II-10.5: Execution of a cooperation agreement entered into between the French financial and energy regulators in relation to the regulation of the market for CO2 emission allowances

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MAIN INFORMATION

On December 10, 2010, the Commission de Régulation de l'Energie (CRE – French Commission for Energy Regulation) and the Autorité des marches financiers (French Securities Regulator – the AMF) entered into a memorandum of understanding (the MoU). Cooperation between these two sector based regulators is, for the most part, set against the background of, and aims at, a better (or, rather, burgeoning) regulation of the market for CO2 emission allowances and is grounded in the following principles:

- both regulators undertake to transmit information necessary to fulfilling each other's respective expanded legal mandate, i.e.:

o protecting investments made in CO2 emission allowances (e.g. by detecting and punishing market abuses, i.e. insider trading, market manipulations, dissemination of false information) for the AMF and;

o overseeing transactions made by market participants on the spot and derivatives markets for CO2 emission allowances to make sure that such transactions are in line with transactions made on the markets for electricity and natural gas for the CRE;

- such mutual information is to notably take the form of regular bilateral meetings at various levels and mutual information may now cover data that the AMF had to keep confidential due to strict legal privilege restrictions applicable to its officers.

CONTEXT AND SUMMARY

Greenhouse gas emissions trading within the European Union is nothing new[1]. However, the Emission Trading Scheme (ETS) experienced a number of setbacks (VAT fraud, unlawful quota issue), as a result of which the ETS could have been readily discredited as the optimal way to reduce greenhouse gas emissions. Further, the ETS will engage in the third phase of the arrangement as from January 1, 2013, paving the way for the phase-in of an allocation of CO2 emission allowances on an auction basis instead of the free-of-charge allocation applicable thus far[2]. As a result, oversight should cover both the primary (first hand allocation of CO2 emission

allowances - close to inexistent up to now) and secondary segments (trade of the quotas) of the ETS.

Against this background, French Minister of the Economy, Christine Lagarde instructed former AMF Chairman Michel Prada to issue a report on the regulation of the market for CO2 emission allowances (the **Prada Report**). Among the issues addressed (refer to Anselme Mialon, *The burgeoning regulation of the market for CO2 emission allowances*), that of the oversight of the market is of decisive importance and implied taking a stand between four workable options:

1. A first option would have been to entrust the regulation of the market for CO2 emission allowances to an EU wide *ad hoc* regulator – the European carbon market monitoring authority (the **ECMA**), which would coexist with the newly born European Securities and Markets Authority (the **ESMA**). Such an option is intellectually appealing, as the regulation of the market for CO2 emission allowances does not neatly overlap with either of the pre-existing national regulators' jurisdiction: Under currently applicable regulation, the AMF had jurisdiction for protecting savings invested in financial instruments (i.e. securities in EU jargon); however, CO2 emission allowances cannot qualify as financial instruments pursuant to EU legislation[3]. On the other hand, regulation as it stood entrusted the CRE with jurisdiction over electricity and natural gas markets. However, this first option is ruled out as unrealistic in view of the 2013 (phase-in of the auctions).

2. A second option would have been to entrust the regulation to the financial regulator (be it the AMF or the ESMA), which could be warranted in a variety of ways. First, while CO2 emission allowances do not qualify as financial instruments (which should logically be a defining criterion for financial regulators' jurisdiction), futures or forwards on allowances as underlying assets may qualify as financial contracts (i.e. derivatives in EU jargon), which is a subcategory of financial instruments[4]. Hence the financial regulator does have oversight over the derivatives market, which today stands for 85 percent of the exchanges of the European market for CO2 emission allowances. Centralizing the responsibility for the oversight of the various segments of the CO2 emission allowances market (primary/secondary, spot/derivatives) with the financial regulator would have offered the merit of providing it with the information it lacked to properly monitor the derivatives market.

3. The opposite third option would have been to equip the energy regulator with the oversight of the whole sector. The energy regulator does have expertise on markets correlated with that for CO2 emission allowances, and the energy regulator could have then been provided with an integrated approach of the markets for energy and CO2 emission allowances. However, it would have flown in the face of the financial regulator's long nurtured expertise in detecting and punishing market abuses and regulating market infrastructures and participants.

4. Finally, the option favoured by the Prada Report and materialized by the execution of the MoU lies with the cooperation between the financial and energy regulators.

