



U.K. Withdrawal from the E.U.: Issues of Legal Uncertainty Arising in the Context of Emissions Allowances

January 2019

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Registered Charity Number: 1164902.

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1. EXECUTIVE SUMMARY AND INTRODUCTION

- 1.1. The role of the Financial Markets Law Committee (the “**FMLC**” or the “**Committee**”) 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.
- 1.2. On 23 June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (the withdrawal process is known colloquially and hereafter in this paper as “**Brexit**”). As a result of that decision, HM Government has begun to negotiate the delinking of the U.K.’s markets from the E.U. internal market. One of the markets in which the U.K. participates *qua* Member State is emissions trading. At a European level, this involves participation in the European Union Emissions Trading Scheme (“**E.U. ETS**”).
- 1.3. On 29 March 2017, HM Government officially served notice of the U.K.’s withdrawal to the E.U. under Article 50 of the Treaty on European Union. On 26 June 2018, the European Union (Withdrawal) Act 2018 (the “**Withdrawal Act**”) received royal assent, after significant debate in both Houses of Parliament.
- 1.4. The Withdrawal Act serves two main purposes: (1) it repeals the European Communities Act 1972, and (2) it incorporates the body of E.U. legislation—the *acquis*—into U.K. law from the date of exit (“**Exit Day**”).² At present, E.U. law applies in the U.K. by means of directly-applicable treaties and regulations (“**Direct E.U. Legislation**”) and domestic legislation which implements E.U. directives (“**E.U.-derived Domestic Legislation**”). The Withdrawal Act provides that Direct E.U. Legislation, so far as operative immediately before Exit Day, forms part of domestic law on and after Exit Day.³ Similarly, it provides that E.U.-derived Domestic Legislation, as it has effect in domestic law immediately before Exit Day, continues to have effect in domestic law on and after Exit Day.⁴ The Withdrawal Act also provides wide powers

² Exit day is defined in the Withdrawal Act to mean 29 March 2019 at 11.00 p.m., but it can be amended by a Minister of the Crown.

³ Section 3(1). “Direct EU legislation” is defined in Section 3(2) of the Withdrawal Act. Such legislation can be described as “converted legislation” as it is effectively converted from E.U. legislation to domestic legislation under the Withdrawal Act.

⁴ Section 2(1). “EU-derived domestic legislation” is defined in Section 2(2). Such legislation can also be described as “preserved legislation” in that it was already a part of domestic law.

to ministers to amend retained E.U. law,⁵ which includes both Direct E.U. Legislation and E.U.-derived Domestic Legislation.⁶

- 1.5. As far as emissions trading is concerned, if the Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, as agreed at negotiators' level on 14 November 2018,⁷ (the "**Withdrawal Agreement**") is signed by the U.K. and E.U., the U.K. will remain a participant of the E.U. ETS until the end of 2020. HM Government has indicated, in the event of a hard Brexit, that the U.K. will cease to be part of the E.U. ETS from Exit Day.⁸
- 1.6. This paper examines the legal complexities which will arise from the U.K.'s withdrawal from the E.U. ETS in the event that no agreement is reached regarding its future participation beyond March 2019 or the current Phase III of the E.U. ETS ending on 2020.⁹ Section 2 sets out the background to the current emissions trading framework, including the manner in which it is implemented in the U.K. Section 3 analyses the legal uncertainties that would be caused by a hard Brexit. These include, *inter alia*, the impact on existing emissions trading contracts, the application of Directive 2014/65/EU on markets in financial instruments ("**MiFID II**") and Regulation (EU) No 596/2014 on market abuse (the "**market abuse regulation**" or "**MAR**"), the U.K.'s domestic transposition of E.U. legislation and the legal nature of emission allowances. Section 4 considers the impact of Brexit on the U.K.'s involvement in the E.U. ETS, including the status of U.K. accounts, certain transitional measures and the effect of the transposition into U.K. law of E.U. legislation by means of the Withdrawal Act. The paper concludes in Section 5 by recommending some mitigants by which these uncertainties might be resolved.

⁵ Section 8.

⁶ Section 6(7).

⁷ Available online: https://ec.europa.eu/commission/sites/beta-political/files/draft_withdrawal_agreement_0.pdf .

⁸ *Policy Paper: Carbon emissions tax*, available online: <https://www.gov.uk/government/publications/carbon-emissions-tax/carbon-emissions-tax>.

See also: *Guidance: Meeting climate change requirements if there's no Brexit deal*, available online: <https://www.gov.uk/government/publications/meeting-climate-change-requirements-if-theres-no-brexite-deal/meeting-climate-change-requirements-if-theres-no-brexite-deal>.

⁹ Assuming that such a delinking will occur in the context of the unsuccessful negotiation of a Withdrawal Agreement or future relationship, it is referred to in this paper as a "**hard Brexit**".

2. THE CURRENT EMISSIONS TRADING FRAMEWORK

Introduction to the E.U. ETS

The international regime

- 2.1. At an international level, countries which are parties to the United Nations Framework Convention on Climate Change (“UNFCCC”) are under an obligation to each other to take steps to address their emissions of greenhouse gases. The UNFCCC establishes the overall framework pursuant to which specific agreements are negotiated. The first such agreement was the Kyoto Protocol, which was adopted in 1997 and entered into force in 2005. The Kyoto Protocol has required developed countries to reduce their greenhouse gas emissions in phases between 2008 and 2020, expressed as a percentage of 1990 levels.¹⁰ The U.K. is a party to the UNFCCC and the Kyoto Protocol, both as a member of the E.U. and in its own right, and so will remain a party to both even after Brexit. The E.U. also signed both the UNFCCC and the Kyoto Protocol as a party and E.U. Member States, in accordance with a provision in the Kyoto Protocol, agreed to meet their emissions targets on an aggregate basis. This is reflected in an Effort Sharing Decision, adopted in 2009, which redistributes the burden of emissions reductions (in sectors other than those covered by the E.U. ETS) by setting national targets for each Member State.¹¹
- 2.2. In 2015, the Paris Agreement was adopted. The Paris Agreement governs the responsibilities of signatories beyond 2020. It records as its central objective an international target of keeping global temperature rise in this century well below 2 degrees Celsius and making efforts to limit it to 1.5 degrees Celsius (as compared with pre-industrial levels). Under the Paris Agreement, all signatories are required to put forward “nationally determined contributions” to emissions reductions. In October 2014, the E.U. committed to reducing emissions by at least 40% below 1990 levels by 2030. A further Effort Sharing Regulation, also governing emissions outside the scope of the E.U. ETS, entered into force on 9 July 2018.¹²

¹⁰ The Kyoto Protocol covers six greenhouse gases (“GHGs”): carbon dioxide (“CO₂”), methane, nitrous oxide (“N₂O”), hydrofluorocarbons, perfluorocarbons (“PFCs”) and sulphur hexafluoride.

¹¹ Decision No 406/2009/EC of the European Parliament and of the Council of 23 April 2009.

¹² Regulation (EU) 2018/842 of the European Parliament and of the Council of 30 May 2018 on binding annual greenhouse gas emission reductions by Member States from 2021 to 2030 contributing to climate action to meet commitments under the Paris Agreement and amending Regulation (EU) No 525/2013.

The E.U. Emissions Trading System

- 2.3. The E.U. ETS was established by 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 (the “**ETS Directive**”).¹³ The E.U. ETS helps to achieve part of the E.U.’s international obligations by reducing overall emissions in certain industries including aviation.
- 2.4. In essence, the E.U. ETS provides a framework for the issuance, trading and surrender of emissions allowances across the E.U. Article 3(a) of the ETS Directive defines an emission allowance as:
- an allowance to emit one tonne of carbon dioxide equivalent during a specified period, which shall be valid only for the purpose of meeting the requirements of this Directive and shall be transferable in accordance with the provisions of this Directive
- 2.5. The E.U. ETS operates as a “cap and trade scheme” over specified industrial sectors. Under the scheme, operators of installations that emit over a certain volume of greenhouse gases are required to obtain permits.¹⁴ They are then subject to caps on their emissions. At the end of each operating year, which is designated as 30 April, operators must surrender emissions allowance units (“**EAUs**”) equal to their emissions in the preceding year. Failure to surrender sufficient EAUs results in the imposition of penalties. During the operating year, those with a surplus of EAUs can trade with others who need extra EAUs. The caps are progressively reduced to lower overall emissions.
- 2.6. The E.U. ETS operates in phases—Phase I ran from 2005 to 2007, Phase II ran from 2008 to 2012, and Phase III runs from 2013 to 2020. Phase III is significantly different from the earlier Phases because considerably fewer EAUs are being allocated for free, and the decisions about how many free EAUs to allocate are made by the European Commission rather than by Member States. Phase IV will run from 2021 to 2030. The exact legislative proposals and reduction targets are being negotiated for Phase IV.

¹³ Directive 2003/87/EC had established the scheme for the trading of allowances relating to emissions of CO₂ only. The ETS Directive extends the scheme to include CO₂ from power and heat generation, certain energy intensive industrial processes and aviation (supplemented by Directive 2008/101 of 19 November 2008 amending Directive 2003/87/EC so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community), N₂O from acid production, and PFCs from the production of aluminium.

¹⁴ See Part 2, Chapter 1 (Permits) of the GHG Regulations, which sets out the various permits that operators may apply for and the various conditions surrounding the holding of permits.

The Legal Framework of the E.U. ETS

The Registries Regulation and the Auctioning Regulation

- 2.7. Pursuant to Regulation (EU) 389/2013 establishing a Union Registry (the “**Registries Regulation**”), a single centralised E.U. registry (the “**Union Registry**”) was established to record the creation, allocation, auctioning, trading and surrender of EAUs, replacing the national E.U. ETS registries. It is operated by the European Commission (the “**Central Administrator**”) and supported by an E.U. Transaction Log (“**EUTL**”) which records, checks and authorises transfers made between accounts. National Administrators in each Member State such as the Environment Agency in the U.K. are responsible for the administration of accounts under their jurisdiction, for example by being the point of contact for companies or individuals opening or closing accounts.¹⁵
- 2.8. The Union Registry covers countries participating in the E.U. ETS only, and there is no provision in the ETS Directive for allowances to be allocated to Third Countries.¹⁶ In addition, the Registries Regulation does not contemplate National Administrators representing jurisdictions outside the E.E.A.
- 2.9. Auctioning is the default method of allocating allowances. Regulation (EU) 1031/2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances (the “**Auctioning Regulation**”) created a central E.U. auctioning platform, but allowed Member States to opt out and adopt their own national platform, as the U.K. has done.¹⁷ Under the Auctioning Regulation, a single-round, sealed-bid auction for EAUs takes place on a weekly basis.
- 2.10. In order to integrate the E.U. ETS with Member State obligations under the Kyoto Protocol, in October 2004 the E.U. Council adopted Directive 2004/101/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms (the “**Linking Directive**”). This allows operators to use credits from the Clean Development

¹⁵ See Recital (9) of the Registries Regulation.

¹⁶ In this paper, a “Third Country” refers to any country not in the E.U. Although Norway presently participates in the E.U. ETS this is by way of the EEA Agreement rather than any mechanism established by the ETS Directive or Registries Regulation.

¹⁷ The U.K. appointed ICE Ltd to operate its auctioning platform. The common platform used by the E.U. is currently managed by EEX.

Mechanism (“**CDM**”) and the Joint Implementation (“**JI**”) mechanism for compliance with the E.U. ETS, within certain qualitative and quantitative limits.¹⁸

- 2.11. To address the risks of Brexit to the “environmental integrity” of the E.U. ETS, on 12 February 2018 the European Commission adopted Regulation (EU) 2018/208 (the “**Safeguarding Regulation**”) which amends the Registries Regulation. In its guidance to the Safeguarding Regulation, the European Commission highlighted the underlying risk that, if the U.K. ceased to be part of the E.U. ETS from 30 March 2019, then the U.K. would no longer be required to surrender allowances for its 2018 verified emissions by 30 April 2019. As a result, the allowances auctioned and allocated for free by the United Kingdom in 2018 and 2019 could increase the surplus of allowances on the E.U.'s carbon market, just as the market stability reserve comes into effect to reduce this surplus.¹⁹
- 2.12. The Safeguarding Regulation therefore provides that, unless E.U. law continues to apply in the U.K. after 30 March 2019 or another legally enforceable measure is taken to ensure the surrender of allowances before 15 March 2019, those EAUs issued by the U.K. after 1 January 2018 are “marked” as such (“**U.K. EAUs**”). U.K. EAUs cannot be surrendered to meet compliance with the ETS Directive. The Safeguarding Regulation also allows the Central Administrator to suspend temporarily the acceptance by the EUTL of relevant ETS processes in relation to the U.K. if the above conditions are not met.
- 2.13. The Safeguarding Regulation would, however, have created serious difficulties for U.K. operators in meeting their compliance obligations on 30 April 2018 for the preceding year (as EAUs issued after 1 January 2018 would not have met compliance requirements). HM Government addressed this by amending the Greenhouse Gas Emissions Trading System Regulations 2012 (SI 2012/3038) (the “**GHG Regulations**”),²⁰ so that dates for compliance in 2019 are brought forward to be before 15 March 2019. Accordingly, EAUs held by U.K. entities since 1 January 2018 were

¹⁸ The CDM and JI are two project-based “flexible mechanisms” under the Kyoto Protocol. The CDM allows Annex B countries (i.e. countries with an emission reduction or limitation commitment, listed under Annex B of the Protocol) to earn certified emission reduction (“**CER**”) credits from implementing emission-reduction projects in developing countries. These CER credits can be counted towards the Annex B countries’ Kyoto targets. JI enables Annex B countries to earn emission reduction units, which can be counted towards their Kyoto targets, from carrying out emission reduction or removal enhancement projects in other Annex B countries.

¹⁹ *Commission proposes safeguard measures for EU Emissions Trading System Frequently Asked Questions*, available online: https://ec.europa.eu/clima/sites/clima/files/news/20171024_faq_en.pdf.

²⁰ This was done by way of The Greenhouse Gas Emissions Trading Scheme (Amendment) Regulations 2017. See paragraph 2.18 for further information on the GHG Regulations.

not “marked” as U.K. EAUs and were compliant for surrender on 30 April 2018. The amendment also ensures that U.K. operators will be able to comply with their regulatory obligations in 2019, albeit slightly ahead of schedule.²¹

Application of MiFID II

- 2.14. In addition to being traded between operators subject to the ETS Directive, EAUs are also traded by third parties including financial institutions who are able to open accounts with the Union Registry. A significant proportion of trading in EAUs is carried out by way of derivatives. Futures, options and other types of derivative contracts relating to emission allowances have been classified as financial instruments for the purpose of E.U. regulation since the implementation of Directive 2004/39 on markets in financial instruments (“**MiFID**”).²²
- 2.15. Spot trades in emissions allowances on the secondary market were not within the definition of financial instrument in MiFID. Since the introduction of MiFID II, however, all emission allowances that can be used for E.U. ETS compliance have been classified as financial instruments (in addition to derivatives thereof, as was the case under MiFID).²³ Secondary spot market trading in EAUs has therefore been brought within the remit of E.U. financial markets legislation. This was intended to address fraudulent practices in secondary markets for emissions allowances, which were largely unregulated prior to the introduction of MiFID II, and to improve the regulatory regime for these instruments.
- 2.16. The designation of emissions allowances as financial instruments had several consequences. First, market abuse regulation and the related practices of disclosing insider information and maintaining insider lists have become relevant to emissions trading. Secondly, settlement finality and irrevocability protections afforded under Directive 98/26/EC on settlement finality in payment and securities settlement systems (the “**Settlement Finality Directive**” or the “**SFD**”) have been extended to transfer orders for emissions allowances. Finally, the existing regulation of brokerage, custody and associated arrangements are now also applicable to persons dealing with EAUs.

²¹ The E.U. has confirmed that this measure has the effect of ensuring that EAUs issued in the U.K. in 2018 are not marked, see *Update on safeguard measures for EU Emissions Trading System due to the UK's withdrawal from the European Union* (13 February 2018), available online: https://ec.europa.eu/clima/news/update-safeguard-measures-eu-emissions-trading-system-due-uks-withdrawal-european-union_en.

²² Annex I, Section C(10).

²³ MiFID II, Annex I, Section C(4) and (11). Section C(11) brings within scope “Emission allowances consisting of any units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme).”

U.K. Implementation

- 2.17. In the U.K. the Climate Change Act 2008 (the “**Climate Change Act**”) enacts a target to reduce GHG emissions by 80% before 2050 (compared to 1990 levels). The Climate Change Act also set up an independent body, the Committee on Climate Change, with statutory responsibilities to propose appropriate carbon budgets and assess progress towards the long-term emission targets. This statutory framework is independent of obligations under the ETS Directive.
- 2.18. The E.U. ETS is primarily operated in the U.K. pursuant to GHG Regulations (as amended), which came into force on 1 January 2013. The GHG Regulations implemented the changes introduced into Phase III of the E.U. ETS by the ETS Directive. The regulators for the E.U. ETS are the Environment Agency in England, Natural Resources Wales in Wales, the Scottish Environmental Protection Agency in Scotland, and the Chief Inspector in the Department of Environment in Northern Ireland. The Financial Conduct Authority regulates E.U. ETS auctions.

Post-Brexit Emissions Trading

- 2.19. The U.K. has sought to remain in the E.U. ETS until at least the end of 2020.²⁴ If there is a hard Brexit, however, and no agreement is reached for continued participation, the U.K. will cease to be (i) subject to the ETS Directive; and (ii) a part of the E.U. ETS from Exit Day.²⁵
- 2.20. If a hard Brexit occurs, then the U.K. will leave the E.U. ETS from Exit Day and a U.K. carbon emissions tax will come into effect.²⁶ HM Government included legislation on a possible carbon tax in the Finance (No. 3) Bill 2017–19.²⁷ It is not yet

²⁴ On 21 March 2018, the Minister for State for Energy and Clean Growth informed the E.U. Energy and Environment Sub-Committee in the House of Lords that HM Government intends to stay in the E.U. ETS until the end of 2020. This has not been finalised as yet, as the Withdrawal Agreement has not yet been ratified. More information is available online: <https://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-energy-environment-subcommittee/news-parliament-2017/minister-ets/>.

See also the *White Paper in relation to the future relationship between the E.U. and U.K.*, published in July 2018 by the U.K. Government, in which HM Government indicated that it is exploring the option of remaining in the E.U. ETS: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725288/The_future_relationship_between_the_United_Kingdom_and_the_European_Union.pdf.

Article 127 of the Withdrawal Agreement provides that there will be implementation period until 31 December 2020 during which time E.U. law will continue to apply in the U.K. See also paragraphs 4.12 to 4.13 below.

²⁵ See paragraphs 4.15 to 4.16 below.

²⁶ *Policy Paper: Carbon emissions tax*, available online: <https://www.gov.uk/government/publications/carbon-emissions-tax/carbon-emissions-tax>.

²⁷ Part 3 of the Finance Bill (No. 3) 2017-19, available online: <https://publications.parliament.uk/pa/bills/cbill/2017-2019/0282/18282.pdf>.

clear, however, whether a carbon tax would be a long-term measure (and if not, what other measures would succeed it). HM Government is considering a range of options with respect to its carbon pricing approach, including continued participation in the E.U. ETS, a U.K. ETS (linked or standalone) or a carbon tax.²⁸

- 2.21. HM Government has also published a draft statutory instrument relating to emissions allowances (the “**draft Emissions SI**”),²⁹ which will take effect in the event of a hard Brexit. The draft Emissions SI revokes, *inter alia*, various E.U. decisions and regulations relating to the surrender and trading aspects of the E.U. ETS, while also amending certain provisions of the GHG Regulations so that these remain operable after Exit Day. In particular, the draft Emissions SI maintains and amends the existing monitoring, reporting and verification requirements for greenhouse gas emissions, as these requirements will provide information to allow for the implementation of the potential carbon tax.³⁰
- 2.22. If the U.K. does reach an agreement to remain in the E.U. ETS until the end of Phase III in 2020, it is unclear what further measures (if any) will be implemented after this time. HM Government has not yet published any evaluation of alternative options to the E.U. ETS after the end of Phase III. The House of Commons Business, Energy and Industrial Strategy Committee (the “**BEIS Committee**”) has recommended that HM Government should seek to retain membership of the E.U. ETS beyond the end of Phase III, contingent upon commitments to reforming the E.U. ETS.³¹ The BEIS Committee also suggested that HM Government should consider alternative options, such as establishing a separate U.K. trading system, if sufficient reforms to the E.U. ETS do not appear achievable.³² In the Protocol to the Withdrawal Agreement, the

²⁸ *Explanatory Memorandum to The Greenhouse Gas Emissions Trading Scheme (Amendment) (EU Exit) Regulations 2018*, available online: https://assets.publishing.service.gov.uk/media/5c0feb1ed915d0bd3e4da92/081118_MRV_Explanatory_Memorandum_FINAL.pdf.

²⁹ *The Greenhouse Gas Emissions Trading Scheme (Amendment) (EU Exit) Regulations 2018*, available online: https://assets.publishing.service.gov.uk/media/5c0feb9ced915d0b8a31a394/EU_ETSnodalSI.Finaldocx.pdf.

³⁰ The present monitoring, reporting and verification framework for emissions allowances under the E.U. ETS is set out in the Commission Regulations on Monitoring and Reporting (No. 601/2012) and Accreditation and Verification (No. 600/2012).

³¹ *Leaving the EU: negotiation priorities for energy and climate change policy*, available online: <https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/909/909.pdf>.

³² Witnesses to the BEIS Committee inquiry identified a number of areas in which the E.U. ETS is in need of reform including, among other things, the over-allocation of allowances. The BEIS Committee noted certain reforms that have been made to the E.U. ETS to address the surplus of allowances, such as a market stability reserve which will be introduced in 2019. The European Commission has also put forward proposals for negotiation for Phase IV to address this surplus.

U.K. also commits to introduce a carbon pricing system “of at least the same effectiveness and scope” as the E.U. ETS.³³

- 2.23. It is possible that, in due course, the U.K. will create its own national scheme (“**U.K. ETS**”). Such a U.K. ETS may or may not be “linked” with the E.U. ETS under the ETS Directive. The option of linking a U.K. ETS with the E.U. ETS is also contemplated in the recent political declaration regarding the U.K./E.U. relationship post-Brexit.³⁴ Article 25 of the ETS Directive anticipates and mandates linking the E.U. ETS with other greenhouse gas emissions trading schemes. This mechanism was used for the first time recently. In November 2017, after many years of negotiations, the E.U. and Switzerland signed an agreement to link Switzerland’s national ETS to the E.U. ETS, though implementation has not yet taken place.³⁵
- 2.24. The uncertain status of U.K. emissions allowances following a hard Brexit leads to a number of specific legal and regulatory uncertainties, which are discussed in further detail in section 3 below.

3. ISSUES OF LEGAL UNCERTAINTY ARISING IN THE CONTEXT OF BREXIT

Effects on Existing Contracts

- 3.1. This section considers specific legal uncertainties in existing contracts relating to over-the-counter (“**OTC**”) transactions in EAUs. It proceeds on the “worst-case” assumption that U.K. accounts in the Union Registry become inaccessible or suspended due to action by the Central Administrator, as a result of a hard Brexit. As noted above, the Registries Regulation does not contemplate Third Country participation in the Union Registry and HM Government also anticipates that U.K. account holders may lose Union Registry access in the event of a hard Brexit.³⁶

³³ Part Two, Article 2(5) of the Protocol on Ireland/Northern Ireland, available online: https://ec.europa.eu/commission/sites/beta-political/files/draft_withdrawal_agreement_0.pdf.

³⁴ Draft political declaration setting out the framework for the future relationship between the European Union and the United Kingdom of Great Britain and Northern Ireland, agreed at negotiators’ level and agreed in principle at political level, subject to endorsement by Leaders, available online: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/758557/22_November_Draft_Political_Declaration_setting_out_the_framework_for_the_future_relationship_between_the_EU_and_the_UK_agreed_at_negotiators_level_and_agreed_in_principle_at_political_level_subject_to_endorsement_by_Leaders.pdf.

³⁵ *EU and Switzerland sign agreement to link emissions trading systems* (23 November 2017), available online: https://ec.europa.eu/clima/news/eu-and-switzerland-sign-agreement-link-emissions-trading-systems_en. It should be noted that the ETS Directive was incorporated into the EEA Agreement, effectively linking the emissions trading schemes of the EEA countries (i.e. Norway) to the E.U. ETS, but this has not been carried out by means of the Article 25 mechanism.

³⁶ This is further discussed in paragraphs 4.4 to 4.8 below.

- 3.2. The effects on existing contracts which are identified below are not exhaustive. Most importantly, emissions allowance trades may be affected by the U.K.'s withdrawal from the E.U. because of the application of general law doctrines such as frustration. This issue and other risks to contractual continuity are discussed in detail in a separate paper published by the FMLC.³⁷

Introduction to OTC Emissions Trading Terms

- 3.3. Most transactions for the spot or forward delivery of emissions allowances entered into OTC (i.e. not on an organised trading venue or auction platform) are documented under terms provided by the following industry associations:
- a) the International Swaps and Derivatives Association, Inc. (“**ISDA**”), which publishes the 2002 or 1992 Master Agreements, along with the ISDA Emissions Annex,³⁸ (together, the “**ISDA Terms**”);
 - b) the European Federation of Energy Traders (“**EFET**”), which publishes a General Agreement for Power or Gas with (as applicable) the EFET E.U. ETS (Power) Annex or EFET E.U. ETS (Gas) Annex, (together, the “**EFET Terms**”); and
 - c) the International Emissions Trading Association (“**IETA**”), which publishes the International Emissions Trading Master Agreement (“**IETMA**”) or the IETA Single Trade Agreement with the E.U. ETS Schedule (together, the “**IETA Terms**”).

These are collectively known as the Market Standard Terms.³⁹

- 3.4. A key aspect of the contractual relationship which may be affected by a hard Brexit is settlement of transactions (both in spot trades and other related option transactions where settlement may occur after execution). The Market Standard Terms contain

³⁷ See FMLC, *U.K. Withdrawal from the E.U.: Issues of Legal Uncertainty Arising in the Context of the Robustness of Financial Contracts*, available online: <http://fmlc.org/report-the-robustness-of-financial-contracts-after-brexit/>.

³⁸ Form of Part [7] to the Schedule to an ISDA Master Agreement for EU Emissions Allowance Transactions (incorporating options) (Version 5: May 2012) (Modified for Phase 3 delivery).

³⁹ The publishers of the Market Standard Terms have progressively conformed their documents in recent years to introduce equivalent provisions (or at least equivalent choices of applicable provisions) so that key issues are dealt with in the same way.

It is important to note, however, that the Market Standard Terms can be governed by different laws. For example, the 1992 and 2002 ISDA Master Agreements have been designed to be governed by English law or New York law, while the EFET General Agreements are commonly governed by English law or German law. This paper only considers Market Standard Terms governed by the laws of England and Wales.

broadly similar provisions for the settlement of transactions, such that it takes place when the buyer (the “**receiving party**”) makes payment to the seller (the “**delivering party**”) and the delivering party makes delivery of the emissions allowances to the receiving party. Both parties may specify a holding account (a “**Specified Holding Account**”) in the confirmation for the relevant emissions allowance transaction.⁴⁰ Various penalties may arise under the Market Standard Terms if the delivering party and/or receiving party fail to meet their respective obligations under the relevant document (e.g. if the delivering party fails to deliver the required emissions allowances within the agreed timeframe). These obligations and penalties are described in further detail in Appendix A.

3.5. Depending on the Market Standard Terms document, a failure to make delivery may be excused by certain defined events including an Illegality, a Suspension Event, *Force Majeure* or the receiving party’s failure to comply with the requirements under the E.U. ETS.⁴¹ Although there is some variation across the documents, these excusing circumstances may be broadly described as follows:

- An event of Illegality arises where it becomes unlawful for the delivering party to perform its obligations.
- A Suspension Event generally arises where it has become impossible for the affected party to perform its obligations due to: (i) the absence of continued operation of the Relevant Registry (“**absence of Registry Operation**”);⁴² or (ii) the suspension of some or all of the processes of the Relevant Registry or the EUTL by the relevant National or Central Administrator, including if the registry is not operated and maintained in accordance with the provisions of the Registries Regulation (“**Administrator Event**”).

⁴⁰ For ease of reference, “Specified Holding Account” is used in this paper to refer to the designated holding accounts of the delivering party and the receiving party for emissions allowances transactions under the Market Standard Terms generally. Note, however, that “Specified Holding Account” is only used as a defined term under the ISDA Emissions Annex (see Appendix A). Different terminology is used in the EFET Terms and IETA Terms, although this has the same meaning as “Specified Holding Account” in the ISDA Emissions Annex. In the EFET Terms, the designated holding accounts of the delivering party and the receiving party are known as “Transfer Points” and “Delivery Points” respectively. In the IETA Terms, these are called the “Delivering Party’s Holding Account” and the “Receiving Party’s Holding Account” respectively.

⁴¹ This last excusing circumstance regarding the failure to comply with requirements under the E.U. ETS (the “**Requirements of the Scheme**”) is unique to the ISDA Terms.

⁴² The “Relevant Registry” is defined under the Market Standard Terms to mean the Registry through which a party is obliged to perform a delivery or acceptance obligation under and in accordance with an E.U. emissions allowance transaction. “Registry” refers to each Member State’s separately administered registry (which together constitute the Union Registry).

- *Force Majeure* (equivalently described as a “Settlement Disruption Event” under the ISDA Terms) refers to the impossibility of an affected party performing its obligations due to an event or circumstance beyond its control.

The specific settlement provisions and excusing circumstances under each of the Market Standard Terms documents are discussed in Appendix A to this paper.

Potential Uncertainties in Existing Contracts under a Hard Brexit

- 3.6. In the event that the U.K. registry ceases to operate or is otherwise suspended under a hard Brexit, under each set of Market Standard Terms, both the delivering party and receiving party to transactions may find themselves unable to meet their contractual obligations. The parties may therefore need to consider whether they can avail themselves of the excusing circumstances under the Market Standard Terms that are identified above. Various issues of uncertainty may arise when analysing the application of such excusing circumstances in the event of a hard Brexit, as well as the application of other provisions of the Market Standard Terms. Parties may need to consider and potentially clarify these uncertainties on a fact-specific basis.
- 3.7. Ultimately, the interpretation of any Market Standard Terms contract agreed between two parties will be a matter for those parties to decide, in consultation with their lawyers.⁴³ It is beyond the FMLC’s remit to offer any views on how contracts between private counterparties should be interpreted. Nevertheless, given the significance and widespread use of Market Standard Terms as a base for documenting emissions allowances transactions, the FMLC has identified a few general issues of uncertainty that it believes could arise under the Market Standard Terms under a hard Brexit.
- 3.8. These issues of uncertainty are considered in the context of two factual iterations: (i) the delivering party has an account administered by the U.K. (“**U.K. Holding Account**”) as one of its Specified Holding Accounts; and (ii) the delivering party’s Specified Holding Account is not administered in the U.K., and the receiving party is a U.K. Account Holder who has listed that account as its only Specified Holding Account. The issues of uncertainty include the following:
- A delivering party might raise the argument that the suspension or closure of the U.K. registry under a hard Brexit constitutes a Suspension Event under one of

⁴³ It is also worth noting that contractual parties usually elect to amend various provisions of the Market Standard Terms document used, in order to account for the specific facts of the transaction. The FMLC can only comment on the Market Standard Terms as published by the relevant industry body.

the Market Standard Terms. This in turn may raise the question as to whether the U.K. registry in fact still constitutes a “Relevant Registry” under the definition of a Suspension Event (see section 3.5 above), given that the U.K. is no longer a Member State. Parties in both factual iterations may need to analyse this in the context of the Market Standard Terms document used and the facts of the matter.

- Additionally, parties who have entered into an IETMA may need to consider whether the obligation thereunder to have at least one Holding Account “validly” registered in a Registry “in accordance with the Trading System Rules” is a continuing obligation. If so, then in the event of a hard Brexit, this obligation might require a delivering party that had previously specified an account in the U.K. registry to open an account in a Member State registry after the date the U.K. ceases to be a Member State. Alternatively, the obligation could be narrowly interpreted as applying only with respect to any Registry at the time it is initially specified. Parties in both factual iterations may need to consider these points and clarify their interpretation accordingly.
- Under iteration (ii), in the event of a hard Brexit, the receiving party may need to consider whether having only one Specified Holding Account (which is a U.K. Holding Account) is still compliant with the Requirements of the Scheme under any ISDA Terms agreed with another party.⁴⁴ Depending on the facts and the parties’ interpretation, the receiving party may need to open another account in the Union Registry or designate another account as its Specified Holding Account in order to remain compliant.

3.9. The FMLC has identified a few provisions in the Market Standard Terms that, in the event of a hard Brexit, may give rise to uncertainty for parties that utilise such terms to document emissions allowances transactions. Ultimately, though, it will be for these contractual parties to identify and resolve any such issues of uncertainty that may arise under their Market Standard Terms contracts.

Regulatory and Legal Uncertainties

3.10. This section considers the impact of Brexit and a potential U.K. ETS on the status of emissions allowances under E.U. regulation (MiFID II and MAR) and U.K. domestic

⁴⁴ Under the ISDA Terms, the Requirements of the Scheme include an obligation on each party to ensure that, on a delivery date, it has one or more Holding Accounts validly registered in accordance with the Registries Regulation.

law (the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the “**RAO**”)). It explores various uncertainties in relation to the legal nature of EAUs, U.K. EAUs and emissions allowances under a solely U.K. ETS. It also evaluates how emissions allowances, and activities related to such allowances, will be treated for regulatory purposes in the U.K. and E.U. following Brexit. Finally, the consequences of a hard Brexit in relation to settlement finality are briefly noted.

MiFID II and MAR

- 3.11. As described above in paragraph 2.15 above, MiFID II brings within scope “[e]mission allowances consisting of any *units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme)*” (emphasis added).⁴⁵ This definition means that if the U.K. disengages from the E.U. ETS and develops its own national scheme, allowances under any newly created and independent U.K. scheme would not fall within the ETS Directive definition of “emission allowance” nor, therefore, within the MiFID II definition of “financial instrument”. The same outcome follows in respect of MAR because it adopts the MiFID II definition of emissions allowances.⁴⁶
- 3.12. Accordingly, emission allowances under an independent U.K. ETS would not be financial instruments for the purposes of MiFID II or MAR, absent (i) any amendment to the ETS Directive or MiFID II, or (ii) (subject to the terms agreed) a linking of the two schemes under the ETS Directive. If no such amendment or linking takes place, then, among other things, the protections discussed in paragraph 2.15 above would cease to apply to spot trades in emissions allowances on the secondary market.
- 3.13. On 5 October 2018, HM Treasury published the draft statutory instrument relating to MiFID II, titled the Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 (the “**draft MiFI SI**”).⁴⁷ The draft MiFI SI will take effect only in the event of a hard Brexit, with the aim of ensuring that the MiFID II regime continues to operate effectively following Brexit. To this end, the draft MiFI SI amends key pieces of

⁴⁵ MiFID II, Annex I, Section C(11).

⁴⁶ MAR, Article 3(19).

⁴⁷ Available online: http://www.legislation.gov.uk/ukdsi/2018/9780111173480/pdfs/ukdsi_9780111173480_en.pdf. The statutory instrument was made (signed into law) on 19 December 2018: http://www.legislation.gov.uk/ukdsi/2018/1403/pdfs/ukdsi_20181403_en.pdf.

(i) retained E.U. law following Brexit,⁴⁸ and (ii) the U.K. legislation that implemented the MiFID II package of legislation.⁴⁹

- 3.14. Among other things, the draft MiFI SI brings EAUs in scope as financial instruments under the U.K. regime, so that there is no change to how they are currently traded on U.K. markets.⁵⁰ The draft MiFI SI does not, however, bring within scope emission allowances under a future independent U.K. ETS.
- 3.15. The draft MAR SI,⁵¹ published on 6 December 2018, retains notification requirements for emission allowance market participants registered in the U.K., along with certain other references to emission allowances markets.⁵² Like the draft MiFI SI, however, the draft MAR SI does not refer to emission allowances under a future independent U.K. ETS.
- 3.16. Finally, if the U.K. ceases to participate in the E.U. ETS, there is also a broader policy question of whether EAUs should be treated differently as a matter of U.K. law to emissions allowances under other international schemes such as those established in, *inter alia*, New Zealand, the state of California and the province of Quebec. The draft MiFI SI is silent on this issue.

The Regulated Activities Order and Auctioning Regulation

- 3.17. At the U.K. level, the RAO implements elements of the Auctioning Regulation and MiFID II. The RAO designates as “specified investments” both (i) greenhouse gas emissions allowances which are auctioned as financial instruments or as two-day spots,⁵³ and (ii) emission allowances themselves, which meet, *inter alia*, the requirements

⁴⁸ The draft MiFI SI amends Regulation (EU) No 600/2014 on markets in financial organisational requirements and operating conditions for investment firms and defined terms; and Commission Delegated Regulation 2017/567/EU supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions.

⁴⁹ The draft MiFI SI also amends the RAO, the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2017, and the Data Reporting Services Regulations 2017.

⁵⁰ See the *Explanatory Memorandum to the Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018*, available online: http://www.legislation.gov.uk/ukdsi/2018/9780111173480/pdfs/ukdsiem_9780111173480_en.pdf.

⁵¹ The Market Abuse (Amendment) (EU Exit) Regulations 2018, available online: http://www.legislation.gov.uk/ukdsi/2018/9780111176313/pdfs/ukdsi_9780111176313_en.pdf.

⁵² The draft MAR SI retains these requirements and references because, even under a hard Brexit, U.K. firms may still participate in secondary market trading of emissions allowances under the E.U. ETS and some U.K. firms may continue to participate in the E.U. ETS schemes through an E.U. branch. See the *Explanatory Memorandum to the Market Abuse (Amendment) (EU Exit) Regulations 2018*, available online: http://www.legislation.gov.uk/ukdsi/2018/9780111176313/pdfs/ukdsiem_9780111176313_en.pdf.

⁵³ Article 82A. This designation incorporates various definitions from E.U. law: (i) “greenhouse gas emissions allowances” are defined by reference to the definition of allowance under the ETS Directive; (ii) “two-day spot” is defined by reference to the Auctioning Regulation; and (iii) “financial instruments” are defined by reference to MiFID II.

under the ETS Directive.⁵⁴ The latter are also recognised as “non-equity MiFID instruments” under the RAO.⁵⁵ Therefore, without amendment, emission allowances under an independent U.K. ETS would not be regarded as specified investments or non-equity MiFID instruments under the RAO. This in turn means that certain activities in respect of U.K. emissions allowances—such as bidding in emissions auctions and operating an organised trading facility on which emissions allowances are traded—would not constitute “specified kinds of activity” under the RAO.⁵⁶ Furthermore, various exemptions to the RAO and MiFID II that apply to, (for instance), compliance operators, or dealers in emissions allowances under the “ancillary activities” exemption, would no longer be applicable in the context of U.K. emissions allowances under an independent U.K. ETS.

- 3.18. To some extent, amendments to the RAO addressing such issues could be implemented by means of ministerial powers under the Withdrawal Act.⁵⁷ The specified activities and exemptions identified above and the possible amendments to the relevant RAO provisions are explored in further detail in Appendix B.
- 3.19. On 21 December 2018, HM Government published a draft statutory instrument (the “**draft FSMA SI**”) relating to the Financial Services and Markets Act 2000 (“**FSMA**”), which will only take effect in the event of a hard Brexit.⁵⁸ The draft FSMA SI makes, *inter alia*, further changes to the RAO, which are summarised in Appendix B. Broadly speaking, though, if a hard Brexit did occur and the draft FSMA SI took effect, similar issues regarding the regulation of U.K. emissions allowances under a potential U.K. ETS would still arise.
- 3.20. Finally, bidding in and conducting emissions auctions are currently regulated by the Auctioning Regulation as a matter of E.U. law. Only certain authorised and regulated persons may participate in and carry out such auctions. Whether a hard Brexit or a

⁵⁴ Article 82B.

⁵⁵ Article 25DA.

⁵⁶ This is also anticipated in the FCA’s *Consultation Paper 18/36: Brexit: Proposed changes to the Handbook and Binding Technical Standards—second consultation*, para 3.92, available online: <https://www.fca.org.uk/publication/consultation/cp18-36.pdf>.

⁵⁷ The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2012/1906 and The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2017/488 implement the relevant amendments to the RAO and would qualify as retained E.U. law.

⁵⁸ The Financial Services and Markets Act 2000 (Amendment) (EU Exit) Regulations 2019, available online: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767598/Draft_FSMA_EU_Exit_Amendment_Regs_19.pdf.

transition period takes place, various issues regarding access to E.U. and U.K. auctions will arise. Further detail on this is provided in Appendix B.

Legal Nature of Emissions Allowances

Background

- 3.21. The ETS Directive does not specify the legal nature of EAUs. The categorisation of EAUs, for example as property (and, if so, what type of property), a permit or a license is left to be determined as a matter of domestic law by each Member State. Emission allowances share characteristics both with administrative grants / licences and private property and Member States have developed diverging views on the nature of EAUs as a matter of their respective domestic law. EAUs have been described varyingly as financial instruments, intangible assets, property rights (both private property and state property) and commodities.⁵⁹
- 3.22. Legal uncertainty is compounded because neither the ETS Directive nor the Registries Regulation set out how to determine which law should govern the rights relating to particular EAUs. The matter therefore falls to be determined under general European directives concerning conflicts of law and national conflicts of law rules.
- 3.23. The FMLC has previously published a paper on legal uncertainties surrounding the classification of emission allowances under the E.U. ETS and the potential ramifications of the varying legal classifications across Member States.⁶⁰ The European Court of Auditors also recommended that the Commission should provide further clarity on the legal status of EAUs and should analyse the benefits of treating emission allowances as property rights across the E.U.⁶¹ In response, the Commission noted that in accordance with Article 345 of the Treaty on the Functioning of the European Union, property law remains the prerogative of the Member States. The Commission continued by stating that it considers that “legal interests are duly protected and allowances can be contested as civil matters in national courts.”⁶² The Commission

⁵⁹ These descriptions were provided in response to reporting obligations imposed by Article 21(2) of the ETS Directive. Member State responses are summarised in Annex 1 of the “Report on the functioning of the European carbon market Accompanying the document Report from the Commission to the European Parliament and the Council”, 18 November 2015, p. 25.

⁶⁰ FMLC, *Legal Assessment of Lacunae in the Legal Framework of the European Emissions Trading Scheme and the Case for Legislative Reform*, 1 October 2009, available online: <http://fmlc.org/wp-content/uploads/2018/02/Issue-116-Emission-allowances-1.10.2009.pdf>.

⁶¹ European Court of Auditors Special Report “The integrity and implementation of the E.U. ETS” (6/2015), p. 47.

⁶² *Ibid.* p. 60.

nevertheless stated it will endeavour to analyse the potential benefits of clarifying the legal status of allowances in E.U. law. Separately, under MiFID II, emissions allowances are now treated as “financial instruments”. This may assist some but not all characterisation questions.

- 3.24. The U.K. High Court considered the legal nature of EAUs in the case of *Armstrong DLW GmbH v Winnington Networks Ltd* (“*Armstrong*”).⁶³ The Court held that, as a matter of English law, EAUs are intangible property rather than a licence or chose in possession.⁶⁴ It was held that EAUs satisfy the threefold test for determining whether an administrative law exemption should be treated as property at common law. Applying the test set out in *In re Celtic Extraction Ltd*,⁶⁵ EAUs were considered to be property rather than licenses because (i) there is a statutory framework which confers an entitlement on the holder of an EAU to exemption from a fine; (ii) EAUs are an exemption which are expressly transferable under the statutory framework; and (iii) the EAU is an exemption which has value as it can be used to avoid a fine and because there is an active market for them.⁶⁶
- 3.25. The Court in *Armstrong* went further to observe that EAUs are likely to be some form of intangible property but ultimately decided that it did not need to determine whether the EAU is a chose in action or merely some form of “other intangible property” for the purposes of the case in question.⁶⁷ Therefore, although the Court indicated that it was minded to conclude EAUs are some other form of intangible property rather than a chose in action, this question was not definitively settled by *Armstrong*.
- 3.26. As discussed above, emissions allowances are now categorised as financial instruments under MiFID II. Although this does not determine their legal nature for other non-regulatory purposes, MiFID II is likely to influence the legal analysis of emissions allowances by Member State courts going forward and encourage a consistent legal categorisation of allowances under national laws. It is unlikely, however, that MiFID II

⁶³ *Armstrong DLW GmbH v Winnington Networks Ltd* [2012] EWHC 10 (Ch).

⁶⁴ Notably, the parties to the dispute agreed that emission allowances constitute intangible property (*see* para 40); therefore, the court did not benefit from submissions suggesting that an emission allowance may instead be a form of licence or chose in possession. Despite this, the court gave reasoned consideration to the question of whether EAUs are property or licences.

⁶⁵ [2001] Ch 475.

⁶⁶ *Armstrong*, para 58.

⁶⁷ *Ibid*, para 48-49, 60-61.

would be understood to conflict even implicitly with the legal analysis and conclusions in *Armstrong*.

Impact of Brexit on characterisation issues

- 3.27. As discussed above, the Withdrawal Act allows ministers to remedy retained E.U. law where such law contains E.U. references that are no longer necessary. If the U.K. remains party to the E.U. ETS immediately following Brexit, it is expected that the relevant ministers would need to use such powers to amend the GHG Regulations. The effect of this would likely be that EAUs would remain as the sole form of emission allowance under English law (unless and until a U.K. ETS is introduced).
- 3.28. If a U.K. ETS is adopted, it would introduce distinct emissions allowances recognised for compliance under the national scheme in the U.K. Under the current drafting of the ETS Directive, “allowances” are defined by their ability to meet the requirements of the ETS Directive. Although this may appear to be a jurisdiction-neutral definition, U.K. emissions allowances would only be valid for meeting the requirements of the ETS Directive if there is linkage⁶⁸ or some other mutual recognition between the two schemes.
- 3.29. An eventual division between U.K. and E.U. emission allowances would increase the likelihood of conflicting legal categorisations of each type of emission allowances. If the U.K. creates a separate scheme, the following issues will arise. First, the legal nature of (i) EAUs and (ii) new U.K. emissions allowances will need to be determined under English law. It is likely a U.K. Court would apply the test in *In re Celtic Extraction Ltd* and *Armstrong* to determine the nature of any new emission allowance, by reference to the precise terms of the new domestic regime under which it is created and transferred. Secondly, the legal nature of (i) EAUs and (ii) U.K. emissions allowances will need to be determined under the law of each Member State.
- 3.30. As mentioned above, the E.U. has adopted the Safeguarding Regulation to mark U.K. EAUs in the event that E.U. law no longer applies in the U.K. after 30 March 2019. In any event, making EAUs contingent upon the issuing Member State’s continued participation in the E.U. ETS does not necessarily conflict with the *Armstrong* analysis and upset the conclusion that EAUs should be treated as property as a matter of English law. Following Brexit, it is likely that EAUs would continue to be characterised in accordance with the *Armstrong* precedent and to therefore be treated as intangible

⁶⁸ Pursuant to Article 25, ETS Directive.

property as a matter of English law. It is also likely that identically structured replacement U.K. instruments will also be treated similarly. The legal categorisation of EAUs, however, remains open to conflict of law challenges, especially if the U.K. implements its own emissions trading scheme.

- 3.31. From an English conflicts of law perspective, disputes about EAUs may involve foreign elements, including parties based in non-U.K. countries and EAUs held in non-U.K. registries. If a litigant brings a claim with such foreign elements in the U.K., a Court may need to consider its jurisdiction and whether English law or a foreign law should apply. Characterisation issues regarding whether or not EAUs are property will be relevant to this assessment. In *Armstrong*, conflicts of law submissions were not made by counsel although the EAUs in question had been transferred from a German registry to an English registry. Therefore, jurisdictional issues surrounding EAUs remain untested under English law.

Title over EAUs

- 3.32. As described above, EAUs are currently held on the centralised Union Registry. The Registries Regulation provides that “the Union Registry shall constitute prima facie and sufficient evidence of title over an allowance...”⁶⁹ and “allowances” are defined, in accordance with the ETS Directive, as allowances that can satisfy requirements under the ETS Directive.
- 3.33. If U.K. emissions allowances under a future U.K. ETS were listed on the Union Registry despite not falling within the definition of “allowance” in the Registries Regulation, they would not benefit from the otherwise conclusive nature of the Union Registry. If similar protections were not afforded to U.K. emissions allowances, this would increase uncertainty in relation to the ownership and transfer of U.K. emissions allowances and therefore make them less attractive than E.U. emissions allowances.
- 3.34. Ideally, the Union Registry will continue to act as a conclusive register of title in respect of all allowances recorded therein as a matter of English law after Brexit. If U.K. emissions allowances are eventually included in the Union Registry, they ought to benefit from the same level of protection under English and E.U. law to avoid fragmentation of the market. Likewise, if the U.K. establishes its own registry, it should be a conclusive register of title under both E.U. and English law.

⁶⁹ Article 40(2).

Settlement Finality

- 3.35. The FMLC is aware that Brexit poses a number of threats to settlement finality under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the “SFR”),⁷⁰ which implement the SFD in the U.K. The size and remoteness of such threats depend on how Brexit is handled. Although settlement finality is not specific to emissions allowances and is, in principle, beyond the scope of this paper, given the significance of this topic for market participants, a brief discussion of the key issues under Brexit is set out in Appendix C.

4. THE IMPACT OF BREXIT ON U.K. PARTICIPATION IN THE E.U. ETS

- 4.1. This section considers the legal and practical impact of Brexit on the U.K.’s participation in the E.U. ETS.
- 4.2. As discussed above, if there is a hard Brexit and no agreement is reached for continued participation, the U.K. will cease to be (i) subject to the ETS Directive; and (ii) a part of the E.U. ETS from Exit Day.
- 4.3. To meet its own targets, the E.U.’s Effort Sharing Agreement will need to be amended to account for the U.K.’s departure by recalibrating the allocation of allowances amongst Member States. Alternatively, the E.U. could reduce its own target to correspond with the percentage reductions required.

Impact of a Hard Brexit on U.K. Accounts with the Union Registry

- 4.4. As noted in paragraph 2.8, it is not clear that a legislative basis exists for U.K. participation in the Union Registry following a hard Brexit. Accordingly, unless a special agreement is reached, there is uncertainty as to how U.K. accounts will continue to operate after a hard Brexit. The legal status of existing accounts after a hard Brexit is not clear, for example, with respect to the Registries Regulation which provides that accounts shall be governed by the laws and fall under the jurisdiction of the Member State of their Administrator, given that the U.K. will no longer be a Member State.⁷¹ The extent to which the U.K. will retain access to the Union Registry if the Withdrawal Agreement is ratified is discussed in paragraph 4.12 below.

⁷⁰ Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979).

⁷¹ Article 11(5).

- 4.5. As the day-to-day operation of accounts and transactions is centrally managed, it is possible that U.K. accounts will continue to operate in the short term following a hard Brexit, even if the National Administrator loses its status under the ETS Directive. As mentioned above, the National Administrator's role is somewhat limited and is concerned with point-of-contact issues with account holders. It is unclear, however, whether U.K. accounts could be closed or suspended in the long term. There are limited circumstances in which accounts can be closed. Generally, accounts can only be closed by a National Administrator, for example where there is a zero balance and no transactions in the preceding year, or if an account holder applies for its account to be closed.⁷² The Central Administrator can also temporarily suspend the acceptance by the EUTL of a Member State's processes pursuant to new powers in the Safeguarding Regulation, as mentioned in paragraph 2.14 above. In the event that an account is closed, the Registries Regulation provides that allowances in that account should be transferred to another account nominated by the account holder.⁷³
- 4.6. HM Government has acknowledged that operators and traders with E.U. ETS allowances in their account in the U.K. section of the Union Registry should plan for a loss of registry access in a hard Brexit scenario and consider taking action, such as opening a second account in another Member State's Registry as part of their contingency planning for a no deal scenario.⁷⁴ However, such persons may face difficulties opening an account in other Member States. For instance, aircraft operators and installation operators must open their Union Registry account by engaging their relevant National Administrator.⁷⁵ Aircraft operators and installation operators that are regulated by the United Kingdom would therefore appear to need to apply to the U.K. National Administrator.⁷⁶ Such persons would, as a corollary, be unable to open an account in the Union Registry if the U.K. National Administrator is no longer able to open accounts on their behalf.

⁷² See Article 33(2) and Article 27 of the Registries Regulation.

⁷³ Article 32.

⁷⁴ *Guidance: Meeting climate change requirements if there's no Brexit deal*, available online: <https://www.gov.uk/government/publications/meeting-climate-change-requirements-if-theres-no-brex-it-deal/meeting-climate-change-requirements-if-theres-no-brex-it-deal>.

The draft Emissions SI also amends certain provisions of the GHG Regulations to reflect the fact that the U.K. is not guaranteed access to the Union Registry after exiting the E.U.

⁷⁵ Article 17(1) of the Registries Regulation.

⁷⁶ See Commission Regulation (EU) 2017/294 for a list of which Member States will be regulating a particular aircraft operator.

4.7. For persons seeking to open holding or trading accounts in the Union Registry, the Member State of the National Administrator may require as a condition for opening a holding or trading account that (i) the prospective account holders have their permanent residence or registration in the Member State of the National Administrator administering the account, and/or (ii) prospective account holders are registered for value added tax (VAT) in the Member State of the National Administrator of the account.⁷⁷ However, as far as the FMLC is aware, some Member States have not exercised this condition and therefore would allow U.K. persons to open an account.

4.8. It is possible that transitional agreements could be reached to transfer U.K. accounts to another Member State or to allow the Central Administrator to take control of the U.K. part of the Registry. There are currently no plans in place, however, for such transitional arrangements. Proceeding on a “worst-case” assumption, if parties are unable to make or receive transfers of EAUs through registry accounts administered by the U.K., the settlement of executed spot and forward transactions may be disrupted. As a matter of practice, participants in the E.U. ETS are likely to hold EAUs that they anticipate needing in the current year as well as subsequent years to fulfil their carbon reduction strategies. This means that an abrupt drop-out of the E.U. ETS will create market-based and legal risks for regulated operators as well as other traders in EAUs.

Transitional Measures and the Withdrawal Agreement

4.9. As discussed in paragraphs 2.11 to 2.13, the Safeguarding Regulation was introduced to address risks arising in the auctioning and allocation of allowances, in the event the U.K. ceased to be part of the E.U. ETS from 30 March 2019.

4.10. If the U.K. leaves the E.U. ETS following a hard Brexit, then requirements relating to the U.K.’s surrender of emissions allowances will cease to operate, after the end of the scheme year 2018.⁷⁸ However, if the U.K. does remain in the E.U. ETS until the end of 2020, it is not clear whether a similar approach to the Safeguarding Regulation will be adopted for compliance in the year 2019 (to be met on 30 April 2020), and this may depend on when any transition period ends. It is also not clear how compliance will be managed for the relevant part of the operational year in 2020.

4.11. If U.K. EAUs are marked separately and cannot be used to meet compliance in the Union Registry, this will create two tiers of EAUs. It will also be unlikely that U.K.

⁷⁷ Articles 18(2)-(3) of the Registries Regulation.

⁷⁸ See regulation 27 of the draft Emissions SI.

operators will be able to manage these risks by selling U.K. EAUs to other entities in advance of leaving the E.U. ETS.

4.12. Article 8 of the Withdrawal Agreement provides that:

Unless otherwise provided in this Agreement, at the end of the transition period the United Kingdom shall cease to be entitled to access any network, any information system and any database established on the basis of Union law

To avoid a cliff-edge loss of access to the relevant emissions registries prior to the end of the operating year in April 2021, Article 96 of the Withdrawal Agreement contains saving provisions, that will continue to apply certain E.U. law in the U.K., as a means of dealing with emissions that will be emitted in 2020 or would otherwise fall within the second Kyoto commitment period, which runs to the end of 2020. HM Government's explainer for the Withdrawal Agreement states that Article 96 contains

arrangements for the orderly winding down of UK involvement in certain climate schemes where compliance deadlines extend beyond the end of the implementation period⁷⁹

Specifically, Article 96(6) provides that, as a derogation from Article 8 of the Withdrawal Agreement, the U.K. will have access to the Union Registry and the United Kingdom's Kyoto Protocol Registry beyond the transition period, to the extent necessary to give effect to these saving provisions. It therefore appears that the intention is that the U.K. will be permitted to continue administering accounts for the E.U. ETS until at least April 2021. These saving provisions do not, however, conclusively settle how the complications caused by the Safeguarding Regulation will be resolved for U.K. EAUs in the final operating year.

4.13. Under the Withdrawal Agreement, unless a comprehensive trade deal is reached or the U.K. and E.U. agree to extend the transition period in accordance with Article 132 of the Withdrawal Agreement, the U.K. will enter a "single customs territory" with the E.U. in accordance with the Protocol to the Withdrawal Agreement. Under the Protocol, separate consideration has been given to the unique electricity market in

⁷⁹ HM Government, *Explainer for the agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union*, 14 November 2018, para 103, available online: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/756376/14_November_Explainer_for_the_agreement_on_the_withdrawal_of_the_United_Kingdom_of_Great_Britain_and_Northern_Ireland_from_the_European_Union_1.pdf.

Northern Ireland, which is connected to the Republic of Ireland.⁸⁰ Article 11 and Annex 7 of the Protocol, read together, identify a number of E.U. acts that will apply to and in the U.K. in respect of Northern Ireland insofar as they apply to the generation, transmission, distribution, and supply of electricity, trading in wholesale electricity or cross-border exchanges in electricity. These acts include, *inter alia*, the ETS Directive. A number of associated acts that give effect to the E.U. ETS which have been referred to in this paper, including the Registries Regulation and Auctioning Regulation, have not been listed in Annex 7. It is therefore not entirely clear whether Northern Ireland will continue to participate in the E.U. ETS, as not all applicable acts have been referred to in the Withdrawal Agreement.

Impact of a U.K. ETS

- 4.14. If a U.K. ETS is established and linked with the E.U. framework, then depending on the grounds and scope of the linkage, this could give rise to legal and commercial uncertainties including whether certain Kyoto Protocol emissions units could be traded directly with U.K. allowances (which is not possible in Phase III of the E.U. ETS). On the other hand, as discussed in paragraphs 3.21 to 3.31 above, if the U.K. establishes an entirely independent scheme, the status of U.K. emission allowances would need to be reconsidered as a matter of property law and financial regulation.

Impact of the Withdrawal Act

- 4.15. The Withdrawal Act makes it clear that E.U. Directives will no longer apply in the U.K. after Exit Day. This means that the ETS Directive will no longer apply in the U.K. and will not directly apply to operators from the United Kingdom. E.U.-derived Domestic Legislation will, however, remain in place. This includes statutory instruments enacted pursuant to section 2(2) of the European Communities Act 1972, such as the GHG Regulations. The GHG Regulations are intended to be read with the underlying ETS Directive as they cross-refer to definitions and concepts established by the ETS Directive. To a degree, this can be mitigated by the use of powers granted to ministers under the Withdrawal Act to maintain coherence and ongoing applicability. For

⁸⁰

See HM Government, *Explainer for the agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union*, 14 November 2018, paras 206-207:

"The Northern Ireland electricity market is separate from the market in Great Britain. Northern Ireland shares a wholesale electricity market with Ireland, the Single Electricity Market (SEM) ... while supported by domestic legislation, is underpinned by E.U. law. The Government therefore made clear from the outset of the negotiations that protecting the ongoing operation of the SEM is a key priority.

Article 11 of the Protocol ensures that a clear legal underpinning is provided for the SEM to ensure that it will continue to operate. The approach taken provides for alignment with only those rules (listed in Annex 7 to the Protocol) needed to ensure the SEM's continued functioning of the SEM, linked to the governance of wholesale electricity markets, as well as relevant measures to ensure the same carbon price and emissions limits across the market."

example, ministers are empowered to make regulations to prevent, remedy or mitigate any deficiency in retained E.U. law or any failure of retained E.U. law to operate effectively.⁸¹

- 4.16. Unless the GHG Regulations are subsequently repealed, operators will need to maintain their permits to carry on emissions activities though, as mentioned above, there are uncertainties over the availability of accounts established by the U.K. with the Union Registry following Brexit. If the U.K. establishes its own ETS, it will need to substantially amend or repeal the GHG Regulations.

5. SOLUTIONS AND MITIGANTS

- 5.1. Some of the uncertainties identified in this paper, for example regarding the adoption of a U.K. ETS and the consequent amendments to the GHG Regulations, will be resolved in due course by political and legislative processes. Specific issues examined in the main body and the appendices of this paper which can be assisted by further guidance, however, are identified below.

Continued participation in the E.U. ETS

- 5.2. Further clarity is needed as to whether the U.K. will be able to participate in the E.U. ETS until the end of Phase III in 2020, and on the alternatives to such participation.
- 5.3. In accordance with the Withdrawal Agreement, the extent to which the E.U. ETS will continue to apply in Northern Ireland after 2020 should also be clarified.

Contractual Issues

- 5.4. In the event that the U.K. registry ceases to operate or is otherwise suspended under a hard Brexit, certain issues of uncertainty may arise under existing Market Standard Terms contracts. Counterparties will need to analyse and clarify any ambiguities in contractual interpretation. Additionally, the Market Standard Terms may merit further consideration by the industry associations who publish them.
- 5.5. The scope of what the industry can do is limited, however, until the status of U.K. accounts in the Union Registry becomes clearer. Further clarity from the European Commission and/or the Environment Agency would assist parties so that they can plan in advance for whether they will be able to comply with their contractual obligations.

⁸¹ Section 6(7).

Regulatory and Legal Uncertainties

U.K. Level Issues

- 5.6. If the U.K. introduces a U.K. ETS, the legislation establishing such a scheme may consider pre-empting legal uncertainty by defining the legal nature of U.K. emissions allowances. If these are defined in a way that is aligned with EAUs (subject to resolving the uncertainties discussed above regarding the legal nature of EAUs), this will assist parties by minimising legal complexities. A harmonised approach will also support possible linking between the U.K. and E.U. ETS. A new legislative framework could also make it clear that disputes in relation to U.K. EAUs and U.K. emissions allowances are to be governed by English law, to avoid complex conflicts of laws disputes.
- 5.7. In the event that the U.K. introduces its own ETS, it is likely that the RAO will need to be amended so that emissions allowances under the U.K. ETS qualify as “specified investments” and “non-equity MiFID instruments”. Provisions dealing with the specified activities that relate to emissions auctioning and trading may also require amendment to replace references to E.U. law with the U.K. legislation that is eventually introduced to replace it. Consideration might be given to whether U.K. activities in connection with EAUs should be covered by the RAO. The exemption for compliance operators may also need to be extended to operators dealing with U.K. emission allowances.
- 5.8. To ensure its consistent application following Brexit, the ancillary activities exemption will require amendment, so that it continues to encompass: (a) activities in the U.K.; (b) activities by U.K. persons; and (c) trading on U.K. platforms. If a separate U.K. ETS is established, the U.K. should consider whether it would be most appropriate to continue calculating the ancillary nature of a U.K. person's activities by comparing its activities against the E.U. and U.K. emissions trading market as a whole (rather than just the U.K. market).
- 5.9. The U.K. should determine which types of non-U.K. persons, if any, should be permitted to hold accounts on an eventual U.K. emissions register, the types of accounts such persons may hold and the procedures for on-boarding such overseas persons.
- 5.10. The U.K. should consider whether persons authorised in the E.U. to bid in and act as auctioneer for the E.U. ETS should have the right to participate, on equal or similar terms, in any U.K. ETS. Their inclusion could be achieved by expressly permitting

their participation under the relevant U.K. legislation establishing the U.K. ETS and by providing an exemption to local authorisation requirements that would otherwise be triggered by their activities. This outcome could also be achieved as an ancillary consequence of any broader, Third Country recognition between the U.K. and E.U.

- 5.11. The U.K. should ensure that its currently designated auctioneering platform will not be in breach of domestic law if it is no longer a "regulated market" under E.U. law as a result of Brexit. This may be achieved by exercising powers granted under the Withdrawal Act.
- 5.12. If the U.K. ceases to participate in the Union Registry, the records of title in a future U.K. registry should, as a matter of law, have the same conclusive nature that the Union Registry currently has.
- 5.13. The U.K. should continue to respect the conclusive nature of the Union Registry in respect of title to EAUs.

E.U. Level Issues

- 5.14. To ensure consistent outcomes across Member States, the legal nature of emission allowances could be harmonised at an E.U. wide level. This has previously been the subject of a recommendation by the FMLC.⁸²
- 5.15. The linking of the U.K. and E.U. schemes may be a protracted process that is not established by the date the U.K. ETS comes into existence. Therefore, if it is deemed prudent to progress the objectives of MiFID II and MAR by encompassing emission allowances under a U.K. ETS, the definition of financial instruments could be amended in MiFID II so that it also includes U.K. EAUs and U.K. emission allowances under a national emissions trading scheme. If this amendment takes place, the E.U. will also need to consider whether it wishes to exempt compliance operators in a U.K. scheme from regulation under MiFID II.
- 5.16. The ancillary activities test under E.U. legislation may also benefit from recalibration to reflect the impact of Brexit, as Brexit is likely to shrink the overall market size that is used as the denominator in the calculation. The E.U. may also need to consider whether it should align the ancillary activities test under E.U. legislation with HM

⁸² See FMLC, *Report: Emission Allowances and Legislative Reform: 1 October 2009*, available online: <http://fmlc.org/wp-content/uploads/2018/02/Issue-116-Emission-allowances-1.10.2009.pdf>.

Government's proposal, and thereby continue to carry out the calculation based on U.K. and E.U. market data initially.

- 5.17. Reciprocal protection of settlement finality systems in the U.K. would be beneficial to emissions market participants in both the E.U. and the U.K. This could be achieved by the introduction of either a Third Country recognition regime under the SFD or an amendment of Article 2(a) of the SFD which would permit non-E.U. and E.U. law governed systems to qualify as a “system” for the purposes of the SFD.
- 5.18. The E.U. should give consideration to how U.K. persons may continue to both hold existing accounts in the Union Registry and open new accounts, through the U.K. National Administrator or otherwise.
- 5.19. The E.U. should continue to allow authorised U.K. persons that are currently permitted to participate in the E.U. ETS to directly bid in auctions under the E.U. ETS. It should also consider how to allow U.K. regulated markets to act as auctioneers for E.U. emissions auctions.
- 5.20. For all emissions allowances recorded on an eventual U.K. Registry, E.U. law should recognise the U.K. registry as conclusive as to title in the same manner as EAUs in the Union Registry.
- 5.21. If U.K. emissions allowances are instead recorded on the Union Registry, the Union Registry should be conclusive as to their title in the same manner as EAUs.

6. CONCLUSION

- 6.1. In this paper, the FMLC has highlighted the issues of uncertainty which market participants will face in the context of Brexit and the U.K.’s participation in the E.U. ETS. The FMLC has explored the numerous legal and regulatory uncertainties that will arise, whether the U.K. leaves the E.U. ETS upon Exit Day (which is now expected in the event of a hard Brexit) or stays in the E.U. ETS until the end of Phase III in 2020. The FMLC has further explored the legal uncertainties that would emerge should a U.K. ETS be established. The FMLC has also considered the impact that Brexit would have upon the U.K.’s participation in the E.U. ETS, in particular upon U.K. account holders in the Union Registry. Finally, the FMLC has examined some of the ways by which the uncertainties identified might be mitigated, including through clarification by the Commission and industry associations, various forms of contingency planning by market participants and possible legislative action by the U.K. and the E.U.

APPENDIX A

Settlement under the Market Standard Terms

ISDA Terms

- 1.1. As with all the Market Standard Terms documents, the ISDA Terms provide that the delivering party must deliver emission allowances of the specified type and relating to the specified compliance period to the receiving party on the specified delivery date.
- 1.2. The ISDA Emissions Annex sets out the precise mechanism for delivering emissions allowances:
 - Paragraph (d)(i)(2)(A) states that the delivering party's obligation to deliver emissions allowances shall be discharged by the completed transfer of the emissions allowances from a "Holding Account" of the delivering party, and that such a transfer shall be considered to be completed when the relevant emissions allowances are received at the "Specified Holding Account" of the receiving party.
 - Paragraph (d)(i)(2)(B) provides that if the delivering party has one or more Specified Holding Accounts for a relevant transaction, then the delivering party's obligation is limited to an obligation to deliver from any such Specified Holding Account to the relevant Specified Holding Account of the receiving party.
 - Paragraph (d)(i)(2)(C) provides that if the receiving party has more than one Specified Holding Account for a relevant transaction, then the delivering party's obligation is to deliver to the first listed Specified Holding Account unless prevented by a "Settlement Disruption Event" or "Suspension Event", in which case the obligation is to deliver to the next listed Specified Holding Account (if any), and so on.
- 1.3. Under the ISDA Terms, the delivering party must deliver the required emission allowances on the agreed delivery date unless excused by the existence of a defined event such as an Illegality,⁸³ a Settlement Disruption Event,⁸⁴ a Suspension Event,⁸⁵ or

⁸³ Broadly speaking, an Illegality occurs where it would be unlawful for the delivering party to perform its obligations.

⁸⁴ Settlement Disruption Event is defined as "an event or circumstance beyond the control of the party affected that cannot, after the use of all reasonable efforts, be overcome and which makes it impossible for that party to perform its obligations either to deliver or to accept [a]llowances in accordance with the terms of [a transaction]".

the receiving party's failure to comply with the requirements under the E.U. ETS or by an abandonment of the E.U. ETS.

- 1.4. If no such event has occurred, failure by the delivering party to make the delivery will generally result in termination of the relevant transaction unless remedied within a short period (at most two business days) following notice from the receiving party. In certain cases, the delivering party will be required to pay replacement costs.
- 1.5. Similarly, failure by the receiving party to comply with specified requirements under the E.U. ETS may result in termination at the option of the delivering party and payment of replacement costs by the receiving party.

EFET Terms

- 1.6. The EFET Terms are substantively similar to the ISDA Terms in respect of delivery obligations. The central obligation is on the delivering party to deliver the contracted quantity of emission allowances of the specified type and relating to the specified compliance period to the holding account of the receiving party on the specified delivery date.⁸⁶ In the EFET Terms, the holding accounts of the delivering party and the receiving party are known as Transfer Points and Delivery Points respectively. Parties may limit the scope of their transfer and acceptance of transfer obligations by designating (in the case of the delivering party) one or more holding accounts from which to make delivery and (in the case of the receiving party) one or more holding accounts in which to receive allowances.
- 1.7. The EFET Terms provide that the delivering party can be excused from its obligations to deliver in certain circumstances which include *Force Majeure*,⁸⁷ a Suspension Event⁸⁸

⁸⁵ Suspension Event is defined as “any date a party to the Agreement is unable to perform its delivery or acceptance obligations under and in accordance with [a transaction] and the [E.U. ETS] through a Relevant Registry as a result of... the absence of Registry Operation ... or ... the occurrence of an Administrator Event”.

Registry Operation includes the continued functioning of the “Relevant Registry”, being the registry through which a party is obliged to perform an obligation under the transaction. Administrator Event means the suspension of some or all of the processes of the Relevant Registry or the EUTL by the applicable National or Central Administrator in various circumstances.

⁸⁶ The EFET Terms use different terminology such as Buyer, Seller, Transfer Point and Delivery Point.

⁸⁷ *Force Majeure* is defined in terms similar to Settlement Disruption Event in the ISDA Terms: “the occurrence of an event or circumstance beyond the control of the ... Affected Party that cannot, after using all reasonable efforts, be overcome and which makes it impossible for the Affected Party to perform ... its Transfer or acceptance of Transfer obligations in accordance with the terms of this Agreement and the relevant Emissions Trading Scheme.” For a detailed discussion of the *Force Majeure* event in the ISDA Terms, see the FMLC paper titled *U.K. Withdrawal from the E.U.: Issues of Legal Uncertainty Arising in the Context of the Robustness of Financial Contracts*, available online: <http://fmlc.org/wp-content/uploads/2018/08/Report-Robustness-of-Financial-Contracts.pdf>.

or the receiving party's non-performance. In the absence of such an excuse, a failure by the delivering party to deliver the required emissions allowances on the delivery date entitles the receiving party to demand replacement costs instead of the emissions allowances, unless the failure is remedied within a short period (usually two business days) or the receiving party agrees to a deferred delivery date.

IETA Terms

- 1.8. The IETA Terms are also substantively similar to the ISDA Terms and EFET Terms in terms of the delivery obligation. The IETA Terms provide that a failure to make delivery may be excused by an Illegality, Suspension Event,⁸⁹ *Force Majeure*⁹⁰ or by the receiving party's non-performance.

⁸⁸ Suspension Event in the EFET Terms is defined in similar terms to Suspension Event under the ISDA Terms. It occurs when it is impossible for an affected party to perform its obligations through a Relevant Registry due to (i) the absence of Registry Operation, or (ii) the occurrence of an Administrator Event. The definitions of Relevant Registry, Registry Operation and Administrator Event are substantively the same as those definitions in the ISDA Terms.

⁸⁹ This is defined in similar terms to Suspension Event under the ISDA Terms and the EFET Terms, including the corresponding definitions of Relevant Registry, Registry Operation and Administrator Event. The concept of "Registry" itself, however, under the IETA Terms is somewhat narrower than that in the ISDA Terms and EFET Terms. The ISDA Terms and EFET Terms define Registry to mean a registry established by a Member State, non-Member State or the E.U. under a broad set of rules including the Kyoto Protocol. The IETA Terms, however, define "Registry" to mean a registry established by a Member State or the E.U. under the ETS Directive or Registries Regulation. The significance of this is considered above in paragraph **Error! Reference source not found.**

⁹⁰ As with the EFET Terms, the definition of *Force Majeure* in the IETA Terms aligns with the definition of a Settlement Disruption Event in the ISDA Terms.

APPENDIX B

Specified Kinds of Activity under the RAO

- 2.1. This section considers the impact of Brexit on the regulation of U.K. emissions allowances under a potential U.K. ETS, whether the RAO is retained in its present form or amended in the event of a hard Brexit.
- 2.2. The RAO designates as a specified kind of activity “the reception, transmission or submission of a bid at an auction” of such an emission allowance conducted on (a) a recognised auction platform, or (b) any other auction platform which has been appointed under the Auctioning Regulation.⁹¹ As emissions allowances under an independent U.K. ETS would not be specified investments as presently defined in the RAO (see paragraph 3.17), the reception, transmission or submission of bids at auction of solely U.K. emissions allowances would not be specified kinds of activity under the RAO.
- 2.3. The RAO also makes the operation of an organised trading facility on which “non-equity MiFID instruments” are traded a specified kind of activity.⁹² As discussed in paragraph 3.17, emissions allowances that are recognised as complying with the ETS Directive requirements constitute “non-equity MiFID instruments”. Emission allowances under an independent U.K. ETS would therefore, without further action, fall outside of the definition of “non-equity MiFID instruments” and operating an organised trading facility on which only U.K. emissions allowances are traded would not be a specified kind of activity.
- 2.4. If the U.K. decides to introduce its own emissions trading scheme, then, the RAO will need to be amended to regulate the scheme in a similar way, and consideration would also be needed as to how to regulate U.K. activities in relation to the E.U. scheme.
- 2.5. Amendments addressing such issues could be implemented by means of ministerial powers under the Withdrawal Act. It would be necessary to expand the definition of specified investments and non-equity MiFID instruments under Article 82A and 82B of the RAO in order to capture emission allowances under a U.K. ETS. U.K. legislators would also need to consider whether they intend for EAUs to continue to be specified investments and non-equity MiFID instruments under the RAO.

⁹¹ Article 24A(1).

⁹² Article 25DA.

- 2.6. The definitions of the specified activity of “bidding in emissions auctions” and “operating an organised trading facility” are presently linked with the Auctioning Regulation and MiFID II.⁹³ If the U.K. intends to introduce its own independent legislation covering emissions auctions and trading, these definitions would require amendment. Otherwise, auctions/trades on a U.K. platform would still need to be in accordance with E.U. law to be a platform upon which the specified activity could be carried out. Instead, reference should be made to the equivalent U.K. legislation which will regulate the trading and auction of U.K. emissions allowances.
- 2.7. In the event of a hard Brexit, the draft FSMA SI will take effect. The draft FSMA makes several changes to the status of emissions allowances under the RAO. In particular, the draft FSMA SI removes the specified activity of “bidding in emissions auctions” from the RAO and also provides that greenhouse gas emissions allowances which are auctioned as financial instruments or as two-day spots will no longer be specified investments under the RAO. Emission allowances which meet (*inter alia*) the requirements under the ETS Directive do, however, remain specified investments under the RAO.
- 2.8. Therefore, if a hard Brexit took place, and an independent U.K. ETS were eventually established, emissions allowances under this U.K. ETS would still not constitute specified investments under the amended RAO. Equally, the reception, transmission or submission of bids at auction of U.K. emissions allowances would not constitute specified kinds of activity under the amended RAO. As noted above, therefore, consideration would need to be given as to how U.K. emissions allowances and activities related to these should be regulated under this amended RAO.

Exemptions under MiFID II and the RAO

- 2.9. Certain exemptions under MiFID II and the RAO may also need to be amended as a result of Brexit, including (i) the exemption for compliance officers and (ii) the “ancillary activities” exemptions. These are discussed in further detail below.

The Exemption for Compliance Operators

- 2.10. MiFID II does not apply to:

operators with compliance obligations under Directive 2003/87/EC who, when dealing in emission allowances, do not execute client orders and

⁹³ Articles 3(1), 24A and 25DA RAO.

who do not provide any investment services or perform any investment activities other than dealing on own account, provided that those persons do not apply a high-frequency algorithmic trading technique.⁹⁴

2.11. The ETS Directive defines “operator” as:

any person who operates or controls an installation or, where this is provided for in national legislation, to whom decisive economic power over the technical functioning of the installation has been delegated.⁹⁵

2.12. Further, the ETS Directive defines “installation” by reference to certain emission/pollution emitting equipment.⁹⁶ As MiFID II categorises emission allowances as financial instruments, this exemption was introduced to exclude from its scope industrial operators that deal on their own account in emission allowances (but not derivatives thereof).

2.13. The U.K. has transposed Article 2 of MiFID II in its entirety into the RAO.⁹⁷ The draft MiFI SI substitutes certain references to “compliance obligations under Directive 2003/87/EC” under the RAO with references to the GHG Regulations and provides that operators with such compliance obligations do not constitute “investment firms” under U.K. law.⁹⁸

2.14. If the U.K. decides to introduce its own emissions trading scheme, the U.K. may need to consider whether to extend the exemption to operators dealing with U.K. emission allowances. The E.U. would also need to consider whether it wishes to exempt participants in a U.K. scheme from regulation under MiFID II.

The Ancillary Activities Exemption

2.15. MiFID II also exempts (i) persons dealing on own account in emission allowances or derivatives thereof (but not persons who deal on own account when executing client orders) and (ii) persons providing investment services, other than dealing on own account, in emission allowances or derivatives thereof to the customers or suppliers of

⁹⁴ Article 2(1)(e), MiFID II.

⁹⁵ Article 3(f) and Annex 1.

⁹⁶ Article 3(e).

⁹⁷ Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2017/488, Article 11.

⁹⁸ Part 3(1), article 4(8)(1)(f) of the draft MiFI SI.

their main business, provided that, in either case, individually and on an aggregate basis this is an ancillary activity to their main business when considered on a group basis.⁹⁹ The draft MiFI SI equally excludes such persons from the definition of an “investment firm” under the draft amendments to the RAO.¹⁰⁰

- 2.16. In its guidance to the draft MiFI SI, HM Government commented that it would also maintain the current provision granting firms an exemption from the prohibition on carrying out a regulated activity, until they can perform the calculation to determine whether they still meet the ancillary activities exemption. If the calculation indicates that firms no longer meet the ancillary activities exemption, then firms will need to seek authorisation as a MiFID investment firm within a specified period, in order for the exemption under the RAO to continue.¹⁰¹
- 2.17. The thresholds for calculating whether an activity is “ancillary” under MiFID II have been specified by means of delegated regulations.¹⁰² In relation to emissions allowances, one of the three tests involves comparing a person’s activities against the whole emissions trading market to determine whether such person accounts for less than 20% of the overall market in emission allowances or derivatives thereof (the “**Overall Market Threshold Test**”).¹⁰³
- 2.18. The numerator in the Overall Market Threshold Test, which is composed of the value of the contracts traded by the relevant person, is limited to activities “undertaken in the Union”.¹⁰⁴ Therefore, for persons located in the E.U. (and outside of the U.K.) following Brexit, this would not include activity carried out in the U.K. Similarly, calculations of activity at a group level appear to be limited to members of the group that are located in the E.U. This interpretation of the scope of activities undertaken in

⁹⁹ Article 2(1)(j).

¹⁰⁰ Part 3(1), article 4(8)(1)(k) of the draft MiFI SI.

¹⁰¹ *Guidance on Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018: explanatory information*, available online: <https://www.gov.uk/government/publications/draft-markets-in-financial-instruments-amendment-eu-exit-regulations-2018/markets-in-financial-instruments-amendment-eu-exit-regulations-2018-explanatory-note>.

