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5 January 2012

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Dear Bertrand

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

I refer to the letter dated 12 July 2010 sent to you by Sir John Gieve on behalf of the Financial Markets Law Committee (the "FMLC") and the e-mail dated 13 September 2010 to you from the then Acting Secretary of the FMLC. That correspondence expressed the FMLC's view that the development of a clear legal framework for the European Union in respect of emission allowances is conducive to the continued growth and success of the EU emissions trading scheme.

As you may recall, the role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. It was on this basis that the FMLC prepared its paper "Emission Allowances: Creating Legal Certainty" in October 2009 (a further copy of which is enclosed for your convenience)[1] (the "2009 Paper"). The 2009 Paper set out a number of respects in which it appeared to the FMLC that the developing market for carbon emission allowances was at risk of being adversely affected by legal uncertainties. It is the view of the FMLC that many of those uncertainties remain, and the FMLC has therefore reviewed with interest the Commission Regulation (EU) No 1193/2011 of 18 November 2011 establishing a Union Registry for the trading period commencing on 1 January 2013, and subsequent trading periods, of the Union emissions trading scheme pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No 280/2004/EC of the European Parliament and of the Council and amending Commission Regulations (EC) No 2216/2004 and (EU) No 920/2010 (the "Regulation"), which has entered into force since the date of the FMLC's last correspondence with you.

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

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

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

Allowances as a Fungible Instrument

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

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

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

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

Creation of Security

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

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

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

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

Uncertainties in the Wording

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

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

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

Securities Law Directive and Conflict of Laws

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

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

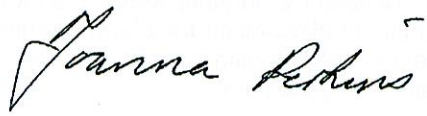
3 Available at: http://www.fmlc.org/papers/Ltr2DGECre136.pdf.

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

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

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

Yours sincerely



Joanna Perkins
FMLC Director

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

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4 See footnote 8 of the 2009 Paper.

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

OCTOBER 2009

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 116 – EMISSION ALLOWANCES:

CREATING LEGAL CERTAINTY

Legal assessment of lacunae in the legal framework of the European Emissions Trading Scheme and the case for legislative reform.

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1 Thanks also go to Belinda Ellington, Legal Counsel of Deutsche Bank AG London, for her comments.

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1. INTRODUCTION AND EXECUTIVE SUMMARY

(a) Introduction

1.1 The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 On 7 February 2007, the FMLC sent a letter addressed to DG Markt, outlining certain issues in relation to physically-settled derivative instruments through which emission allowances are traded and the question of how these contracts are dealt with under MiFID level 2. The letter invited DG Markt to concur with the FMLC's interpretation on this topic.

1.3 The Commission responded by inviting the FMLC to a meeting in Brussels. The meeting took place on 29 November 2007, and members of the Working Group attended. Following the meeting it was agreed that the FMLC would identify the relevant issues in writing and propose a plan of action to address some of the issues at the European level. To that end, the FMLC presents this paper.

(b) Executive Summary

1.4 The number of indexes covering the carbon market is a sign of the growing maturity and importance of emissions trading. Emissions trading is a rapidly growing market, in particular the European Union Emissions Trading Scheme ("EU-ETS"), which continues to be the largest carbon markets scheme in both volume and value and dominates allowance-based transactions.[2] It is therefore of

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2 See 'Carbon Markets 2008' published by IFSL Research and "State and Trends of the Carbon Market" published by the World Bank (the "2009 Report") - the carbon market continued to grow through 2008 and reached about $130 billion at the end of the year, twice its value in 2007 and 12 times its value in 2005. EU-ETS transactions for 2008 reached approximately $90 billion. It should be noted that the other major scheme is that established under the Kyoto Protocol. Moreover, there are also voluntary schemes in existence. The discussion of that scheme is out with the ambit of this paper, although it should be noted that the definition of a carbon emission

concern that there are significant legal uncertainties surrounding the carbon emission allowances which underlie this entire market. The central area of difficulty is that nothing in the EU-ETS provides any indication of the legal nature of emission allowances. Emission allowances have aspects of both administrative grants or licences and of private property, and it is understood that different conclusions as to their legal classification may already have been, or are in the course of being, reached in a number of Member States.

1.5 The potential ramifications of alternate legal classifications are far reaching. Most significantly, the legal nature of an emission allowance will be relevant in determining which law properly governs the creation, transfer and cancellation of that allowance, and whether (and how) security rights can be created over that allowance. Further issues include how allowances should be treated for tax and accounting purposes, how allowances should be dealt with in the insolvency of a registered holder, whether and to what extent allowances, or derivative interests in allowances, should be treated as subject to regulation as an investment, and whether allowances are capable of being stolen, or otherwise being the subject of property-based criminal activity.

1.6 The FMLC believes that unless there is some clarification the issues identified could significantly impede upon the development of the market in carbon emission allowances. It is proposed that this issue should be tackled at a European level by the Commission. A group of market practitioners and experts should be established to assist the Commission in analysing the main problems in this area and ensuring that there is an appropriate level of legal coherence throughout Europe.

