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## Proposed Regulation of EU Emissions Allowances as Financial Instruments

The European Commission's recent proposals to revise and recast the Markets in Financial Instruments Directive, or MiFID, and the Market Abuse Directive, or MAD, include, for the first time, regulating carbon emissions allowances as financial instruments. If implemented, certain spot emissions market participants would become subject to the full panoply of financial regulations, such as conduct of business rules, client classification and regulatory capital requirements. In addition, the proposals would potentially create a new duty to disclose inside information for the largest emitters under the EU Emissions Trading System.

### The EU Emissions Trading System

The EU Emissions Trading System (the "ETS") began on 1 January 2005 in order to implement EU policy to reduce the emission of greenhouse gases. Under the ETS, Member States are allocated national emission caps and then distribute EU allowances ("EUAs") to operators of installations falling within the scope of the ETS. An EUA is an allowance to emit one tonne of carbon dioxide equivalent, and operators of covered installations must surrender a sufficient number of EUAs each year to cover their emissions for the previous year. The intention of the scheme is to create financial incentives for polluters to reduce their emissions and, in doing so, to bring down greenhouse gas emissions in the EU and help combat global warming.

Other emissions units issued pursuant to the Kyoto Protocol, such as Certified Emission Reductions (or "CERs") and Emission Reduction Units (or "ERUs"), are also recognised for compliance under the ETS and are therefore widely held and traded in the EU. Any person, in addition to operators of covered installations, can buy or sell EUAs or Kyoto units, whether privately, over-the-counter (using a broker), by trading on spot markets or by entering into a commodity derivative that goes to delivery. The European carbon market has grown substantially, from €6 billion turnover in 2005 to €90 billion in 2010.<sup>1</sup>

In preparation for its third trading period which begins in 2013, the ETS is transitioning from the allocation of EUAs to installations by Member States to a centralised allocation by the European Commission. In addition, it is transitioning to a system where allocation will increasingly occur by auctioning rather than free distribution.<sup>2</sup>

Various further changes are being proposed to bring additional regulation to the trading of EUAs, CERs and ERUs in Europe, justified by the European Commission in its legislative proposals as a response to recent scandals affecting the ETS. The infrastructure of the ETS has recently been compromised by recent incidents of fraudulent activity. In January 2010, 250,000 EUAs worth €3 million were "phished" from an account held at the German registry. In November 2010, 1.6 million

<sup>1</sup> Review of the Markets in Financial Instruments Directive (MiFID) and Proposals for a Regulation on Market Abuse and for a Directive on Criminal Sanctions for Market Abuse: Frequently Asked Questions on Emission Allowances (MEMO/11/719).

<sup>2</sup> See the Auctioning Regulation (Regulation No. 1031/2010, as proposed to be amended as follows: [http://ec.europa.eu/clima/policies/ets/auctioning/third/docs/draft\\_consolidated\\_en.pdf](http://ec.europa.eu/clima/policies/ets/auctioning/third/docs/draft_consolidated_en.pdf)).

EUAs were “hacked” from an account held at the Romanian registry. Further hacking incidents reportedly followed from accounts in the Greek, Austrian and Czech registries. The value of stolen credits up to the end of January 2011 was estimated at up to €45 million. In connection with some of the later thefts, which were made from accounts in Member States whose property laws may protect victims rather than purchasers, uncertainty arose as to who “owns” EUAs that had previously been misappropriated. These issues contributed to a crisis in confidence in the European carbon market.

It is in this context that the European Commission recently proposed, among other measures, enhanced security measures for a new centralised European Union registry for emissions allowances, as well as clarifying that transactions involving emissions allowances will be deemed final and irrevocable absent clerical error.<sup>3</sup> Proposals to update two pieces of financial regulation — MiFID and MAD — have now been made with a view to enhancing market stability.

