August 11, 2011

Clerk of the Board
California Air Resources Board
1001 I Street
Sacramento, California 95814

Re: 15-day comments on proposed changes to cap and trade regulations
July 10 Discussion Draft

Subchapter 10 Climate Change, Article 5, Sections 95800 to 96022,
Title 17, California Code of Regulations

Dear Sir or Madam:

The Green Exchange LLC ("GreenX") welcomes the opportunity to comment on the proposed rules in for implementation of the AB 32 cap and trade program, referenced above.

GreenX is a consortium of leading financial institutions, energy companies, environmental brokerages, and CME Group that was created to offer the trading community a global solution for managing risk in environmental commodity-based futures and options products. These include products based upon the European Union carbon trading program, the Kyoto protocol carbon offset program, the U.S. Regional Greenhouse Gas Initiative, and other regional, national, and international markets. GreenX intends to list a California carbon allowance futures contract for trading in the next month and, as part of its ongoing efforts to provide service to the environmental market, GreenX would consider listing a carbon offset contract if regulatory and market conditions permitted it to do so.

GreenX supports the efforts of California and the Air Resources Board to adopt and implement not only a cap-and-trade regulation, but also its efforts to be the model for effective and efficient use of cap-and trade-rules to reduce greenhouse gas emissions in California, and in other jurisdictions in North America. GreenX is vested in California, has been extensively involved and active in the EU ETS as well as other U.S. emission allowance trading programs and is one of the leading global environmental commodity exchanges. We welcome this opportunity to share our support for and recommendations for improvement to the proposed rules.

Regulated exchanges like GreenX have played an important role in the development of environmental markets by providing liquidity, price transparency and a safe and secure venue for companies to manage their short and long term risk. The exchange's central clearinghouse acts as an intermediary to all transactions, which greatly reduces credit and delivery risks. The clearinghouse stands between each party to a trade -- it buys every contract from each seller, and sells every contract to each buyer, effectively guaranteeing the performance of each trade. Exchanges also serve the critical roles of providing price transparency and a level-playing field for buyers and sellers to transact.

When a futures contract on an emissions allowance or offset credit expires, the clearinghouse matches buyers with sellers of equivalent offsetting positions. The clearinghouse then facilitates the delivery, collecting payment and transferring allowances when both counterparties have fulfilled their end of the transaction. To execute the delivery, the clearinghouse will take temporary (*i.e.*, normally immediate, but can take an extra day or two if there are any delivery complications) possession of the asset in its registry account before transferring allowances or offsets to the appropriate buyer's account. At no other point does the clearinghouse hold a balance of allowances or offset credits in its own account.

We wish to provide our input on three topics, each of which we believe is significant to having an effective and well-functioning greenhouse gas reduction program based on a cap and trade approach. We first address comments that are administrative in nature; the second comment focuses on the proposed holding limit rules, and the third suggests a different approach to the perceived issue of defective offsets as opposed to the "Buyer Liability" approach.

1. ARB has adopted a realistic and appropriate definition of a Voluntarily Associated Entity which provides clearing services.

Generally, the proposed rules concerning the administrative issues unique to inclusion of an exchange as part of the trading system are strong and appropriate. We appreciate the proposed definition of voluntarily associated entity, which provides clearing services.

However, GreenX perceives three issues in the proposal because of the various types of "holding accounts" that are now in the rule. The proposed rule, in 95831(a)(5), uses the term "Exchange Clearing Holding Accounts." Elsewhere in the rules, "holding accounts" are addressed. While in one situation it would appear that ARB intended to include exchange clearing holding accounts, in another that interpretation appears unintended. For purposes of clarity and efficiency, GreenX suggests the below revisions to the rules.

We presume that ARB intended that exchange clearing trading accounts would be able to trade with regular holding accounts. In order to make clear that transfers from holding accounts may

go to, or from, an exchange holding account, we would propose the following change to 95921(a)(2).

> "(2) Except when the transaction is undertaken by the Executive Officer, all transactions shall be between two entities and will involve transfers between two holding accounts and/or an exchange clearing holding account."