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allowance is different to that under the EU-ETS – inevitably, given the global aspect of trading, problems will arise as to whether an allowance under one scheme also falls within the operation of the other scheme.

2. TRADING IN CARBON EMISSION ALLOWANCES: LEGAL ISSUES

(a) Legal framework

2.1 The European Union Greenhouse Gas Emissions Trading Scheme (the "Scheme") was brought into being by the Emissions Trading Directive (2003/87/EC) (the "ETS Directive") combined with Directive 2004/101/EC (the "Linking Directive") and Commission Regulation No. 2216/2004/EC (the "Registries Regulation"). 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 the [ETS] Directive..."*

2.2 The Registries Regulation established and defined the parameters for a standardised and secure system of EU Member State Registries for the issue, transfer and cancellation of allowances. Such registries are not trading platforms for allowances but rather are intended to provide for the accurate accounting of compliance and allowance ownership within the Scheme. The Registries Regulation provides that each Member State and the European Commission should establish a registry in the form of a standardised electronic database.[3]

2.3 The Community Independent Transaction Log ("CITL") is a standardised electronic database which records the issue, transfer, surrender and cancellation of allowances within national registries. Currently, Member States' registries are connected to the CITL through a communication link. Allowance trading between entities in different Member States is possible through the CITL, which tracks all such transactions and transfers between Member States' registries.

2.4 Each Member State's registry is required to operate three types of accounts:

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3 Article 8 of the Registries Regulation.

a. the "party account", which is the account for the public body responsible for running the Scheme, where allowances are held before being issued to operators each year;[4]

b. operator accounts, which are the accounts held by the operators of regulated installations, and into which operators' annual allocations are placed;[5] and

c. person holding accounts, which can be used, for example, by bodies which trade in allowances without having any installations.[6]

2.5 The Scheme was designed to provide a practical basis for the establishment of a market in the EEA in carbon emission allowances. Trading is already taking place between operators and financial institutions appear to take the view that this is a potentially significant market in which they wished to be involved.[7] Exchanges and trading platforms are being established for this purpose. An allowance is therefore a valuable financial commodity.

(b) Areas of specific legal uncertainty

2.6 It is, however, increasingly being recognised by lawyers in a number of relevant jurisdictions that there are significant legal uncertainties surrounding emission allowances under the Scheme. The central area of difficulty is that nothing in the Scheme provides any indication of the legal nature of allowances. Existing and prospective EC instruments on judicial co-operation in civil and commercial

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4 Article 12 of the Registries Regulation.

5 Article 15 of the Registries Regulation.

6 Article 19 of the Registries Regulation.

7 The 2009 Report states that the allowances markets value for 2008 was $92,859 billion. See also the FT.com, "Finance Groups Demand Tough Climate Targets" on 17 September 2009, which states that some of the biggest names in finance (e.g. HSBC, Hermes, ING Group, Societe Generale, Swiss Re and Allianz Global) called on the UK Government to strike a tough deal on emissions reductions in the forthcoming meeting in Copenhagen this December, in effort to boost investment into climate change. See also the FT.com, "EU Sets out Euro15bn Climate Aid Plan" on 8 September 2009 , which states that it is estimated by the EU Commission that as much as 38bn Euro per year could flow to developing countries from the international carbon market by 2020.

matters provide no conclusive solution and there is currently no European wide test for differentiating between proprietary and personal rights, with such matters being determined by Member States applying their national law. Allowances have aspects of both administrative grants or licences and of private property, and it is understood that different conclusions as to their legal nature may already have been, or are in the course of being, reached in certain Member States.

2.7 These are not solely academic issues, but have potentially very significant ramifications for the development of the market in carbon emission allowances. Most significantly, the legal nature of an emission allowance will be relevant in determining which law properly governs the creation, transfer and cancellation of that allowance, and whether (and if so, what) security rights can be created over that allowance. Further issues include how allowances should be treated for tax and accounting purposes, how allowances should be dealt with in the insolvency of a registered holder, whether and to what extent allowances, or derivative interests in allowances, should be treated as subject to regulation as an investment,[8] and whether allowances are capable of being stolen, or otherwise being the subject of property-based criminal activity.[9]

2.8 These issues may be amplified in a cross-border context. It should be noted that the existing and prospective EC instruments on judicial co-operation in civil and commercial matters (the Brussels and Lugano Conventions, the Brussels Regulation, the Rome Convention, the Rome I and Rome II Regulations) do not

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8 Emissions are not a financial instrument for the purpose of Directive 2004/39/EC (MiFID) with the result that there are no European requirements in respect of the authorisation or capitalisation of firms dealing in emission allowances (although derivatives on emission allowances are within the scope of MiFID). It follows that there is no European passport to establish a branch or provide services in respect of emissions trading. Nor do any requirements exist in respect of conduct of business rules or the prevention of insider dealing and market abuse.

