Comments of Morgan Stanley Capital Group, Inc.
Proposed Regulation Order
Cap-and-Trade Program
California Air Resource Board
Appendix A.1
June 13, 2012

Morgan Stanley Capital Group, Inc. ("MSCG") appreciates the opportunity to comment on the most recent proposal to amend the Cap-and-Trade regulation, currently scheduled to be voted on by the Board at its June 28 meeting. MSCG, as a large First Jurisdictional Deliverer of electricity, will have a significant compliance obligation under the Regulation, and thus will be directly affected by the proposed amendments. For questions or follow-up discussion, please contact Steve Huhman at (914) 225-1592, or via e-mail at Steven.Huhman@morganstanley.com.

Listed below are our main concerns:

Registration Requirements for Officers, Directors, Representatives and Agents

MSCG strongly believes that the requirements for personal information from company representatives is grossly excessive, is largely unprecedented in any similar US situation, and is not necessary to achieve the otherwise legitimate objectives of the ARB for accountability and fraud prevention. Providing driver's license and passport information is simply not necessary, and disclosing personal bank account information is simply egregious. No entities with similar concerns, such as the Regional Greenhouse Gas Initiative ("RGGI"),[1] the Financial Industry Regulatory Authority ("FINRA"),[2] the National Futures Association ("NFA"),[3] or the U.S. Environmental Protection Agency ("EPA")[4] (for Sox and Nox emissions allowance trades), require this sort of personal data for either trading rights or administrative access to accounts.

To the extent that these proposed requirements are motivated by a fear of "fly-by-night" entities engaging in inappropriate or illegal activities and then "vanishing", the concern might be understandable. However, for large, publicly traded entities like MSCG, there is

[1] *See*, REGIONAL GREENHOUSE GAS INITIATIVE, INC., *Qualification Application: Version 3.0* (issued Apr. 10, 2012) (not requiring the disclosure of individual passport, driver's license, nor personal bank account information to the RGGI).
[2] *See* FINANCIAL INDUSTRY REGULATORY AUTHORITY, *Form U-4: Uniform Application for Securities Industry Registration or Transfer* (not requiring the disclosure of individual passport, driver's license, nor personal bank account information to the self-regulating organization as monitored by the Securities and Exchange Commission).
[3] *See* NATIONAL FUTURES ASSOCIATION, *Form 8-R: Individual Application for Associated Persons* (not requiring the disclosure of individual passport, driver's license, nor personal bank account information to the self-regulating organization as monitored by the Commodities Futures Trading Commission).
[4] *See* Environmental Protection Agency, *EPA Form 7610-5: General Account Form* (approval expires Jul. 31, 2014); *see also*, Environmental Protection Agency, *EPA Form 7610-7A: Letter of Credit (2012) EPA Allowance Auctions* (2012); *see further*, 40 C.F.R. Part 73 (2011).

no question of being able to find and hold them accountable for any transgressions. To the extent that their duly appointed representatives commit any violations, their employers are fully responsible for their conduct, even if the individual cannot be located.

For these reasons, MSCG strongly urges ARB to reconsider and eliminate the various proposed requirements for company personnel to supply personal information. In the alternative, to the extent that ARB has legitimate concerns about being able to hold "small" entities responsible, it may be appropriate to devise a bifurcated set of rules, with more extensive requirements applicable to personnel of entities that do not have strongly established corporate presences. For example, it might be sensible to exempt employees of publicly traded and/or SEC, CFTC or Federal Reserve regulated entities from personal data requirements.

Limitation of Participation to US Companies

Under the proposed rules, ARB essentially proposes to limit participation in the California market to "US companies". MSCG views this decision to be problematic and fraught with the risk of unintended consequences. First, the ARB must provide more definition with regard to what constitutes a "US Company". Is US incorporation required? Does it depend on the citizenship of the stockholders of the company? How about a country with a US subsidiary but a parent incorporated in another country?

Second, ARB should consider whether exclusion of "foreign" companies is really in the best interests of the program. For example we would note that many large investors in and developers of US renewable resources are foreign companies. Is it really good public policy to exclude these entities from participation in the program?

Third, has ARB considered the possibility that an entity with a compliance obligation may not be a US company? That would create quite a headache trying to resolve that dilemma.

Although MSCG considers it unlikely that it will not be able to qualify, under whatever final definition of a "US company" ARB might adopt, that is not 100% clear. For example, MSCG's parent company is 20% owned by a foreign entity. For all of the reasons discussed above, and in the interest of avoiding adverse unanticipated consequences, we believe that barring non-US companies outright should be re-considered. A better approach to addressing legitimate concerns would probably be to focus on requiring participants to have a US presence. This might be done in a way similar to the way that businesses are often required to establish a California presence, e.g. by establishing an agent for service of process, if a physical office is not maintained in the state.
We further note that, however a "US company" is ultimately defined, many such companies have worldwide operations, and may very well perform certain tasks required for compliance, or other participation in the allowance markets, in other countries. For example, MSCG has offices in both London and Budapest where certain functions related

to transaction administration might plausibly be assigned. We would note that, relating back to our objections to supplying personal information in the prior section, an employee authorized to direct movement of allowances among accounts might very well be stationed in one of those locations, and would be highly unlikely to have a US bank account.

The underlying point is, as a general principle, ARB should not design its regulations so as to force market participants to restructure their administrative staffing assignments without a compelling reason, and no such reason exists here. Therefore, we strongly urge ARB to think about how its regulations might impact companies' unobjectionable business practices, particularly with regard to country of residence of task performers, and avoid any interference in those practices without a compelling need. We submit that no such need exists with regard to the country of residence of authorized officers, directors, agents or representatives.

Allowance Auction Provisions

Although, ideally, MSCG believes the program would be better served with less restrictive holding and purchase limits, we do not generally object to the structure of limits as currently proposed, and believe it will allow workable markets. However, we strongly object to different holding and purchase limits among customer classes, and in particular, object to the large 40% purchase limit on current vintage allowances granted solely to Electric Distribution Utilities. In particular, this doesn't make much sense for the Investor Owned Utilities, as their portfolios of owned generation, the facilities for which they will be responsible, are so heavily weighted towards hydro, nuclear and renewable resources. Other compliance entities such as MSCG, with, potentially, larger compliance obligations, will be placed at a significant and unfair disadvantage. Furthermore, the rule is likely to inappropriately skew commerce. If EDUs have preferential access to allowances, then it is likely that more electricity procurement transactions will take place outside the borders of California, so as to make the EDU the importing entity and therefore First Jurisdictional Deliverer, without regard to whether or not this is (otherwise) the most efficient mode of transaction. So, some potential exists for the preferential access rule to artificially raise costs to consumers.

Again, MSCG would prefer no discrimination among customer classes with regard to holding and purchase limit rules, but to the extent that any such distinction is made it should be with regard to compliance requirements, not entity type or function. For example, a larger holding or purchase limit for all compliance entities might be somewhat defensible. At least with a rule of this type, a need-based argument can be made. Furthermore, if such a need-based standard is devised, then the limit should be based in some manner on the anticipated compliance obligation, so that entities with similarly sized anticipated compliance obligations are assigned the same purchase limits. Finally, providing disproportionately large (relative to need) opportunities to purchase to one customer type is inconsistent with general ARB concerns about hoarding and other forms of market manipulation. Either the concerns are legitimate, and apply equally to all entities, or they are not and should not be in effect at all.

Administration of Account Limits

MSCG strongly approves of and appreciates the additions to the administrative practices with regard to holding limits. In particular we believe the "notice to cure" approach is 'best practice" and that the 5-day time available is reasonable.

Conduct of Trade

Morgan Stanley finds the proposed rules governing transactions to be confusing at best and problematic at worst. Depending on ARB's actual intent, we believe that the wording needs to be changed, at a minimum, and that the substance of the proposals may also need to change.

At the core of the confusion is the following wording "…the day of settlement of the transaction agreement for which the transfer request is submitted". In general industry parlance, "transactions" are settled, not "transaction agreements". So, the confusion starts with what ARB might mean here. Is it simply a matter of meaning "transactions", and not using the customary industry terminology? Or does ARB have something else in mind? When combined with the "three day following" requirement, additional confusion results. Generally, settlement (that is, payment) would occur AFTER receiving confirmation of the completion of a transfer request (although a counterparty without good credit might be required to pay in advance).

