positions from those with accounts in the cap-and-trade tracking system or ownership interest in a compliance instrument that is additional to the information currently collected by commodities regulators;
- **B.** Collect on an ongoing basis information on derivative positions from some entities, e.g., registered intermediaries;
- **C.** Do not collect derivative position information on an ongoing basis, but ensure that regulatory authorities are authorized to collect and fully disclose derivative position-related information in a timely fashion on an as-needed basis, including information that would be material to an investor’s decision to acquire or dispose of a derivative;
- **D.** Do not collect additional information on derivative positions.

Depending upon which of the options above the Markets Committee recommends, the WCI cap-and-trade program may or may not have information on derivative positions to retain internally or disclose publicly. If information on derivative positions is collected on an ongoing basis, the Markets Committee has identified the following options for disclosure of derivatives market information:

- **A.** Disclose all derivative positions reported (i.e., those of participants with tracking system accounts or ownership interest in a compliance instrument);
- **B.** Disclose the largest derivative positions (e.g., exceeding a certain percentage of the total market);
- **C.** Disclose derivative positions aggregated to a level similar to the Commodity Futures Trading Commission Commitments of Traders reports; or
- **D.** Do not disclose information on derivative positions.

The Markets Committee has considered the following options in terms of how derivatives market information could be disclosed:

- **A.** Directly through a central derivatives information repository, and through search functions;
- **B.** Through exchanges where transactions occur;
C. Through periodic WCI market reports published on a website; and/or,
D. Situationally by commodities derivatives regulators, as they deem appropriate.

Frequency of data collection will also have important consequences for each of the above options. The Markets Committee has considered daily, weekly, monthly, and quarterly disclosures.

4.1.2.3 Evaluation of Options: Data Collection

Rationale for Data Collection

Three main benefits may accrue from collecting data on account holders’ derivative positions. First, though data on exchange transactions is relatively transparent to regulators, the Partner jurisdictions appear to be in a position to collect information on OTC transactions that is not currently routinely accessible to market monitors. Data collection as part of the cap-and-trade program could supplement the regular efforts to monitor compliance instrument derivatives markets; the data could be transmitted to provincial and US federal monitors. A consolidated repository of information on the compliance instrument derivatives markets across jurisdictions and trading venues could enhance transparency of the cap-and-trade market.

Second, in the event of unexpected or suspicious activity, the derivatives position data collected could serve a forensic purpose as regulators examined market activity and traced causes.

Third, as stated in the Design Recommendations for the WCI Regional Cap-and-Trade Program, "the WCI Partner jurisdictions are committed to providing appropriate technical and other compliance assistance to the program participants." If it is using derivatives contracts as part of its strategy, an entity may be better able to demonstrate that it is on track and managing its risk in the accumulation of compliance instruments during a compliance period if derivative positions are reported. (In the EU ETS, the majority of the market is in derivatives, not the spot market. Derivatives would not be reflected in the tracking system until settlement.)

Timing

To identify trading irregularities as they occur and initiate immediate enforcement actions, regulators need to receive and evaluate market data on an ongoing basis. Product innovation and market structure changes challenge regulators, in their policymaking role, to constantly consider whether the current regulatory framework continues to provide investor protection and market integrity given new products and structures. Collecting, aggregating, maintaining,
and analyzing large amounts of data requires informational technology and staff resources. The cost of collecting data more frequently should also be weighed against its benefits.

If the goal is more limited, e.g. to identify trends and maintain data for use during longer-term enforcement actions, daily reporting by market participants becomes less important. In that instance, weekly or monthly reports may be sufficient to monitor general trends in trading behavior and have on record in the event enforcement actions become necessary.

**Proposed Derivative Reforms**

Systematic ongoing collection of OTC derivatives data would go beyond the approach currently used by commodities regulators in North America, which may be seen to be an advantage or disadvantage. The Partner jurisdictions may feel that a nascent market created by government action has intrinsic differences from other commodities, including necessary public support, to say that the standards and tools of effective oversight are also different. The Partners jurisdictions may wish to anticipate or influence the financial reform efforts in favor of reporting OTC derivatives. Requiring such reporting in advance of the uncertain outcome of such reform efforts would make a strong statement about its importance in effective market oversight, and could influence the reforms.

US federal legislative proposals on financial market reform generally would require increased reporting and disclosure of OTC derivatives. In May 2009, the US Treasury Department released a proposal to reform OTC derivative markets.\(^{11}\) A key component of the proposal is mandatory clearing of standardized contracts and giving the regulators authority to determine whether a contract is standardized or not.

The US House of Representatives passed a financial reform bill in December 2009 that addresses mandatory clearing and transparency.\(^ {12}\) Title III of the bill applies to derivative markets and creates a presumption that standardized swap transactions will be cleared. The clearing requirement does not apply if one of the counterparties (a) is not a swap dealer or major swap participant, (b) is using swaps to hedge a commercial risk, or (c) notifies the CFTC how it meets financial obligations when entering into non-cleared swaps. If one of these exemptions applies and a swap transaction is not cleared through a registered clearing facility, the transaction must be reported to a registered swap repository. If no repository will accept the transaction, the transaction must be reported directly to the CFTC.

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Senate Banking Committee Chairman Christopher Dodd released a financial reform bill on March 16, 2010. As in the bill that passed the House of Representatives, Senator Dodd’s bill would require central clearing of standardized OTC contracts. The bill includes exemptions for certain swap transactions, but would require the CFTC to consult a Financial Stability Oversight Council before issuing an exemption. The Dodd bill would expand the CFTC’s jurisdiction over OTC instruments and grant federal regulators and clearing houses a role in determining whether clearing is required; regulators would have to pre-approve contracts before clearing houses could clear them. The bill would require federal regulators to determine margin requirements for un-cleared transactions and also require data collection through clearing houses or swap repositories. The Senate has not acted on the Dodd bill, and the Senate Banking Committee may amend the OTC provisions during the committee process.

Collecting information about derivatives contracts from registered intermediaries (e.g., brokers, merchants, traders, advisors, and pool operators) could provide regulators with a more complete picture of market activity, thereby helping regulators identify and prevent fraudulent activity. The WCI Partner jurisdictions could collect information from these entities about the products offered and sold during the reporting period, including volume, prices, contracting parties, types of contracts, and locations of the trades.

**Arguments**

There may be a number of drawbacks to collecting data on account holders' derivative positions. First, assuming the implementation of Draft Recommendation 4 (Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System), the WCI Partner jurisdictions may not be able to collect derivatives information from some entities who have neither tracking system accounts nor ownership interest in compliance instruments. Such participants represent a potentially large portion of the derivatives market. For example, entities who only participated in cash-settled derivatives markets would not need to hold accounts. Entities trading physically-delivered derivatives could still avoid holding accounts if they closed their positions before the delivery date. In addition, violations of the reporting requirement might not be visible to regulators; whether or not a report was complete in its listing of OTC derivatives would be difficult to determine.

Second, the potential benefit of collecting information on derivatives positions must be weighed against the potential increase administrative burden and cost for regulators and for the compliance entities that use derivatives to manage their risk. It may be challenging to anticipate new financial innovations that lead to market manipulation by analyzing the information on derivatives positions, so regulators may be limited to primarily using the information for forensic purposes.
Third, due to the nature of OTC derivatives, it may be difficult to collect derivatives positions information in a sufficiently consistent manner through the tracking system to allow broad analysis.

It is important to note that mandatory reporting of OTC derivative positions would require development of a new information technology platform. There exist companies that provide repository services and associated automated processing services for OTC derivatives. WCI Partner jurisdictions may therefore consider that there are models for collection of derivatives information that would not require an investment of funds from the jurisdictions. However, the process to select a provider would demand time and resources.

The International Swaps and Derivatives Association (ISDA) has recently concluded the selection of independent systems as global repositories for interest rate and equity derivatives, and is rumored to be considering a selection process for a commodity derivatives repository. If ISDA designates a repository, it could be a strong candidate for selection by the WCI jurisdictions as well, depending in part on the access regulators would have to collected data.

4.1.2.4 Evaluation of Options: Public Disclosure

In the view of at least one trade association of professional derivatives market participants (ISDA), policy makers tend to view transaction transparency—meaning in this circumstance “public disclosure”—as a desirable end in itself.13 In contrast, ISDA asserts, the academic literature tends to view transparency as a means to an end, for example, improved market efficiency, which implies the existence of tradeoffs. On the one hand, ISDA states, transparent markets might be more efficient from the standpoint of the information content of prices; but on the other hand, transparent markets might be less efficient when considering spreads and other transaction costs. For example, ISDA asserts that one would expect mandated transparency to lead to increased explicit costs (e.g., for accounting) because of the necessity to maintain both systems and staff to comply with the requirements; in addition, central reporting structures, if used, might charge fees to reporting firms.

