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Dear Yvon

ISSUE 116: Commission Regulation establishing a Union Registry in connection with the Union emissions trading scheme

In April 2011 you held a meeting with a representative of the Financial Markets Law Committee (the "FMLC") in connection with the issue of emission allowances. At that meeting, the discussion anticipated the creation of a single register for the European Union for, among other things, the accurate accounting of allowances under the EU emissions trading scheme.

As you may recall, the role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. It was on this basis that the FMLC prepared its paper "Emission Allowances: Creating Legal Certainty" in October 2009 (a further copy of which is enclosed for your convenience)[1] (the "2009 Paper"). The 2009 Paper set out a number of respects in which it appeared to the FMLC that the developing market for carbon emission allowances was at risk of being adversely affected by legal uncertainties. It is the view of the FMLC that many of those uncertainties remain, and the FMLC has therefore reviewed with interest the Commission Regulation (EU) No 1193/2011 of 18 November 2011 establishing a Union Registry for the trading period commencing on 1 January 2013, and subsequent trading periods, of the Union emissions trading scheme 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 and amending Commission Regulations (EC) No 2216/2004 and (EU) No 920/2010 (the "Regulation"), which has entered into force since the meeting in April 2011.

Based on that review, the FMLC does not consider that the Regulation addresses (or, indeed, is designed to address) many of the issues identified in the 2009 Paper, and the FMLC would encourage further discussion of these issues. Nonetheless, the FMLC welcomes the introduction of the Regulation, but is of the view that, in the interest of enhancing legal certainty, the issues identified below should be considered and the relevant areas of the Regulation amended accordingly.

[1] The paper is also available at: http://www.fmlc.org/papers/Issue116Oct09.pdf.

Article 37 (*Nature of allowances and finality of transactions*) of the Regulation

Allowances as a Fungible Instrument

Merely providing in Article 37 that "[a]n allowance or Kyoto unit shall be a fungible, dematerialised instrument that is tradable on the market" will not be effective if national authorities and courts take differing views on fundamental issues regarding allowances, in particular in the context of insolvency. The FMLC recognises that as a practical matter, the risk of this occurring in the future may be much less acute, given that pursuant to the Regulation the current system of national registries is to be replaced by the Union Registry as of January 2013. This replacement should, in theory, cause national authorities and courts to regard the analysis of the legal nature of allowances as a matter of Community, rather than national, law; however, the FMLC is sceptical that Article 37 will in practice give rise to that result. It would be helpful in this regard if, at a minimum, Article 37 addressed the question of applicable law.

With respect to the word "fungible", the Regulation suggests that the full fungibility of allowances is in some way a necessary condition for settlement finality in respect of a transaction effected under the Regulation. This is illustrated by Article 37(3) and by Recital 12, which provides that:

> to reduce the risks associated with the undoing of transactions entered in a registry, and the consequent disruption to the system and to the market that such undoing may cause, it is necessary to ensure that allowances and Kyoto units are fully fungible.

The FMLC does not share the view that there is any necessary or logical connection between the fungibility of allowances and settlement finality. Both are desirable in the sphere which the Regulation seeks to govern, but should be separately addressed in the Regulation. The FMLC is concerned that as it stands, the Regulation conflates the two concepts with the result that a court may face difficulty in applying the relevant provisions. An earlier discussion draft of the Regulation did not include any reference in Article 37 to fungibility (although it did address settlement finality); perhaps the inclusion of the concept of fungibility, at least in its current form, merits further consideration and development.

Creation of Security

Another concept that should be addressed in Article 37 is the creation of security. The FMLC is aware that earlier this year a proposal was made that Article 37 should include express provision for the creation of security over allowances and that views were sought from various interest groups in this regard. It appears, however, that the proposal was dropped at the last moment and the only mention of security interests in the Regulation now appears in Recital 13, which simply notes that the issue "should be examined in the context of a future review of th[e] Regulation." This inconclusive treatment raises many more questions than it answers and the withdrawal of the initial proposal may give rise to the adverse inference that the European Commission has reservations about the assignment of allowances by way of security interest, either from a legal-conceptual or a policy perspective. One may, for instance, infer that the European Commission is concerned that allowances are mere licences at law—and therefore, being non-proprietary choses, not susceptible to security interests—or is contemplating enacting legislation in order to characterise allowances as mere licences.

Given the importance in the context of commercial dealings of robust security interests (and of a clear and simple procedure for creating them), it would seem appropriate and desirable for this issue to be addressed at Community level by an amendment to the Regulation. There may be practical problems in arriving at a solution acceptable to all Member States, particularly as the creation of security interests is at present a matter determinable at national level (and perhaps this contributed to the abandonment of the proposal to provide expressly for security interests in Article 37). However, the concerns raised above and in the FMLC's previous correspondence with you cannot, in the FMLC's view, be resolved unless the Regulation is amended to address, at a minimum, the question whether allowances are capable of being the subject of security interests.

The FMLC recognises that it may not be feasible at this stage to prescribe in detail procedures for the creation of security interests across the EU, but even a minimal treatment of the question whether allowances are capable of being the subject of security interests would improve matters as they stand. In the FMLC's view, such question cannot be addressed without first clarifying the legal

nature of emission allowances in an amendment to the Regulation.[2] Absent a full treatment in the Regulation of the question whether allowances are capable of being the subject of security interests, clarification of the legal nature of allowances would at least allow interested parties and Member States to formulate a response which in due course could inform further work by the Commission.