So, in MSCG's mind, three possibilities occur to us with regard to ARB's intent:

1) "Settlement of a Transaction Agreement" might be intended to mean "execution of a contract" or, similarly, "agreement on a deal" (even if the paperwork lags the verbal discussions). If either of these variants is an accurate interpretation, it would appear to prohibit many "normal and routine" types of transactions. Two quick examples: A: Party A signs a deal in April agreeing to deliver 10,000 allowances to Party B seven days prior to the final compliance deadline date for the current vintage year. B: Multi-year deals - -e.g. a deal such as described in "A", except for each of the next three years. None of these deals would be allowed because all related allowances must be delivered within three days of the agreement.
2) Accepting payment AFTER delivery of allowances is prohibited, since transfer requests must be made within three days of receipt of payment (settlement).
3) ARB simply means that, <u>if</u> payment is made prior to allowance transfer, then transfer requests must be made "post haste". While this last interpretation is the most benign, even it is problematic. Suppose two parties struck a deal for end-of-year delivery, with the buyer having the option to get a discount for early payment. This type of deal would be prohibited by even the "benign" interpretation, and it is difficult to understand why ARB would feel the need to prevent such transactions.

In summary, regardless of ARB's intent, better language needs to be crafted so as to make that intent clear. Equally important, we strongly urge ARB to reconsider any intent to mandate transfer requests within restrictive time frames of either reaching agreement or making payment. Doing so would prevent many kinds of normal and routine transactions, and ARB simply does not have a vested interest in interfering with routine, non-manipulative commerce to this degree.

Price Reporting

As a matter of principle, MSCG objects to reporting transaction prices on transfer requests. We consider this to be proprietary business data and also would find it administratively burdensome. It simply is not needed to perform reasonable market monitoring. To the extent that ARB wants information on market prices, numerous trade publications are already reporting market prices for California Greenhouse Gas ("GHG") emissions allowances, and no allowances have even been issued yet. It is highly likely that Exchanges and brokers will also be issuing price survey data. Getting data on market prices should not be a problem even absent a transaction reporting requirement.

Philosophical differences on this issue aside, there are also practical problems with price reporting. While many, perhaps most transactions are straightforward "X allowances for $Y each", more complicated transactions are not uncommon, and an unambiguous price may not be available. For example, a "package deal" for a variety of goods and services, including allowances, would not be uncommon, and the price would be for the entire, bundled package. No separate, explicit price for allowances would exist.

Another type of transaction that could occur would be a non-cash trade. For example, party A might agree to deliver 20,000 California allowances for each vintage year 2013 – 2018 to party B, in return for 10,000 WTI crude futures for December 2013 at Cushing, Oklahoma. What price should be reported for a transaction of this type?

Given all the complications, concerns over proprietary data and bureaucratic administrative burdens, MSCG strongly recommends that ARB not require transaction price reporting.

Beneficial Holding

In the most recent draft proposal, ARB is removing the ability to engage in "Beneficial Holding". The lack of ability to undertake this type of activity does not concern MSCG per se, as we had not contemplated engaging in that kind of activity. That said, our lack of concern is based on our understanding of a "Beneficial Holding" account as one where the account holder was merely acting as a custodian for another party who had complete and sole ability to direct disposition of the beneficially held allowances. In other words, a "Beneficial Holding Account" would have been a warehouse service.

We do have one potential concern over a possible interpretation, which we would urge ARB to address via explicit language in the text of the Regulation. That is, an account

holder that has a contract to deliver allowances to a counterparty at some future time, will likely be accumulating allowances over time to fulfill that contract, among other purposes. Our reading of the "plain text" of the proposed Regulation is that this kind of accumulation would not be considered to be engaging in "beneficial holding", and indeed we believe this is both the right policy choice and the correct legal interpretation of the text, as written. That said, it would provide significant relief of anxiety among many parties if the ARB were to explicitly confirm this interpretation in the text of the regulations.