ISDA argues that this trade-off suggests that market transparency should be evaluated in the context of specific market circumstances and public policy should push for higher transparency only in those cases where it can demonstrably make markets more efficient and more beneficial to users. To the extent that market participants demand more transparency as markets mature, ISDA believes that financial markets are likely to evolve ways to address market participants’ desire for more information relevant to their trading and risk transfer

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decisions. Mandated transparency, in contrast, specifies a particular solution across the board. ISDA cautions that such a “one-size-fits-all policy” runs the danger of disregarding the inherent nature of specific markets and could short-circuit the evolution of market-based transparency provision that would otherwise arise in response to real market demands.

The current Chairman of the CFTC, Gary Gensler, has a different view. In his words, “[t]he financial regulatory system failed the American public.”\(^\text{14}\) He has testified that “as a critical component of reform... we have to bring comprehensive regulation to the over-the-counter (OTC) derivatives markets. We must lower risk, promote greater market integrity and improve market transparency.” He proposes to “eliminate exclusions and exemptions from regulation for OTC derivatives,” such that the law “covers the entire marketplace, without exception.” The reforms he proposes have many components, only one of which is public disclosure. On that subject, he calls for “mandatory public disclosure of aggregate data on swap trading volumes and positions.” Rather than arguing for transparency as a desirable end in itself, Chairman Gensler argues for transparency and other steps “to protect the American Public.”

Canada’s financial regulatory system has fared well through the economic recession, illuminating an alternate perspective. Prime Minister Stephen Harper delivered a message at the World Economic Forum in Davos, Switzerland that “Canada believes that financial sector regulation... must not be excessive.” Canada’s model is based on a simpler regulatory approach that focuses more on the outcomes the regulated community must achieve than how they are achieved, to ensure innovation is not stifled.

In comments to the WCI Markets Committee on the market oversight white paper issued November 19, 2009, several commenters recommended greater transparency in and oversight of the OTC derivatives markets.

In this issue as in many that the Markets Committee is considering, there may be a tradeoff between a desire to allow a secondary market to evolve and a desire to adopt lessons and best practices from experience in other markets.

4.1.2.5 Comparison to Other Markets

In the United States, the Commodity Exchange Act (CEA) and its implementing regulations require that regulated exchanges provide information regarding derivative trades to the CFTC.

This information is collected on a daily basis and includes aggregated position limits and trading activity for all of their members. The aggregated data for each member includes:

open long and short positions, purchases and sales, exchanges of futures for cash, and futures delivery notices for the previous trading day. This data is reported separately by proprietary and customer accounts by futures month, and for options by puts and calls, expiration date and strike price.\(^{15}\)

The CEA also requires regulated exchanges to make data available to the public regarding trading volume, open contracts, futures delivery notices, exchanges for cash, and prices.\(^{16}\)

Futures commission merchants, members of regulated exchanges, and foreign brokers must provide a daily report to the CFTC regarding “special accounts,” those with futures and options positions above the reporting level specified by the CFTC. The requirement to provide this specific data is referred to as the CFTC’s Large Trader Reporting Program.\(^{17}\) The reports must include data regarding “each futures position, separately for each reporting market and for each future, and each put and call options position separately for each reporting market....”\(^{18}\) Reporting entities must aggregate their interest in or control of multiple accounts for the purpose of determining whether their positions trigger reporting requirements.\(^{19}\)

In Canadian provinces, the obligation to report positions or trades is determined by exchange rules. For example, in Quebec all members of the Montréal Exchange,\(^{20}\) a derivatives exchange, must disclose to the exchange their net positions when they exceed a certain threshold that triggers the reporting requirement. There are no obligations to disclose, on a daily basis, information to the regulator, the Autorité des marchés financiers (AMF).

The US Acid Rain Program, RGGI, and the EU ETS do not require special reporting of OTC derivatives in compliance instrument markets.

\(^{15}\) http://www.cftc.gov/industryoversight/marketsurveillance/ltrp.html
\(^{16}\) 17 CFR Part 16.
\(^{18}\) 17 CFR 17.00(a)(1).
\(^{19}\) 17 CFR 17.00(a)(2).
4.1.2.6 No Draft Recommendation

The Markets Committee has not yet decided upon a Draft Recommendation on the collection and public disclosure of derivative positions. The Committee requests public comment on this issue.

4.1.2.7 Requirements of Tracking System

Collecting information on derivative positions would require the establishment of a repository for that information. Such a repository could, but is not required to be, a part of the compliance instrument tracking system. If the repository and tracking system are different, protocols for information exchange between them may be necessary.

4.1.3 Draft Recommendation 3: Treat Allowances and Offset Certificates Identically for Market Oversight Purposes

4.1.3.1 Background

The WCI cap-and-trade design involves two types of compliance instruments: allowances and offset certificates. There are differences between the creation and use of these two types of compliance instruments. First, Partner jurisdictions will issue offset certificates for projects that can demonstrate that removed or avoided emissions are real, additional, verifiable, and permanent. That process will have requirements for information transparency and disclosure, project approval, monitoring, and treatment of the risk of reversal that are separately being considered by the Offsets Committee. The process by which allowances are created and issued, in a predetermined quantity, will be different. Second, the WCI Partners have approved final recommendations for limiting the use of offset certificates to meet compliance. Third, offset projects and allowances have differing risks; offset certificates may carry some risk of reversal, depending on jurisdictions’ policy choices. Partly for these reasons, the market prices for allowances and offset certificates are different in the EU ETS, and likely to be different in a WCI market. Further, the number of offset certificates will be much smaller than the number of allowances.

4.1.3.2 Options

The Markets Committee has identified the following options for treatment of different types of compliance units:

A. Treat allowances and offset certificates identically for market oversight purposes; or,
B. Establish distinct requirements for offset certificates.

4.1.3.3 Evaluation of Options

For the purposes of this section, the Markets Committee considered the Market Oversight Draft Recommendations to define the scope of the policy decisions. In the case of each of the eleven other Draft Recommendations, the Committee evaluated the different nature of allowances and offset certificates and the additional complexity that would likely follow if the types of compliance instruments were treated differently.

In two cases, Draft Recommendation 7 (Holdings Limits) and Draft Recommendation 12 (Market Monitoring), the much smaller number of offset certificates could lead to differences in the implementation of a recommendation. In each, for example, the definition of market power would be different. However, these are likely to be quantitative differences rather than qualitative differences.

4.1.3.4 Experience in Existing Environmental Cap-and-Trade Programs

No offset certificates are issued in the Acid Rain Program, and none have yet been issued in RGGI. To the best of our knowledge, offset certificates usable for compliance in the EU ETS are treated, like allowances, as commodities.

4.1.3.5 Draft Recommendation

The Markets Committee recommends that the WCI cap-and-trade system treat allowances and offset certificates identically for market oversight purposes.

4.1.3.6 Relationship to Other Draft Recommendations

All other Draft Recommendations assume the adoption of this one, and are written for compliance instruments without distinction.

4.1.3.7 Requirements of Tracking System

This Draft Recommendation implies no additional requirements of a tracking system.

4.2 Market Participants

4.2.1 Draft Recommendation 4: Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System

4.2.1.1 Background

The WCI Partner jurisdictions intend to create a system to track compliance instruments. The instruments would exist as electronic records rather than physical certificates. The Partner
jurisdictions are designing the requirements for this tracking system, and considering options for implementation.

This paper describes Draft Recommendations on market oversight. For each, the Markets Committee evaluated enforceability of the Draft Recommendation. A consideration for enforceability is the existence and nature of the relationship between the regulator and the market participant. The nature of the relationship will differ, for example, depending on whether or not a person has a legal obligation to surrender compliance instruments (is a “compliance entity”).

The nature of the relationship will also hold some combination of a “regulatory” relationship, and a “contractual” relationship. Here, a regulatory relationship is considered to be mandatory for designated persons, with the authority of a regulator established by statute and written into the regulations of a jurisdiction. A “contractual” relationship would be one voluntarily entered into by a person, with a counterparty of one or more jurisdictions or the tracking system, that provides the person the ability to take certain actions, under certain conditions. These types of relationships also imply differences in enforcement actions.

The Partner jurisdictions will have established relationships with the entities that will have compliance obligations under the cap-and-trade program. These relationships include reporting requirements and surrender obligations, though they are not the subject of these Draft Recommendations, which are focused on the activities around the holding and trading of compliance instruments.

The Markets Committee is particularly interested in defining the relationship between regulators and entities that do not have a compliance obligation under the cap-and-trade program.

