

Discussion paper

in view of a European Climate Change Programme (ECCP) stakeholder meeting

on carbon market oversight

organised by the Commission services

Brussels, 4th May 2011

1. Introduction

On 21 December 2010 the Commission published a communication on carbon market oversight.¹ The communication provided a preliminary assessment of the current level of protection of the carbon market² from market abuse and other forms of market misconduct. It concluded that a major part of the carbon market was subject to appropriate oversight, at the same time indicating that a gap existed in the regulation and supervision of the secondary market for immediate delivery of allowances (spot market). The communication also signalled that two broad policy options would be examined to address deficiencies in this regard:

- a consistent coverage of all segments of the European carbon market by financial markets legislation (e.g. by classifying emission allowances as financial instruments), with possible adaptations as appropriate;
- a tailor-made regime for emission allowances that would build on the financial markets rules.

Enhancements to the carbon market oversight were also initially considered in the preparation of the Commission proposal on Regulation on Energy Market Integrity and Transparency (REMIT)³, but that legislative initiative was eventually deemed not appropriate.

Following up on those conclusions, DG CLIMA launched a detailed study of the structure of the carbon market, the existing levels of market oversight, as well as implications of introducing new measures which would deal with the risks of market misconduct or abuse and would enhance the carbon market's integrity and transparency.

¹ Communication from the Commission to the European Parliament and the Council, 21 December 2010, *Towards an enhanced market oversight framework for the EU Emissions Trading Scheme*, available at: http://ec.europa.eu/clima/news/docs/communication_en.pdf

² For the purpose of this discussion paper and unless otherwise stated the term "carbon market" shall be used to refer to trade (both spot and derivatives) in emission allowances and other units that may be used for compliance under the EU ETS.

³ Commission proposal on Regulation on Energy Market Integrity and Transparency, COM (2010) 726 final

This stakeholder meeting should lead to obtaining feedback from stakeholders on the appropriateness and impacts of pursuing either of the outlined approaches, where possible providing market evidence.

You are invited to comment on the policy options presented in this paper and to state your preference for the approach that should be followed to enhance carbon market oversight. Please note that the options are only an indication of the approach the European Commission may take and are not its final policy position.

We are keen to fully understand and assess the financial and other impacts of the policy options considered.

Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effects on market access, integrity and efficiency and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information. We are also keen to hear from you on any other issues you consider important in the context of enhancing carbon market oversight.

2. Scope of the market oversight exercise

As a matter of priority, the following objectives should be fulfilled in any forthcoming proposal enhancing carbon market oversight:

1. comprehensive and cross-border supervision of the carbon market with robust rules for detecting and sanctioning cases of market misconduct or abuse
2. high standards of market transparency and investor protection
3. a level playing field for intermediaries and trading venues active in the various parts of the carbon market (primary and secondary, spot and derivatives)
4. consistency with the EU ETS Directive⁴ and the Auctioning Regulation⁵, financial markets regulations and energy markets regulations
5. a regime where the costs to market participants are proportionate to the benefits of enhanced market integrity

⁴ 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, as last amended by Directive 2009/29/EC, OJ L 140, p. 63.

⁵ 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.

Commission proposals would primarily focus on the secondary market trading activity involving emission allowances and other ETS compliance units.

While any forthcoming proposals concerning carbon market oversight may be expected to bring tighter controls on the access to the carbon market and to bar potential perpetrators from engaging into transactions through intermediaries, they would not be used to provide a exclusive solution to the EU ETS registries security issues – those aspects are currently addressed in a separate work stream i.e. the single EU registry.

Furthermore, any changes to VAT treatment of transactions in emission allowances across the Union could only be pursued in a separate exercise, additional to the carbon market oversight enhancements currently considered.

Questions:

1. Do you agree with the above objectives of the Commission's work on enhancing carbon market oversight? Which goals should be particularly emphasized? Which objectives and issues should be considered in addition?
2. Do you consider that carbon trading is sufficiently transparent? Are there significant gaps in the availability of fundamental data or transaction data? How does carbon market transparency compare to transparency in other markets you may be familiar with?
3. Do you consider the current carbon market oversight regime as providing sufficient investor protection? What are the main deficiencies of the current regime?
4. To what extent is it desirable to have coordinated market oversight across the EU ETS, compared to the extent that it is not coordinated at present?
5. If a regulatory framework is established for emission allowances, should it also cover other ETS compliance units? In what ways should the regulatory treatment differ in their case?
6. Should any group of carbon market participants (e.g. small and medium enterprises with ETS compliance duties) be afforded specific treatment under the new rules? What should it involve?
7. What authorities would be best placed to supervise the carbon market: national financial supervisors, national energy supervisors, European Securities Markets Authority (ESMA), Agency for Cooperation of Energy Regulators (ACER), other? Would shared responsibility for supervision among two or more of those authorities be desirable?