### The MiFID and MAD Proposals

MiFID originally came into force in November 2007 as a piece of European legislation to harmonise financial regulation for investment firms. It was intended to enhance investor protection, improve cross-border market access and promote competition in the financial markets across the EU.<sup>4</sup> The European Commission has proposed that MiFID be amended and recast in two separate pieces of legislation: a second MiFID (“**MiFID II**”) and a Regulation (“**MiFIR**”). We refer to both pieces of legislation together as “**MiFID II**” in this client note.

MAD came into force in January 2003, aiming to harmonise national laws prohibiting the misuse of inside information (sometimes referred to as “insider trading”) and market manipulation.<sup>5</sup> The European Commission has similarly proposed that MAD be amended and recast in two separate pieces of legislation: a Regulation (“**MAR**”) and a Directive on Criminal Sanctions for Market Abuse (“**CSMAD**”).

The European Commission’s package of amendments to both MiFID and MAD includes changes unrelated to emissions allowances, which are not discussed in this bulletin. Further information on the MiFID II proposals is presented in our separate client publication dated 20 October 2011.<sup>6</sup>

### MiFID Changes: Regulation of Spot Transactions in Emissions Allowances

Under the MiFID II proposals, EUAs and Kyoto units such as CERs and ERUs will be included in the definition of “financial instruments”. This will have the effect of prohibiting the provision of investment services or carrying on of investment activities relating to spot transactions in such units as a main business activity, unless the person in question obtains authorisation from the FSA or another financial regulator in the European Economic Area.

The changes in MiFID II will have an effect on all markets and financial institutions, including in relation to the derivatives markets. Derivatives based on EUAs and Kyoto units are already within the scope of the existing MiFID and MAD. As a result, those who operate and trade relevant derivatives markets are already subject to financial regulation and are covered by the market abuse regime under MAD. Transactions involving derivatives, therefore, would generally be unaffected by the proposals. However, the European Commission has proposed narrowing or removing certain exemptions in MiFID II and other reforms, which, if adopted in their current form, will have a significant regulatory impact even on existing participants in the derivatives ETS market.<sup>7</sup>

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<sup>3</sup> See [http://ec.europa.eu/clima/policies/ets/registries/docs/regulation\\_amendments\\_en.pdf](http://ec.europa.eu/clima/policies/ets/registries/docs/regulation_amendments_en.pdf) for the latest draft of the proposed Regulation.

<sup>4</sup> Directive 2004/39/EC.

<sup>5</sup> Directive 2003/6/EC.

<sup>6</sup> See "[A Changing Landscape: the MiFID II Legislative Proposal](#)".

<sup>7</sup> *Ibid.*

## ETS Compliance Buyers

In many, if not most, cases, ETS compliance buyers – that is, corporates owning or operating installations regulated under the ETS, such as power generators, aviation companies and manufacturers – will trade in EUAs or Kyoto units as an ancillary activity to their main business as an industrial company. Companies whose emissions trading activities are “ancillary” would remain exempt from the requirement to obtain regulatory authorisation for the trading of spot transactions. Such companies would be able to participate directly in carbon derivatives exchanges and spot marketplaces, provided they meet relevant membership criteria. Where a company operates a trading desk due to its expertise in the market generally, authorisation will be required unless it can be shown that these activities are “ancillary” to that company’s main commercial activities. However, the definition of “ancillary” in the proposed MiFID II is vague at this stage. Further technical criteria will be produced by the European Commission as to whether a given activity is ancillary to a company’s main business.

## Professional Spot Market Traders

Traders whose main business activity is trading in the EUA and/or Kyoto spot market will be brought within the purview of financial regulation under the proposed text of MiFID II. The following services and activities relating to EUAs and Kyoto units will be regulated, among others:

- dealing on own account;
- dealing on behalf of clients;
- reception and transmission of orders;
- investment advice; and
- safe-guarding and administration of clients’ assets (custody);.

