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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT AND THE COUNCIL**

**Towards an enhanced market oversight framework for
the EU Emissions Trading Scheme**

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1. INTRODUCTION

The EU Emissions Trading Scheme (EU ETS)¹ was introduced on 1 January 2005. The scheme ensures that emission reductions are made at least cost to society, and it is therefore one of the EU's most important tools for reducing greenhouse gas emissions. The scheme covers energy-intensive industrial sectors, the power sector and as from 2012 also the aviation sector. As part of the Climate and Energy Package adopted in April 2009, the EU ETS was strengthened and improved to give a longer-term stability of the regulatory framework². In fact, a declining cap on the number of emission allowances has been set until 2020 and beyond. While this cap might be revised downwards in the context of future policy developments, market participants already now can integrate the currently known minimum decline in their investment decisions.

Although the European carbon market³ has grown significantly both in size and sophistication during its first six years of operation, it remains a relatively young market. It is therefore important to ensure that the market can continue to expand and safely be relied upon to give an undistorted carbon price signal. It follows that the market needs to have an appropriate market oversight framework. Such a framework needs to secure fair and efficient trading conditions for all market participants through transparency requirements as well as by preventing and sanctioning market misconduct, in particular insider dealing and market manipulation. Such a framework should also provide safeguards to minimise the risk that the carbon market is used as a vehicle for other illegal activities, such as money laundering or VAT fraud.

2. OBJECTIVE OF THIS COMMUNICATION

Article 12(1a) of Directive 2003/87/EC (the EU ETS Directive) provides that the Commission shall examine whether the market for emission allowances is sufficiently protected from insider dealing and market manipulation and, if appropriate, shall bring forward proposals to ensure such protection.

¹ Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, OJ L 275, 25.10.2003.

² Directive 2009/29/EC amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community, OJ L 140, p. 63.

³ For the purpose of this Communication, "European carbon market" covers the trading in the 30 countries that currently participate in the EU ETS (the EU-27, Iceland, Liechtenstein and Norway) in EU allowances and other units that may be used for compliance under the EU ETS.

This Communication provides a first assessment of the current levels of protection of the carbon market from such market misconduct or similar problems. On the basis of this stock-taking, the Commission will launch a broad stakeholder consultation on the best way forward during the first half of 2011 with a view to presenting, if necessary, any legislative proposal by the end of 2011.

3. THE EUROPEAN CARBON MARKET TODAY

3.1. Structure of the market – who can trade, what can be traded and where?

At present any person is able to access the carbon market either directly or indirectly via a financial intermediary. There are two main types of participants in the market for emission allowances: compliance buyers, who have a regulatory obligation to surrender allowances within prescribed deadlines, and financial intermediaries, who have no compliance obligations themselves⁴. Among the **compliance buyers** one can distinguish between power companies and industrial companies. The two largest groups of market participants are the power companies, who are the biggest emitters of greenhouse gases among the participating sectors, and the financial intermediaries.

A salient feature of the EU ETS is the active participation by **financial intermediaries** that have facilitated trading among installations and developed derivative products, such as futures, options and swaps, to help participating firms manage risk. The resulting broader participation in the carbon market increases its liquidity and contributes to the emergence of a reliable price signal. The intermediation provided by financial firms is particularly important for small and medium-sized companies and for operators of individual installations who may not have adequate resources or expertise themselves, or whose compliance needs are too small to justify continuous direct presence on the carbon market.

The **products** that are currently traded in the carbon market and that can be used for compliance in the EU ETS are allowances as defined in Directive 2003/87/EC establishing the EU ETS¹ (the EU ETS Directive), and credits under the Kyoto Protocol's offsetting mechanisms, namely Certified Emission Reductions (CERs) stemming from the Clean Development Mechanism (CDM) and Emission Reduction Units (ERUs) from Joint Implementation (JI) projects⁵. All these units can be traded for immediate delivery, so-called **spot trade**, but the major part of the transactions relate to **derivatives** based on allowances and CERs, such as forwards, futures, options and swaps. Preliminary information available to the Commission indicates that in 2009, 75-80% of the total volume was traded as derivatives contracts.