In addition, GreenX suggests revising 95921 to exclude holders of exchange clearing holding accounts from the obligation to report the information required to be provided in 95921(c)(4)-(7). This information potentially will be reported already by the buyer, seller, the buyer's clearing firm and the seller's clearing firm. Any reporting of these transactions by an exchange will be duplicative information, will be overly burdensome for the exchange, and unnecessarily onerous for ARB to process this repetitive information. In addition, since the exchange holding account fills the transparency function of reporting, there is no need for an additional reporting by the exchange or the with respect to the exchange clearing holding account. We propose the following change to 95921:

> "Holders of Exchange Clearing Accounts are exempt from providing the information required under 95921(c)(4)-(7). However, exchange clearing holding requests transactional records will be preserved for five (5) years and may be made available, upon reasonable prior written request, to ARB."

In addition, with respect to proposed 95832, Designation of Authorized Account Representatives, GreenX requests ARB exempt exchange clearing holding accounts from the limit on a single authorized account representative and an alternate authorized account representative. The purpose of such a change is to support efficient delivery of exchange traded allowances. Permitting only two account representatives for clearinghouse accounts could significantly delay the transfer of cleared contracts, making the market less efficient. Liquidity in futures markets tends to pool in specific contract months. For example, in the EU ETS, trading is most active and open interest is largest in the December contract. The result is that a large number of deliveries of exchange contracts occur on a single day, or several days, throughout the course of a calendar year. On these specific days, millions of allowances may pass through clearinghouses' registry accounts. To facilitate timeline and accurate deliveries, the clearinghouse will often dedicate the entire Deliveries Team (5-10 staff members) to the process. By allowing up to ten users access to the exchange clearing holding account, these risks will be mitigated. We would therefore propose the following additional paragraph to the proposed rule 95832:

> "(i). For exchange clearing trading accounts, the authorized representative may designate up to ten delivery analysts responsible for the account to directly access the account and

assist in performing the functions of an entity meeting the requirements of 95814(a)(3) and making submissions pursuant to 95832(h)."

These administrative clarifications are appropriate and strengthen the functionality of the proposed rules.

2. We urge ARB to adjust and revise its approach to holding limits in relation to exchange cleared credits

We support the inclusion in the proposed rules of a revised approach to holding limits, but suggest further revisions exempting exchange clearing holding accounts in the context of permissible holding limits. We also identify two practical problems with the proposed language below and suggest language to address each issue.

The proposed 95920(a) specifically states the holding limit applies to each voluntarily associated entity. There are several difficulties with this approach. First, applying this concept to a clearinghouse disregards its basic function: such an entity does not make choices on its investment decisions, but serves the needs of the market participants. Second, it is not clear how such an entity could take measures to comply; the holding limit for an individual covered entity has many source and company specific terms that are not easily calculable or even known to the exchange, and the exchange will only know the anticipated flow of allowances mere days before they are transferred to the exchange clearing holding account, and then immediately transferred out again. Third, the exchange will receive allowances from the seller's clearing firm – it is also worth noting that clearing firms may need a similar exemption as they will be pooling their selling customers' allowances to transfer to the exchange. Finally, the rule already counts, in the holding limit for the purchaser, any instruments which have been delivered from an exchange clearing trading account. (see (b)(3)).

To address this issue, we recommend modifying (b)(1). Our preferred option is to delete the applicability of a holding limit to exchange clearing holding accounts. As an exchange, it is not clear how a holding limit could be calculated and exchanges are not in the business of holding commodities.

Exchange-traded environmental contracts are physically settled on specific expiration dates. For the California market, this could mean the transfer of tens of thousands of allowances on a single day. An unintended consequence of the proposed holding limit approach is that no clearinghouse will be able to serve the critical role as a true intermediary in any physically-settled contracts due to the likely violation of the holding limit levels on delivery days.

In the alternative, (b)(2) could be modified to read as follows:

> "(2) The holding limit calculation will not include allowances contained in limited use holding accounts created pursuant to 95831 or exchange clearing holding accounts except pursuant to section 95920(b)(3) below."

We urge ARB to not rely on "reversal" of trades by the Executive Officer

We recognize the importance of holding limits to protect the integrity of the market. We also support the authority of the Executive Officer to monitor and oversee the transfers and compliance. However, this particular set of regulations is unlike the past California environmental rules, and the power given to the Executive Officer poses a substantial risk to the market.

