I-1.22: The burgeoning regulation of the market for CO2 emission allowances

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As part of the Kyoto Protocol, it was agreed that the purpose of reducing greenhouse gas emissions would be better served if a *cap* policy, i.e. imposing limits on the total amount of certain greenhouse gases that can be emitted by factories, power plants and other installations, were complemented by a *trade* policy whereby companies that reduce their emissions by more than their allocated allowance can sell their "surplus" to others who are not able to meet their assigned target.

As a signatory and ratifying party to the Kyoto Protocol and as a member state of the European Union that implemented an Emissions Trading Scheme (**ETS**) in anticipation of the abovementioned *trade* policy, France has had to come to grips with such an arrangement. Yet, playing the market to solve an issue of public interest is arguably not what first comes to mind to French policymakers. Hence the interest in looking into how the French *Autorité des marchés financiers* (Securities Regulator - the **AMF**) is intent on making use of its newly expanded legal mandate[1] - now encompassing the protection of savings invested in emission allowances[2].

To this effect, the AMF issued a call for evidence on December 1, 2010 (the **Call For Evidence**) on suggested changes to its rulebook (the **AMF Rulebook**) to address the oversight of the market for CO2 emission allowances and the prior and ongoing requirements with which market participants have to comply in order to operate on said market.

Why designing regulation oversight targeting the market for CO2 emission allowances is no easy task

The Call For Evidence draws heavily on a report commissioned by the French Minister of the Economy, Christine Lagarde, in relation to the regulation of the market for CO2 emission allowances issued by former AMF Chairman Michel Prada[3] (the **Prada Report**). The Prada Report was made public on April 19, 2010, and was shortly followed by a consultation launched on May 31, 2010 by the Directorate-General for Energy of the European Commission on measures to ensure the transparency and integrity of wholesale markets in electricity and gas[4].

Such activism came partly as a response to those tempted to throw out the baby with the bath water due to a series of incidents affecting the ETS[5]. Respondents argued that such incidents (VAT fraud or unlawful quotas issues, for example), were about organized crime, and that the rationale for resorting to market mechanisms remained unaffected. The Prada Report concludes that doing away with the ETS was not an option, but how to best monitor the carbon market raises a number of thorny issues.

The first reason why designing oversight regulation targeting the market for CO2 emission allowances is no easy task is because CO2 emission allowances do not neatly fall into any legal category which existing regulations had already come up with[6]. Hence, the middle approach consensus that the market for CO2 emission allowances stands to date on the borderline between a market for commodities and a market for financial instruments[7].

The whole issue of classifying CO2 emission allowances might seem overly theoretical, yet it bears tangible implications in terms of the applicable legal regime: the categorization of CO2 emission allowances as financial instruments would have triggered the applicability of the whole legal corpus applicable to financial instruments built up by EU legislation over time. Yet, said legal corpus contains provisions that are altogether irrelevant to CO2 emission allowances[8]. When the implementation of the Directive creating ETS[9] into national French law became due, an *ad hoc* classification was chosen by rule makers[10]. This classification allows for some cherry picking of existing provisions applicable to financial instruments where relevant, and the creation of *ad hoc* provisions elsewhere.

Beyond the debate surrounding the elusive nature of CO2 emissions allowances, the oversight of the market for CO2 emission allowances is driven by EU legislation that imposes regulated market status upon trading venues so that they may take part in the auctions to be phased in as of 2013[11]. In France, the trading platform queuing up for regulated market status is Bluenext[12], which today represents 85 percent of spot trading in Europe[13], thus allowing Bluenext to be designated by the European Commission as the future European common auctioning platform.

Another reason why the AMF's task is tricky is because monitoring needs to be designed in such a way that it covers all segments of the market for CO2 emission allowances: primary (i.e. original issuance by means of auctions from 2013 onwards, the **Auctions segment**), secondary (second-hand exchange of the allocated quotas), spot (i.e. immediate settlement and delivery) and derivatives (exchange of products having CO2 emission allowances as underlying products). Those three segments represent different stakes in terms of regulation: derivatives have been depicted by the industry as "a paper product without the physical characteristics of energy products"[14] whereas the spot market correlates with other markets of tangible assets[15].

The reason why these three segments had never been regulated using the same approach is because of the simultaneous yet uncoordinated developments in specific EU legislation, which flew in the face of the increasing financialization of energy markets[16]. Yet, under MiFID, a 2004 EU directive that revamped the whole legal framework for financial structure, it was acknowledged that certain commodity derivatives could require a regulatory treatment comparable to that applicable to traditional financial instruments[17].