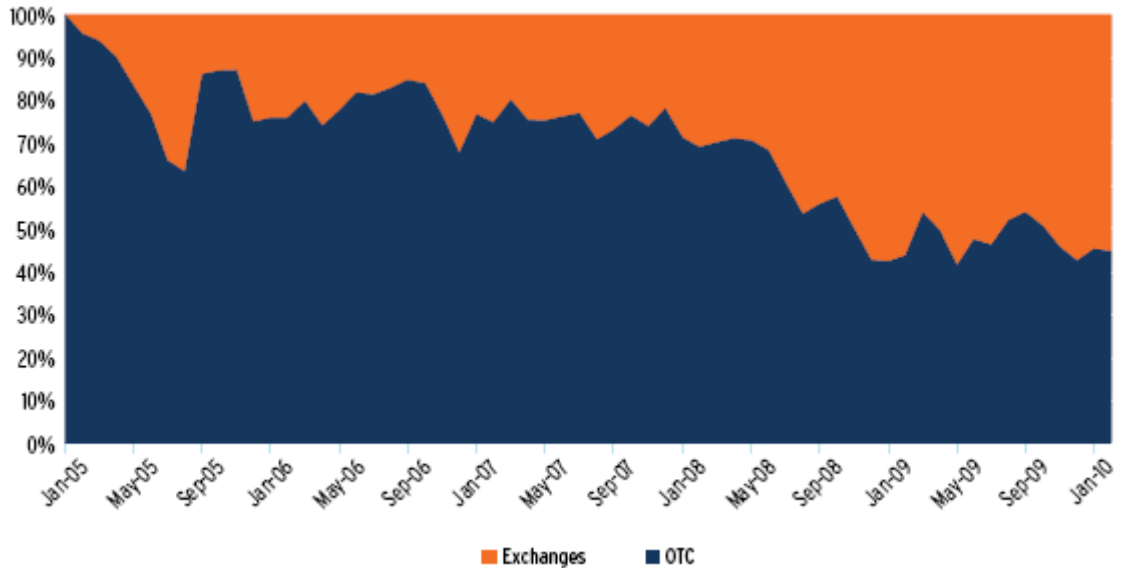
Table 1 in the Annex illustrates the diversification of the European carbon market with an overview of the products offered by a number of **climate exchanges**.

⁴ A.D. Ellerman, F.J. Convery and Ch. de Perthuis. 2010. *Pricing Carbon*. Cambridge University Press, New York. See pages 127-139 for an overview of the market development.

⁵ See Directive 2004/101/EC amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms (the so-called "Linking Directive"), OJ L 338, 13.11.2004, p. 18.

Over-the-counter (OTC)⁶ spot and forward transactions, which used to prevail on the carbon market, receded with the development of standardised exchange-based spot and future trades, as illustrated in Figure 1.

Figure 1 – Transactions on exchanges versus OTC since 2005⁷



In addition to trading at an exchange or OTC via a broker, bilateral trades directly between two parties who are known to each other are also possible. Bilateral transactions tend to be large in size, and their prices are not disclosed. An increasing number of bilateral trades are now cleared through a central counterparty⁸.

Finally, it is also possible to buy allowances at **auctions** held by a number of Member States, although this possibility has so far been used only to a limited extent⁹. As from 2013, however, auctioning will be the main allocation method in the EU ETS. It will be phased in over time with a view to full auctioning as from 2027. Under the new Auctioning Regulation (cf. section 5.2) access to this primary market will initially be restricted to certain categories of participants. However, it is not excluded that the list of persons eligible to apply for participation in the auctions may be extended to include further categories of participants as more evidence will be gathered with the auctions in the third trading period.

3.2. Data availability and market transparency

Market transparency increases the ability of participants in a specific market to make informed trading decisions. It also reinforces their confidence in that market's integrity and efficiency. At the same time, transparency is one of the basic tools

⁶ OTC transactions are privately negotiated between two counterparts rather than via a market exchange.
⁷ Source: State and trends of the carbon market 2010, p. 9. http://siteresources.worldbank.org/INTCARBONFINANCE/Resources/State_and_Trends_of_the_Carbon_Market_2010_low_res.pdf

⁸ A.D. Ellerman, F.J. Convery and Ch. de Perthuis. 2010.

⁹ In phase 2 of the EU ETS (2008-2012) around 4% of allowances are issued via auctions organised by Austria, Germany, Hungary, Ireland, the Netherlands and the United Kingdom.

available to counter various forms of market misconduct. It is therefore important to look at the current data availability in the European carbon market. Usually, a distinction is made between transaction data and fundamental data, and between data available to the public and data which is only available to regulatory authorities.

The **exchanges and other organised trading venues display anonymised information about bids, offers, trades and closing prices** in real time for market participants. Such information is also available for the general public with some minutes delay. The **details of OTC transactions are in principle not available to other market participants**. However, a number of market analysts and financial news agencies publish and sell trading data to the public, including daily information on the volume of OTC transactions that have been cleared at exchanges (both spot and forward transactions).

The most relevant fundamental data pertain to the verified emissions of the around 11,000 installations that are subject to the obligation under the EU ETS to surrender allowances to cover their greenhouse gas emissions. The **Community Independent Transaction Log (CITL)¹⁰ provides annual data on the independently verified emissions** of all installations covered by the EU ETS. The level of emissions of the installations determines the demand in the market and the information is thus highly price sensitive. According to the revised Registries Regulation, the Commission will make the verified emissions data per installation relating to the previous calendar year available to the public on 1 April, or, if 1 April falls on a weekend or on a holiday, the verified emissions figures will be displayed on the first working day following 1 April¹¹. Information on the number of free allowances that Member States have allocated to installations is also public¹². The importance of this information on free allocation will decrease gradually over time as auctioning is phased in as the principal allocation method in the EU ETS. Other relevant disclosures (e.g. regarding the measures taken to implement the EU ETS Directive) are also made in a general and non-discriminatory manner by the Commission.

Furthermore, several transparency measures are envisaged under the Auctioning Regulation (cf. section 6.2) , which *inter alia* relate to the auction calendar, the announcement of results and monthly and annual reporting on the auctions.

4. TYPES OF MARKET ABUSE AND OTHER ISSUES TO BE ADDRESSED

The term "market abuse" in the strict sense of the Market Abuse Directive¹³ (MAD) covers only **insider dealing and market manipulation** as defined in that Directive.

¹⁰ The CITL is the electronic system that records the issue, transfer and cancellation of allowances, and conducts an automated check on each transaction to ensure that there are no irregularities.

¹¹ Annex XVI point 4(a) of Commission Regulation (EC) No 2216/2004 of 21 December 2004 for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No 280/2004/EC of the European Parliament and of the Council, OJ L 386, 29.12.2004, p. 1 as last amended by Commission Regulation (EU) No 920/2010 of 7 October 2010 for a standardised and secured system of registries pursuant to Directive 2003/87/EC, OJ L 270, 14.10.2010, p. 1.

¹² http://ec.europa.eu/environment/climat/emission/2nd_phase_ep.htm

¹³ Directive 2003/6/EC on insider dealing and market manipulation (market abuse), OJ L 96, 12.4.2003, p. 16.

This is also what the EU ETS Directive refers to in its Article 12(1a) and what will be the focus for the remainder of this Communication. However, the Commission considers it important to look more broadly at the problems of market misconduct and abuse in order to ensure that the integrity of the carbon market is sufficiently protected. As the market matures, it will be necessary to ensure that safeguards are in place which protect the European carbon market in its entirety and which enable the prevention, detection and sanctioning not only of insider dealing and market manipulation, but also of other forms of misconduct, such as **money laundering, terrorist financing and other criminal activities**.

During 2009 and 2010, three incidents occurred in the European carbon market which illustrates the wider range of risks that need to be dealt with. Although these incidents do not constitute market abuse in the sense of the Market Abuse Directive, they did give rise to calls for stricter regulation of the European carbon market:

- Cases of **Value Added Tax (VAT) fraud** were detected in the carbon market in 2009-2010. While presenting a serious problem, this type of fraud is not specific to the carbon market and has in the past occurred on other markets as well. The Commission worked closely with Member States to combat this problem, and a new Directive on the application of the VAT reverse charge mechanism for emissions trading¹⁴ was adopted on 16 March 2010 and came into force in April 2010 helping to close off opportunities for fraud.
- So-called "**phishing attacks**" from fraudsters trying to get unauthorised access to accounts of market participants are also not specific to the carbon market, but nevertheless prompted the Commission to take rapid action in cooperation with Member States¹⁵.
- The resale in the European carbon market by a Member State of CERs that had already been used for EU ETS compliance, however, was an incident specific to the carbon market. The EU reacted quickly to prevent such **CER recycling** by way of amendments to the Registries Regulation¹⁶, and the Commission will not hesitate to act swiftly again if new risks should emerge.

