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CHAIRMAN:
THE RT.HON. THE LORD WOOLF

Mr Jorgen Holmquist
Director General
European Commission
DG Internal Market and Services
C-107 5/32
B-1049 Brussels
Belgium

Dear Mr Holmquist,

**FINANCIAL MARKETS LAW COMMITTEE
ISSUE 116; EMISSIONS ALLOWANCES**

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.

Since July 2005, the FMLC has been considering certain issues in relation to emission allowances and the European green house gas emissions trading scheme. The Committee is cognisant of the fact that the trading scheme falls within the remit of DG Environment, but believes nevertheless that it is appropriate to raise its observations and concerns – many of which relate to regulation of the trading in emission allowances – with DG Markt, in the first instance. The reason for this is that the focus of the FMLC's concern in regard to possible legal and regulatory uncertainties relating to emission allowances is the impact of that uncertainty on the liquidity of the internal market in these instruments, rather than on their allocation or ability to generate environmental benefits.

Background

The EU Emission Trading Directive (2003/87/EC) establishes a scheme for greenhouse gas emissions allowance trading within the European Community. The key components of this scheme are:

Firstly, that emission allowances are issued by Member States to certain installations in accordance with a national allocation plan;

Secondly, that the emission allowances are transferable to any person or institution within the Community and Member States are required to ensure the recognition, within the jurisdiction, of allowances issued by another Member State; and

Thirdly, the issue, holding, transfer and cancellation of emission allowances is recorded in registries established by Member States.

The intended purpose of the EU Emission Trading Directive is to establish a market or markets to enable the trading of emission allowances. Liquidity in this market is desirable not only from the perspective of the internal market in financial services but also, indirectly, from the perspective of the European environment.

Since the Directive came into force, markets in emission allowances have developed which comprise both a spot market and a derivatives market in forward and future contracts. The derivatives market is used by both industrial installations and by financial market participants and contracts are traded both on exchanges and over the counter. This market activity is currently centred on London.

The regulation of the trading in emission allowances

The derivatives markets in emission allowances fall within the regulatory ambit of the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID") by virtue of Section C10 of Annex I, which expressly refers to:

Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances ... that must be settled in cash or may be settled in cash at the option of one of the parties.

Until the publication of the Level 2 Regulation implementing MiFID, it was unclear whether physically-settled derivative contracts for emission allowances were also covered by MiFID. Section C10 does go on to refer to "any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section". However, this wording is ambiguous: it is not clear whether the words "not otherwise mentioned in this Section" encompass the derivative contracts or merely the underlying assets referred to immediately beforehand. If the latter, then the "catch all" provision appears to exclude physically-settled derivative contracts in relation to the aforementioned emission allowances. In this case, these contracts fall outside MiFID.

Article 39 of the Level 2 Implementing Regulation for MiFID, goes some considerable way towards clearing up any unresolved ambiguity. The Article provides that in addition to derivative contracts of a kind referred to in Section C10 of Annex 1 to MiFID a derivative contract relating to any of a number of additional types of asset, rights, obligations etc shall also fall within that Section (C10). It seems that Article 39 of the Regulation addresses the meaning of the words "assets, rights, obligations, indices and measures not otherwise mentioned in this section". The FMLC infers from this that the sweeping up language of the words "not otherwise mentioned" can only expand the types of underlying asset contemplated and not the types of derivative contract in contemplation. On this basis, physically-settled contracts in relation to emission allowances do not appear to fall within Section 10C.

Given the earlier uncertainty and the importance of resolving this issue for the derivative markets in emission allowances, the FMLC would be grateful if you would confirm this conclusion, namely that: *physically settled derivative contracts in relation to emission allowances do not fall within Section 10c of Annex 1 of MiFID for regulatory purposes.*

In addition to this MiFID-related issue, the FMLC has identified a number of other concerns in regard to possible legal and regulatory uncertainties relating to emission allowances and

representatives of the Committee would very much appreciate the opportunity to discuss these concerns with the appropriate staff members of your Directorate General. I would be most grateful for an indication that such an approach would be welcomed by you.

Yours sincerely

A handwritten signature in black ink, appearing to read "Lord Woolf". The signature is written in a cursive style with a long horizontal line underneath.

Lord Woolf

Copies to: Ruth Walters
Laurence White
Nathalie de Basaldua
David Wright