9 Inconsistency in the legal treatment of allowances will result in diverging treatment under the criminal law, which may impede the cross-border investigation and prosecution of crime. The point being made is not that there are differences in criminal laws that require harmonization, but that a core understanding of what emission allowances constitute is essential for the effective application of existing criminal laws.

provide a solution as none of these provide a test for differentiating between proprietary and personal rights, apparently on the assumption that Member States will apply their national law.

2.9 The EC Insolvency Regulation (Regulation 1346/200/EC) as well as the Credit Institutions Winding Up Directive (Directive 2001/24/EC) provides some protection for third party rights in rem.[10] However, neither provides a basis for determining whether rights in emission allowances (or anything else) constitute a right "in rem". The interface between the proprietary and contractual effects of assignments of contractual rights was sufficiently controversial in the negotiations on Rome I to require deferral for future consultation.

(c) Non-European Schemes

2.10 Issues arising under the EU-ETS must, of course, be considered in the wider international context. Although the EU-ETS represents probably the most developed system for trading carbon emissions, it is only part of the framework for inter-governmental efforts to address climate change, now embodied in the Kyoto Protocol. The FMLC understands that participants in the developing emissions trading market are currently trading in allowances created under the EU-ETS, allowances created under other schemes within the Kyoto framework and also allowances created outside the Kyoto framework in voluntary schemes.[11] The Committee believes that the problems that have been identified in relation to allowances created under the EU-ETS are almost certain to apply

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10 Article 5 of the Insolvency Regulation and Article 21 of the Credit Institutions Winding Up Directive.

11 Prior to February 2005, when the Kyoto Protocol came into effect, the international carbon market was relatively inactive, particularly within the private sector. With the entry into force of the Kyoto protocol, the international carbon market grew to $30 billion in two years. See "Flexible Mechanisms for Climate Change Compliance: Emission Offset Purchase under the Clean Development Mechanism, Christopher Carr and Flavia Rosembuj, N.Y.U Environmental Law Journal, Volume 16, p. 44.

equally to allowances created under other schemes. It is not aware of any attempt having been made as part of the Kyoto process to address any of these issues.

2.11 Because the EU-ETS is a self-contained and focused regime, however, it appears at present to offer the most practical context for the informed consideration and resolution of the problems that have been identified. The FMLC believes that if a coherent, workable approach to the unresolved legal issues relating to carbon emissions can be found in the EU context, then it is likely that the originators of other schemes will be encouraged to adopt similar measures in order to enable a genuinely international market to thrive. Unless there is a consistency of approach to these matters among the Member States, it is difficult to see how any pressure can be exerted to achieve clarification at the wider international level.

3. THE PROBLEM ILLUSTRATED

3.1 It may be helpful to illustrate the nature and potential consequences of the concerns mentioned above by postulating an example: assume that twenty units of emission allowances are issued in the UK to a UK based operator, and recorded in the name of the operator on the UK register operated by the UK Environment Agency. That operator then sells ten units to a German entity, with the result that those units are transferred via the CITL from the UK register to the equivalent register in Germany. At the same time, that German entity acquires ten further units from a Dutch operator and twenty further units from a Hungarian operator. The German entity then sells thirty of the forty units which it holds to the German branch of a UK entity which maintains its emission allowances account on the German register. That UK entity then creates a floating charge under English law over all of its assets to secure its liabilities to a syndicate of lending banks based in a range of European and non-European jurisdictions. The UK entity then becomes insolvent and the banks seek to enforce their security.

3.2 At this point it becomes critical for all parties, and also for other creditors of the insolvent entity, to know whether the UK entity has good title to the units registered in its name and whether the security which it has purported to create

over its assets attaches to those units and has been validly created. It is also critical for the lending banks to know how they may go about enforcing their security, if it is indeed valid. There are no established rules to indicate which law will be applied to answer these questions and it is unlikely that every jurisdiction would reach the same conclusions. Clearly a number of potential areas of uncertainty could arise.

3.3 In the case of other assets held by an insolvent UK company (for example, land, plant and machinery, debtors and investments) while there will inevitably be practical questions for creditors to address in these circumstances, the legal issues as to title and security, including issues as to the law which will govern disposition of assets situated outside the UK, should be very clear, being based on well-established rules. This is not the case, however, in relation to the emission allowances.

3.4 So far as English law is concerned, although the point is by no means settled, there is every likelihood that an English court would reach the conclusion that emission allowances constitute "property". This view is supported by recent judicial decisions in relation to milk quotas (*Swift v. Dairywise Farms Ltd* [2000] 1 W.L.R. 177) and waste management licences (*Re Celtic Extraction* [2001] Ch. 475, 489). In the latter case, the Court of Appeal indicated three tests which must be satisfied before an administrative permit could be considered to constitute property:

i) there must be a statutory framework conferring an entitlement on one who satisfies certain conditions, even though there is some element of discretion exercisable within the framework;

ii) the permit must be transferable; and

iii) the permit must have value.