The remedy provided to the Executive Officer in 95920(b)(4) is extremely problematic and will have a significant disruptive effect on the market. Specifically, the provision to reverse a transaction will interfere with the sanctity of contract, will result in litigation between market participants, could result in gaming where a party may try to unwind the least economic favorable contract(s) and will cause a lack of confidence in exchange-traded and over-the-counter contracts.[1]

There are significant risks involved in attempting to reverse a transaction. If a transaction is cancelled, the rule as proposed would result in a chain reaction: each of the trades that resulted in the invalid trade may have to be unwound. Such reversals may also result in further holding limit violations by the sellers up the transaction chain. As the rule stands, sellers can be harmed by errors made by other sellers because good faith transactions would also be reversed. A seller may have sold the allowances to ensure that it did not violate its own holding limits, but the reversal of the transaction would put this seller at risk at violating its own holding limits, thereby causing significant confusion and cost for market participants who have attempted to comply with the rule. Unwinding an exchange-traded transaction which promotes the anonymity of

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1 In California, and throughout the country, the sanctity of contracts is a bedrock principle of American law. *See, e.g., Vernon v. Drexel Burnham & Co.,* 125 Cal. Rptr. 147 (1975) ("There is perhaps no higher public policy than to uphold and give effect to contracts validly entered into and legally permissible in subject matter… The sanctity of valid contractual agreements in a free society, such as ours, is of paramount importance and is rooted in both the United States and California Constitutions[.]"); *see also Morta v. Korea Insurance Corp.*, 840 F.2d 1452, 1460 (9th Cir. 1987) ("Despite recent cynicism, sanctity of contract remains an important civilizing concept."); *In re Schenck Tours, Inc.*, 69 B.R. 906, 910-911 (E.D.N.Y. 1987) ("Sanctity of contract constitutes the most fundamental underpinning of commerce.")

counterparties will be particularly difficult. In addition, if it was more than one transaction that resulted in multiple deliveries in one day, it will be difficult to discern the contract to be invalidated. Worse, a buyer who had purchased an allowance at a higher price than the current market could be incentivized to exceed their holding limit for the sole purpose of having selected transactions reversed by the rule.

Further, under each purchase contract, there may be claims regarding encumbrances, and any reversal may trigger those provisions, resulting in litigation amongst market participants due to ARB's actions. Mandatory arbitration may be triggered under bilateral agreements or exchange rules. Each time the transaction must be unwound, there is a possibility that more than one party would be involved and that more than one transaction may be involved causing multiple litigations or arbitration actions. It likely will take many years and cost a significant amount for each party in the chain to resolve the claims. Some parties may try to use the re-opening to undo a trade which, in hindsight, they regretted, or just to get a better deal. ARB likely would become a party to some if not all of the litigation or arbitration actions based on its prior approval of the invalidated offset credit.

GreenX believes that the methodology developed for speculative position limits by regulated exchanges is instructive for ARB's objectives with respect to holding limits. As a regulated futures exchange, GreenX has position limits on its futures contracts, which are not dissimilar to the "holding limit" concept proposed by ARB.[2] These limits are set by the exchange at a point which, in the judgment of the exchange, is appropriate to have a balanced market—where no one entity has excessive market power. GreenX monitors the levels of positions on the exchange and, if GreenX's Regulatory Oversight Department determines that a position on the exchange is close to the applicable position limit, it will inform the Participant that it is approaching the position limit. If a GreenX Participant exceeds the limit, and fails to take appropriate corrective measures, the exchange has the ability to sanction the Participant, including suspending or prohibiting exchange access or issuing a financial penalty. Our experience has been that the entities that trade in environmental commodities are familiar with these processes. For the futures contract on California carbon allowances that will be launched in the near future, GreenX established relatively low position limits, since the potential size of the market is unknown. This process, authorized and reviewed by the CFTC, works for these kinds of environmental commodities. It is very different from a "reversal", which would lead to the significant disruption and difficulties described herein.

We recommend that the rule be revised to instead allow for a cure period of fifteen days to allow market participant to sell any excess allowances, and, if the participant does not do so, then the

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[2] See GreenX Rules 532 to 535 on Position Limits at http://thegreenx.com/docs/GreenEx_Rulebook.pdf#page=39. In addition, the GreenX website lists our position limits at http://www.thegreenx.com/market-regulation/position-limits.html.

penalties already contemplated in (b)(4) would apply. ARB may also wish to make clear that the penalties will increase for repeat offenses.