4.2.1.2 Draft Recommendation
The Markets Committee recommends that either or both of having ownership interest in a compliance instrument and having an account in the tracking system would establish a legal relationship between one or more regulators and the account holder. These relationships would entail certain obligations of the entity.

4.2.1.3 Relationship to Other Draft Recommendations
Among the obligations entailed by holding an account in the tracking system would be Draft Recommendations 6 (Require Registration of Intermediaries as Market Professionals) and 9 (Require Disclosure of Beneficial Ownership). In addition, this Draft Recommendation assumes the implementation of Draft Recommendation 5 (Do Not Limit Market Participation to Compliance Entities), that compliance entities not be the only market participants. If
participation is limited to compliance entities, the need to create a regulatory relationship to implement trading rules would probably be largely satisfied.

4.2.1.4 Requirements of Tracking System

This Draft Recommendation suggests a conceptual role for the tracking system. Technical requirements may include the ability to perform enforcement actions, such as revocation or suspension of trading for an entity or for all accounts.

4.2.2 Draft Recommendation 5: Do Not Limit Market Participation to Compliance Entities

4.2.2.1 Background

A WCI carbon market could involve diverse participants who may trade to satisfy a compliance obligation, purchase for resale to emitters, speculate on the price of compliance instruments, or diversify an investment portfolio. Entities that could participate in the carbon market may include compliance entities, investors, brokers and other intermediaries. Each entity would play a different role in the market.

Even if compliance entities receive allowances without charge from a government, the number may not be equal to their obligation, perhaps due to growth or contraction in their emissions or policy decisions on the quantity or formula for distribution. These entities may then choose to purchase additional compliance instruments from the primary or secondary market, or sell compliance instruments they will not require for compliance or for other reasons. In early 2009, industrial facilities in the EU ETS sold allowances, many freely allocated, to raise cash when other avenues of raising funds became more difficult.\(^{22}\)

Though they would not be required to hold compliance instruments for compliance, other categories of participants could play market roles. Brokers and other intermediaries may, for a fee, arrange trades of compliance instruments between parties, or provide advice or other services. Investors may desire to be market participants to profit from trading.

4.2.2.2 Options

With regard to the secondary market, the WCI cap-and-trade program could either:

A) Limit market participation to compliance entities; or,

B) Open market participation to non-compliance entities.

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The Market Committee is separately developing Draft Recommendations on participants in the auctioning of allowances (primary market).

4.2.2.3 Evaluation of Options

The WCI Partner jurisdictions have received oral and written comments from stakeholders suggesting that market participation be limited to compliance entities. Many of these comments referred specifically to auctions, which are the subject of a separate WCI white paper, but may also be addressed in the context of secondary markets. The concerns expressed can be summarized as:

1) That participation by non-compliance entities will increase the price of allowances.
2) That participation by non-compliance entities increases the chances of market manipulation.
3) That participation by non-compliance entities will limit access to allowances.

The first concern may be related to questions regarding the role of speculation in markets. Investors can play important roles in competitive markets by increasing liquidity. A healthy market is “liquid,” meaning there is a sufficient number of buyers and sellers in the marketplace to allow trading to take place. Larger numbers of market participants make it more likely that there will be counterparty (i.e., another party willing to participate in a trade). A market with less liquidity may be subject to more price volatility and it may be more difficult for entities needing to buy compliance instruments to locate willing sellers. Unlike a traditional commodity market, a compliance instrument market will not have natural sellers outside of the primary market. Consequently, concerns about potential “excess” speculation by investors must be weighed against these benefits of allowing investors access to the carbon market.

The second concern implies either that more market participants increases the ease or risk of manipulation, or that non-compliance entities might attempt market manipulation while compliance entities would not. However, a larger number of market participants would most likely make manipulation more difficult, not less, by increasing liquidity and making control of a significant proportion of compliance instruments by one or a few persons harder.

The Markets Committee assumes for this discussion that the fraction of potential market participants who would attempt a manipulation is small. However, the potential for damage from a successful manipulation is large, and has precedent in recent experience in energy markets in WCI Partner jurisdictions, notably the energy crisis of 2000 – 2001. The Committee believes that participants who would consider an attempt to manipulate the market exist both among compliance and non-compliance entities. Limiting market participation to compliance entities would exclude some number of beneficial participants without measurable benefit in changing the fraction of participants who would consider market manipulation.
The third concern is that non-compliance entities may hold compliance instruments for some period of time, making them unavailable to compliance entities that may need them for compliance. There are many possible non-compliance reasons to hold compliance instruments; the auction design recommendation report commissioned by RGGI identifies five: speculation; allowance market manipulation; electricity market interference; competitive advantage; and external compliance. In none of these cases would market risks be reduced by restricting the market to compliance entities, save potentially external compliance. When restricting a market reduces liquidity, in fact, the risks are increased. Though this risk might be enhanced by allowing non-compliance entities to participate, it is nevertheless very small, as it has not been proposed by the existing GHG cap-and-trade programs, RGGI and the EU ETS.

In addition to considering whether participation limits are desirable, the Committee has considered whether they are practical. Fairly and reliably determining who has a compliance obligation in advance of the reporting deadline for a given year’s emissions is not possible. The identities of compliance entities will also change as some enter or leave the program due to changes in their emissions or change in program scope, such as the inclusion of transportation fuels and residential and commercial fuel combustion in the second compliance period.

Limiting participation to compliance entities would also be difficult to enforce. For example, a person who would like to attempt a market manipulation but was otherwise excluded by participation rules might purchase some fractional interest in a facility that was a compliance entity, with an agreement that the person could trade as a representative of the entity. Under Draft Recommendation 1 (Treat Compliance Instruments as Commodities for Market Oversight Purposes), US states in the WCI would not have primary jurisdiction over derivatives markets and would therefore have constrained ability to enforce a participation limit in markets considered broadly.

4.2.2.4 Experience in Existing Environmental Cap-and-Trade Programs

The Acid Rain Program, RGGI, and EU ETS do not limit participation to compliance entities.

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24 “External compliance” is the possibility of another cap-and-trade program accepting WCI compliance instruments in lieu of its own, without any reciprocal acceptance of the program’s compliance instruments by WCI jurisdictions.
4.2.2.5 Draft Recommendation
The Markets Committee recommends that both compliance and non-compliance entities be allowed to participate in the secondary compliance instrument market. Broad participation would be beneficial, and narrow participation harmful, to an compliance instrument market, especially in its early stages. Limiting participation to compliance entities would not be an effective policy to reduce the potential for market manipulation.

4.2.2.6 Relationship to Other Draft Recommendations
Draft Recommendation 6 (Require Registration of Intermediaries as Market Professionals) describes a requirement for a type of participant, assuming that intermediaries who are not compliance entities could be participants.

4.2.2.7 Requirements of Tracking System
The adoption of this Draft Recommendation would require that the tracking system be able to accommodate more accounts, and potentially more trades, than one for a program with limited participation.

4.2.3 Draft Recommendation 6: Require Registration of Intermediaries as Market Professionals

4.2.3.1 Background
There will likely be numerous types of market participants in the WCI cap-and-trade program. Each account holder would be required to provide some information (e.g., identifying information) to regulators in order to establish an account, a process that could be called “registration.”

One category of market participants could be “intermediaries,” which would include traders, dealers, advisers and investment managers in the market. There exist precedents of registration requirements for intermediaries operating in the majority of commodities derivatives markets and in limited commodities markets. In both the US and Canada, some commodities derivatives traders are required to register with regulators and/or self-regulatory organizations. This process is also widely referred to as “registration.” According to the National Futures Association (NFA), “The primary purposes of registration are to screen an applicant’s fitness to engage in business as a futures professional and to identify those individuals and organizations whose activities are subject to federal regulation.” 25 The screening can improve consumer and market protection. In this discussion, the question is whether to require that persons be subject

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to the requirements of knowledge of trading law, capital requirements, etc. that are needed to trade or offer professional advice on derivatives in the US and Canada, as described below. This type of registration is referred to in this paper as “market professional registration.”

In the US, the CFTC oversees market professional registration of entities engaged in trading of commodities and derivatives. The CFTC authorizes the NFA, a private organization, to perform registration processing functions on behalf of the Commission. Regulation of similar activities in Canada is performed by a combination of provincial regulatory authorities, a national database, and the Investment Industry Regulatory Organization of Canada (IIROC). Like the NFA, the IIROC is a private organization.

Under both countries’ regulatory systems, entities must determine whether the business being conducted qualifies as trading or advising under the applicable law. If the activity does fall within the applicable law, the next step is to determine whether there is an exemption from the requirement to be registered set out in the law. If there is no exemption, the person or firm will be required to obtain market professional registration in order to conduct trading activities.