3. Making spot carbon trading subject to EU financial markets rules

Under this approach, the scope of the EU financial markets legislation would be extended to apply to the spot segment of the carbon market. This would be achieved by **classifying emission allowances (and other ETS compliance units) as financial instruments under the Markets in Financial Instruments Directive (MiFID)⁶ (i.e. by listing them as a new class of financial instruments in Annex I Section C of that Directive)**. That Directive is currently subject to a comprehensive review by the Commission and a legislative proposal to amend it is expected to be adopted by the Commission in the coming months.⁷

- ⇒ Since intermediation in spot trade of emission allowances would qualify as an investment service under the MiFID, entities providing such services would be required to hold a MiFID licence for investment firms and to comply with all ensuing organisational and conduct of business requirements in the course of that activity.
- ⇒ Trading venues specialising in spot trade in emission allowances and thus not currently subject to the MiFID, would be expected to obtain a MiFID authorisation in accordance with their specific profile (as a regulated market, a multilateral trading facility (MTF), or the new category of organised trading facility envisaged in the MiFID review if finally approved by the European Parliament and the Council).
- ⇒ Under the revised MiFID several exemptions currently provided under that Directive would be eliminated or narrowed down significantly. Nevertheless, the remaining exemptions and proportionality clauses, as well as any implementing measures developed by the Commission to give effect to the revised MiFID, could be used by eligible carbon market participants to mitigate the impact of the requirements of that Directive should those be inadequate or disproportionate to the scale or the nature of their activity in the spot carbon market.
- ⇒ Unlike professional intermediaries or market venues, ETS operators dealing on their own account in emission allowances would not be subject to the compliance duties stemming from the MiFID, as long as their trading activity remains ancillary to their main business and they are not a part of a financial group.
- ⇒ All carbon participants would be subject to the rules of the Market Abuse Directive (MAD)⁸ which prohibits insider dealing and market manipulation, introduces preventive measures against those types of abuse and empowers financial regulators to investigate and take enforcement action against market participants in breach of its rules. Limited

⁶ 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.

⁷ For more information about the scope of the MiFID review please refer to the relevant Commission consultation webpage: http://ec.europa.eu/internal_market/consultations/2010/mifid_en.htm

⁸ Directive 2003/6/EC on insider dealing and market manipulation (market abuse), OJ L 96, 12.4.2003, p. 16. As in the case of the MiFID, the MAD is currently subject to a comprehensive review by the Commission and a legislative proposal to amend it is expected to be adopted by the Commission in the coming months. For more information about the scope of the MAD review please refer to the relevant Commission consultation webpage: http://ec.europa.eu/internal_market/consultations/2010/mad_en.htm

adaptations would be necessary to the provisions of the MAD applicable to spot trade in emission allowances.⁹

- ⇒ The coverage by the MiFID of transactions in emission allowances would not be complete: transactions between two exempt market participants outside regulated venues (so-called purely bilateral spot OTC trade in emission allowances) would be beyond its remit; even so, such transactions could be examined on the grounds of market abuse pursuant to the MAD rules.¹⁰
- ⇒ As a result of the classification, not only would the MiFID rules apply. A number of other EU financial-market measures cross-referencing to the MiFID would also be applicable to transactions and other market activity involving emission allowances. DG CLIMA, with support of external consultants, is currently mapping out the implications the classification will have on the grounds of the various other EU measures. On a preliminary basis, those impacts would include, for example:
 - a) as investment firms licensed under the MiFID, intermediaries in the spot carbon trade would be expected to perform customer due diligence measures pursuant to Article 7 of the Anti-Money Laundering Directive¹¹;
 - b) the provisions of the Settlement Finality Directive¹² would apply to transactions in emission allowances settled through the systems covered by that Directive.

The on-going reviews of the MiFID and the MAD, with Commission proposals to be tabled in the next months, represent an opportunity to enhance carbon market oversight through those directives in a comprehensive and structured manner.