The draft FSMA SI retains the criteria (set out in the MiFID II Delegated Regulation, as below) for determining when an activity is ancillary to the main business. See Part 3, article 122(6) of the draft FSMA SI.

¹⁰² Commission Delegated Regulation 2017/592 (the “**MiFID II Delegated Regulation**”).

¹⁰³ Article 2(1)(h) of the MiFID II Delegated Regulation.

¹⁰⁴ “The size of the activities referred to in Article 1 *undertaken in the Union* by a person within a group in each of the asset classes referred to in paragraph 1 shall be calculated by aggregating the gross notional value of all contracts within the relevant asset class to which that person is a party.” (emphasis added), Article 2(2), MiFID II Delegated Regulation.

the Union is supported by a joint association of industry bodies.¹⁰⁵ Therefore, without amendment, the activities of U.K. entities would cease to be relevant for this purpose.

- 2.19. The total market size, which forms the denominator in the Overall Market Threshold Test, is determined by:

aggregating the gross notional value of all contracts that are not traded on a trading venue within the relevant asset class *to which any person located in the Union is a party* and of any other contract within that asset class that is *traded on a trading venue located in the Union...*¹⁰⁶ (emphasis added)

- 2.20. Emissions traded on-venue are, therefore, only relevant if they are traded on a venue located in the E.U.; in other words, the first italicised limb does not mean E.U. persons trading on a trading venue located outside of the E.U. fall within the overall market. This would mean, absent any amendment, that once the U.K. ceases to be a member of the E.U., OTC emission contracts between persons located in the U.K. and another Third Country and, more importantly, emissions traded on a venue located in the U.K. by persons wherever they may be established, would cease to be included in the total market size. It might be useful for the Commission and ESMA to identify what volume of contracts would be excluded from the current test as a result of Brexit, i.e. by quantifying (i) the volume of activity carried out in the U.K.; (ii) the value of OTC contracts involving a U.K. established person and a Third Country person; and (iii) the value of contracts traded on a U.K. trading platform.

- 2.21. HM Treasury has, for its own part, acknowledged these issues by stating that the ancillary activities exemption will continue to be based on U.K. and E.U. market data to ensure that Brexit does not affect the scope of this regulatory perimeter.¹⁰⁷ U.K. legislators will also need to supplant the MiFID II Delegated Regulation as otherwise it will exclude the U.K. exchange-traded market, activities within the U.K. and U.K.-established persons once they cease to be located “in the Union”.¹⁰⁸ The Commission

¹⁰⁵ Joint Associations' Questions & Answers (Q&A) on Regulatory Technical Standard (RTS) 20 of the Markets in Financial Instruments Directive (MiFID II), 16 February 2017. The Joint Association comprises of: Bundesverband der Energie- und Wasserwirtschaft, the European Federation of Energy Traders, Eurelectric, Energy U.K., EUROGAS, Futures Industry Association and International Oil and Gas Producers association.

¹⁰⁶ Article 2(3) of the MiFID II Delegated Regulation.

¹⁰⁷ *Guidance on Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018: explanatory information*, available online: <https://www.gov.uk/government/publications/draft-markets-in-financial-instruments-amendment-eu-exit-regulations-2018/markets-in-financial-instruments-amendment-eu-exit-regulations-2018-explanatory-note>.

¹⁰⁸ This amendment is contemplated in Annex N of the FCA's *Consultation Paper 18/28: Brexit: proposed changes to the Handbook and Binding Technical Standards*, available online: <https://www.fca.org.uk/publication/consultation/cp18-28.pdf>.

may also need to consider whether the ancillary activities exemption under E.U. law should be aligned with the revised version under U.K. law.

Bidding in and conducting emissions auctions

- 2.22. Only certain persons, including investment firms, credit institutions and operators or aircraft operators that hold the appropriate account at the Union Registry, are eligible to apply for admission to bid directly in emissions auctions.¹⁰⁹ “Investment firms” and “credit institutions” are defined by reference to MiFID II and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV) respectively, and so are restricted to regulated E.U. firms.¹¹⁰
- 2.23. Upon a hard Brexit, once the U.K. ceases to be a Member State, persons authorised by the U.K. competent authority as an investment firm or credit institution will lose the right to participate in E.U. emissions auctions as they would, post-Brexit, constitute third-country persons. Likewise, if U.K. installation operators or aircraft operators do not hold the appropriate Union Registry account, for the reasons set out in paragraph 4.7 or otherwise, they too will be excluded from bidding directly in auctions.
- 2.24. Additionally, if a hard Brexit takes place, then the Auctioning Regulation will be revoked under U.K. law.¹¹¹ Authorised E.U. persons and installation operators and aircraft operators will no longer be able to access U.K. emissions auctions, as the operation of such auctions will have ceased. Indeed, the U.K. has not scheduled any auctions for new emissions permits beyond December 2018, in case a hard Brexit takes place and allowances for 2019 become invalid.¹¹²
- 2.25. If there is a transition period, however, and the Auctioning Regulation is retained under U.K. law, then this may still pose issues for both E.U. operators and U.K.-authorised auction platforms. Following any transition period, authorised E.U. persons and installation operators and aircraft operators that do not hold the appropriate U.K. account could face similar issues to those described in paragraph 2.23 above in accessing a U.K. emissions auction. The U.K. should consider whether such E.U.

¹⁰⁹ Article 18(1) of the Auctioning Regulation.

¹¹⁰ Articles 3(8)-(9) of the Auctioning Regulation.

¹¹¹ See Part 4 of the draft Emissions SI.

¹¹² Financial Times, *Shape of EU carbon market unclear after UK axes auctions*, available online (with subscription): <https://www.ft.com/content/87b02cdc-e8f5-11e8-885c-e64da4c0f981>.

persons should continue to be permitted to directly bid in a domestic auction, and if deemed desirable, to provide a carve-out to local licensing requirements that would otherwise be triggered by E.U. persons participating in a U.K. auction.

- 2.26. Furthermore, under the Auctioning Regulation, emissions auctions may only be conducted by an auction platform authorised as a “regulated market” in accordance with MiFID II.¹¹³ Following any transition period, then, platforms that are authorised by the U.K. regulator will fall outside of the definition of “regulated market” under the Auctioning Regulation, absent legislative intervention or an equivalency determination. Therefore, such persons will no longer be eligible to host emissions auctions on behalf of states participating in the E.U. ETS as a matter of retained E.U. law. This will have an immediate impact on the U.K.’s currently designated auctioneer; as a U.K. authorised person, absent legislative intervention, their appointment will become inconsistent with the Auctioning Regulation. Similarly, the U.K. should consider whether persons authorised as a regulated market by the competent authorities of the remaining Member States should be permitted to conduct U.K. auctions without the equivalent authorisation from a U.K. competent authority.

¹¹³ Article 35(1) of the Auctioning Regulation.

APPENDIX C

Background to the SFD

- 3.1. The SFD (implemented in the U.K. by the SFR) is designed to reduce the systemic risk associated with participation in payment, clearing and securities settlement systems. It requires Member States to ensure that their laws protect the payment and settlement systems of other Member States from the impacts of insolvency proceedings against individual members of those systems.
- 3.2. The SFD provides for the finality and irrevocability of “transfer orders” entered into a system that is designated under the SFD. By preserving the finality of such transfer orders, the SFD protects designated systems such as clearing houses from the potentially systemic impacts of an individual member’s insolvency. Protections of transfer orders under the SFD currently do not apply to the delivery of commodities. Transfer orders relating to the transfer of title or interest in “securities” are within scope, however, and the definition of securities cross-refers to the list of financial instruments in MiFID II. This means that transfer orders for emission allowances have benefitted from the settlement finality and irrevocability protections under the SFD since 3 January 2018.

Effect of Brexit on settlement finality

- 3.3. Article 2(a) of the SFD provides that a “system” recognised under the SFD must be “governed by the law of a Member State”. Following Brexit, an English law system designated under the SFR (“**U.K. System**”) would cease to be governed by the law of a Member State and therefore fall outside of the SFD (even if it continued to be recognised in the U.K. as a designated system under the SFR, as discussed in paragraph 3.5 below). The SFD does not contain a recognition regime through which Third Country systems subject to equivalent regulation in their home state may benefit from the protections in the SFD.
- 3.4. The main consequence of non-coverage by the SFD is that transfer orders relating to emissions allowances in a U.K. System will not be able to rely on finality and irrevocability protections under the SFD throughout the E.U. This is principally an issue for U.K. clearing houses for emissions trading. Following the default of an E.U. participant of a U.K. System, the court of an E.U. Member State could issue an order in favour of that E.U. participant's insolvency practitioner or another interested creditor on the basis of insolvency clawback laws or property laws. This would unwind completed settlements that had already taken place on the U.K. System, without settlement finality protections protecting precisely this under E.U. laws. In the insolvency of an E.U.

participant of a U.K. System, contract law matters would remain governed by English law. Matters relating to insolvency, however, such as the priority of creditors, availability of clawback and applicability of any moratorium would instead be governed by the national laws of the insolvency proceedings, which will typically be those of the place of incorporation of the insolvent participant.

- 3.5. HM Government has published a draft statutory instrument (the “**draft Financial Markets SI**”) which, *inter alia*, seeks to ensure the continuation of settlement finality protections after Brexit.¹¹⁴ Post-Brexit, a U.K. clearing system would still be able to continue to rely on the protections under the Companies Act 1989 and the SFR as it currently does, in respect of its U.K. business and transactions with U.K. participants. The Bank of England would also be given new powers to grant designation to systems that are not governed by U.K. law, including E.U. law governed systems,¹¹⁵ thereby maintaining legal certainty for E.U. systems conducting business with U.K. participants.¹¹⁶ This would not, however, protect U.K. clearing systems under E.U. national laws without equivalent measures being introduced by the E.U.
- 3.6. In relation to the enforcement of adverse foreign judgments in an English court, section 183 of the Companies Act 1989 and Regulation 25 of the SFR prevent an English court from recognising or giving effect to: (i) any order of a court exercising insolvency law jurisdiction in relation to a participant outside the U.K.; or (ii) any act of a person appointed in such a jurisdiction to discharge any insolvency law functions, where the making of the order or the doing of the act would itself be prohibited under the provisions of Part VII of the Companies Act 1989 or Part III of the SFR. These provisions would ensure that foreign judgments that an English court could not make as a result of protections under the Companies Act 1989 and the SFR would not be recognised or given effect to by the English courts. These protections under U.K. law do not, however, restrict E.U. Member State courts from making contrary judgments,

¹¹⁴ The Financial Markets and Insolvency (Amendment and Transitional Provision) (EU Exit) Regulations 2018, available online: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752797/Financial_Markets_Insolvency_Draft_SI_Text.pdf.

See also HM Treasury’s Guidance on The Financial Markets and Insolvency (Amendment and Transitional Provision) (EU Exit) Regulations 2018: explanatory information, available online: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752797/Financial_Markets_Insolvency_Draft_SI_Text.pdf.

¹¹⁵ Part 4(17) of the draft Financial Markets SI.

¹¹⁶ See the letter from the Bank of England to designated systems dated 24 July 2018, available online: <https://www.bankofengland.co.uk/-/media/boe/files/letter/2018/letter-to-eu-systems-designated-under-the-settlement-finality-directive.pdf?la=en&hash=67C3509971A3381713439132785EA57AF9F0CA67>.

nor do they prevent judgments being enforced in Member States that hold collateral for U.K. Systems such as central securities depositories based in the E.U. While the actual impact of these judgments may be limited due to difficulties in their enforcement, the existence of such judgments may have adverse effects, for example, by limiting the extent to which the U.K. System may conduct business in the relevant E.U. jurisdiction and placing U.K. institutions into contempt of local E.U. courts.

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