US Registration Requirements

The US Commodity Exchange Act sets forth registration requirements for entities engaged in trading commodities and regulated derivative transactions. The CFTC identifies the following categories of market participants that must register with the NFA unless they qualify for an exemption:

- **Merchants**
  - Futures Commission Merchant (FCM) – A FCM is an individual or organization which does both of the following:
    - Solicits or accepts orders to buy or sell futures contracts or options on futures and
    - Accepts money or other assets from customers to support such orders.
  - Agricultural Trade Option Merchant (ATOM) – Any person that is in the business of soliciting or entering option transactions involving an agricultural commodity listed in the CEA that are not conducted or executed on or subject to the rules of an exchange.

- **Brokers**
  - Introducing Broker (IB) – A person who is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on an

exchange who does not accept any money, securities, or property to margin, guarantee, or secure any trades or contracts that result therefrom.

- Floor Broker (FB) – A person with exchange trading privileges who executes trades for others by being personally present in the pit or ring for futures trading.

- **Floor Trader** (FT) – A person with exchange trading privileges who executes his or her own trades by being personally present in the pit or ring for futures trading.

- **Commodity Trading Advisor** (CTA) – A person who, for pay, regularly engages in the business of advising others as to the value of commodity futures or options or the advisability of trading in commodity futures or options, or issues analyses or reports concerning commodity futures or options.

- **Commodity Pool Operators** (CPOs) – A person engaged in a business similar to an investment trust or a syndicate and who solicits or accepts funds, securities, or property for the purpose of trading commodity futures contracts or commodity options. The commodity pool operator either itself makes trading decisions on behalf of the pool or engages a commodity trading advisor to do so.

- **Associated Person** (AP) – An individual who solicits or accepts (other than in a clerical capacity) orders, discretionary accounts, or participation in a commodity pool, or supervises any individual so engaged, on behalf of a FCM, IB, CTA, CPO, or an ATOM.

The NFA develops registration requirements for each category of intermediary listed above. In general, the registration requirements include a completed registration form with information about the activities of the intermediary, an application fee, NFA membership dues, and fingerprint cards for principals and associated persons, as well as proficiency requirements.

FCMs and IBs must also include a financial statement (if the firm does not meet minimum capital requirements, it may face additional reporting requirements), and a description of procedures regarding the following:

- money laundering;
- business continuity and disaster recovery;
- electronic order routing;
- promotional materials;
- supervision of associated persons;
- customer complaints; and
- margins/segregation (if applicable).

### Canadian Registration Requirements

1. **Provincial legislation**

Depending on their type of market activity, intermediaries may be required to register with provinces and with the Investment Industry Regulatory Organization of Canada. The statute that establishes jurisdiction in a province and territory varies. In most provinces and territories
The Securities Act establishes the requirement to register to trade or advise in the trading of securities or derivatives.

In Ontario and Manitoba, The Commodity Futures Act requires that entities register with the provincial regulator before trading or providing advice regarding the trading of exchange-traded derivatives. The Act also provides jurisdiction to define what will be included under the term “commodity.”

In Quebec, registration to trade or provide advice in exchange traded or over the counter derivatives is mandated in The Derivatives Act.

The legislation in each province permits enactment of regulations or rules that provide the detailed requirements to obtain or maintain registration. In many cases these requirements are consistent among the provinces and territories and are referred to as National Instruments (when all jurisdictions have adopted the requirements) or Multilateral Instruments (when one or more jurisdictions have not adopted the requirements).

Canadian Securities Administrators interpret and apply the “National Instrument 31-103,” enacted in September 2009, and Companion Policy 31-103CP “Registration Requirements and Exemption,” which contain categories and requirements for registration of individuals and firms for trading or advising in exchange contracts.

ii. National Registration Database
In Canada, the National Registration Database\(^{27}\) (NRD) is an internet-based system which provides firms and individuals with the ability to file most registration information electronically with any number of the provinces and territories. The use of NRD is mandated by all provinces and territories for securities and derivatives registrations.

The forms that are required to be used and submitted on NRD are standardized.

iii. Investment Industry Regulatory Organization of Canada (IIROC)
In all provinces and territories in Canada, in most cases a business or individual in the business of trading or advising in the trading of derivatives contracts is required to be a member of the IIROC. IIROC has been recognized as a self regulatory organization responsible for setting standards and regulating the conduct of its members.

The inclusion of the IIROC membership requirement by the provincial and territorial regulators means the same standards apply to all Investment Dealers in the business of carrying out derivatives transactions in Canada.

Applicability of the provincial and territorial laws, as well as the requirements of IIROC establishes a comprehensive set of proficiency, capital, solvency, and client relationship requirements. In addition there is authority to conduct compliance audits of members, investigate and take action to suspend or cancel registration, and take action to stop activities that pose a risk to markets and market participants.

4.2.3.2 Options

The Markets Committee has identified the following options:

A. Requiring every account holder to register as a commodities market professional.
B. Requiring every account holder in the business of advising or trading on behalf of other entities to register as a commodities market professional.
C. Not requiring any market participants to register as a commodities market professionals.

In addition, the Committee considered with whom an entity would register: with the state and provincial governments, or with a third party.

4.2.3.3 Evaluation of Options

As stated by the NFA, the two primary advantages of requiring registration are to screen the fitness of potential traders, and an identification of those traders to regulators. The disadvantages are that market professional registration requirements impose burdens on the entities that are required to register, as well as on the governments enforcing the requirements and the entity (government or third-party) that establishes criteria and evaluates applicants against them. In addition, assuming the implementation of Draft Recommendation 4 (Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System), WCI Partner jurisdictions would be able to require registration of account and compliance instrument holders, but may not have the ability to require registration of entities without tracking system accounts or ownership interest in compliance instruments.

Requiring market professional registration would also create an enforcement obligation for government regulators to maintain and monitor registration data.

The specialized expertise to register as a market professional is not typically found in the firms that will be compliance entities, and so would have to be acquired if all participants were required to register. The NFA’s two arguments for registration are also weaker when
considering compliance entities: First, they have been identified to regulators through their compliance obligation. Second, it could be argued that they have been “pre-screened” by their very inclusion in the cap-and-trade program—that is, regulators have already determined them to be fit to trade.

Intermediaries with tracking system accounts could similarly be said to be identified to Partner jurisdiction regulators. However, they would not necessarily be identified to US federal regulators in the way that derivatives traders are. In addition, it may aid confidence in the market to have intermediaries “screened” as described above. Especially in a new market, participant confidence in intermediaries is important. Many prospective intermediaries are already registered to trade commodity derivatives, and standards for, e.g., record keeping and accounting for customer funds are reasonable protections for clients.

Intermediaries without tracking system accounts or ownership interest in compliance instruments, who are active only in the secondary market, may fall outside this requirement, which could weaken its effect.

The Partner jurisdictions could require market professional registration with an agency of the jurisdiction. This would allow for determination of the specific market professional registration requirements appropriate for the regional cap-and-trade system, and could expand upon existing registration requirements in Canada. It could also mean that requirements would not necessarily be subject to changes in US law. It could further provide for consistency across jurisdictions. Partner jurisdictions would also have full access to registration documents and any required reports.

Alternatively, Partners jurisdictions could require market professional registration with a third party. Doing so could reduce administrative costs for governments by shifting the burden to define requirements, evaluating applications, and receiving reports. The WCI Partners could contract with an independent market monitor to facilitate market professional registration, or attempt to establish relationships with the NFA and/or the IIROC. As noted above, many potential intermediaries are already registered with those organizations.

4.2.3.4 Experience in Existing Environmental Cap-and-Trade Programs
Neither RGGI nor the US Acid Rain Program requires market professional registration to participate in the secondary market. Derivatives trading in both markets, including registration requirements, is overseen by the CFTC.

4.2.3.5 Draft Recommendation
The Markets Committee recommends that brokers, merchants, and advisors who hold accounts in the tracking system and are in the business of trading or offering financial advice regarding
4.2.3.6 Relationship to Other Draft Recommendations

This recommendation assumes the implementation of Draft Recommendation 4 (Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System), Draft Recommendation 1 (Treat Compliance Instruments as Commodities for Market Oversight Purposes), and Draft Recommendation 5 (Do Not Limit Market Participation to Compliance Entities).

4.2.3.7 Requirements of Tracking System

Adoption of this Draft Recommendation would necessitate a way to associate a registration number with a tracking system account.