As a result of classification of emission allowances as financial instruments, consequential application of other EU measures concerning financial instruments should be the rule. However, where such application is expected to lead to unintended negative consequences, as a further step, additional legislative adaptations (beyond the MiFID and the MAD) may have to be envisaged to adjust the resulting regulatory framework to the specificities of the spot trade in emission allowances.¹³

Questions:

8. Would classification of emission allowances as financial instruments provide a comprehensive and sustainable solution to the existing gaps in carbon market oversight? Would a different method (other than the described classification) be more effective to

⁹ E.g. concerning the disclosure duty by the issuer of financial instruments pursuant to Article 6 of the MAD.

¹⁰ To the extent that a financial instrument is covered by the MAD, transactions in that instrument are covered by the MAD regime even if they take place outside a regulated market (see Art. 9 of the MAD). This overall approach is likely to be maintained further to the review of the MAD.

¹¹ 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.

¹² Directive 98/26/EC on settlement finality in payment and securities settlement systems, OJ L 166, 11.6.98, p. 45.

¹³ For example, specific rules exist in the area of value added tax on exemptions of financial instruments.

ensure coverage by financial markets rules? Should emission allowances also be classified as transferable securities?

9. Are there specificities in intermediation in the spot carbon markets which should be considered? Should spot carbon market intermediaries be exempt from some of the rules that apply to investment firms under the MiFID? If so which ones? Please substantiate.
10. Are there any specific patterns of market abuse in the carbon market? How should they be addressed? What rules of the MAD should be dissapplied, if any, in the case of spot trading activity in emission allowances?
11. How would classification of emission allowances as financial instruments impact the clearing and settlement processes of emission allowances? Would it require any specific measures to be included in the Registries Regulation¹⁴?
12. Should purely bilateral OTC trade in emission allowances be subject to some form of reporting duty?
13. Would classification of emission allowances as financial instruments impact how market participants other than intermediaries access the carbon markets and/or manage their exposure, including for accounting and tax purposes?
14. What additional knock-on effects of classification may be expected? Which of those impacts need to be mitigated?
15. Do you expect that compliance costs of your organisation will increase as a result of classifying emission allowances as financial instruments? Please describe major cost items and provide estimates of those costs, if possible.
16. Would classification of emission allowances as financial instruments help reduce the uncertainty around the legal status of allowances on the grounds of private and/or criminal law in the jurisdiction in which you operate (or know best)?

¹⁴ 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.

4. A tailor-made regime for spot carbon trading

This approach would consist of introducing a specific framework to cater for the needs of the spot trading in emission allowances. Any such framework would cover 10-30% of the carbon trading currently not covered by market oversight rules and it would complement the existing rules applicable to trade in allowances derivatives and those envisaged for the auctioning of emission allowances in the ETS third trading period starting in 2013. In practical terms, such framework could involve, for example:

1. extending the application of the MiFID and the MAD to the secondary trading of emission allowances without classifying them as financial instruments, or
 2. a new set of rules covering such issues as:
 - taking up and pursuit of activity of intermediaries and market venues involved in the trading of spot emission allowances;
 - prohibitions and preventive measures against market misconduct and abusive behaviour of participants in the trading of spot emissions;
 - measures enhancing transparency and investor protection in the spot carbon market, including know your customer checks by intermediaries;
 - supervision of the spot carbon market with adequate investigative and sanctioning powers for the competent authority (-ies), or
 3. a combination of measures outlined under points 1 and 2.
- ⇒ This approach would offer more flexibility in terms of developing a regime suited to the specificities of the spot carbon trade. At the same time, that flexibility would be largely limited by the need to conform to the overall approach to market regulation set out in the EU financial markets rules (i.e. MiFID, MAD etc.) applicable to the other segments of the carbon market.

Questions:

17. What regulatory provisions from the above options should the tailor-made regime comprise? In what respects should it diverge from existing MiFID/MAD approach? What additional elements should it cover? Please be specific in terms of how and why trading and intermediation in spot emission allowances necessitates specific rules.
18. Based on your experience, to what extent can the activity of intermediaries in the carbon market be strictly confined to dealing in spot instruments?
19. Do you expect that compliance costs of your organisation will increase as a result of introducing a specific tailor-made regime for secondary spot trade in emission allowances? Please describe major cost items and provide estimates of those costs, if possible.
20. Any other observations, comments you wish to provide?