3.5 These tests would appear to be satisfied in the case of emission allowances. In the case of the insolvency of a UK entity, the assets of which included UK-registered emission allowances, the FMLC would therefore expect that these allowances would be treated as part of the property of the insolvent entity,

capable of being disposed of in the insolvency by the liquidator or other insolvency practitioner, and that security created over that property prior to the insolvency would (subject to the usual considerations) be effective.

3.6 In the example given above however, while the insolvency of the UK entity would, of course, be primarily governed by English law, to the extent that the allowances which form part of the assets of the entity are properly to be regarded as property situated in another Member State, then *prima facie* one would expect that the English courts would look to the laws of that Member State to determine for example, whether the security which the English entity had purported to create over its assets was an effective disposition of the allowances. Since the allowances were, at the date of the purported creation of the security, registered in the German registry, then, although the fact that the allowances in question originated on the registers of three different Member States may make the analysis more difficult, English law should regard questions as to their legal nature and the appropriate manner of their disposition as being matters of German law. The reason for this is that it is anticipated that an English court would regard the appropriate system of law to determine proprietary issues in respect of rights in allowances held through a local emissions registry to be the law of the jurisdiction where the registry is located. This is well established in the case of intellectual property rights which are situated in the country whose law governs their existence and which applies to all proprietary issues. Nevertheless, although an English court would apply German law, other possibilities exist, including EC law and the *lex fori* - where allowances originate from different national registers and are fungible, it could be argued that no other system of law is capable of being consistently applied so that the *lex fori* should apply by default. In this case, each Member State would apply its own law regardless of where the emission allowances were held or had originated from.

3.7 Alternatively, if the correct analysis of the nature of the allowances is that they are not in fact property, but rather some form of personal licence (albeit one which by its terms is transferable), then it is less clear where they should be regarded as being located, and whether it is in fact possible to regard all allowances currently registered in the single German account as being identical

in legal nature for these purposes, given their separate states of origin. An English court generally regards personal rights as being situated when they are capable of enforcement by action,[12] although the artificiality of identifying a situs for personal rights might suggest that a court should apply the *lex fori* instead.

3.8 It is understood that the current view of Hungarian lawyers is that emission allowances are personal rights of some sort rather than property, whereas English, Dutch and German lawyers are tending to the opposite conclusion i.e. recognising them as proprietary rights. The Dutch implementing legislation contains a provision specifically prohibiting the pledging of emission allowances. It is not clear how an English court, faced with questions as to the efficacy of security over a pool of allowances originating from different Member States, would resolve these inconsistencies. While one would normally expect that, in relation to a right constituted under the laws of another state, the English courts would look to the laws of that state to determine the true analysis of that right, such an approach would be unworkable in this context if it meant that, for example, emission allowances created in Hungary were mere personal licences (and therefore by definition incapable of constituting property the subject of a trust or other disposition), while emission allowances created in the UK and the Netherlands constituted property but, in the case of those created in the Netherlands, were nevertheless, as a matter of Dutch statute, not capable of being pledged as security for the obligations of the holder. Where, as in the example above, an insolvent UK entity had acquired allowances from a range of sources and then purported to create security over them, or over some of them, it is difficult to see how the English court could reconcile the differing national analyses of the assets which, on the face of it (and as contemplated by the EU

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12 *Braun v. The Custodian* [1944] 3 D.L.R. 412; *Brown, Gow, Wilson v. Beleggings - Societeit N.V.* (1961) 29 D.L.R. (2d) 673. For rights of action: *Sutherland v. Administrator of German Property* [1934] 1 K.B. 423; *Jabbour v. Custodian of Israeli Absentee Property* [1954] 1 W.L.R 139 and *Lorentzen v. Lydden & Co. Ltd.* [1942] 2 K.B. 202.

Scheme), form a single pool of fungible assets. One would expect that courts in other EU jurisdictions would face equivalent difficulties.

3.9 Furthermore, the issues raised in connection with an English insolvency will increase in complexity if an insolvent company is incorporated outside of England and Wales. If the EC Insolvency Regulation applies then the company may be subject to insolvency proceedings both in the jurisdiction of the centre of its main interests ("COMI") and also where it has an establishment, although in the latter case the proceedings will have territorial effect only. In either case, third party rights in rem benefit from protection under Article 5. However, for the reasons given above, national courts may reach conflicting conclusions as to whether a right in allowances is a right "in rem" giving rise to possible inconsistent results depending on whether the proceedings are universal or territorial. If the EC Regulation does not apply, and the sectoral winding up directives (insurance, banking) are not applicable, then Member States will apply their national law (including, where relevant, conflict of law rules). This is the case, in particular, for investment firms.[13]

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13 At a higher level of generality it is debateable whether it is appropriate to apply a conflict of laws analysis to determine questions relating to what are in fact *sui generis* rights created under Community law. In particular, the FMLC identifies the following factors as capable of giving rise to legal uncertainty

(1) differences in approach between states as to the existence of a "conflict" of laws. An approach based on government interest analysis, or the search for the "better" law (as is common in the US), will not lead to the same outcome as a traditional approach based on connecting factors as applies in England;

(2) differences in the characterisation of the legal issue e.g. does it involve a question of title to property, the proprietary effects of an assignment, the validity of an assignment or transfer, the effects of such between assignor/assignee, etc;

(3) the possibility of an incidental question; and

(4) differences in procedural law.