4.3 Holdings and Transfers

4.3.1 Draft Recommendation 7: Holdings Limits

"Market power" is the ability of an entity to move prices through its behavior. Market power can be derived from the control of a large fraction of the instruments in question. Though not all exercises of market power are malign, some are intended to manipulate the market. The Markets Committee is interested in the possibility of reducing the risk of market manipulation by limiting the accumulation of market power. One mechanism it has identified is the use of "holdings limits," or limits on the number of compliance instruments any one entity could control in the tracking system. The Committee has commissioned a consultant's report on holdings limits, and will consider that report among other information as it works towards final recommendations.

4.3.2 Draft Recommendation 8: Require Use of a Central Limit Order Book for Secondary Market Transactions

4.3.2.1 Background

In secondary market trading, counterparties exchange cash or its equivalent for prompt delivery of compliance instruments. Any other type of transaction or contract—one, for example, in which counterparties agree to exchange cash for compliance instruments at some future date—is not a secondary-market trade but a derivative contract, and is subject to derivatives market regulations. For the purpose of discussion in this section, adoption of Draft Recommendation 1 (Treat Compliance Instruments as Commodities for Market Oversight Purposes), is assumed,
implying no new restrictions on derivatives trades. The discussion here will then be of secondary markets.

Secondary market trades may be executed in a variety of venues, with different characteristics, including how market participants determine prices, transparency, and clearing. The Markets Committee has focused on three types of venues: exchanges, central limit order books (CLOBs), and “over the counter” (OTC) transactions.

Exchange Transactions:
Exchanges are trading venues that have agreed rules for membership, trade reporting, order matching, and many other facets of transactions. One set of rules determines how buyers and sellers agree on prices. In general, exchanges maintain “order books.” An order is the instruction to buy (a “bid”) or sell (an “offer” or “ask”) under certain conditions. A “limit order” is the instruction to buy or sell a certain quantity at a certain price (the bid or ask price). A “market order” is the instruction to buy or sell a certain quantity at the best price available. The order book lists the bids and offers, arranged by price and then by the time the order was placed. If there are a bid and offer at the same price, an order matching system will pair them and the transaction will be completed, for the volume of the smaller order. The remainder of the larger order remains on the order book for a subsequent match. In very liquid markets, the time between the posting of an order and its fulfillment is very short.

Members of an exchange can see the entire order book, and the available orders—both price and volume—contain information that will influence orders they place. For example, the “bid-ask spread” is the difference between bid prices and offer prices. A trader would typically place an order within the spread. Visibility of the order book may tend to keep the spread smaller, as a central price is clear to market participants. However, exchange order books and transactions are typically anonymous.

Exchanges typically make the price and volume of transactions publicly available after they have been executed.

Exchange transactions also imply other services to participants, including settlement (the exchange of money and goods or instruments) and clearing (in which a central organization is the counterparty for both the buyer and the seller). Clearing is discussed in more detail in the next section.

Central Limit Order Book Transactions:
A central limit order book (CLOB) is separable from the other services of an exchange. A CLOB would be an order book visible to market participants. A “hard” CLOB would, like the order-matching system on an exchange, execute matching orders automatically. A hard CLOB would
allow orders either anonymously or with an identification of the participant. A “soft” CLOB would be a central location to post and find bids and offers, but would not automatically match them; traders would have to separately contact each other to complete the transaction. A soft CLOB could not be anonymous. Bids and offers would be as transparent as on an exchange. Post-transaction data could also be reported by a CLOB; this could be largely automatic on a hard CLOB, where orders were automatically and bindingly matched, but on a soft CLOB participants would have to report final prices and volume for public disclosure. Final prices and volume might well be different than the posted order as a result of the counterparties’ negotiation.

Clearing, if it were used, and settlement would be through venues other than the CLOB, selected by the counterparties.

**Over-the-Counter Transactions:**
For purposes of this discussion, “OTC” refers to cash market trades of compliance instruments that bypass centralized quotation and execution systems, and which may trade outside the bid-ask spread listed on those systems. There is no central order book; prices are determined by bilateral negotiation between parties, who may refer to data on transactions in other venues, if they are available, to determine a fair price. In most OTC markets, there is no prompt and automatic reporting and disclosure of price and volume, making activity relatively opaque. Whether this opacity is damaging is subject to debate, and depends among other things on the liquidity of trades in more transparent venues. Clearing, if it is used, and settlement are through venues chosen by the counterparties.

**4.3.2.2 Options**
The Markets Committee has identified two categories of options in trading venues. The first category is whether or not to require transparency in orders:
- A. Require all secondary market transactions to occur on one or more exchanges.
- B. Require orders for all secondary market transactions to be posted on a hard CLOB.
- C. Require orders for all secondary market transactions to be posted on a soft CLOB.
- D. Allow OTC transactions without use of a central order book.

The second category is whether or not to require clearing of all transactions, independent of order book transparency.

**4.3.2.3 Evaluation of Options**
**Choice of Venue**
The Markets Committee seeks a recommendation that would maximize both market transparency and market liquidity. It believes that both are needed for price discovery for compliance instruments, which is necessary for entities to make efficient decisions on
investments and compliance strategies. However, there may be tradeoffs between transparency and liquidity.

Transparency is important for several reasons. First, transparency is crucial to market participants’ evaluation of the trades they are considering. Participants without knowledge of the current buying and selling interest in the form of firm bid and ask quotations and transaction reports are at a distinct disadvantage in assessing the value of traded assets. Thus, transparency is crucial to pricing efficiency, the market’s ability to accurately reveal the value of traded assets. In addition, transparency permits investors to evaluate whether the market is treating them fairly by identifying the best available price. Without access to the prices other market participants are paying for the same asset, they cannot effectively determine whether they have paid a fair price.

Second, access to accurate market information enhances the ability of regulatory examiners and independent auditors to carry out their respective responsibilities to ensure that transactions and positions are priced appropriately.

Pre-trade market transparency is supported by exchange-based and central limit order book trading. Pre-trade transparency makes the price and quantity of actionable buying and selling interest accessible to all market participants.

Post-trade transparency makes the price and size of the most recently executed trades accessible to all market participants. An exchange or a hard CLOB could make immediate post-trade transparency automatic. If a transaction price is required to transfer allowances from one account to another, post-trade transparency from all venues, including OTC, could also be supported by publication of data submitted to the tracking system (see section 4.3.4). However, timing is crucial. If the market is changing rapidly, delays in reporting by participants could obscure important information. The Markets Committee is concerned about the enforceability of requirements to report transactions promptly.

In a wholly OTC secondary market, buyers or sellers would solicit prices by telephone or email from whatever subset of intermediaries or potential counterparties they have the time and resources to contact, and hope that they have gotten a fair price. If traded prices are not promptly reported, traders cannot confirm whether or not they have obtained a fair price. In the absence of centralized collection and reporting of quotations and traded prices, intermediaries such as brokers and broker-dealers may emerge as market makers, offering pockets of liquidity to counterparties who might not otherwise find each other. The less transparent the market is, the more reliant compliance entities and others would be on intermediaries that would charge fees for transactions and could have significant information advantages.
At the same time, intermediaries can increase liquidity. First, a broker may have a broader understanding of a market than compliance entities or other participants, and may be able to facilitate negotiation of trades. Second, dealers may act as “market makers,” willing to either buy or sell compliance instruments at any time. Market makers make money on the spread, always attempting to sell allowances for a price higher than they paid. The narrower the spread is, the less incentive there is for an intermediary to be a market maker. Narrower spreads could then decrease liquidity.

Selecting one or a small number of trading venues may “drive liquidity” to that venue and ensure that buyers and sellers can find each other. However, exchanges and CLOBs fund themselves in part through fees which, though small, may discourage some transactions. Liquidity is not only affected by policy decisions, but can affect them as well. The importance of driving transactions to one or more regulated platforms depends in part on the liquidity of other pieces of the market. If a sufficient number of transactions occur that the current fair market price for a compliance instrument is discernable from widely available data, e.g., from exchanges, then bid and ask spreads should be small and transactions should seldom deviate far from that price. However, if secondary market transactions are rare, the reported price could be quite volatile, and current orders opaque.

The derivatives markets also play roles in price discovery and liquidity that may affect the tradeoffs in a policy decision to select one or more venues. The various inputs to consider appear to be impossible to predict.

In principle, multiple venues could be linked to a single quotation system. As an example of such a system, in the secondary market for US equity securities, all exchanges and Alternative Trading Systems (ATSs) are required to contribute their quotations in real time to a central quotation system called a securities information processor. The collection, processing, and distribution of quotations is a central function of a collection of rules, practices, and infrastructure known as the national market system (NMS). The purpose of the NMS is to ensure transparency, effective oversight, fairness and pricing efficiency. Nearly all secondary-market transactions of U.S. securities listed on exchanges and ATSs are executed at prices within the NMS’s published bid-ask spread for listed shares, and last-trade price and quantity are available in real time to all market participants.

Customization in OTC transactions and duration of OTC contracts compared to illiquid long-term markets are often cited as reasons to allow OTC derivative contracts. However, in secondary markets, neither of these is a strong argument: there is very little to customize, and the timescale is short by definition. An exception is repurchase or “repo” agreements, in which compliance instruments are sold by one entity to another, with an agreement that the first
entity will buy them back in the future. This is effectively creating a loan with the compliance instruments as collateral. Technically derivatives, repos still require an OTC transfer of ownership.

Partner jurisdictions could enforce use of a particular venue by requiring an identifying number for an order or executed transaction to accompany transfers of allowances from one account to another. The venue could be required to provide information on transactions to the jurisdictions, as well as quotations and last-trade prices. Compliance entities might be offered low- or no-cost access to order-matching services at the designated venue (though see section 4.2.2 for a discussion of identifying compliance entities).

However, there is a blurry line between the secondary and derivatives markets. The European Climate Exchange offers a standard contract for European Union Emission Allowance Daily Futures, which are settled by physical delivery in at most two business days. If the Draft Recommendation 1 (Treat Compliance Instruments as Commodities for Market Oversight Purposes) is adopted and the Partner jurisdictions make no collective recommendations to restrict derivatives trades, then restrictions on secondary market transactions might be easily dodged by firms creating forward contracts with very short expirations. Treatment of allowance transfers that are the fulfillment of derivatives contracts and not secondary market transactions would be another implementation consideration. Also, compliance entities might desire to transfer compliance instruments between facilities owned by a single company, or between entities owned by the same holding company. From 1994 – 2003, only about half of the allowance transfers in the U.S. Acid Rain Program were between “economically distinct organizations.”28 The implications for creating and enforcing exceptions to a venue requirement should be considered.

**Clearing**

In a recent case of a systemic problem due to counterparty risk, the September 15, 2008 bankruptcy filing of Lehman Brothers was part of, and greatly accelerated, a financial panic, in part because Lehman Brothers was counterparty to many other large financial institutions in a variety of transactions. Its collapse left counterparties uncertain about their losses, and uncertain about the exposure of others. This uncertainty helped to freeze financial activity.

The clearing organizations associated with exchanges require from all members security deposits that can be used if a member defaults on its contracts. In this way, the risk of default

from one company is shared by clearing members. The members then have a strong incentive to set the rules for membership and for transactions to balance default risk and the cost of doing businesses.

Clearing through a central counterparty can reduce the risk of systemic problems by setting requirements for collateral, limiting the exposure of any single member, and collecting information for regulators and the public. On the other hand, clearing organizations may not be willing to guarantee all trades that would be economically efficient, and will charge for their services. The clearing function is typically integrated with trade confirmation, netting, registry (or “depository”) and settlement services. Without clearing organizations, traders would need to individually evaluate the credit risk of every trade and counterparty, and establish separate payment and delivery arrangements with each counterparty. Central counterparty clearing reduces transaction processing costs for participating traders, and enables higher trading volumes by streamlining post-trade processing. However, clearing is effectively the extension of credit by the central counterparty, which comes at some cost. Many end users of commodities can obtain similar credit for at smaller expense, and so prefer not to clear transactions.

Though there are differing opinions about the advantages of clearing, in general it is believed to reduce the risk of systemic problems by reducing or redistributing counterparty risk. This risk is larger in derivatives markets, where positions may be built up over some period of time, and during which time the price may change, than in secondary market transactions, which are settled in the matter of a day or two at an agreed-upon price.

In a typical secondary-market exchange, only firms that sustain a high volume of trades are clearing members. Lower-volume or occasional traders trade through intermediaries (brokers or asset managers, e.g.) that are also clearing member firms. It is not necessary to operate as a clearing member firm in order to benefit from the transaction-processing efficiencies of a cleared market. However, requiring an intermediary that is a clearing member is potentially a cost to compliance entities and others.

4.3.2.4 Experience in Existing Environmental Cap-and-Trade Programs
Neither the Acid Rain Program nor RGGI requires secondary market transactions to go through a single venue, quotations to be reported to a central service, or clearing for secondary market transactions.

4.3.2.5 Draft Recommendation
The Markets Committee recommends that orders for secondary market transactions be required to be reported to a “hard” central limit order book to centralize liquidity and enhance transparency. The CLOB could be the order-matching system of a designated exchange or another system designated by the WCI Partner jurisdictions. Considering all the tradeoffs
identified above, the Committee believes that the public is best served by clear and immediate price signals. However, we recognize that this is a particularly complex issue and we invite stakeholder comment on this Draft Recommendation.

In the event that the CLOB is not part of an exchange, the Committee does not recommend requiring clearing of non-exchange transactions. The risks identified are small in secondary markets.

4.3.2.6 Relationship to Other Draft Recommendations

This Draft Recommendation relies on the adoption of Draft Recommendation 4 (Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System). It assumes the adoption of Draft Recommendations 1 (Treat Compliance Instruments as Commodities for Market Oversight Purposes); 5 (Do Not Limit Market Participation to Compliance Entities), and 10 (Information Required for Compliance Instrument Transfer).

4.3.2.7 Requirements of Tracking System

The tracking system would be required at least to accept and verify a transaction number from the central limit order book before compliance instruments were transferred between accounts. The tracking system could potentially provide the function of the central limit order book.

4.3.3 Draft Recommendation 9: Require Reporting of Beneficial Ownership

4.3.3.1 Background

When one person holds property (or some other interest) for the benefit of another person, the person holding the property is referred to as the “record” or “legal” owner and the person for whom the property is being held is referred to as the “beneficial,” “equitable,” or "indirect" owner. For example, where title to land is registered in the name of a trustee who holds the property for the benefit of the owners of the trust, the trustee is the record owner and the beneficiaries of the trust are the beneficial owners. Similarly, when a brokerage firm holds securities (e.g., stock certificates) in their own firm’s name (their “street name”) for their customers’ accounts with the firm, the firm is the legal owner and the customers are the beneficial owners.

4.3.3.2 Options

WCI Partner jurisdictions have several options regarding reporting of beneficial ownership, including, but not limited to the following:

A. Requiring that account holders publicly disclose beneficial ownership;
B. Requiring that account holders report beneficial ownership to regulators on a confidential basis;
C. Require that account holders maintain records of beneficial ownership and produce such records upon written request of regulators; or
D. Not require that account holders maintain records of or disclose information regarding beneficial ownership.

Should the WCI jurisdictions elect to require reporting of beneficial ownership to regulators and/or disclosure to the public, decisions must also be made regarding the timing of such disclosures. For example, disclosure of the beneficial ownership could be required
A. When an account is opened on the registry;
B. Contemporaneously with any transaction transferring ownership
C. On a periodic basis, or
D. With some other fixed or variable requirement regarding the timing of the disclosure.

4.3.3.3 Evaluation of Options
The different options outlined above in 4.3.3.2 have significant implications for the regulators charged with the administration, monitoring and enforcement of the compliance instrument markets and the overall cap and trade program. In addition, the different options have impacts on the level of transparency in the market. Below we discuss the major implications identified to date.

The regulators responsible for prevention of manipulation and speculative activity that leads to price distortion in the compliance instrument markets will benefit from access to information regarding the beneficial ownership of compliance instruments. Absent this information, regulators may not be able to perform their duties, which may include: (a) monitoring the market for manipulative trading schemes such as “wash” sales, which are trades that appear to be between two parties but are really between different accounts controlled by the same person; (b) detecting the accumulation of substantial positions in compliance instruments that could allow the beneficial owner to exercise of market power; (c) enforcing a holdings limit or other rule designed to avoid speculative activity that leads to price distortion; or (d) providing accurate and timely information on the compliance instrument and derivatives market to other regulators (e.g., US federal regulators of derivatives markets).

In addition, the regulators responsible for environmental compliance could also benefit from access to information regarding beneficial ownership. Those regulators may want the ability to track the actual compliance instrument holdings of reporting sources (at least at a business entity level) over time, rather than simply at the end of a three-year compliance period. Such information would allow early detection of sources that have (a) taken insufficient steps to procure the compliance instruments they will need at the end of the compliance period, or (b)
appear to be taking on excessive risk through the accumulation of a large excess of compliance instruments. Such assessments would be difficult, if not impossible, without accurate information as to the beneficial ownership of compliance instruments.

The public disclosure of beneficial ownership has several potential implications we have identified to date. Public disclosure of beneficial ownership would enhance the transparency of the cap and trade program. This may help maintain public confidence in the program. Transparency in ownership also would allow local interests to track the market position of local sources. Transparency in ownership would enhance the flow of information in the market, which could lead to improved efficiency. Transparency in ownership also puts more “eyes” on the market, increasing the likelihood that market violations will be detected and reported. Transparency in ownership could also reveal corporate trading strategies; however, such information may already be public for a large number of sources (e.g., because the account holder and owner are one and the same, or because disclosure is required by another regulator such as the SEC or a Utilities Commission).

4.3.3.4 Experience in Existing Environmental Cap-and-Trade Programs

In existing emissions markets in the United States, the EPA and RGGI have set up at least two classifications of accounts on their registries: compliance accounts and general accounts. Each facility with a compliance obligation must have a compliance account registered in its own name. In creating the compliance account, EPA and RGGI regulations require that the facility disclose the names of the legal and equitable owners and operators of all emitting units at the facility, identify those units in detail and assign an individual as the authorized account representative. Since the compliance account is tied to a single facility, it is relatively easy to track beneficial ownership.

Under the EPA’s and RGGI’s regulations, general accounts may be opened by a facility, a person owning one or more facilities, or a person with no compliance obligation (e.g., brokers, dealers, banks, individuals, non-governmental organizations, etc.). General accounts are opened in the name of the representative and her company or organization, as opposed to the name of a single facility. Registration of a general account requires identification of “all parties with an ownership interest in the allowances held in this account.” If the parties to an account change, the form must be amended and resubmitted within 30 days. In this way, the EPA and RGGI appear to capture some beneficial ownership information both up front and on an ongoing basis through the registration process.

30 US Code of Federal Regulations, Title 40, section 73.31 (c)(iv).
In addition, all persons or groups participating in a RGGI auction must disclose their beneficial relationships to other persons and groups participating in the auction. Information on beneficial ownership is gathered via a thorough online application system for participants in the regional auctions and is used, in part, to ensure that participants comply with the 25% purchase limit.

Not currently gathered by RGGI and the EU ETS, however, is each beneficial owner’s fractional interest in compliance instruments in an account. This information would be necessary if the WCI Partner jurisdictions were to decide to fully evaluate an entity’s holdings (see section 4.3.1).

4.3.3.5 Draft Recommendation
The Markets Committee recommends that account holders be required to report beneficial ownership of all compliance instrument holdings to regulators on a confidential basis, including each owner’s share in an account. This means each participant in compliance instrument markets where WCI compliance instruments are sold will be obligated to report any party who sponsors or benefits from an agent’s activities.

The Committee further recommends that account holders be required to report changes in the fractional ownership of compliance instruments in an account immediately upon the transaction, even if the transaction does not involve a transfer of allowances between accounts.

When some portion of the ownership information is proprietary, it should be kept confidential.

4.3.3.6 Relationship to Other Draft Recommendations
This Draft Recommendation assumes the adoption of Draft Recommendations 4 (Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System), 5 (Do Not Limit Market Participation to Compliance Entities), 6 (Require Registration of Intermediaries as Market Professionals), and interacts with Draft Recommendations 10 (Information Required for Compliance Instrument Transfer), and 11 (Secondary Market Holdings and Transfer Information Disclosed to Public). Implementing a holdings limit, discussed in Draft Recommendation 7 (Holdings Limits), would require disclosure of beneficial ownership to regulators.

4.3.3.7 Requirements of Tracking System
If disclosure of beneficial ownership is required, the tracking system would need to accommodate multiple owners for accounts, their fractional ownership, and mechanisms to update this information quickly as it changes.
4.3.4 Draft Recommendation 10: Information Required for Compliance Instrument Transfer

4.3.4.1 Background
Assuming the adoption of Draft Recommendation 4 (Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System), the tracking system would hold the record of ownership of compliance instruments. Collection of basic information would be required upon transfer of ownership to make the tracking system a reliable repository and to collect market information that is important for transparency. (Draft Recommendation 11 considers which of this collected information would be disclosed to the public).

4.3.4.2 Options
At a minimum, the tracking system, to be a complete record of ownership, would need to record for each transfer:
- A. The account of origin, and name of the authorized person for that account;
- B. The receiving account;
- C. The serial numbers of the compliance instruments being transferred (and by implication the quantity being transferred); and,
- D. The date and time of the transfer.

Any number of additional data could be collected; the Markets Committee has identified the following to be of particular interest:
- E. Changes to beneficial ownership;
- F. The name of an authorized person for the account that will receive compliance instruments;
- G. The compliance instrument price and currency (US or Canadian dollars);
- H. Date of the contract, if different from date of transfer (e.g., for derivatives contracts);
- I. Other information related to derivatives transactions.

4.3.4.3 Evaluation of Options
A minimum amount of information must be kept by the tracking system in order for it to be a reliable record of ownership. Additional information may assist regulators in oversight of the market, and disclosure to the public would increase market transparency. These benefits can be weighed against the additional burden to participants of reporting more information, and to regulators in collecting and analyzing it.

Draft Recommendation 9 (Require Disclosure of Beneficial Ownership) includes a discussion of beneficial ownership. Draft Recommendation 8 (Require Use of a Centralized Order-Matching
System for Transactions) includes a discussion of a centralized quotation service. Draft Recommendation 11 (Secondary Market Holdings and Transfer Information Disclosed to Public) includes a discussion of public disclosure of both account holder information and secondary market information.

In general, it is only a small amount of additional reporting burden to request the name of the authorized person for the receiving account. In the case of exchange trading where transactions are netted and anonymous, the jurisdictions may choose to require a net report of accounts from which or to which allowances were transferred. The compliance instrument price for the transaction could be challenging if, for example, compliance instruments were bundled with another product (electricity or natural gas) with a single price. However, the Partner jurisdictions could insist on a price report.

The price and date of contract could also be challenging for some derivatives. For example, an exchange-traded futures contract is settled at an agreed-on date, with the product transferred for a settlement price that is likely to be different than the price at which the contract was purchased. The gain or loss is computed at some interval, say, daily, and added to or subtracted from the margin accounts of market participants. The “date of contract” and price would then have to be carefully defined in order to avoid confusion.

4.3.4.4 Experience in Existing Environmental Cap-and-Trade Programs

The Acid Rain Program does not require price information or any information about the date of a contract to deliver compliance instruments. RGGI requires price information for any transfer between non-affiliated entities, as well as date of contract; the date of contract is defined to be the settlement date.

4.3.4.5 Draft Recommendation

The Markets Committee recommends requiring identification of: the name of the authorized person for the account of origin; the number of the account of origin; the name of the authorized person for the account that receives compliance instruments; the account receiving compliance instruments; the serial numbers of the compliance instruments being transferred, and the compliance instrument price. It further recommends requiring a net report from an exchange or any organization that nets transactions. It recommends that the tracking system supply the time and date stamp. If the Partner jurisdictions require collection of derivative positions (Section 4.1.2) it would be duplicative to require information on date of contract.

4.3.4.6 Relationship to Other Draft Recommendations

This Draft Recommendation assumes the adoption of Draft Recommendations 4 (Establish Legal Relationship with Market Participants Through Compliance Instrument Ownership Interest and Tracking System), 5 (Do Not Limit Market Participation to Compliance Entities), 8 (Require Use
of a Centralized Order-Matching System for Transactions), 9 (Require Disclosure of Beneficial Ownership), and 11 (Secondary Market Holdings and Transfer Information Disclosed to Public).

4.3.4.7 Requirements of Tracking System

This Draft Recommendation would require the tracking system to allow and require that the fields for all the above named data, as well as net reports, and supply a time and date stamp with the submission of information.

4.3.5 Draft Recommendation 11: Secondary Market Holdings and Transfer Information Disclosed to Public

4.3.5.1 Background

As stated in the Market Oversight white paper released in November 2009, the central purpose of a market mechanism is to aggregate and transmit price information. With full, true and plain disclosure, both regular and timely, market participants can use the information to determine a fair market price. In the secondary market, it is important for participants to have reliable, good quality and timely information about outstanding bids and offers, and recent trades, so they can discover the right price and act accordingly.

The WCI Markets Committee has proposed the principle of “Transparency and the Reporting and Disclosure of Relevant Information,” to acknowledge that the release of information on the operation of the compliance instrument market builds and retains public confidence, and can change the decisions of market participants.

“A transparent marketplace could provide carbon market participants, regulators, and potentially the general public with information to determine where carbon instruments are trading, the entities involved in the transactions, the trading volume, and the prices at which they are trading. This, in turn, could allow government officials and market watchdogs to quickly determine the cause(s) of unusual price volatility. In addition, information about prices, volume, and bid/ask spreads could also help market participants make informed investment decisions, thereby reducing some of the causes of price volatility in the first place.”