There are also a number of other issues that are not related to market abuse or fraud, but which, if and when clarified, would increase the transparency and overall efficiency of the EU ETS. **Harmonised accounting standards** for emission allowances are one such issue¹⁷. After a failed attempt to establish accounting rules in 2004 (IFRIC 3 which was withdrawn), the International Accounting Standards Board (IASB) in 2008 started a joint project with the Financial Accounting Standards Board (FASB) in the United States to develop comprehensive guidance on the accounting for emission allowances¹⁸. The Commission encourages the IASB and the

¹⁴ <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1376>

¹⁵ <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/125>

¹⁶ Article 53 of Commission Regulation (EC) No 2216/2004 as last amended by Commission Regulation (EU) No 920/2010.

¹⁷ Another related issue is the national accounting of allowances and credits.

¹⁸

[Http://www.ifrs.org/Current+Projects/IASB+Projects/Emission+Trading+Schemes/Emissions+Trading+Schemes.htm](http://www.ifrs.org/Current+Projects/IASB+Projects/Emission+Trading+Schemes/Emissions+Trading+Schemes.htm)

FASB to complete their work as soon as possible, so that the resulting standards can be considered for endorsement at EU level.

5. EXISTING FRAMEWORK UNDER THE ETS DIRECTIVE AND OTHER RELEVANT LEGISLATION

The EU ETS **Directive gives the Commission a specific monitoring role** over the ETS that is linked to, but not limited to, the introduction of auctioning as the main allocation method.

The Directive provides that the Commission shall monitor the functioning of the carbon market submit an **annual report to the European Parliament and to the Council**. The report shall include the implementation of the auctions and the liquidity and volumes traded in the market. If the Commission has evidence that the carbon market is not functioning properly, it shall submit a report to the European Parliament and to the Council, accompanied by any appropriate legislative proposal aiming at increasing the transparency of the carbon market and improving its functioning.

As financial intermediaries and power companies are the major actors in the European carbon market, an examination of the level of market oversight has to take account of both financial and energy markets legislation. Furthermore, the Auctioning Regulation sets out a framework that aims to ensure the integrity and transparency of the auctions in emissions allowances.

5.1. Financial markets legislation

Financial markets legislation is relevant for the carbon market to the extent that trading in that market involves use of financial instruments, is carried out by authorised financial intermediaries or is channelled through marketplaces and/or infrastructures organised and supervised in accordance with financial market regulation. The diverse mix of products, trading venues and participants in the carbon market means that financial markets rules apply differently to the different market segments. However, a number of general observations can be made on how the financial markets legislation currently regulates the operation of the carbon markets.

Firstly, the **Market Abuse Directive** applies to emission allowance derivatives that conform to a definition of a financial instrument provided in the Directive. For the MAD to apply, the financial instrument must be admitted to trading on a "**regulated market**" or a request for its admission to trading on such a market must have been made. Emission allowance derivatives traded on regulated markets are therefore already subject to the prohibitions of insider dealing and market manipulation set out in the MAD. Financial regulators in the Member States have the duty to maintain on-going surveillance of those markets and are able to take enforcement measures against market abuse, whenever necessary.

Secondly, the **Markets in Financial Instruments Directive**¹⁹ (MiFID) applies to emission allowance derivatives provided that they meet certain criteria, for example they are traded on a regulated market or a "**multilateral trading facility**" (MTF). As a result, financial intermediaries providing investment services concerning such emission allowance derivatives have to obtain an authorisation under the MiFID and are subject to on-going supervision by financial regulators. This also means that their activity has to conform to a series of operational and reporting requirements (e.g. conduct of business rules, transaction reporting for intermediaries, ensuring sufficient availability of information on instruments admitted to trading on regulated markets and MTFs) that all aim to secure sufficient investor protection and market transparency.

Some of the exchanges where emission allowances, CERs and ERUs are traded are regulated markets and some are multilateral trading facilities. Other trading venues for spot products are either regulated at national level or self-regulated.