Be that as it may, the status of CO2 emission allowances derivatives is not clear-cut either and not all of them qualified as commodity derivatives. While it was observed that derivatives transactions on the carbon market essentially serve a function of forward physical delivery[18], one of the criteria defining commodity derivatives is if they are cash-settled or provide an option for cash settlement[19].

Finally, further difficulty stems from the fact that the market for CO2 emission allowances is open to all participants, meaning that it is not restricted to companies subject to the ETS[20]. This runs counter to conventional wisdom: factories, power plants and other installations might want to purchase extra quotas because they did not meet their target in terms of emission cuts - possibly after rationally balancing the costs of reducing pollution, e.g., in investing in less damaging equipment vs. that of purchasing some on the market. In view of the ultimate environmentally, not financially, focused goal, it is expected that such trade-off will be in favor of investing in greener technologies and selling the excess quotas. The expected rationale is that the benefit derived from the sale of CO2 emission allowances on the market will outweigh the cost of reducing emissions. However, the ETS is reminiscent of game theory in the sense that if all participants embrace the same reasoning, the ultimate goal will not be reached:

- on the one hand, all companies subject to the ETS will embark on massive investments in greener technologies, in order to cut their emissions and sell their excess quotas, at the best price possible,
- on the other hand, the market price of the assets depends logically on the anticipation of the law of supply and demand, and will be dragged down by the excess supply created by participants that all engage in parallel effort to cut their emissions and trade the excess quotas.

This is where financial intermediaries (i.e. not industry companies) step in. Not only do they engineer the abovementioned derivatives, but they also fuel speculation which helps sustains market price, which is instrumental in preventing the non-cooperative situation described above. Furthermore, the presence of financial intermediaries helps achieve atomistic competition, bearing in mind that dominant positions are a breeding ground for market manipulations[21]. An additional reason why they play an indispensable role is that companies subject to the ETS may need to hedge their positions in order to reduce their market or counterparty risks. This can be only achieved because on the other end of the spectrum, some participants are keen to speculate[22].

The intervention of financial, non-industry participants can therefore be warranted in a variety of ways and the Prada Report did not call this into question. It doesn't defeat the fact, though, that the presence of already authorised participants has further strengthened the need for a level playing field where no operator would able to gain a competitive advantage from regulatory loopholes.

The Call For Evidence: should financial law become CO2 emission allowance specific?

Suggested changes to the AMF Rulebook include new provisions relating to:

- the market operator managing a regulated market for emissions trading;
- market members, regardless of whether they are investment services providers or whether they trade for own account or for their client's;
- detection and prevention of market abuse in emissions trading;
- dissemination and reliability of investment recommendations on emissions trading.

MiFID rules on the conduct of business are for the most part replicated to members of the regulated market, irrespective of whether they qualify as investment firms or not, when they engage in services relating to CO2 emission allowances.

However, the debate between replication, or seeking a sector specific approach, is better illustrated in the market abuse regime.

The Market Abuse Directive sets out the prohibition on insider trading[23] and market manipulation[24]. While the former undermines markets participants' equality, the latter damages the formation of the market price as a signal.

As underlined by contributions to the abovementioned EU Commission consultation[25], neither of the two types of misconduct is applicable without previous adjustment to correspond to the market for CO2 emission allowances.

As for market manipulation, the market for CO2 emission allowances currently offers only limited liquidity, to such an extent that every deal has the potential to materially shift the market price.

As for insider dealing, most market participants are "insiders". The Prada Report underlined that the action of market participants (closing of a facility, change in the generation processes) and all information related thereto, will significantly impact the price of the physical market. Replication of the Market Abuse Directive is even trickier because the possession of inside information is defined in one way, but triggers two distinct requirements:

- a duty to abstain,
- but also a requirement to disclose said inside information that directly relates to them.[26]

When applied to the market for CO2 emission allowances, the latter requirement could force a company subject to the ETS to disclose operational information (*endogenous* information) that could favor its competitors. That is why this requirement was not replicated in the Call For Evidence.

The Prada Report therefore suggested the definition of inside information should be restricted to serious information asymmetries and apply only to *exogenous* information.

The Prada Report further added that the information that would be mostly likely to qualify as inside information would be regulatory information (methods for allocating quotas, consolidated emissions data).

