18th February 2014

Emily Chan
Europe Economics
Chancery House
53-64 Chancery Lane
London WC2A 1QU

FINANCIAL MARKETS LAW COMMITTEE

Dear Emily

Response to the EU ETS Stakeholder Consultation Survey dated 15 October 2013

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 give rise to material risks, and to consider how such issues should be addressed.

The FMLC is grateful to Europe Economics ("**EE**") for the invitation to respond to the consultation survey titled 'EU ETS Stakeholder Consultation Survey' dated 15 October 2013 (the "**Survey**"). The EU emissions trading scheme ("**EU ETS**") was created by Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a system for greenhouse gas emission allowance trading within the Community (the "**EU ETS Directive**"). The FMLC previously published a paper on the EU ETS entitled 'Emission Allowances: Creating Legal Certainty' (the "**2009 Paper**") which identified a number of legal uncertainties in this context.[1] The FMLC takes this opportunity to respond to certain aspects of Survey which relate to issues of actual or potential legal uncertainty concerning the use of emission allowances. This letter does not address other sections of the Survey as these are concerned with policy questions, infrastructure and operational risk and other matters which fall outside the FMLC's remit.

There are, however, two areas of concern to the FMLC raised by the Survey. The first is the legal uncertainty arising out of the lack of full articulation of the post-trade infrastructures for emission allowances, as highlighted in Section 3 of the Survey, and the second is the use of emission allowances as collateral, as discussed in Section 4 of the Survey. In relation to post-trade infrastructure for emission allowances, the Committee has not identified any additional areas of uncertainty beyond those mentioned in the Survey. This letter, therefore, principally concerns the use of emission allowances as collateral.

Section 4.1 of the Survey identifies reasons for the lack of widespread use of emission allowances as collateral. The commercial and operational reasons identified include the lack of a liquid market for emission allowances, problems with the operation of the registry on which emission allowances are traded and the low price of emission allowances. This letter, however, considers and develops the legal issues identified in the section, which include: (i) the 'exotic' nature of the asset class and (ii) the lack of coverage of emission allowances by the Financial Collateral Directive (Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002, the "**FCD**").

T +44 (0)20 7601 5989
contact@fmlc.org

8 Lothbury
London
EC2R 7HH
www.fmlc.org

The uncertainty as regards the legal nature of emission allowances is a central area of difficulty within the EU ETS.[2] The FMLC noted in the 2009 Paper that there is no indication within the legal framework for the EU ETS as to whether emission allowances constitute proprietary rights (i.e. as movable property which can be transferred and over which security can be created) or personal rights (i.e. as a form of personal licence which allows the use of the emission allowances by the entity to whom it is issued). This lack of clarity can lead to emission allowances being assessed differently in different jurisdictions and could potentially affect the validity of any security arrangements created using emission allowances. The problem would become magnified in circumstances of default or insolvency of the party granting the security over emission allowances.

While the decision of the High Court in *Armstrong DLW GmBH v Winnington Networks Ltd*, where the court held that an emission allowance is intangible property at common law, served to clarify the position within the UK, the risk remains of a different characterisation of emission allowances in other EU jurisdictions leading to conceptual difficulties and legal uncertainty.[2] It is suggested that a Europe-wide agreement on the nature of emission allowances is required to establish a safe environment for the use of emission allowances as collateral. Market participants are unwilling to use emission allowances in security arrangements so long as their legal nature is uncertain.

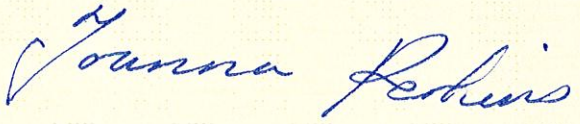
Despite the promise implicit in its title "*Nature of allowances and finality of transactions*" Article 40 of Commission Regulation (EU) No 389/2013 establishing the Union Registry (the "**2013 Union Registry Regulation**") does not serve to shed much light on the legal nature of emission allowances as the FMLC noted in its letter to the DG Markt in 2012 in relation to Article 37 of the Commission Regulation (EU) No 1193/2011, the virtually identical predecessor to Article 40 of the 2013 Registry Regulation.[3] Article 40 provides a functional definition of "allowances" and "Kyoto units", but does not go to the core question of whether an emission allowance is a property right, personal right or something else.

It is proposed that greater clarity in this area could be achieved by amending the EU ETS Directive so as to incorporate a provision specifying the legal nature of emission allowances. This would be a simple and effective way of dealing with this underlying lack of clarity once and for all and would provide greater confidence to market participants and more stability to the EU ETS.

The opportunity could be taken in the same instrument that amends the EU ETS Directive to extend the scope of the FCD to include emission allowances, as suggested in the Survey.[4] It is possible that such a provision, as part of a package intended to improve legal uncertainty (and other aspects, for example, post-trade infrastructure) of the EU ETS, would be more readily accepted than a stand-alone proposal to amend the FCD to include emission allowances. Your attention is also drawn to paragraph 6.3 of the FMLC's 2009 Paper which sets out issues relating to emission allowances and the EU ETS system that would benefit from a partial harmonisation of substantive Community law.

I and Members of the Committee would be delighted to meet with you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely



Joanna Perkins
Chief Executive

---

1 Available at http://www.fmlc.org/Documents/Issue116Oct09.pdf.

2 [2012] EWHC 10 (Ch).

3 Available at http://www.fmlc.org/Documents/Issue116Ltr2Dumont.pdf.

4 Section 4.1 of the Survey states:

> "Coverage of the Financial Collateral Directive (FCD). The current lack of coverage of emission allowances by the FCD raises legal uncertainties and may act as a barrier to their use as collateral. While there has been some harmonisation on the legal nature of an emission allowance and the law applicable to questions of title, the FCD would provide [*sic*] further support for such harmonisation and limit the scope of legal challenge in the event of insolvency. At present, there remain differences in the way in which security over an emission allowance can be granted and the extent to which such security interests are capable of challenge by third parties in different Member States.
>
> Our view is that extending the legal protections of the FCD to emission allowances would to some extent encourage collateral takers and collateral givers to make greater use of allowances, but that other barriers would need to be resolved before the use of allowances as collateral increases."