Both the MAD and the MiFID are currently subject to comprehensive reviews and Commission proposals are expected in 2011. While the outcome of those reviews is yet to be determined, one of the general objectives of the MAD review is to extend the scope of application of that directive to take account of technical and regulatory developments in the financial markets, with the rules on market abuse becoming applicable to those new types of trading venues and financial instruments that are currently beyond its scope. The MAD review will also consider ways to reinforce the effectiveness of enforcement and supervisory co-ordination with a prominent role of the European Securities Markets Authority (ESMA). The review will also seek improvements to transparency, supervisory oversight and integrity in derivative markets, including commodity derivatives and related spot markets. As for the MiFID review, the Commission aims *inter alia* to look at improving oversight and transparency measures to ensure commodity derivative markets function efficiently for hedging and price discovery purposes. Targeted improvements may also be considered with regard to information and protection needs of investors as catered for by financial intermediaries. Any legislative measures that may eventually be proposed by the Commission in those areas will have clear bearing on the regulatory treatment of the carbon market and the protection of investors in that market.

Thirdly, a number of new financial markets measures may become applicable in other specific segments of the carbon market. Notably, on 15 September 2010, the Commission adopted a proposal for a Regulation on OTC derivatives, central counterparties and trade repositories²⁰. The Regulation is in particular expected to introduce a reporting obligation for OTC derivatives, a clearing obligation for qualifying classes OTC derivatives (decided by ESMA), and measures to reduce *counterparty credit risk* and operational risk for bilaterally cleared OTC derivatives. Those specific duties would apply to carbon market participants involved in OTC derivatives trade in emission allowances, unless they are covered by one of the limited exemptions foreseen for non-financial firms under the draft Regulation.

¹⁹ Directive 2004/39/EC on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004, p. 1.

²⁰ COM(2010) 484 final.

5.2. Auctioning Regulation

The Auctioning Regulation²¹ establishes a regulatory framework for the auctions of emission allowances for the third trading period. The Regulation has effectively broadened the scope of application of the MAD and the MiFID rules in the carbon market, as it requires auction platforms and financial intermediaries to follow largely the same requirements even if their activity is pursued outside the typical secondary market setting and may involve emission allowances that do not qualify as financial instruments (one of the products that may be auctioned is a two-day spot contract). Under the Auctioning Regulation, the application of several measures stemming from the Anti-Money Laundering Directive will also be extended to the participants in the auctioning process. Specifically, the Regulation *inter alia* imposes on the auction platforms obligations to notify the supervisory authorities where incidents of market abuse, money laundering, terrorist financing or other criminal activity have been detected or suspected.

The various elements of this framework will be re-assessed in the Commission's further work on carbon market oversight.

5.3. Energy markets legislation

In December 2010, the Commission adopted a legislative proposal which follows up on the Third Energy Market Liberalisation Package and addresses the transparency and integrity of European wholesale energy markets. The draft Regulation on Energy Market Integrity and Transparency (REMIT²²) prohibits market abuse (insider dealing and market manipulation) on wholesale markets in electricity and related products and on wholesale markets in natural gas and related products. The measures under REMIT are consistent with the Market Abuse Directive and do not apply to financial instruments which are already covered by that Directive. While the framework does not apply directly to any part of carbon market, it is relevant in the sense that it concerns a market with significant linkages to carbon trading and its introduction may have a disciplining effect on the overall market conduct of certain players with presence in both the energy and carbon markets.

6. CONCLUSION AND NEXT STEPS

Conclusions:

- (1) **The carbon market has developed well in terms of liquidity, EU-wide participation of intermediaries and transparency, which, other things equal, reduces the risks of market abuse compared for example to some commodities markets.** The emergence of climate exchanges alongside the over-the-counter market and the strong participation of financial intermediaries alongside compliance buyers are signs that the European carbon market has matured significantly.

²¹ Commission Regulation (EU) No 1031/2010 of 12 November 2010. on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and the Council establishing a scheme for greenhouse gas emission allowances trading within the Community, OJ L 302, 18.11.2010, p. 1.