The possible inappropriateness of the use of such techniques has been recognised in the context of the community trade mark, and in the case law of the Court of Justice under the Brussels Convention/Regulation where an autonomous definition under EC law applies to most legal concepts, as well as the ambit of the exceptions, and the requirements for valid jurisdiction clauses under Article 21 (Case C-269/95 *Benincasa v. Dentalkit Srl* [1997] ECR I-3767). Applying conflict of law rules would also raise the issue of renvoi as it is accepted by many legal systems (including England and Wales), and commentators, that renvoi applies in respect of

4. ARE THESE CONCERNS RELEVANT AND PRACTICAL?

4.1 In response to these concerns, it might be argued that the fact that trading in emission allowances is already taking place, and that market infrastructure is being developed, indicates that there are theoretical issues which will not, in practice, prevent the successful development of a market where the commercial interests of operators and financial institutions require it. The FMLC does not believe that this is the case: the reason why these uncertainties have not so far impeded the early stages of the development of the market is simply that they have not been appreciated.[14]

4.2 There is an assumption among the commercial players that, since the concept of the emission allowance has been created by EU legislation with the clear policy intent that an active market should be encouraged, it must therefore be possible for such allowances to be traded. The legal issues reflected above are only just beginning to be recognised. As more interested parties contemplate entering the market and take legal advice about doing so, there will be a wider recognition of the difficulties and consequently one would expect, increasing pressure for them to be resolved at an EU level.

4.3 The New World Bank Figures announced at the recent CARBON EXPO in Barcelona[15] show that the International Emissions Market continues its rapid

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disputes concerning proprietary issues. While possibly providing a greater degree of consistency in ultimate outcomes, renvoi adds to the level of complexity, and has generally been rejected in Community law.

14 Important to note that the international carbon market is a relatively young one and was mainly triggered by the entry into force of the Kyoto Protocol in 2005. With the entry into force of the Protocol the market grew to $30 billion in two years. The volume of credits generated by projects that reduce greenhouse emissions more than quadrupled from 2004 to 2006 (See supra note 11, Carr and Rosembuj, p.51) and the potential growth of the market is much larger with Clean Development Mechanism Projects being registered in over 55 countries (see UNFCCC Registration 15 September 2009).

15 The "Global Trade Fair and Conference for Emissions Trading, Carbon Abatement Solutions and New Technologies" took place between 27 and 29 May 2009 with 276 exhibitors from 83 countries and around 3,000 visitors from 111 countries.

growth; the global market doubled in 2008 and now totals $126 Billion – despite the turmoil in the financial world and its long term prospects are strong.[16]

4.4 The worst case scenario would be for the market to develop without any such resolution, because it is inevitable that there will eventually be an insolvency or default involving a market participant, leading to a need for the courts of one or more Member States to resolve the issues identified. It seems very unlikely, against the current background, that any such national resolution would be capable of producing an outcome which could apply across all Member States. At that point there must be a serious risk that the market would be seriously destabilised. Even without such an insolvency or default, uncertainty and/or inconsistency in legal outcomes impose costs on economic action and impede the efficiency of the market in emission allowances contrary to the purpose of the Member States in establishing the scheme.

5. REVIEW OF THE EMISSIONS TRADING DIRECTIVE

5.1 The Commission recently published a review of the Emissions Trading Directive[17] which is intended to come into effect after 2012 when the Kyoto Protocol expires. Under the Kyoto Protocol, Members States were allocated a set amount of emission allowances so that each allowance had a country of origin. In the future it is envisaged that this will change and allowances will be allocated across the EC (i.e. there will be a single set of allowances across all EEA States).

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16 The second most active segment of the carbon market, the secondary market for Certified Emissions Reductions (CERs) experienced the biggest growth in activity over the period, with transactions (spot, futures and options) in excess of $26 billion (a five-fold increase in both value and volume over 2007). The Financial Times reported that carbon trading volumes nearly doubled in the first half of the year for Climate Exchange, the world's biggest emissions trading exchange operator; first half turnover rose from £10.8m to £18.8m for the six months to June 30, while pre-tax profits were £1.5m compared with a lose of £304,000 last year. The report also states that carbon trading could get a big boost if US legislators set up a cap-and-trade system covering emissions (the House of Representatives has already passed a bill to this end and it is currently awaiting the US Senate's decision. See The Financial Times, "Carbon Trade Rise Lifts Climate Exchange" on 17 September 2009. However, the carbon market has also been affected to some degree by the recession - according to the World Bank publications, starting in the fall of 2008, carbon prices started to slide down as the economic crisis deepened.

17 COM (2008) 16 final, Brussels, 23.1.2008 together with accompanying impact statement.

5.2 It is difficult to anticipate the consequences of the implementation of such proposals, which remain subject to consultation and negotiation between Member States. It is of course premature to attempt to assess the implications of any post-Kyoto arrangements that may be put in place, hence this paper is restricted to some tentative suggestions at this stage.