Despite these warnings, the Call For Evidence suggests aligning the definition of market abuses of financial instruments with that applicable to CO2 emissions allowances. Roughly speaking, the proposed provisions are a copy-paste of those of the Market Abuse Directive except that the interactions between the three abovementioned market segments are taken into account. For instance, it is suggested to define 'Inside information' as "information of a precise nature which has not been made public, relating, directly or indirectly (all such features apply to issuers financial instruments), to one or more categories of quotas and which, if it were made public, would be likely to have a significant effect on the price of the offers of the quotas of those financial instruments or on the price of offers on the Auctions segment, the market price of CO2 emission allowance or CO2 emission allowance derivatives."[27] This is the acknowledgement that three segments correlate and that the same market operator may trade on the derivatives segment so manipulate another market segment.

The responses to the Call For Evidence should soon be summarized by AMF and will be materialized by a change to its Rulebook.

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[1] French law no. 2010-1249 dated 22 October 2010 on banking and financial regulation, Articles 3 and 9 of which rephrased Article L. 621-1 of the Monetary and Financial Code.

[2] Admitted to trading on a regulated market

[3] Mr Michel Prada, The Regulation of CO2 Markets, available at (not translated to date) : http://www.economie.gouv.fr/service...

24 Here understood as a financial instrument with a relatively short time for delivery.

[4] http://ec.europa.eu/energy/gas_elec...

[5] Mialon, Anselme, '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 allowance', *The Journal of Regulation*, 2010, II-6.19.

[6] The terms of the debate as to the classification of CO2 allowances vary from movable assets (French categorization) to financial instruments (Romanian categorization), although the latter is unquestionably incompatible with EU legislation which enumerates (as opposed to defines) financial instruments.

[7] Charpin Report on auctioning of CO2 allowances, an English version of which is available at: http://ec.europa.eu/clima/consultations/0002/Charpin_en.pdf, page 2

[8] Notably the Prospectus Directive and the Takeover Directive.

[9] 2003/87/EC of the European Parliament and of the Council of October 13, 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community.

[10] Article L. 229-15 of the French Environment Code: "movable assets which are exclusively materialised by their inclusion on the national register (...), are negotiable, transferable by transfer on the register from one account to another and [which confer] identical rights to their holders".

[11] 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

[12] AMF press backgrounder dated 23 December 2010 (http://www.amf-france.org/documents/general/9794_1.pdf): *The AMF is currently preparing to examine the application file for approval to transform Bluenext into a regulated market in early 2011. The final decision on this approval is in the hands of the Ministry for the Economy, Finance and Industry. Other operators have also announced that they are candidates for the organisation of this platform.*

[13] Prada Report, p. 53

[14] EDF Trading's response to *Public Consultation on measures to ensure transparency and integrity of wholesale markets in electricity and gas*, July 23, 2010, J. Törnquist

[15] This is why a CRE and AMF entered into an MoU.

[16] Response of French authorities to the public consultation by the Directorate General for Energy on measures to ensure transparency and integrity of wholesale markets in electricity and gas, Question 1 on the state of legislation and its expected evolutions.

[17] Recital (4) to Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

[18] J. Törnquist, cited above

[19] Under Article 38-3 of the 1287/2006/EC MiFID implementation directive, only derivative contracts having CO_2 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.

[20] Under Article 19 2 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community, any person may hold allowances.

[21] Under the proposed future Article 743-2 1°) of the AMF Rulebook, the AMF makes of the observation of a dominant position (notably as a result of the share of daily volumes) an indication on the secondary market by which to detect potential market manipulation.

[22] A. Constantin, Revue de Droit bancaire et financier No 6, November 2010, *Les outils contractuels de gestion des risques financiers*: *At the end of the day, hedging one's positions means transferring risks to someone else who is willing to bear those risks.*

[23] The insider dealing regime forbids any person who possesses insider information:
- from making use of insider information by acquiring or disposing financial instruments for their own profit;
- from disclosing or making available insider information to a third party without the authority to do so; and
- from recommending, on the basis of insider information, to a third party to acquire or dispose of financial instruments, or from otherwise inducing a third party to do so.

[24] The prohibition of market manipulation forbids any person:
- from disseminating information which gives or is likely to give, false or misleading signals to the price of financial instruments;
- from executing transactions or giving orders to trade, which give or are likely to give, false or misleading signals to the price of financial instruments, and
- from manipulating the price of financial instruments via other forms of deception.

[25] See for example London Energy Brokers Association Reply to European Commission: Public Consultation by the Directorate General for Energy on measures to ensure transparency and integrity of wholesale markets in electricity and gas, 31 May 2010

[26] As an exception, issuers are allowed to delay in order not to prejudice their legitimate interests.

[27] Proposed article 742-1 of the AMF Rulebook.