We would therefore suggest that section (b)(4) be revised as follows:

> "(4) If the Executive Officer determines that a reported transaction, whether or not it has been ~~yet~~ recorded into the tracking system would result in an entity's holdings exceeding the applicable holding limit, then the Executive Officer shall provide notice to the entities involved, and allow a fifteen day cure period for correction of the potential exceedence. The potential exceedence may be cured by a sale of the excess credits, or transfer of credits into a compliance account. If the potential exceedance has not been corrected by the end of the fifteen day cure period, ~~then the Executive Officer shall not approve the transaction pursuant to section 95921(a)(1). If the violation is not discovered until after the transaction is recorded, then the transaction may be reversed pursuant to sectoin 95921(a)(2) and~~ penalties may be imposed pursuant to section 96013. Such penalties may increase due to repeated violations of this section."

The preceeding change to section (b)(4) will not only facilitate the efficient use of exchange traded contracts, which brings the benefits of market liquidity, price transparency and a safe and secure venue for companies to manage their short and long term risk, but also will help prevent unintended consequences and the gaming opportunities described above. At the same time, it preserves ARB's authority to oversee and monitor the program, and take appropriate action if needed.

3. We strongly recommend ARB reconsider the concept of invalidating offset credits. If it chooses to retain this type of sanction, ARB should refocus on those who created and verified the improper credit, rather than disrupt the market and penalize good faith buyers

GreenX commends ARB staff for revising Section 95985. The revised draft presents a serious effort by ARB staff to provide greater clarity with respect to the situations under which offsets would be subject to being invalidated. We fully support and endorse the principle of promoting quality offsets and having measures that penalize bad actors. However, the revisions are still likely to have unintended consequences.

This provision as drafted is still counter-productive. It is unclear how it would reduce the risk of the anticipated poor quality offsets from being produced and puts the potential liability on the wrong parties. This uncertainty will prevent a market for offset credits from developing. Secondary buyers would be extremely hesitant to take the risk of paying for nothing and being penalized when they acted in good faith and had no involvement in the prohibited activity. Therefore, exchanges like GreenX would not list offset credits as exchange-traded contracts

because of the lack of interest in the contracts due to the risk and uncertainty regarding good title to the offsets.

Proposed 95985 would threaten the offset market and the use of exchanges for offset trading

There are several features of 95985, which would make a market for offsets quite unlikely. The principal reason is uncertainty on the part of buyers. From the first off-take to the end user (the last in the chain of title), the possibility, even if remote, that a commodity for which value has been paid would suddenly turn into worthless paper or a lawsuit would make offsets very unattractive. Offsets are a key policy measure in many ways for cap-and-trade systems. They are a price safety valve. They provide a financial incentive for green projects that are not required by law to be undertaken. Without the income from offsets, scores of worthy projects and millions of tonnes of reductions in GHG emissions just will not occur. The presence of 95985 as presented will chill the market for third party buyers and make the listing and/or clearing of offsets impracticable to an exchange such as GreenX.

This provision, if adopted as proposed, will undo the utility of offsets by permitting the taking of a commodity which has real value and was purchased in good faith. It will penalize not those who do the project to create the emission reduction, but also to the utilities, fuel suppliers and users, and manufacturers who would buy offsets as a key part of a cost effective strategy for compliance and as support for the development of new technologies. It will penalize not those who committed the invalidation, but the utilities, fuel suppliers and users, and manufacturers who purchased the offsets as part of their cost effective strategy for compliance.

The proposed rule as drafted could drive GreenX and other exchanges away from listing offset contracts because of the uncertainty involved and the lack of market participants willing to trade in any secondary offset market. The likely result would be many potential participants in the offset market would instead shy away from use of offsets as a compliance tool thereby significantly decreasing if not eliminating demand. An exchange is not compelled to participate in any market. It can choose which contracts to trade and which are not suitable for it to clear. Exchanges list contracts on physical products that have already reached a certain level of liquidity and where there is a market demand for standardized futures contracts on such underlying products. This rule may result in the loss of fungibility of the offsets – if there is a different value to different projects creating the offsets, and differing risks, there also will be different contract terms and pricing related to those offsets, making it almost impossible for an exchange to list any standardized contract related thereto.