5.3 The proposals will involve the creation of a single EU-wide register from January 2013, but without prejudice to the maintenance of national registries for emissions not covered by the Community scheme. Based on the above analysis of English conflict of law principles, an English court would be likely to regard such allowances as a species of property, and would apply the law of the Member State where the register is situated to determine proprietary questions. The appropriateness of such an approach to a Community right is questionable as it would subject all proprietary questions to the law of the Member State where the register happens to be located, perhaps necessitating review of the appropriateness of such law prior to deciding where to locate the register. If renvoi is admitted to apply (see footnote 11), the outcome may depend on the conflict of law rules of the Member State where the registry is located. If, on the other hand, a *lex fori* were applied by some Member States then the analysis will vary from Member State to Member State even after the establishment of a single registry.

5.4 For emission allowances held outside of the Community Scheme, national registries will continue to exist with the result that the legal position will be unchanged from the present in respect of emission allowances held after 2013 in such registries.

5.5 It follows that revision of the Emissions Trading Directive is unlikely, without further steps, to resolve the legal difficulties considered in this paper even if it does reduce the range of national laws that need to be considered in respect of emissions covered by the Community scheme.

6. PROPOSED SOLUTIONS

6.1 The legal issues discussed above give rise to significant potential risks that may undermine the development and efficiency of the European emissions trading market. If, as is hoped, the market is extended to include third states, or non-state emissions trading schemes (such as those operating in various US states), then these difficulties will increase. Rather than leaving the issue to be addressed by the courts of Member States in the context of the default or insolvency of a participant, a European solution is required. The FMLC has considered three possible options for legislative change, in ascending order in terms of the legal certainty that they would provide, together with some initial observations on possible advantages and disadvantages.

(a) Option 1: Harmonisation of Member States' Conflict of Law Rules

6.2 This proposal would require Member States to apply a uniform set of conflict of law rules for contractual and proprietary issues. Provided that legal issues are characterised in the same way, and each Member State applies the same connecting factors, then theoretically the outcome should be the same regardless of the court where a dispute is litigated. In practice, this would be of limited benefit to market participants as it would leave unresolved differences in substantive laws which pose a greater challenge, particularly the question whether emission allowances are a form of property or a personal right. In practice, harmonisation of conflict of law rules may not yield uniform outcomes due to differences in national procedural rules as well as national approaches to the proof of foreign law (for example, whether courts conduct their own research into foreign law).

(b) Option 2: Partial Harmonisation of Substantive Law

6.3 Under this option, Community law would harmonise key areas of substantive law where differences in approach between Member States give rise to significantly different outcomes and legal risk to market participants. It is beyond the scope of this paper to consider in more than outline issues for such harmonisation.

However, the following are possible areas where a common approach between Members States could prove beneficial:

(i) whether emission allowances constitute a form of property or a personal right, and, if the latter, against whom (e.g. the relevant national registry);

(ii) the effect on third parties of assignment/transmission including any necessary formal and substantive requirements to create a valid proprietary interest in emission allowances;

(iii) the possibility of creating security, or other limited proprietary interests, in emission allowances, including any necessary formal and substantive requirements;

(iv) the registerability of security interests in emission allowances; and

(v) priorities between competing claims to emission allowances.

6.4 All legal issues not harmonised would be left to be determined under national law. For simplicity, and because all key issues would have been harmonised, the legislation should make clear that Member States would apply the *lex fori*. The application of national law to such issues would also be subject to two principles recognised in the case law of the Court of Justice:

(i) national law must be applied in a manner that does not discriminate between claims based on Community law and national law ("non-discrimination"); and

(ii) national law must not make the enforcement of claims based on Community law impossible or excessively difficult ("effectiveness").

6.5 This option would provide the necessary level of legal certainty without unduly interfering with national legal systems. This approach respects the principle of subsidiarity by restricting itself to harmonisation of essential matters. Although harmonisation could be effected by a directive or regulation, the former seems more appropriate given the need to integrate the scheme within national law.

Option 3: Complete Harmonisation or a Community Code

6.6 This option is based on the *sui generis* nature of emission allowances as a bundle of rights created by, and dependent on, Community Law. Legislation would therefore seek to harmonise all legal issues relevant to allowances. Community law would govern the issues referred to under Option 2 as well as any other issues that may arise. In practice, this would probably involve a Community code. Complete harmonisation would ensure consistent outcomes and would minimise legal risk as all relevant issues would be addressed in the Community instrument.

6.7 Such an approach is, however, arguably not consistent with the principle of subsidiarity. Complete harmonisation would also not eliminate the need to consider the interface between national law and emission allowances, as national law would still apply to issues outside the scope of harmonisation (e.g. insolvency law and criminal law). Option 3 would also be considerably more complex than Option 2, owing to the need to identify and agree in advance solutions to issues that could arise in connection with transactions in allowances. For this reason the FMLC does not recommend option 3.