As noted in section 4.3.3.4, RGGI and the Acid Rain Program have created two types of accounts: general accounts, which any person may have and can be used for trading; and compliance accounts, which are established for entities that must surrender compliance instruments matching their emissions to satisfy a regulatory obligation. The Partners are developing requirements for a tracking system; the Markets Committee considered the possibility of two types of accounts in developing this Draft Recommendation.

4.3.5.2 Options

Account Information Disclosure
The Markets Committee has considered the following options for public disclosure of account holder information:
   A. Account representative for compliance and trading accounts;
   B. Owner/operator associated with compliance accounts;
   C. Beneficial owners of compliance units held within account;
   D. State/province in which account representative is located.

Secondary Market Information Disclosure
The Markets Committee has considered the following options in for public disclosure of compliance instrument transfers:
   A. Trade volume, quantity and settlement prices of compliance units traded;
   B. Names of counterparties to each transaction;
   C. Names of beneficial owners;
   D. Compliance account holdings;
   E. Trading account holdings.

The Markets Committee has considered the following options for means of disclosure of secondary market information:
   A. Directly through the online tracking system, and through search functions;
   B. Through exchanges where transactions occur; and/or,
   C. Through periodic WCI market reports published on the WCI website.

The Markets Committee has considered the following options for the frequency and timing of the secondary market information disclosure:
   A. In real time for volumes and prices;
   B. Daily for volumes and prices; and/or,
   C. Quarterly or post-regional auctions for summaries.

4.3.5.3 Evaluation of Options
The WCI Markets Committee recognizes that a balance must be struck between the benefits of transparency and the need for entities to protect certain sensitive information, consistent with applicable law relating to the disclosure of information. Some information may reveal
competitive positions that would do more to assist market manipulation than prevent it. Thus, certain information collected through the tracking system or other aspects of the WCI cap and trade system should not be disclosed publicly in its original reported form. In some cases information can be aggregated in order to maintain the anonymity of the actors while still relaying important market information.

The WCI Partner jurisdictions will have access to the raw information reported to the tracking system, as it is required for regulatory authorities to conduct effective oversight and monitor compliance. In its Final Recommendations, the Markets Committee may recommend restrictions on staff of those regulatory authorities who have access to confidential market information collected through the tracking system from operating in the market, to prohibit insider trading based on undisclosed material information and tipping.

The key characteristics that the WCI Markets Committee seeks in terms of disclosed information are that it is:

- Full;
- Straightforward;
- Good quality;
- Reliable;
- Regular; and,
- Timely.

The holdings in a compliance account are useful to reveal to support compliance, as an indication of whether a regulated entity is on track to retiring as many compliance instruments as are required to cover its covered emissions for a compliance period. However, holdings in trading account are not required for the same purpose, and may reveal sensitive information. The total number of compliance instruments within the cap and trade will be publicly established by the Partner jurisdictions as they create their allowance budgets.

The increased transparency resulting from a high frequency of market information disclosure must be balanced against the administrative cost to market participants and regulatory authorities to report, collect and process that information within the given timeframe.
4.3.5.4 Experience in Existing Environmental Cap-and-Trade Programs

Existing environmental cap and trade programs handle public disclosure in the following ways:

<table>
<thead>
<tr>
<th>DISCLOSURE</th>
<th>EU ETS: Community Independent Transaction Log</th>
<th>RGGI: RGGI COATS(^{32})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery</td>
<td>Information on all transactions (transfer, issuance, etc. of allowances) recorded by the Community Independent Transaction Log, including originating and destination account number, holder and type. This information will be made available online and at EU level but not until five years after the year in which the transaction took place. Price is not recorded in ETS registries or in the CITL.</td>
<td>RGGI CO₂ Allowance Tracking System (COATS) allows public to view, customize and download reports of allowance market activity</td>
</tr>
<tr>
<td>Account information</td>
<td>Varies by country. In the UK, reports listing operator holding accounts and person holding accounts are published on UK registry website. Reports are updated regularly.</td>
<td>Account number, account name, facility owner/operator (for compliance accounts), parties with an ownership interest in the allowances in the account (for general accounts), account type, authorized account representative, and state are all public.</td>
</tr>
<tr>
<td>Transaction information</td>
<td>Counterparties not disclosed.</td>
<td>Transaction type, financial transaction date, RGGI COATS allowance transfer recordation date, price and number of allowances for each transaction, and weighted average price of all transactions during the range of dates specified by the query are public.</td>
</tr>
<tr>
<td>Trading/active account holdings</td>
<td>Number of instruments in each account is not disclosed.</td>
<td>Number of instruments in each account is not disclosed.</td>
</tr>
<tr>
<td>Compliance/retirement account holdings</td>
<td>Not applicable.</td>
<td>Number of instruments in each account is not disclosed.</td>
</tr>
<tr>
<td>Derivatives positions</td>
<td>Not disclosed.</td>
<td>Not disclosed.</td>
</tr>
<tr>
<td>Market reports</td>
<td>Exchanges and news services produce daily and real-time market reports.</td>
<td>Exchanges and news services produce market reports; the third-party market monitor prepares a public report on each auction.</td>
</tr>
</tbody>
</table>

4.3.5.5 Draft Recommendation

The WCI Markets Committee recommends the following:
Tracking system account information publicly disclosed on an ongoing basis:

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\(^{32}\) RGGI > CO₂ Allowance Tracking System > Data in RGGI COATS > Public Reports (http://www.rggi.org/tracking/data/public_reporting )
A. Account representative for compliance and trading accounts;
B. Owner/operator associated with compliance accounts;
C. Names of beneficial owners of compliance units held within account;
D. State or province in which account representative is located.

Market information publicly disclosed daily through the tracking system:
   E. Compliance account holdings.

Market information not publicly disclosed:
   F. Names of counterparties and beneficial owners to each transaction;
   G. Fraction of each beneficial owner’s interest in an account;
   H. Trading account holdings.

4.3.5.6 Relationship to Other Draft Recommendations

Assuming the adoption of Draft Recommendation 8 (Require Use of a Central Limit Order Book for Secondary Market Transactions), price information will be publicly disclosed through that mechanism, and need not be duplicated through the tracking system. This Draft Recommendation also relies on the implementation of Draft Recommendations 9 (Require Disclosure of Beneficial Ownership) and 10 (Information Required for Compliance Instrument Transfer). Draft Recommendation 2 (Information on Derivatives Positions) includes a related discussion on disclosure of derivatives position information.

4.3.5.7 Requirements of Tracking System

This Draft Recommendation implies that the tracking system must:

- Be online;
- Have some services of the tracking system accessible to the public;
- Have some services of the tracking system restricted to account holders, to authorized staff of regulatory authorities, or to system maintenance service providers;
- Have filters such that, for example: compliance account holdings are shown but general trading account holders are not;
- Have the ability to generate customized reports for regulatory authorities.

4.4 Market Monitoring

4.4.1 Draft Recommendation 12: Market Monitoring

The Markets Committee believes that a third-party contractor may improve oversight by complementing and supplementing the monitoring of the Partner jurisdictions. For its Final Recommendations, the Committee will evaluate options more fully and may describe the recommended role of a contractor.
5 Roles of Provincial, State, and Federal Regulatory Agencies

The Markets Committee is analyzing market oversight jurisdiction at the US federal and state and Canadian federal and provincial levels, for both secondary and derivatives markets. Specifically, the committee is examining whether WCI jurisdictions currently have the authority to implement the recommendations made for oversight of the secondary market, and what agencies have this authority. In its Final Recommendations, the Committee intends to include a discussion of jurisdiction for the oversight authorities recommended, as well as coordination between the relevant regulatory bodies.

6 Conclusion

The Markets Committee believes that these Draft Recommendations, collectively, are in accord with the principles adopted for market oversight, and that they provide good risk management in balancing the potential for market manipulation against the potential to stifle legitimate market activity. It has also identified some areas where additional work is required to make a recommendation. The Committee welcomes comment on the Draft Recommendations individually and collectively, and in particular on:

A. Whether the tools available to WCI Partner jurisdictions for market oversight have been completely and correctly identified;
B. Whether the Draft Recommendations would correctly maximize the environmental and economic benefit to the public and support WCI’s Principles of Market Oversight;
C. Whether the Committee should recommend collection of derivatives position information from market participants, including on over-the-counter derivatives; and if so, what of that information to disclose to the public;
D. The Draft Recommendation to require secondary market trades to use a central limit order book.

Incorporating stakeholder comment on the Draft Recommendations among other sources of information, the Committee plans to release Final Recommendations before June 30, 2010.