Relevant regulatory, organisational and operational requirements which will apply as a result of financial regulation include:

- know-your-customer checks;
- transaction reporting;
- record keeping;
- investor protection rules;
- conduct of business requirements (e.g. terms and conditions of business for clients);
- organisational requirements (e.g. systems and controls, management structures);
- financial promotion rules; and
- capital requirements.

## Carbon Exchanges

Trading venues in which there is spot trading in emissions allowances but which are not currently within the scope of MiFID would, under the proposals, require authorisation from the FSA or another Member State regulator. Broadly, any facility or system that, on an organised basis, executes or arranges emissions allowances transactions based on multiple third-party orders would be within the scope of the proposed MiFID II. There will be an expanded number of different categories of trading venue for these purposes: regulated markets, multilateral trading facilities, organised trading facilities and systematic

internalisers, as discussed further in our separate client memorandum on MiFID II.<sup>8</sup> The degree of regulatory oversight differs according to the category of venue. The European Commission has stated that trading venues will not be required to set position limits for emissions allowances.<sup>9</sup>

### MAD Changes: Duty to Disclose Inside Information

As a consequence of being “financial instruments” under the MiFID II proposals, EUAs and Kyoto units will fall within the scope of the proposed MAR/CSMAD. This will represent a considerable extension of the scope of the market abuse regime to include trades in these instruments (as well as related derivatives). Any person who engages in prohibited behaviour in respect of EUAs and Kyoto units, such as trading whilst in the possession of inside information or market manipulation, may be guilty of market abuse under the proposals, and subject to an unlimited fine or other sanction by the FSA or any other relevant European regulator.

As a consequence of the extension of the scope of MAD, persons engaging in transactions in EUAs and Kyoto units would, under certain circumstances, also have a duty to disclose publicly inside information (or face committing market abuse if they do not do so). Inside information is defined essentially as non-public information of a precise nature that, if made public, would be likely to significantly affect the price of the relevant financial instruments. The duty to disclose inside information would be placed not on the issuer, as is the case with securities, but on ETS market participants whose physical activities — for example, the capacity and utilisation of installations — could have an impact on greenhouse gas emissions and hence on the market price for EUAs and Kyoto units.

This duty to disclose is proposed to apply only to those entities whose activities can have a *material* impact on the price of emission allowances or consequential insider trading risks. In practice, only information concerning the activity of the very largest emitters in the EU ETS, typically belonging to the EU power sector, could be expected to have a significant impact on the price of EUAs. The European Commission is to be directed to develop a threshold, expressed in terms of annual emissions or thermal input or a combination thereof, below which ETS market participants would be exempt from the duty to disclose inside information.

It is separately being proposed that the market abuse regime will be extended to the trading of wholesale energy products under a separate piece of legislation, the Wholesale Energy Market Integrity and Transparency Regulation, which is expected to enter into force by the end of 2011 and become applicable by mid-2013.<sup>10</sup>

### Insiders' Lists

Under the current MAD, issuers and others who are party to inside information must publicly disclose “inside information” relating to them as soon as possible, subject to limited exceptions. Where public disclosure is delayed, issuers must maintain an “insiders’ list” containing details of persons who have access to the information. This requirement is intended to provide a list of contact details for regulators to consider if there are unusual trading activities connected with any market announcements. Large participants in the ETS market would also become subject to an obligation to maintain an “insiders’ list” as regards data on emissions. Further details of the conditions under which there will be an obligation to maintain an insiders’ list in respect of emissions data will be published at a later date.

<sup>8</sup> See fn. 6, above.

<sup>9</sup> Review of the Markets in Financial Instruments Directive (MiFID) and Proposals for a Regulation on Market Abuse and for a Directive on Criminal Sanctions for Market Abuse: Frequently Asked Questions on Emission Allowances (MEMO/11/719).

<sup>10</sup> See the draft Regulation at <http://register.consilium.europa.eu/pdf/en/11/pe00/pe00034.en11.pdf>.