As advocated by the Prada Report, such cooperation requires a pre-established, clear-cut breakdown of roles between both regulators: the AMF is in charge of spotting market abuses and enforcing market participants and infrastructures' compliance with transactions and conducts of business regulation, while the CRE has to analyse the fundamentals of the market and make sure market abuses spotted by the AMF do not correlate with market abuses on related energy markets.

To this end, a recent law made such cooperation possible by extending the jurisdiction of the AMF to the market for CO2 emission allowances spot[5] and symmetrically that of the CRE to encompass the supervision of transactions carried out on the market for CO2 emission allowances by energy market participants.

Against this backdrop, the execution of the MoU allows for mutual information sharing thus far hampered by strict legal privileged restrictions applicable to the officers of the AMF. Under the recent law, transmittal of information may cover privileged information, it being specified that the requesting regulator will be bound by legal privilege.

Exchange of information will go both ways: for instance, the AMF will transmit to the CRE information relating to unusual price change or atypical orders collected by the financial regulator's as part of its monopoly in instructing and punishing market abuses; conversely, the CRE will transmit to the AMF information data relating to the generation and consumption of C02 emission allowances.

[1] Under the 1997 Kyoto Protocol that was approved by the European Community in 2002, 38 industrialized countries individually undertook to reduce their respective emissions of a basket of six gases during 2008-2012, with the goal of cutting their collective emissions of greenhouse gases by 5.2 per cent from the 1990 level. In anticipation of the 2008 deadline, the EU unilaterally undertook to decide to cut its emissions by 20 per cent by 2008 under the EU Emissions Trading Directive 2003/87/EC.

[2] Recital (19) of Directive 2009/29/EC dated 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community: […] *full auctioning should be the rule from 2013 onwards for the power sector* […]

[3] Please note that qualification was made use of only in Romania; the main rationale for excluding CO2 quotas from the category of financial instruments as listed under Section C of Annex I of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (**MiFID**) is that said quotas do not entitle their holders have no rights vis-à-vis their issuer, i.e. national governments, be it a right on assets' surplus upon liquidation, or dividends entitlement (in case of equity securities) or a reimbursement obligation (in case of debt securities), despite some shared features (1. Movable assets materialized only by book-entry to the credit of their holders' account, 2. Negotiability by transfer on the register from one account to another and 3. Conferral of identical rights to any of its holders).

[4] Under Article 38-3 of the 1287/2006/EC MiFID implementation directive, only derivative contracts having CO2 emission allowances as underlying assets with the following features qualify as securities: (i) cash settlement, (ii) trading on a regulated market or an alternative trading system, and (iii) or it is traded on an exchange of a third party jurisdiction and cleared by a clearing house.

[5] French law no. 2010-1249 dated 22 October 2010 on banking and financial regulation questionably added to the definition of regulated markets (i.e. under MiFID over which national regulators have jurisdiction) markets relating to CO2 emission allowances, hence laying bare conflict between EU financial regulation (in the sense that under MiFID regulated markets necessarily relate to financial instruments, which then again CO2 emission allowances are not) and EU environmental regulation (Article 35-1 of Regulation no. 1031/2010 dated 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances requires that auction platforms qualify as regulated markets within the meaning of MiFID in order to take part in the above-mentioned auctions to be phased in as of 2013).

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BRIEF COMMENTARY

As mentioned by AMF Chairman Jean-Pierre Jouyet, it did not take the CRE and the AMF the execution of the MoU to start discussion on the topic of market for CO2 emission allowances regulation. However, this step demanded a law be passed in order to expand both regulators' jurisdiction and to amend legal privilege applicable to the financial regulator.

The middle approach proposed by the Prada Report and materialized by the execution of the MoU is reflective of the dual nature of C02 emission allowances trading platforms and the instruments which they trade, which in turn harks back to the dual purposes of EU policies on greenhouse gas emissions. Quotas may be regarded as pollution rights granted on a unilateral basis by government bodies; however, the whole rationale for setting up a secondary market for trading quotas is that companies subject to the ETS are better incentivized to cut their emissions if they are in a position to trade their excess quotas, which speculation is supposed to keep at a sustained price.

The MoU was flaunted as the first cooperation agreement between the financial regulator and the energy regulator in France. Horizontal co-regulation had already been exemplified by the creation of a joint unit between the AMF and the new single regulator for the financial services and insurance industries, the Prudential Supervision Authority, in relation to the marketing of financial products, irrespective of their legal qualification.

Finally, vertical cooperation between regulators has not been ignored by the Prada Report: although the putative creation of the ECMA has been ruled out in the short run, the newly born ESMA could serve as the model for the perspective C02 exchange