In a similar fashion, holding an offset credit will pose substantial risk to an end-user, or to an investor. Eight years is a very long time to take the risk of a problem. Over that time period, an offset credit may easily have been traded eight or 20 or 50 or more times. This proposed rule is

likely to result in a similar daisy chain effect of litigation and arbitration as described above in the holding limit comments. An affected buyer may claim that its seller had encumbered title to the offset due to its lack of quality, causing the seller to make a claim against its seller, all the way up to the project developer and the verifier, where, in GreenX's opinion, the liability should rightly lie. But instead of directly penalizing those with the most control over the quality, this rule penalizes every participant in the chain.

This process is inefficient and extremely concerning to anyone interested in trading a fungible commodity, since there is nothing akin to this risk in any other commodity market. The conduct with which ARB is concerned and that would lead to the voiding of an offset credit is the conduct of the creator of the credit and/or the original verifier. Exchange cleared contracts would pose quite complex issues to make whole the parties in the chain of title due to the anonymous nature of clearing, just to recover back from those who are responsible in the first instance for the improper offset credit. Given what is required to unwind a transaction, and all of the legal contractual rights and obligations and legal precedent that would be brought into play, for whatever cause, we would expect any exchange to avoid trading and clearing offset credits if buyer liability remains in the rule. Indeed, regardless of the length of time that an offset credit may be vulnerable, the uncertainty involved in making the any buyer liable for the lack of quality in the original offset credit will drive buyers -- and c exchanges and clearinghouses -- away from trading and clearing offset credits.

Making offsets less attractive will drive costs up, and reduce the use of innovative projects

ARB and many others have recognized that the use of offsets is a key price control mechanism to reduce the costs of the GHG reductions required by AB 32. But the use of offsets has an investment and innovation use as well. Projects that are "beyond business as usual" depend on the income provided by offsets. Without income from offsets, the projects will not occur. Thus, any measure which reduces the demand for offsets has the reciprocal affect of reducing the number of GHG reduction projects that are undertaken. Without buyers or with fewer buyers, there will be many fewer offsets created and will limit the power of the market to drive capital to clean energy and environmental technologies.

Offsets are validated and verified before they can even be issued

Section 95985's focus on Buyer Liability for holding an invalid offset also seems anomalous when one considers how much effort is involved in creating an offset. Fully one third of the pages in the 15-day rule addresses offsets, and the categories, qualification and verifications required before they are submitted to ARB for issuance of an ARB Offset Credit. Buyers are not involved in any of those activities.

To create an offset, first the methodologies have to be scientifically valid. The project plans have to be verified against one or more of those methodologies. Then the activities have to be verified against the project plan. All of these steps have been developed for the "voluntary market" which ARB has wisely taken into account in constructing its rules for issuance of offset credits. We presume that ARB will not be requiring less than what is already required by the "voluntary" offset organizations. But we fail to see how purchasers of those offset credits should be held responsible for errors made in the creation and recognition of the offset credits. We respectfully submit that the fear of offsets being promoted by some reflects a significant lack of understanding about what it involved in creating and obtaining a verified offset credit.

GreenX notes that verifiers are in a position of responsibility for invalid offsets. Each of the items identified in 95985 as bases for invalidating an offset are items which are part of either the project verification to a methodology or the verification for issuance of credits. Subparagraph (b)(1) is a general incorporation of the requirements for obtaining ARB offset credits; (b)(2) seems to reflect the verifier requirements of proposed 95977 and 95977.1(b); (b)(3) appears vague and does not seem to add anything to (1) and (2) and the jurisdictions referenced likely would have their own remedies for any violations; and (b)(4) we believe is already covered by (b)(1).

Suggested alternative approaches

We therefore suggest alternative solutions with respect to the concerns behind 95985.

First, enforcement of the verifier and project proponent rules will achieve the very same result as attempted by the proposed 95985. We would recommend the removal of 95985, since it will threaten the use of offsets, investment in green projects, the development of new technologies that California entrepreneurs are uniquely suited to provide, and, if it does not destroy or significantly impair the market for offset projects, it will severely diminish transparency on any trades or transactions involving offsets.