## Other European Legislation That May Become Relevant to Emissions Spot Trading

### Money Laundering Directive

The Money Laundering Directive is designed to prevent the use of the financial system for the purpose of money laundering and terrorist financing.<sup>11</sup> Under the proposed changes to the auctioning regulations, the auctioning of emissions allowances will be subject to new customer due diligence requirements.<sup>12</sup> The proposed amendments to MiFID would result in additional “know your customer” requirements applying at the level of spot market participants that become regulated as investment firms.

### Settlement Finality Directive

The Settlement Finality Directive is designed to reduce the systemic risk associated with participation in payment, clearing and settlement systems, and in particular the risk linked to the insolvency of a participant in such a system.<sup>13</sup> Amendments to the revised Registry Regulation will provide additional comfort in relation to the finality and property rights arising from transactions in EUAs and Kyoto units.<sup>14</sup> The expanded definition of “financial instruments” to include EUAs and Kyoto units also raises the prospect of deliveries of emissions allowances taking place through a clearing house with settlement finality protections under the Settlement Finality Directive. Such a structure would result in transactions in EUAs and Kyoto units being protected from being unwound as a result of insolvency law claw-backs, for example under insolvency laws relating to transactions at an undervalue and preferences.

### Capital Requirements Directives

Any investment firms subject to a new requirement for regulation under MiFID would also become subject to regulatory capital requirements under the European Capital Requirements Directive, which implements the Basel Accords.<sup>15</sup> A new capital requirements regime, known as “CRD IV”, is intended to implement the Basel III Accord.<sup>16</sup>

### Securities Law Directive

The European Commission has separately proposed a Securities Law Directive to establish a harmonised legal framework governing the holding and disposal of securities held in securities accounts.<sup>17</sup> It is not clear at the time being whether EUAs and Kyoto units will be classified as “securities” for these purposes. According to the current timetable, detailed legislative proposals will be available by the end of 2011 and could be implemented by Member States by the end of 2013.

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<sup>11</sup> Directive 2005/60/EC.

<sup>12</sup> See the Auctioning Regulation (Regulation No. 1031/2010, as proposed to be amended as follows: [http://ec.europa.eu/clima/policies/ets/auctioning/third/docs/draft\\_consolidated\\_en.pdf](http://ec.europa.eu/clima/policies/ets/auctioning/third/docs/draft_consolidated_en.pdf)).

<sup>13</sup> Directive 98/26/EC.

<sup>14</sup> Regulation 920/2010. See the proposed amending Regulation at [http://ec.europa.eu/clima/policies/ets/registries/docs/regulation\\_amendments\\_en.pdf](http://ec.europa.eu/clima/policies/ets/registries/docs/regulation_amendments_en.pdf).

<sup>15</sup> See Directives 2006/48/EC and 2006/49/EC as amended by Directive 2009/111/EC (“CRD II”) and 2010/76/EU (“CRD III”).

<sup>16</sup> See the proposed Regulation and Directive at [http://ec.europa.eu/internal\\_market/bank/regcapital/index\\_en.htm](http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm).

<sup>17</sup> See [http://ec.europa.eu/internal\\_market/financial-markets/securities-law/index\\_en.htm](http://ec.europa.eu/internal_market/financial-markets/securities-law/index_en.htm).

### Prospectus and Transparency Directives

The sale of EUAs and Kyoto units would continue to fall outside the scope of the EU Prospectus Directive and no disclosure requirements under the Transparency Directive will apply.

### Next Steps and Legislative Timetable

The European Commission's proposals will be subject to scrutiny and potentially amended by the European Parliament and European Council during the EU legislative process. The enacted legislation may therefore be different in scope and effect to that currently proposed and discussed here. MiFID II is expected to enter into force in 2013, but the measures may not be implemented in individual Member States for another year or more thereafter. The European Commission has stated that Member States will be given two years to implement CSMAD into national law and that MAR will apply from two years after it is enacted. The MAR/CSMAD regime is expected to apply from around mid-2014.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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