



ENVIRONMENTAL DEFENSE FUND

finding the ways that work

Ensuring the Integrity of the Carbon Market

“Trading” within a climate cap and trade program is critical to keeping costs down. Rather than a traditional command-and-control approach in which emitters face a limited set of government-approved options, trading allows emitters maximum flexibility to use the most cost-effective way of reducing emissions. This flexibility means lower costs and creates opportunities for innovations that reduce pollution.

Too much flexibility, however, can lead to abuses. For carbon trading to work right, it must be closely regulated so that it is open, fair, and achieves its environmental purpose.

The good news is that since the Carbon Market is being created from scratch, Congress can ensure the right regulatory balance and avoid the recent problems seen in financial markets. Objectives for market regulation must be:

- The market should be designed around furthering the environmental objectives of the program, i.e. facilitating emissions reductions at the lowest possible cost.
- The market should be designed to be as transparent as possible.
- Participants in the market (and the public) should be protected from price manipulation and fraud.
- The market should prevent the development of speculative bubbles that cause prices to be artificially inflated.

Trades must be through exchanges.

The centerpiece of effective carbon market regulation is to require that all trading, including trading of derivatives, be done through a regulated exchange. This ensures –

1. **Transparency:** Exchange trading maximizes market transparency, because all parties in the market (as well as federal regulators) have access to pricing information in real time, and can see what other traders are doing.
2. **Simplicity:** Exchange-traded products can be easily standardized which makes them easy to understand and easy to price. With no “exotic” or unusual products, trading costs can be lower and limit the level of risk in the system.
3. **Discipline:** The exchange clearing house imposes financial discipline by requiring that transactions be valued by a neutral party each day. This avoids the problems now being faced by banks holding securities and derivatives that are worth much less than the value listed on their balance sheets.

Limits on Traders

Federal authorities must use a variety of tools to reduce volatility and prevent abuses, including setting position limits and margin requirements, tough restrictions on short selling, preventing risky trading activities, and limiting trades if prices suddenly swing sharply.

Tough Enforcement

Traders must be required to maintain records above what is required by an exchange. Federal regulators must have the resources to rigorously oversee the market and civil and criminal penalties for violations must be severe enough to deter illegal activity.