7. A COMISSION-LED EXPERT WORKING GROUP AND FURTHER STEPS

7.1 The FMLC is aware that a number of Member States are examining for themselves the legal framework of the ETS and conducting an investigation into how best the perceived lacunae might be filled by national law. The FMLC views the outcome of this process as critically important to the market in allowances. That is particularly true if the market is likely to be effected by an economic downturn which could place some of the issues discussed above under stress, say, in the event of emitter or intermediary insolvencies. What is crucial, is that Member States should not reach different conclusions as a result of their examination of key questions. However, while the questions remain to be addressed at the supranational level of the organs of the European Community, this must remain a risk.

7.2 With this in mind, the FMLC would like to make a number of suggestions regarding the process of resolving the issues outlined above.

7.3 For any proposed development of the law in this area to be effective, action must be taken on a European level. As the Executive branch of the European Union the European Commission is responsible for proposing any necessary legislative change. However, as a procedural matter, the question arises whether responsibility for any proposal should rest exclusively with DG Environment. That Directorate General has been primarily charged with the ETS hitherto and clearly, therefore, it has the necessary experience, remit and standing to oversee the continuing development of a comprehensive regulatory framework. However, the process of legislating for legal certainty in a new and expanding financial market is a specific undertaking which appears to fit squarely within the experience and mission statement of DG Internal Market and Services (DG Markt) which aims at establishing the legal framework for the integration of the Union's capital markets and the creation of a single market for financial services. Trading in carbon credits is now viewed by financial institutions as a significant market and it is therefore considered that the smooth operation of this market is clearly an issue within the field of concern of DG Markt. The FMLC would tentatively suggest that a project of this sort might benefit from both the leadership of DG Markt and the oversight and advice of DG Environment.

7.4 The FMLC believes that an investigation and treatment of legal certainty issues in the market for emission allowances is one project for which the Commission could usefully consider establishing a high-level advisory and monitoring group of market participants. DG Markt has had previous experience of establishing and managing such groups (such as the Legal Certainty Group and the Inter-institutional Monitoring Group) with a high degree of success. In this instance, a group of market experts drawn from the legal professions of Member States might provide:

a) a high-level forum for discussion of the needs of the market and the precise identification of the legal uncertainty problems it faces;

b) a channel through which information can be gathered, collated and analysed on the developing national legal frameworks for emission allowances; and

c) an advisory panel contributing expertise to the Commission on addressing a legislative solution to any problems identified, according to the options outlined above.

7.5 The FMLC would be honoured to provide any assistance that might be desired in the establishment of a group of this kind.

7.6 The FMLC would also welcome the opportunity to discuss any of the issues addressed in this paper further if that would be helpful.

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21 January 2011

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Dear Sirs

Consultation Paper: Legislation on Legal Certainty for Securities Holding and Dispositions, 5 November 2010 (G2 MET/OT/acg D(2010) 768690)

The remit of the Financial Markets Law Committee (the "FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets that might give rise to material risks and to consider how such issues should be addressed.

This letter sets out the FMLC's response to the European Commission's consultation paper entitled "Legislation on Legal Certainty for Securities Holding and Disposition", dated 5 November 2010 (the "Consultation Paper"), which seeks comments on a set of principles to underpin a proposed European Securities Law Directive ("SLD").

The FMLC considers that the most important requirement for any SLD that may be enacted by the European Union ("EU") is that it be consistent with and complementary to the legal framework established by the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the "Geneva Securities Convention" or the "Convention"). Although the EU is yet to adopt the Convention, the FMLC considers that it will be important for any regulatory regime established under an SLD to be able to operate efficiently and effectively as part of the globally harmonised system that is envisaged by the Geneva Securities Convention. If the Commission considers that an SLD is required in addition to the Convention (for example, in order to harmonise certain matters that are left by the Geneva Securities Convention to non-Convention law), the FMLC considers that compatibility between the two instruments will, *inter alia*, be important to promote legal certainty in this area both within Member States and in relation to cross-border transactions and relationships within the EU and with non-EU entities, thereby supporting the operation of the European securities markets more generally.

Further, the FMLC considers that the likely importance of the Geneva Securities Convention to the international securities markets in the future means that it will be important for any SLD to incorporate an inbuilt structure that provides for the monitoring and review of national implementation of the SLD

on an ongoing basis. In order to keep the two regimes aligned on an ongoing basis, this exercise would need to include monitoring the operation of the Geneva Securities Convention regime by non-EU countries so that any inconsistencies between the parallel regimes that arise in practice can be identified and addressed.

An area of concern for the FMLC is the proposal in the Consultation Paper to define "securities" as financial instruments as listed in Annex I, Section C of Directive 2004/39/EC Markets in Financial Instruments ("MiFID").[1] The list of financial instruments in MiFID includes, *inter alia*, derivative contracts. By referencing MiFID in this way, the Consultation Paper abandons the restrictive qualifier in the definition of "securities" in Article 1(a) of the Geneva Securities Convention, which states that:

> "securities" means any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention. (Emphasis added.)