²² COM (2010) xxx

- (2) **A major part of the carbon market is subject to market regulation already.** To the extent that the allowance derivatives market is within the scope of financial markets legislation, it benefits from the regular safeguards and supervisory arrangements that apply to any other market for commodity derivatives.
- (3) **Spot trading in emission allowances is currently not regulated at the European level.** A handful of Member States have individually decided to extend rules applicable to trading in financial instruments to such allowances when traded on spot markets established within their jurisdiction²³.
- (4) **A key future segment in the primary market, auctions, will come in full under the market oversight regime set out by the Auctioning Regulation,** irrespective of whether the auctioned product qualifies as a financial instrument or not. This will further diminish vulnerability of the carbon market to misconduct.

Next steps:

- (1) The carbon market's continued growth and its ability to provide an undistorted carbon price signal are in part conditioned by that market's ability to deal effectively with the risks of market abuse and other forms of misconduct. **The Commission will launch an in depth study and initiate a stakeholder consultation,** examining in greater detail the structure of the carbon market and the current level of market oversight. The study will cover not only market abuse in the strict sense, but also the overall integrity of the auctions and the trading in the European carbon market, including supervisory aspects.
- (2) **The Commission will consider implications for the carbon market of the revision of financial legislation and the establishment of energy market legislation.** The two frameworks are envisaged to address deficiencies on the flanks of the European carbon market and it is necessary to ensure utmost consistency between those regimes and any appropriate measures that may still need to be taken for the carbon market. In this context, the Commission will consider the inclusion of the European carbon market under financial markets legislation, e.g. by replacing the currently existing spot trade by trade in "spot futures"²⁴ admitted to trading in regulated markets. The option to define EU ETS compliance units as financial instruments will also be explored, with particular focus on the suitability and proportionality of such an approach. Bringing spot transactions in EU ETS compliance units - as instruments in their own right - under the ambit of rules set out in the Market Abuse Directive and/or the Markets in Financial Instruments Directive as well as any other financial markets legislation necessary for the efficiency

²³ For example, Germany already applies rules on regulated markets to trades in commodities and rights taking place on an exchange. In France, legislation was passed in autumn 2010 envisaging coverage of spot carbon market by rules currently applied to regulated markets. The changes in French legislation build on a comprehensive assignment report of Mr Michel Prada, *The Regulation of CO2 Markets*, available at: <http://www.economie.gouv.fr/services/rap10/100419rap-prada.pdf>

²⁴ Here understood as a financial instrument with a relatively short time for delivery.

and integrity of the carbon market, such as the Anti Money Laundering Directive²⁵, the Settlements Finality Directive²⁶ or the Financial Collateral Directive²⁷ is an alternative that will also be studied.

- (3) **The Commission will continue to act swiftly if any new risks should appear, while assessing further the need to present a legislative proposal by end of 2011.** Any legislative proposal to introduce a specific oversight framework for the carbon market would be preceded by an impact assessment. The benefit of any safeguards ensuring market integrity would be weighed against any negative impacts on liquidity and on access to the carbon market for different classes of participants (notably small emitters, SMEs).

²⁵ Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, OJ L 309, 25.11.2005, p. 15.

²⁶ Directive 98/26/EC on settlement finality in payment and securities settlement systems, OJ L 166, 11.6.98, p. 45.

²⁷ Directive 2002/47/EC on financial collateral arrangements, OJ L 168, 27.6.2002, p. 43.

ANNEX

Table 1 – Products offered by various climate exchanges²⁸

Exchange	Country of operation	Continuous Exchange Trading											Swaps	Auctions	OTC Clearing
		Spot			Futures			Forwards		Options					
		EUAs	CERs	ERUs	EUAs	CERs	ERUs	EUAs	CERs	EUAs	CERs	ERUs			
ECX/ICE	UK	√	√		√	√	√			√	√	√			√
Bluenext	France	√	√	√	√	√							√	√	√
EEX	Germany	√			√	√				√				√	√
NASDAQ OMX	Norway	√	√		√	√		√	√	√	√				√
Green Exchange	USA				√	√				√	√				√
Climex	The Netherlands	√	√	√										√	

²⁸ Based on table in *The Post-Trade Infrastructure for Carbon Emissions Trading*. Report prepared for the City of London Corporation by Bourse Consult. Published July 2010. http://217.154.230.218/NR/rdonlyres/EA473E51-37BD-49CA-8729-3CD87BF4A2A0/0/BC_RS_CarbonEmissionsTrading.pdf