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BEFORE THE

U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

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Good morning Chairman Harkin, Ranking Member Chambliss and members of the Committee. Thank you for inviting me to testify today regarding cap-and-trade legislation before Congress. My testimony will focus on the Commission's experience regulating emissions trading markets and how we can apply that experience to trading in government-issued greenhouse gas allowances and offset credits. In the event that Congress passes cap-and-trade legislation, the Commodity Futures Trading Commission has the necessary expertise to regulate trading in the expanded carbon markets.

Before I turn to the carbon markets, I am pleased to report to you that the CFTC has been very active since the last time I testified before this Committee. Since then, we have held three hearings into whether or not to set position limits in the energy markets like we do in the agriculture markets. We have worked with the Treasury Department to deliver legislative language to the Congress that would regulate over-the-counter derivative markets. We have revised a no action letter and reached an agreement with the United Kingdom Financial Services Authority to enhance our oversight of a foreign board of trade. We have withdrawn two additional "no action" letters that permitted traders to exceed position limits in some of the agriculture markets. We have improved our transparency efforts by disaggregating the data in our weekly Commitments of Traders reports. And just last week, we held unprecedented meetings with the Securities and Exchange Commission on how we can better harmonize our regulatory structures to most benefit the American public.

Over the past year, we have witnessed the consequences that regulatory gaps and inconsistencies can have on our financial system, the economy and the American people. As Congress moves forward with potential cap-and-trade legislation, I believe it should ensure that there is a comprehensive regulatory framework over the expanded carbon markets – both the futures market and the cash market – without exception.

Proposed cap-and-trade initiatives would impose a ceiling on the total amount of greenhouse gasses that covered entities can emit and expand the market for pollution rights, which are known as “allowances.” An allowance is a limited authorization by the government to emit a quantity of carbon dioxide equivalent. The allowance could be traded, used by regulated parties to comply with emissions caps or potentially banked. Along with allowances, cap-and-trade programs for greenhouse gases utilize “offset credits” – credits given for activities that reduce, trap or sequester carbon.

It is crucial to ensure that the carbon market functions smoothly, efficiently and transparently. Effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. There are five regulatory components of carbon markets that I believe should be considered:

1. Standard setting and allocation;
2. Recordkeeping (maintaining a registry);
3. Overseeing trade execution system;
4. Overseeing clearing of trades; and
5. Protecting against fraud, manipulation and other abuses.

The first two components – the actual allocation of allowances and offset credits, and recordkeeping (other than recordkeeping of the trades) – fall within the expertise of other agencies. In other words, others are better equipped to regulate the "cap" part of "cap-and-trade."

For example, the EPA currently issues allowances on sulfur dioxide and nitrogen oxide as mandated under the Acid Rain, NOx Budget Trading and Clean Air Market Programs. On a smaller scale, a conglomeration of ten states in the northeast and mid-Atlantic form the Regional Greenhouse Gas Initiative and issue allowances on greenhouse gas emissions. In each case, other entities issue allowances and maintain the registry. The constant, however, is that the CFTC regulates the emissions futures trading markets. In other words, the CFTC has a great deal of experience regulating the "trade" part of "cap-and-trade."

Specifically, we have broad experience in the latter three components of carbon trading: regulating trade execution systems and clearing of trades and guarding against fraud, manipulation and other abuses. The Commission already oversees trading and clearing of futures and options contracts based on sulfur dioxide, nitrogen oxide and carbon dioxide allowances and offsets listed on the New York Mercantile Exchange and the Chicago Climate Futures Exchange. Additionally, just last month, under direction from Congress in last year's Farm Bill, the Commission put out a proposed determination for public comment to classify the Carbon Financial Instrument contract traded on the Chicago Climate Exchange as a significant price discovery contract. This would give the CFTC full oversight authority over the contract, giving us additional experience regulating cash emissions contracts. The Commission has abundant experience in the regulation of centralized marketplaces, and should Congress seek to regulate cash markets for emission instruments, the Commission is well-suited to carry out that function.

In most respects, emissions contract markets operate no differently than the other commodity markets the CFTC regulates. While each contract – such as sulfur dioxide, soybeans, treasury bills or natural gas – presents its own unique challenges, the regulatory scheme is essentially the same. Carbon markets have similarities to several different markets that fall within our regulatory authority. For example, carbon allowances and offsets are similar to agriculture commodities in that there is a yearly "crop" and important programmatic regulations governing the nature of the product. At the same time, carbon contracts have similarities to financial products. For example, government-issued allowances and offset credits would be similar to Treasury-issued debt instruments. Futures contracts on Treasury debt are among the most actively traded CFTC-regulated products.

The emissions trading markets that the CFTC currently regulate are small relative to the expected growth of the carbon market as a result of cap-and-trade legislation. Still, the agency has the expertise to apply the same oversight to the much larger, national and mandatory market.

The Commission has thorough processes to ensure that exchanges have procedures in place to protect market participants and ensure fair and orderly trading, that products are designed to minimize potential manipulation and that exchanges comply with the law and regulations. The Commission's compliance staff actively monitors operations to ensure that exchanges are enforcing their rules and that customers are protected from abusive practices. The oversight of clearing is an integral part of the CFTC's regulatory structure. The Commission has extensive experience and a well-established program to ensure derivatives clearing organizations and clearing firms have safeguards to ensure orderly clearing and settlement of transactions and safekeeping of customer funds. Our surveillance staff keeps a close eye for signs of manipulation or congestion and determines how to best address market threats. We have the authority to set and enforce position limits, and our enforcement staff is actively prosecuting cases. In the past year, the CFTC has expanded the scope of its existing energy advisory committee to create the Energy and Environmental Markets Committee, which significantly enhances the CFTC's ability to anticipate and address the full panoply of regulatory issues pertaining to emissions trading markets.

The CFTC has wide-ranging transparency efforts designed to provide as much information to the American public as possible. Specifically, the Commission publishes weekly Commitments of Traders reports, which, starting last week, include disaggregated data to more accurately depict the makeup of the futures and options markets. The Commission also publishes quarterly data on index investment, a “This Month in Futures Markets” report and annual financial data for futures commissions merchants and futures industry registrants.

Should Congress pass cap-and-trade legislation, the CFTC would work with other regulators and market users to ensure that all transactions in both the carbon futures and cash markets are promptly reported and that a central registry is updated at least on a daily basis. With immediate registry of trades, it will be easier for regulators to identify manipulation in the markets.

The CFTC, however, would need additional resources for new staff and technology to effectively regulate the expanded carbon markets. The Commission is just this year getting back to the staffing levels that it had in the late 1990s. Since then, the markets grew five-fold and the number of contracts grew six-fold, but the agency’s staff was cut by more than 20 percent. To take on additional oversight responsibilities, we will continue to work with this Committee and the Appropriations Committees to secure additional resources.

As Congress moves forward and possibly enacts cap-and-trade legislation, I look forward to working with this Committee to ensure that the new markets are comprehensively and effectively regulated. The CFTC is the exclusive regulator of futures markets. I believe that we have the expertise and experience necessary to help regulate the growth in carbon futures and cash markets that will occur if cap-and-trade becomes law. We must protect against the same hazards in the carbon markets that we currently guard against in other commodity futures markets: fraud, manipulation and other abuses.

Thank you for inviting me to testify today, and I look forward to your questions.