The phrase, "in accordance with the provisions of this Convention", indicates the intention of UNIDROIT to exclude derivatives and other instruments not conventionally regarded as securities from the scope of intermediated securities legislation. The FMLC is of the view that a definition of "securities" in the SLD that mirrors or, at least, includes a similar restrictive qualifier as the definition provided by the Convention would effect greater harmonisation of securities law in the EU and promote legal certainty. Alternatively and as a minimum, the definition should expressly exclude derivatives. If thought desirable, a further provision might require the Commission to make a recommendation at a later date as to whether or not derivatives should be included. (If the Commission's proposals for the centralised clearing of over-the-counter derivatives result in a market wide transfer of derivative settlement to settlement systems, it may be thought appropriate to include derivatives as financial instruments within the purview of the SLD.)

The Consultation Paper has addressed the concerns of the Giovannini Group set out in their first report on clearing and settlement in November 2001,[2] by giving extensive consideration to account holders' interests in securities in cross-border transactions.[3] However, the Paper appears not to appreciate fully the impact of the Commission's proposals on account providers.[4] This is evident when examining the interaction of Principles 1 and 18 as set out in the Consultation Paper. Principle 18 proposes that services provided to account holders for the cross-border holding of securities should be charged at the same rate as for the domestic holding of securities. This would prevent account holders from recovering compensation through (even objectively justifiable) service charges for the costs and risk of providing services for securities held in a foreign central securities depositary.[5] Simultaneously, Principle 1 proposes that "*all*" account providers should be regulated by MiFID, which would increase the regulatory and compliance burdens (and associated costs) on account providers. The combined effect of Principles 1 and 18 is therefore, at one end, to increase costs for account providers and, at the other end, to reduce the means available to recover those costs. The securities industry therefore would become a less viable arena to conduct business in. Whilst it is not within the remit of the FMLC to comment on policy decisions (and rules on fees fall within policy choices), the FMLC believes that the fact that the impact on account providers appears to have been overlooked could cause unforeseen systemic risk in the financial markets. The FMLC, therefore, does not go so far as to urge the Commission to follow a different approach, but does

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1 European Commission: Directorate General Internal Market and Services, 'Legislation on Legal Certainty of Securities Holding and Dispositions' (2010), question 43 and section 22.

2 The Giovannini Group, 'Cross-Border Clearing and Settlement Arrangements in the European Union' (2001) <http://ec.europa.eu/ internal_market/.../first_giovannini_report_en.pdf >. See section 5 on the barriers to efficient cross-border clearing and settlement.

3 Uses of the terms "account holder", "ultimate account holder" and "account provider" in this letter are meant as defined in section 22 of the Consultation Paper.

4 DG MARKT, 'Consultation Paper', questions 1 and 36.

5 Investment firms commonly reflect in their price tariffs the differing levels of intermediation, cost structures and levies imposed in other Member States.

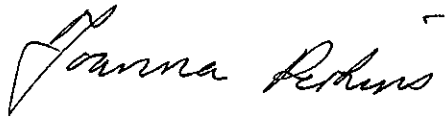
advise the Commission to undertake further consideration of the impact of Principle 18 on account providers.

The broad liability placed on account providers by Principle 4 of the Consultation Paper may also import systemic risk into the financial markets. Principle 4 recommends that an account provider should compensate an account holder for losses suffered and promptly provide additional comparable securities if the account provider makes a credit entry which does not correspond with the actual number of securities held.[6] It further provides that an account provider may enter into a contractual agreement with an account holder to share the costs associated with providing additional securities only in limited circumstances involving cross-border holdings with third countries—notably cases regulated under Article 17(3) of Directive 2006/73/EC implementing MiFID.

Although Principle 4 does not purport to establish a new civil liability regime as such, in reality it will operate to impose liability for loss on the account provider. As the proposed test leaves little or no room for common defences to liability such as *force majeure* or an exercise of reasonable care by the account provider, Principle 4 effectively imposes a new standard of care which is both (i) unfamiliar; and (ii) analogous to strict liability. Where the securities in question are in the control of a sub-custodian, Principle 4 requires an account provider in effect to underwrite the solvency and operational efficiency of that sub-custodian. This would make it costly for account providers to insure their liabilities or perhaps make the liabilities practically uninsurable. The effect of the proposals may, therefore, be to create a degree of systemic financial stability risk. The increased burden on account providers may create a barrier for any newcomers looking to enter securities markets and thus raises concerns from a competition perspective. Again, although it is not within the FMLC's remit to comment on policy choices, the FMLC believes that a thorough impact analysis that considers the effect of the proposals on account providers as well as account holders would be beneficial.

I would be happy to discuss any of the above comments[7] with you further. Please do not hesitate to contact me if you would like to do so.

Yours sincerely



Joanna Perkins
FMLC Director

6 DG MARKT, 'Consultation Paper', question 10.

7 The FMLC is grateful to Guy Morton, Martin Thomas, Habib Motani, John Ahern, Pauline Ashall, Dorothy Livingston and Geoffrey Yeowart for their assistance with preparing this letter.