If there are issues discovered through a rotation of the verifiers, the enforcement should be against those who created or verified the offset credit, who would be liable for economic replacement of the invalidated credit. This approach would put the accountability at the point of concern. The issues identified by proposed 95985 are each issues that the project proponent and/or the verifier for the project are in the best position to not only have the facts, but also to advocate their views. Enforcement should be focused at the source of any problem. Verifiers will want to protect their reputation and thus have a vested interest in verifying only quality offsets. In addition, this risk of a penalty may be able to be addressed through insurance coverage by the verifier, and the costs of riskier projects that may require higher insurance can be passed on via fees to the project developer.

However, if ARB wishes to retain the concept of invalidating issued ARB offset credits, we have two suggestions:

(1) remove the buyer liability terms and put the onus squarely on the entities that put the credit into the compliance market. To do that, we would recommend the following revisions to the sub-sections (c) and (f) in the language as currently proposed:

(c) If ARB determines that an ARB offset credit is invalid pursuant to section 95985(b), ARB will identify the Offset Project Operator, the Authorized Project Designee and the verifier(s) of the offset credit in question. ~~the current holder of the ARB offset credit or the entity that submitted the ARB offset credit for compliance or retirement.~~

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(f) If an ARB offset credit is found to be invalid pursuant to sections 95985(b) and (d), the part~~y~~ies identified in section 95985(c) must replace each metric ton of CO2e with a valid ARB offset credit or another approved compliance instrument pursuant to subarticle 1 within 90 calendar days of the notice of invalidation pursuant to section 95985(e)(2), each outstanding ARB offset credit will constitute a violation pursuant to section 96014. If ~~the~~ any party identified in section 95985(c) is no longer in business ARB will require those who are still in business, whether the Authorized Project Operator, the Authorized Project Designee and/or the verifier(s) to provide the full amount of the replacement within said 90 days and each outstanding ARB offset credit following that 90 days will constitute a violation of section 96014. ~~the Offset Project Operator or Authorized Project Designee to replace each invalidated ARB offset credit and will notify the Offset Project Operator or Authorized Project Designee that they must replace them. The Offset Project Operator or Authorized Project Designee must replace each metric ton of CO2e with a valid ARB offset credit or another approved compliance instrument pursuant to subarticle 4 within 90 days of notification by ARB pursuant to 95985(e)(3) If the Authorized Project Operator or Authorized Project Designee does not replace each invalid ARB offset credit within 90 calendar days of notification by ARB pursuant to section 95985(e)(3), each outstanding ARB offset credit will constitute a violation pursuant to section 96014.~~

The proposed rule already provides that the Offset Project Operator and the Authorized Project Designee must provide a proper ARB offset credit or other compliance instrument, but only if the person who holds the suspect credit is out of business. There is no rationale for putting the liability on the Buyer and that approach will undermine

confidence in the market. Focusing on those who create and verify the credit will enhance the offset market and provide additional comfort to the market as to the quality of offsets thereby promoting a more liquid market.

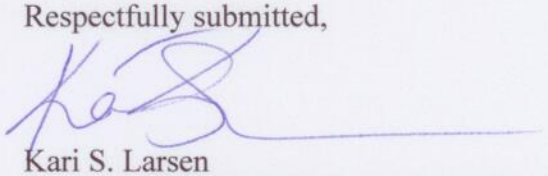
In addition to the above, or perhaps as an alternative,

(2) provide an exemption step for the Offset Project Operator and/or the Authorized Project Designee so either (or the verifier) can choose to avoid the sanctions threatened by 95985 and risk of liability years after the offset credit was created. We would suggest that any project which has had a second verifier review the project - such as the requirements proposed in 95977.1 for rotation to a new verifier -- should be exempt from the threat of invalidation. Again, we believe such is an unnecessary extra cost for projects, but it is far better than putting the market at risk because of the vague and uncertain threat of proposed 95985. This is a concept similar to that suggested by IETA. In lieu of this exemption or "safe harbor" concept, we also would support the buffer pool concept as proposed by IETA.

For the reasons described above, we urge ARB not to include 95985 as proposed.

Thank you for the opportunity to provide these comments. Should you have any questions regarding GreenX's comments, please contact me at 212-299-2510 or Kari.Larsen@theGreenX.com or John Melby, Managing Director, North American Markets, at 858-504-0333 or John.Melby@theGreenX.com.

Respectfully submitted,



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