Uncertainties in the Wording

The focus of Article 37 seems to be the preservation of the integrity of the Union Registry and settlement finality. The wording, however, lacks clarity. In particular, it is unclear what the apparently contradictory phrase "prima facie and sufficient evidence" in Article 37(2) means. The use of the phrase "in kind" in the first sentence of Article 37(3) also creates uncertainty. It would seem to the FMLC reasonable to interpret the phrase to mean "in specie", but such an interpretation would appear to be at odds with the intent of Article 37(3), which concerns fungibility, recovery obligations and restitution obligations.

With respect to the intent of Article 37 as a whole, the FMLC assumes that it is intended that the Article should have the effect that a person relying in good faith on the record of the Union Registry shall be protected in the event of a theft or fraudulent transaction. This assumption is based on Article 37(2) (which provides that the "dematerialised nature of allowances and Kyoto units shall imply that the record of the Union Registry shall constitute prima facie and sufficient evidence of title over an allowance or Kyoto unit") and Article 37(4) (which provides that a "purchaser and holder of an allowance or Kyoto unit acting in good faith shall acquire title to an allowance or Kyoto unit free of any defects in the title of the transferor"). In other words, the FMLC interprets Article 37 to mean that a person shall have good title to allowances transferred to him or her by a registered holder, even if the allowances in question were stolen or otherwise the subject of fraudulent dealings, provided that that person has acted in good faith.

This interpretation is supported by Articles 37(3)(a) and (b), which preclude the reversal, revocation and unwinding of a transaction in the Union Registry, which preclusion would protect the rights of a purchaser of a stolen allowance. Article 37 does not directly address the rights of a victim of theft of an allowance, but does provide in Article 37(3)(b) that Article 37 shall not prevent the taking of legal action (including action for damages or other compensation) against the fraudulent party outside the context of the Regulation, "as long as this does not lead to the reversal, revocation or unwinding of the transaction in the registry." Article 37(3)(a) contemplates the possibility of a court requiring, pursuant to national law, the execution of a new transaction in the Union Registry: the Article provides that the restriction against the unwinding of a final and irrevocable transaction under the Regulation shall be without prejudice "to any provision of or remedy under national law that may result in a requirement or order to execute a new transaction in the registry." Presumably, the reference to such a requirement or order is to a requirement or order to execute a new transaction in order to reinstate an original holder's right to a stolen allowance. Article 37 is not, however, clear on this point and should therefore be amended as appropriate in order to reduce uncertainty. Absent further clarification in Article 37, interested parties will need to monitor and rely on case law at the national level for further certainty as to whether the Article provides sufficient protection for purchasers of stolen allowances or victims of fraudulent dealings.

Securities Law Directive and Conflict of Laws

In a letter dated 21 January 2011 to the Directorate-General Internal Market and Services of the European Commission (a further copy of which is enclosed for your convenience),[3] the FMLC commented on the European Commission's consultation paper titled "Legislation on Legal Certainty of Securities Holding and Dispositions" (the "Consultation Paper"), which invited comments on a set of principles to underpin a proposed European Securities Law Directive (the "SLD"). As noted in the letter and set out in the Consultation Paper, it is proposed that "securities" for the purposes of the SLD will be defined by reference to Annex I Section C of Directive 2004/39/EC (otherwise known as the Markets in Financial Instruments Directive or "MiFID"). According to a Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council recently adopted by the

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2 The proposed inclusion of emission allowances as financial instruments for the purposes of the Markets in Financial Instruments Directive (as described below), does not, in the FMLC's view, substantively address this issue.

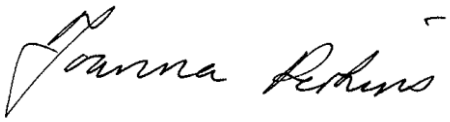
3 Available at: http://www.fmlc.org/papers/Ltr2DGECre136.pdf.

European Commission, emission allowances and derivatives on emission allowances will be financial instruments. However, for the purposes of the current law, derivatives on emission allowances are financial instruments, while emission allowances are not.[4] In the interest of effecting greater harmonisation of securities law in the EU and promoting legal certainty (and in order for the SLD to be consistent with and complementary to the legal framework established by the UNIDROIT Convention on Substantive Rules for Intermediate Securities[5]), the FMLC's view, as set out in the letter dated 21 January 2011, is that the definition of "securities" for the purposes of the SLD should exclude derivatives, whether expressly or by way of a restrictive qualifier that would have the effect of excluding derivatives.

If the SLD does apply to derivatives, then there is a danger that the increased regulatory burden will have a retardant effect on the effective regulation of emission allowances. It is not for the FMLC to comment on this, but the FMLC would like to highlight the importance of compatibility of the legislative frameworks created by, *inter alia*, the SLD (in its final form) and the Regulation. Such compatibility will promote legal certainty and facilitate the smooth operation of the European securities markets. Also of importance here is a uniform conflict-of-laws rule, which the Consultation Paper acknowledges would be of use for all market participants.

The FMLC would be happy to discuss the above matters with you further. Please do not hesitate to contact me with any questions or comments.

Yours sincerely



Joanna Perkins
FMLC Director

cc (by e-mail): Nadia De Souza, DG Environment, European Commission
Daniel Kramer, DG Environment, European Commission

Encs: A copy of the 2009 Paper.
A copy of the letter dated 21 January 2011 from the FMLC to the Directorate-General Internal Market and Services of the European Commission.

4 See footnote 8 of the 2009 Paper.

5 Available at: http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm.