# Legal nature of EU ETS allowances

Final report

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# Legal nature of EU ETS allowances

## Final Report
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# 1 Introduction: Objectives and methodology

The objective of this project is to provide clarity on the legal nature of the allowances of the EU Emission Trading System (EU ETS) excluding the international carbon units (e.g. assigned amount units (AAUs), certified emission reductions (CERs), emission reduction units (ERUs)) pursuant to the Kyoto Protocol to the UN Framework Convention on Climate Change (UNFCCC)[1]. In line with the project specifications, the study aims to:

1. Outline the characteristics of allowances which are typical of private property rights, administrative rights or *sui generis* rights, based on current EU legislation, national Member State regimes, and case law.
2. Provide a detailed legal analysis of the treatment of allowances in five selected Member States: Belgium, Germany, France, Poland and the UK. This analysis is based on Article 21 reports, literature desk research and interviews with relevant authorities and stakeholders.
3. Identify the main issues relating to the legal nature of allowances which may have practical implications on the legal certainty, investment confidence and liquidity of the carbon market.
4. Consider the following aspects of the legal nature of allowances in order to determine their impact on the legal nature of the ETS allowances: property rights, establishing security interest, insolvency, taxation, accounting, and criminal justice.
5. Identify the consequences of recognising the allowances as financial instruments under MiFID II, with respect to the legal nature of the allowances.
6. Present options for further clarification of the legal nature of allowances in view of the abovementioned issues, and propose solutions, including changes to the relevant legal framework or soft law measures. The options and tools should be analysed for their feasibility, benefit and effort required.

The study is also intended to address the European Court of Auditors' report, which highlighted the need for a clearly defined and harmonised definition of the legal nature of the allowances, as the current lack of definition at EU level might affect the legal certainty and liquidity of the market[2]. Based on its assessment of phase II of EU ETS, the European Court of Auditors held that greater clarity on the legal definition of allowances would benefit market functioning. The European Court of Auditors recommended that the European Commission analyse the benefits of a harmonised definition of the legal nature of allowances as property rights, including their registration and use as security interests. While the Commission accepted the recommendation, it stated that the 'EU carbon market has grown and matured, despite the fact that the legal status of allowances is not defined at EU level'[3]. The Europe Economics and Norton Rose Fulbright study commissioned by the Commission highlighted the need to consider mechanisms to register and enforce security interests in allowances[4].

[1] United Nations Framework Convention on Climate Change. United Nations, 1992.
[2] European Court of Auditors, Special Report No 6, 'The integrity and implementation of the EU ETS', Publications Office of the EU, 2015. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf
[3] Ibid, p.66.
[4] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015. Available at: https://ec.europa.eu/clima/sites/clima/files/ets/oversight/docs/interplay_report_en.pdf

In addition, it recommended resolving the ongoing issues of legal certainty and transfer of title in respect of allowances.

This report analyses the existing legislation and practice during phase III of the EU ETS (2013-2020), unless it is indicated that the information refers to previous trading periods. It also takes into account the new amendments to Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union[5] (ETS Directive 2003/87/EC) as adopted by Directive 2018/410/EU[6] and which entered into force as of 8 April 2018. As for the legislation on the financial markets related to the EU ETS, the basic assumptions are grounded in Directive 2014/65/EU on markets in financial instruments[7] (MiFID II), which applies as of January 2018, since which date allowances are classified as financial instruments.

The report provides an analysis of the EU legislation which needs to be considered for the EU ETS and the legal nature of allowances (Section 3). Section 4 presents an analytical overview of property and administrative characteristics of the allowances. In Section 5, a legal analysis of selected Member States (United Kingdom, Germany, France, Poland and Belgium) is provided, followed by a Section 6 analysis of key issues related to the legal nature of allowances, specifically legal certainty, liquidity of the market and criminal issues, including those deriving from the abuse of VAT legislation, accounting and security interests. Section 7 analyses the consequences of recognising allowances as financial instruments. Section 8 presents options for measures to address the issues described in Sections 6 and 7.

[5] 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 Union and amending Council Directive 96/61/EC, OJ L 275 25.10.2003, p. 32 at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536581619010&uri=CELEX:02003L0087-20180408

[6] Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814, OJ L 76, 19.3.2018, p.3. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02003L0087-20180408&qid=1536055866531&from=en

[7] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173 12.6.2014, p.349. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536584176375&uri=CELEX:02014L0065-20160701

## 2 Executive summary

The ETS Directive 2003/87/EC does not specify the legal nature of the allowances traded within the EU Emission Trading System. The applicable EU legislation describes some of the allowances' characteristics without defining them as property or a right, while MiFID II recognises them as a financial instrument. While the ETS Directive 2003/87/EC seems to refer to a concept closer to a transferable administrative right or authorisation to emit established for compliance with regulatory obligations subject to administrative control and monitoring, other pieces of legislation such as Article 40 of Commission Regulation (EU) No 389/2013[8] (Registry Regulation 389/2013) describe the allowances as fungible, dematerialised, tradable instruments closer to an asset regulated under property law. Once the allowances are allocated, auctioned or traded, their private holders have a certain degree of freedom in deciding how to use them. As property, allowances are characterised as clearly defined, identifiable, personal, unique and subject to exclusive ownership or use that is irrevocable, subject to registration and transferable without public authority oversight[9]. The allowances have been designated as financial instruments under MiFID II and are therefore regulated under financial services legislation.

The system thus leaves the definition of the legal nature of the allowances to the discretion of the Member States through their national legislation. In practice, the definitions used by Member States vary considerably as a result of this discretion[10]. While some consider allowances to fall into the category of property rights that thus permit their use as securities or financial instruments, some see them as administrative authorisations to emit[11] or *sui generis* administrative rights (personal rights under common law), while others have established a mixed regime, combining different elements[12]. Each of the five selected Member States described in this report takes a different approach to classifying allowances, with none explicitly defining the legal nature of those allowances. Belgium, the UK and France recognise characteristics of a property right in the allowances, while the legislation in Poland and Germany includes elements of both property and administrative rights.

The characterisation and treatment of allowances may have an impact on the development of the emission trading market if treatment in one country conflicts substantially with that in another. While this takes account of individual national contexts and legal frameworks, some authors argue that it may conflict with the principle of legal certainty[13]. This point has also been raised by the European

[8] Commission Regulation (EU) No 389/2013 of 2 May 2013 establishing a Union Registry pursuant to Directive 2003/87/EC of the European Parliament and of the Council, Decisions No 280/2004/EC and No 406/2009/EC of the European Parliament and of the Council and repealing Commission Regulations (EU) No 920/2010 and No 1193/2011, OJ L 122 3.5.2013, p. 1. Available at:
https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536582217356&uri=CELEX:02013R0389-20180101

[9] Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop'. *Journal for European Environmental & Planning Law*, 2005, Vol.2 (2), p. 125.

[10] Gorzelak, K., 'The legal nature of emissions allowances following the creation of a Union Registry and adoption of MiFID II – Are they transferable securities now?', *Capital Markets Law Journal*, 2014, Vol. 9, no 4, p. 373.

[11] AG Campos Sánchez, Opinion, 5 July 2016, ArcelorMittal Rodange and Schifflange, Case C-321/15, p. 1. Available at: http://publications.europa.eu/en/publication-detail/-/publication/3d9ac471-4287-11e6-af30-01aa75ed71a1/language-en/format-HTML/source-search (accessed 28 October 2016).

[12] Clò, S., 'European emissions trading in practice', Chapter 4 Legal and economic aspects of the European Emissions Trading Scheme, Edward Elgar Publishing, 2011, pp. 60-62; Annex I of this document.

[13] Low, K. F. K. and Lin, J., 'Carbon Credits as EU Like It: Property, Immunity, TragiCO$_2$medy?', *Journal of Environmental Law*, 2015, 27, pp. 377–404.

Court of Auditors[14], whose report raised the issue of clarity and legal certainty on the definition of the legal nature of the allowances in order to support the liquidity of the emission market and the creation or protection of security interests in allowances[15]. However, it did not clarify how such a harmonised definition would solve the issues identified in its assessment of EU ETS implementation, or whether it considered the recent changes in the EU financial legal framework and the harmonisation of the consideration of the allowances as financial instruments a sufficient solution. In its response to the European Court of Auditors, the European Commission stated that the 'EU carbon market has grown and matured, despite the fact that the legal status of allowances is not defined at EU level'[16].

The analysis carried out for this study shows that even if the legal nature of allowances was defined by law, the meaning and scope of the rights attached to such classification is not automatic and would still need to be properly determined under the relevant legislation at EU or national level. In this sense, the Advocate General of the ArcelorMittal case[17] argued that a definition of the legal nature of allowances is unnecessary as it is sufficient for the Court to determine whether the allocation and subsequent order to surrender the allowances complies with the ETS Directive 2003/87/EC. The Court ruling on the case did not define the nature of the allowances but held that allowances issued after an operator has ceased its activities performed in the installation to which those allowances relate, without informing the competent authority beforehand, cannot be classified as emission 'allowances' within the meaning of Article 3(1)(a) of the ETS Directive 2003/87/EC [18].

An additional issue is whether Article 345 Treaty of the Functioning of the European Union[19] (TFEU) precludes the EU adopting legislation to clarify the legal nature of the allowances, as it provides that the Treaties shall in no way prejudice Member States' rules governing the system of property ownership. The Court of Justice of the European Union (CJEU) considers this provision an expression of the principle of neutrality of the Treaties in respect of questions of Member States' rules on private or state ownership of companies[20]. According to some authors, this provision does not confer any exclusive powers to deal with property law on either the EU or the Member States. Rather, the Article confirms the neutrality of the Treaty in respect of questions of private or state ownership of companies[21]. The same authors conclude that Article 345 TFEU '…does not concern the content of the right of ownership, nor the objects of a right of ownership. It does therefore not form an obstacle to the development of a European property law'[22].

The characterisation of allowances seems to have evolved in response to the specific issues raised during implementation which affected the functioning of the EU ETS and triggered the modification of several areas of EU law. MiFID II entered into force on 3 January 2018 and defines allowances as

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[14] European Court of Auditors, Special Report No 6, 'The integrity and implementation of the EU ETS', Publications Office of the European Union, 2015, p. 25. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

[15] *Ibid.*

[16] *Ibid.*, p. 66.

[17] Preliminary ruling from the Luxembourg Court, http://publications.europa.eu/en/publication-detail/-/publication/3d9ac471-4287-11e6-af30-01aa75ed71a1/language-en/format-HTML/source-search

[18] CJEU, Case C-321/15 Arcelor v Luxembourg, http://curia.europa.eu/juris/document/document.jsf?text=&docid=188666&pageIndex=0&doclang=FR&mode=req&dir=&occ=first&part=1&cid=157476

[19] Treaty on the Functioning of the European Union, OJ C 306, 17.12.2007, consolidated version. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:12016E/TXT

[20] Joint cases C-105/12 to 107/12 request for preliminary ruling from Hoge Raad der Nederlanden para 29,

[21] Akkermans, B. and Ramaekers, E., at p. 308.

[22] Akkermans, B. and Ramaekers, E. at p. 292

financial instruments. This might explain why the information available on the selected Member States' legal framework affecting the legal nature of the allowances, in particular on the consequences of the recognition of the allowances as financial instruments under MiFID II, is very scarce.

Liquidity of the market for emission allowances has not been a major concern in the EU ETS. Many emitters covered by the EU ETS nevertheless found themselves sufficiently endowed with allocations to cover their compliance needs for current and future years, and therefore did not need to become active on the carbon market. In addition, a surplus of allowances has depressed the price of allowances, limiting the opportunities for intermediaries to realise gains from trade. The obvious option to restore scarcity of allowances was dealt with through the implementation of the Market Stability Reserve[23]. Since the allowances are considered financial instruments, the implementation of MiFID II is an important means of ensuring future liquidity of the EU carbon market. It is therefore necessary to promote the adoption of national measures to provide information and advice, training and capacity-building for operators on the mechanisms for implementation. Similarly, it is necessary to improve cooperation between administrative bodies, in particular between those in charge of the EU ETS and those responsible for MiFID II and the Market Abuse Regulation (MAR) establishing structural mechanisms to ensure systematic cooperation. Although measures have already been taken to tackle criminal activities affecting the allowances (including market abuse and money laundering), there is a need to ensure consistency of the transparency and reporting obligations under MiFID II and Market Abuse Regulation 596/2014.

The VAT Directive 2006/112/EC[24] considers the sale and transfer of allowances to be a supply of services subject to VAT. In response to the so-called 'carousel fraud' in the transfers of allowances from one Member State to another on the secondary spot market[25], the reverse-charge accounting rule was introduced in 2010[26]. It aims to rectify this situation by requiring the payment of VAT by the person to whom the goods and services are supplied, thereby limiting fraud[27]. On foot of positive results, the Commission adopted a proposal to amend the VAT Directive 2006/112/EC with respect to the period of application of the optional reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud and of the Quick Reaction Mechanism against VAT fraud[28]. This proposal to extend the reverse-charge for trade in services up to 30 June 2022 was adopted on 12 November 2018[29].

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[23] Decision (EU) 2015/1814 of 6 October 2015 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC, OJ L 264, 9.10.2015, pp. 1–5.

[24] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347 11.12.2006.

[25] For instance, in the UK, see *R v Dosanjh and others* [2013] EWCA Crim 2366. In France, various individuals and companies have been found guilty of VAT fraud (Nathanael in 2012; Keslassy in 2013). See also Cour des Comptes, 2012, *Rapport public annuel 2012*, pp. 147-196; Robert, A., 2016, 'Deux Français et un Polonais suspects de fraude sur le $CO_2$ encourent de Lourdes peines', *EurActiv.fr*, viewed on 31 January 2017.

[26] Council Directive 2010/23/EU amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse-charge mechanism in relation to supplies of certain services susceptible to fraud.

[27] The measures taken by the EU to prevent VAT fraud on the EU ETS are described in detail in Section 5.2.2.

[28] Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards the period of application of the optional reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud and of the Quick Reaction Mechanism against VAT fraud, COM/2018/298 final - 2018/0150):https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2018%3A298%3AFIN

[29] Council Directive 2018/1695/EU of 6 November 2018 amending Directive 2006/112/EC on the common system of value added tax as regards the period of application of the optional reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud and of the Quick Reaction Mechanism against VAT fraud. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2018.282.01.0005.01.ENG&toc=OJ:L:2018:282:TOC

MiFID II entered into force on 3 January 2018 and defines allowances as **financial instruments**. This classification raises the question of whether or not the application of MiFID II can help to clarify the legal nature of emission allowances at national level, particularly where they confer rights *in rem* or *in personae* or give rise to both types of rights. Although financial legislation does not provide any clarification on the legal nature of allowances, it does, however, clarify the regulatory framework applicable to emission allowances.

Even if MiFID II requirements do not affect the legal nature of emission allowances, they improve efficiency of trading, provide more safety against market abuse, and increase the level of transparency and integrity of emission trading on the secondary market, thus providing a complementary legal framework for the development of the carbon market itself.

The classification of emission allowances as financial instruments raises issues with respect to the possibility of taking and giving collateral when transferring them (by way of a pledge or security interest or by title transfer collateral arrangement). The current legal framework governing the EU ETS imposes limitations on the types of collateral arrangements available to allowance holders seeking to use these as security. While Article 3(1)(38) of Auctioning Regulation (EU) No 1031/2010[30] expressly states that the collateral required from bidders or the auctioneer under Articles 49 et seq. can include 'any allowances accepted as security by the clearing system or settlement system'[31], it is limited to specific situations. The Union Registry does not currently provide for a registration of limited interests (including security interest) in allowances. In its current form, the Financial Collateral Directive 2002/47/EC[32] does not extend its legal protections to financial collateral arrangements involving allowances. It has been suggested that extending the scope of the Financial Collateral Directive 2002/47/EC to allowances would 'bring commercial and legal advantages, [which…] would also be relatively straightforward to implement'[33]. Doing so would offer greater legal certainty to allowance holders and those parties who accept allowances as collateral (such as some clearing houses).

[30] Commission Regulation (EU) No 1031/2010 of 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowances trading within the Community. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536583781488&uri=CELEX:02010R1031-20171108

[31] See the 'Template Escrow Agreement' contained in Annex 7 of the Tender Specifications for the Appointment of a Common Auction Platform, of 31 May 2016. Available at: https://ec.europa.eu/clima/sites/clima/files/20160726tender_specifications_en.pdf

[32] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168, 27.6.2002, p. 43.

[33] See the 'Template Escrow Agreement' contained in Annex 7 of the Tender Specifications for the Appointment of a Common Auction Platform, Ref. Ares(2016)2516039 of 31 May 2016. Available at: https://ec.europa.eu/clima/sites/clima/files/20160726tender_specifications_en.pdf

# Synthèse

La Directive ETS 2003/87/CE ne précise pas la nature juridique des quotas échangés dans le cadre du système communautaire pour l'échange de droits d'émission. La législation européenne propose une description de quelques caractéristiques des quotas, sans pour autant les définir en tant que propriété ou droits, tandis que MiFID II les reconnaît en tant qu'instruments financiers. Si la Directive ETS 2003/87/CE semble faire référence à un concept proche de celui du droit administratif transmissible ou d'autorisation d'émissions établies pour la mise en conformité avec les obligations règlementaires sujettes à un contrôle et un suivi administratifs, d'autres législations telles que l'article 40 du Règlement sur les registres 389/2013[34] décrit les quotas comme des instruments fongibles, dématérialisés et échangeables, plus proches d'actifs tels que régulés par le droit de la propriété. Les quotas une fois alloués, vendus aux enchères ou échangés, leurs porteurs disposent d'un certain degré de liberté quant à leur utilisation. En tant que biens, les quotas sont caractérisés comme étant identifiables, personnels, uniques et sujets à une propriété exclusive et dont l'usage est irrévocable, sujet à l'enregistrement et transférable sans supervision des autorités publiques[35]. Les quotas ont été désigné comme instruments financiers dans le cadre de MiFID II et sont de fait, régulés par la législation relative aux services financiers.

Le système laisse donc la définition de la nature juridique des quotas à la discrétion des Etats membres, au sein de leur législation nationale. Il en résulte qu'en pratique, les définitions utilisées par les Etats membres varient considérablement[36]. Si certains considèrent ces quotas comme faisant partie de la catégorie des droits de propriété, permettant ainsi leur usage en tant que sécurités ou instruments financiers, certains autres les considèrent comme des autorisations d'émission administratives[37] ou, *sui generis,* comme des droits administratifs (droits des personnes en vertu du droit commun). D'autres Etats membres encore ont établit un régime mixte, combinant divers éléments[38]. Chacun des cinq Etats membres décrits dans ce rapport adoptent une approche de classification des quotas et aucun d'entre eux ne définit explicitement la nature juridique de ces quotas. La Belgique, le Royaume-Uni et la France reconnaissent aux quotas les caractéristiques du droit de la propriété, tandis que les législations polonaise et allemande comprennent à la fois des éléments du droit de la propriété et du droit administratif.

La caractérisation et le traitement des quotas peut avoir un impact sur le développement du marché d'échange de droits d'émissions si leur traitement dans un pays entre significativement en conflit avec celui appliqué dans un autre pays. Si compte est tenu des contextes et cadres législatifs nationaux,

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[34] Règlement (UE) No 389/2013 de la Commission du 2 mai 2013 établissant un registre de l'Union conformément à la Directive 2003/87/CE du Parlement européen et du Conseil et aux décisions no 280/2004/CE et no 406/2009/CE du Parlement européen et du Conseil et abrogeant les règlements (UE) no 920/2010 et (UE) no 1193/2011 de la Commission. Disponible à: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536582217356&uri=CELEX:02013R0389-20180101

[35] Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop'. *Journal for European Environmental & Planning Law*, 2005, Vol.2 (2), p. 125 (en anglais).

[36] Gorzelak, K., 'The legal nature of emissions allowances following the creation of a Union Registry and adoption of MiFID II – Are they transferable securities now?', *Capital Markets Law Journal*, 2014, Vol. 9, no 4, p. 373 (en anglais).

[37] AG Campos Sánchez, Opinion, 5 July 2016, ArcelorMittal Rodange and Schifflange, Case C-321/15, p. 1. Disponible à: http://publications.europa.eu/en/publication-detail/-/publication/3d9ac471-4287-11e6-af30-01aa75ed71a1/language-en/format-HTML/source-search (consulté le 28 octobre 2016) (en anglais).

[38] Clò, S., 'European emissions trading in practice', Chapter 4 Legal and economic aspects of the European Emissions Trading Scheme, Edward Elgar Publishing, 2011, pp. 60-62; Annex I de ce document (en anglais).

certains auteurs affirment que cela peut constituer un conflit avec le principe de sécurité juridique[39]. Cet aspect est également souligné par la CCE[40], dont le rapport soulève la question de la clarté et de la sécurité juridique de la définition de la nature juridique des quotas, afin de soutenir la réserve de liquidité du marché des émissions et la création ou la protection des intérêts liés aux quotas[41]. Cependant, le rapport n'apporte pas de clarifications quant à la manière dont une définition harmonisée pourrait résoudre les problèmes identifiés par l'évaluation de la Directive ETS 2003/87/CE, ni ne précise s'il considère les récents changements opérés dans le cadre législatif financier européen et l'harmonisation de la considération des quotas comme instruments financiers comme une solution suffisante. Dans sa réponse adressée à la Cour des comptes européenne, la Commission européenne déclare que 'le marché européen du carbone s'est développé et a mûri, bien que le statut juridique des quotas ne soit pas défini au niveau de l'Union. Les facteurs à l'origine de la liquidité sont essentiellement de nature économique plutôt que juridique'[42].

L'analyse menée dans le cadre de cette étude montre que bien que la nature juridique des quotas ne soit définie par la loi, le sens et le champ d'application des droits qui se rapportent à ces classifications n'est pas automatique et nécessiterait d'être proprement déterminée par la législation au niveau européen ou national. En ce sens l'avocat général dans l'affaire ArcelorMittal[43] estime qu'une définition de la nature juridique des quotas n'est pas nécessaire, puisqu'il suffit à la Cour de déterminer si l'allocation et l'obligation de restituer les quotas qui s'y rapporte sont conformes à la Directive ETS 2003/87/CE. La décision de justice dans le cadre de cette affaire n'a pas défini la nature des quotas, mais estime que les quotas émis à la suite de la cessation d'activités d'un opérateur dans les installations concernées par ceux-ci, sans en informer les autorités compétentes au préalable, ne peuvent être considérées comme 'quotas' au sens de l'article 3(1)(a) de la Directive ETS 2003/87/CE[44].

Il s'agit en outre de déterminer si l'article 345 du Traité sur le Fonctionnement de l'Union Européenne[45] (TFUE) empêche l'UE d'adopter une législation visant à clarifier la nature juridique des quotas constitue, puisque cet article stipule que les traités ne préjugent en rien le régime de la propriété dans les États membres. La Cour de Justice de l'Union européenne (CJUE) considère ces dispositions comme l'expression du principe de neutralité des traités concernant la question du régime de la propriété privée ou de la participation de l'Etat dans les entreprises des Etats membres[46]. Selon certains auteurs, cette disposition ne confère aucune compétence exclusive aux Etats membres ni à l'UE en matière de droit de la propriété. L'article confirme plutôt la neutralité du traité au vu des questions de propriété privée ou de participation de l'Etat dans les entreprises[47]. Les mêmes auteurs concluent que

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[39] Low, K. F. K. and Lin, J., 'Carbon Credits as EU Like It: Property, Immunity, TragiCO$_2$medy?', *Journal of Environmental Law*, 2015, 27, pp. 377–404 (en anglais).
[40] Cour des Comptes européenne, Rapport spécial n°6, ' L'intégrité et la mise en œuvre du système d'échange de quotas d'émission de l'Union européenne (SEQE-UE)', Office des Publications de l'UE, 2015. Disponible à https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=31989
[41] *Ibid.*
[42] *Ibid.*, p. 60.
[43] Décision préliminaire de la Cour du Luxembourg, disponible à: http://publications.europa.eu/en/publication-detail/-/publication/3d9ac471-4287-11e6-af30-01aa75ed71a1/language-en/format-HTML/source-search (en anglais)
[44] CJUE, Affaire C-321/15, Arcelor contre Luxembourg. Disponible à: http://curia.europa.eu/juris/document/document.jsf?text=&docid=188666&pageIndex=0&doclang=FR&mode=req&dir=&occ=first&part=1&cid=157476 (en anglais)
[45] Traité sur le fonctionnement de l'Union européenne, OJC 306, 17.12.2007, version consolidée. Disponible à: https://eur-lex.europa.eu/legal-content/FR/TXT/?uri=celex%3A12012E%2FTXT
[46] Affaires jointes C-105/12 à 107/12, demande de décision préliminaire de la Hoge Raad der Nederlanden, paragraphe 29.
[47] Akkermans, B. and Ramaekers, E., p. 308 (en anglais)

l'article 345 du TFUE 'ne concerne pas le contenu du droit de la propriété, ni l'objet de ce droit de propriété. Il ne constitue donc pas un obstacle au développement d'un droit européen de la propriété'[48].

La caractérisation des quotas semble avoir évolué en réponse aux problèmes spécifiques soulevés durant la mise en œuvre ayant affecté le fonctionnement de l'ETS et ayant causé des modifications dans plusieurs secteurs du droit européen. MiFID II est entré en vigueur le 3 janvier 2018 et définit les quotas comme des instruments financier, ce qui pourrait expliquer pourquoi peu d'informations dont disponibles sur le cadre juridique concernant la nature juridique des quotas de certains Etats membres, en particulier pour ce qui est des conséquences de la reconnaissance, par MiFID II, des quotas comme instruments financiers.

La liquidité du marché des quotas d'émissions n'est pas une préoccupation majeure au sujet de l'EU ETS. Plusieurs émetteurs concernés par l'ETS se sont toutefois trouvés dotés de suffisamment d'allocations pour couvrir leurs besoins en conformité présents et pour les années à venir, et n'ont de fait pas eu besoin de devenir actifs sur le marché du carbone. En outre, le surplus de quotas a eu pour conséquence une dépréciation du prix de ces quotas, limitant ainsi les opportunités, pour les intermédiaires, de s'enrichir sur ce marché. La mise en œuvre de la Réserve de stabilité du marché[49] constitue la solution évidente à laquelle il a été recouru afin de restaurer la rareté des quotas. Les quotas étant considérés comme des instruments financiers, la mise en œuvre de MiFID II est un moyen important afin d'assurer la future liquidité du marché européen du carbone. Il est donc nécessaire de promouvoir l'adoption de mesures nationales afin d'informer, de conseiller, de former et de renforcer les capacités des opérateurs au sujet des mécanismes de mise en œuvre. De même, il est nécessaire d'améliorer la coopération entre les organes administratifs, en particulier entre ceux en charge de l'EU ETS et ceux en charge de MiFID II et de la législation sur l'Abus de marché, qui met en place des mécanismes assurant la coopération systématique. Bien que des mesures aient déjà été prises pour lutter contre les activités criminelles affectant les quotas (y compris les Abus de marché et le blanchiment d'argent), il subsiste un besoin d'assurer la cohérence et la transparence des obligations de rapports dans le cadre de MiFID II et du Règlement relatif aux Abus de marche (569/2014).

La Directive 2006/112/CE relative à la TVA[50] considère la vente et le transfert de quotas comme une prestation de service sujette à la TVA. La règle comptable de l'autoliquidation fut introduite en 2010[51], en réponse à la "fraude carrousel", concernant le transfert de quotas d'un Etat membre à l'autre sur des marchés secondaires[52]. Cette règle a pour but de rectifier la situation en requérant le paiement de la TVA par la personne à qui les biens et services sont fournis, limitant ainsi la fraude[53]. Suite à des résultats positifs, la Commission a adopté une proposition d'amendement de la Directive 2006/112/CE relative à la TVA concernant la période d'application du mécanisme optionnel d'autoliquidation en lien avec la fourniture de certains biens et services susceptibles d'être l'objet de fraudes, ainsi que le

[48] Akkermans, B. and Ramaekers, E., p. 292 (en anglais).

[49] Décision (UE) 2015/1814 du Parlement européen et du Conseil du 6 octobre 2015 concernant la création et le fonctionnement d'une réserve de stabilité du marché pour le système d'échange de quotas d'émission de gaz à effet de serre de l'Union et modifiant la directive 2003/87/CE.

[50] Directive 2006/112/CE du Conseil du 28 novembre 2006 relative au système commun de taxe sur la valeur ajoutée

[51] Directive 2010/23/UE du Conseil du 16 mars 2010 modifiant la directive 2006/112/CE relative au système commun de taxe sur la valeur ajoutée en ce qui concerne l'application facultative et temporaire de l'autoliquidation aux prestations de certains services présentant un risque de fraude.

[52] Au Royaume-Uni par exemple, voir *R v Dosanjh and others* [2013] EWCA Crim 2366. En France, plusieurs individus et entreprises ont été déclarés coupables de fraude à la TVA (Nathanael in 2012; Keslassy en 2013). Voir aussi: Cour des Comptes, 2012, *Rapport public annuel 2012*, pp. 147-196; Robert, A., 2016, 'Deux Français et un Polonais suspects de fraude sur le $CO_2$ encourent de Lourdes peines', *EurActiv.fr*, viewed on 31 January 2017.

[53] Les mesures prises par l'UE pour prévenir la fraude à la TVA sur l'EU ETS sont décrites en détails dans la section 5.2.2.

Mécanisme de réaction rapide contre la fraude à la TVA[54]. Cette proposition d'étendre l'autoliquidation au commerce de services jusqu'au 30 juin 2022 a été adoptée le 12 novembre 2018[55].

MiFID II est entré en force le 3 janvier 2018 et définit les quotas comme des **instruments financiers**. Il découle de cette classification la question de savoir si l'application de MiFID II pourrait contribuer à clarifier la nature juridique des quotas d'émissions au niveau national, en particulier dans les cas où ceux-ci confèrent des droits *in rem*, *in personae*, ou ouvrent la voie à ces deux types de droits. Bien que la législation financière ne fournisse aucune clarification concernant la nature juridique des quotas, elle éclaircit toutefois le cadre législatif applicable aux quotas d'émissions.

Bien que les obligations de MiFID II n'affectent pas la nature juridique des quotas d'émissions, elles améliorent l'efficacité des échanges, procure davantage de sécurité face aux abus de marché et améliore également le niveau de transparence et l'intégrité des échanges d'émissions sur le marché secondaire. Elles fournissent ainsi un cadre juridique complémentaire au développement du marché du carbone lui-même.

La classification des quotas d'émissions en tant qu'instruments financiers pose soulève plusieurs problèmes quant à la possibilité de prendre et donner des garanties lors du transfert de ces quotas (au moyen de gages ou d'intérêts, ou bien par un contrat de garantie avec transfert de propriété). Le cadre juridique actuel relatif à l'ETS limite le type de contrats de garantie disponibles pour les porteurs de quotas cherchant à en faire usage comme de sécurités. L'article 3(1)(38) du Règlement (UE) 1031/2010[56] relatif à la mise aux enchères établit spécifiquement que la garantie requise de la part des soumissionnaires et de l'adjudicateur selon l'article 49 (et suivants) peut inclure 'tout quota accepté en garantie par le système de compensation ou de règlement'[57] mais cette possibilité est limitée à certaines situations. Le registre de l'Union ne fournit pour le moment pas d'enregistrement des intérêts restreints (y compris les intérêts en matière de sécurité) concernant les quotas. Dans sa forme actuelle, la Directive 2002/47/CE[58] relative aux contrats de garantie financière n'étend pas les protections juridiques aux contrats de garantie financière concernant les quotas. Il a été suggéré qu'étendre le champ d'application de la Directive 2002/47/UE relative aux contrats de garantie financière aux quotas 'apporterait des avantages commerciaux et juridiques, [qui…] seraient également relativement simples à mettre en œuvre'[59]. Procéder ainsi offrirait une meilleure sécurité juridique aux porteurs de quotas et aux parties acceptant ces quotas comme garanties (telles que les chambres de représentation).

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[54] Proposition de Directive du Conseil modifiant la directive 2006/112/CE relative au système commun de taxe sur la valeur ajoutée en ce qui concerne l'application temporaire d'un mécanisme d'autoliquidation généralisé pour les livraisons de biens et prestations de services dépassant un certain seuil.

[55] Directive (UE) 2018/1695 du Conseil du 6 novembre 2018 modifiant la directive 2006/112/CE relative au système commun de taxe sur la valeur ajoutée en ce qui concerne la période d'application du mécanisme facultatif d'autoliquidation aux livraisons de certains biens et prestations de certains services présentant un risque de fraude et du mécanisme de réaction rapide contre la fraude à la TVA. Disponible à: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2018.282.01.0005.01.ENG&toc=OJ:L:2018:282:TOC.

[56] Règlement (UE) No 1031/2010 de la Commission du 12 novembre 2010 relatif au calendrier, à la gestion et aux autres aspects de la mise aux enchères des quotas d'émission de gaz à effet de serre conformément à la Directive 2003/87/CE du Parlement européen et du Conseil établissant un système d'échange de quotas d'émission de gaz à effet de serre dans la Communauté..

[57] Voir 'Template Escrow Agreement', Annexe 7 du Cahier des charges relatif à la nomination d'une plate-forme d'enchères commune du 31 mai 2016. Disponible à: https://ec.europa.eu/clima/sites/clima/files/20160726tender_specifications_en.pdf (en anglais).

[58] Directive 2002/47/CE du Parlement européen et du Conseil du 6 juin 2002 concernant les contrats de garantie financière.

[59] Voir 'Template Escrow Agreement', Annexe 7 du Cahier des charges relatif à la nomination d'une plate-forme d'enchères commune du 31 mai 2016..

# 3 Analysis of EU Law

Allowances under the EU ETS are subject to several areas of EU law. As well as the EU ETS legislation itself, certain provisions in the field of financial law, tax law and criminal law are also applicable. In addition, property law, especially the provision in Article 345 TFEU, plays an important role in determining the vertical competence of the EU. The following section describes the relevant provisions of the applicable legislation in order to determine whether and how they affect the legal nature of allowances and their associated consequences. A detailed analysis of the financial, tax and accounting or criminal law is available in Sections 6 and 7 of this report. The legal framework for this study comprises the following legislative acts:

**Table 1 EU ETS allowances - legal framework**

| | |
|---|---|
| EU ETS legislation | • Directive 2003/87/EC (ETS Directive 2003/87/EC)<br>• Commission Regulation (EU) 389/2013 (Registry Regulation 389/2013)<br>• Commission Regulation (EU) No 1031/2010 (Auctioning Regulation 1031/2010) |
| Financial law | • Directive 2014/65/EU on markets in the financial instruments (MiFID II)<br>• Regulation (EU) 2015/848 of 20 May 2015 on insolvency proceedings (Regulation 2015/848)<br>• Directive 2002/47/EC on financial collateral arrangements (Financial Collateral Directive 2002/47/EC, FCD)<br>• Directive 98/26/EC on settlement finality in payment and securities settlement systems (Settlement Finality Directive 98/26/EC, SFD) |
| Tax law | • Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse-charge mechanism in relation to supplies of certain services susceptible to fraud, as amended (VAT Directive 2006/112/EC)<br>• Directive 2010/23/EU amending Directive 2006/112/EC<br>• Council Directive (EU) 2018/1695 of 6 November 2018 amending Directive 2006/112/EC on the common system of value added tax as regards the period of application of the optional reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud and of the Quick Reaction Mechanism against VAT fraud |
| Criminal law | • Regulation (EU) No 596/2014 on market abuse (Market Abuse Regulation 596/2014)<br>• Directive 2014/57/EU on criminal sanctions for market abuse (Market Abuse Directive 2014/57/EU)<br>• Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (Anti-Money Laundering Directive 2015/849/EU) |
| Property law | • Article 345 Treaty of the Functioning of the European Union (TFEU) |

## 3.1 Legislation establishing the EU ETS

ETS Directive 2003/87/EC, Registry Regulation 389/2013 and Auctioning Regulation 1031/2010 are the cornerstones of the EU ETS. None of these regulatory tools explicitly define the legal nature of allowances. However, certain characteristics of allowances - which can be attributed to either property rights or administrative rights or a combination thereof - are directly or indirectly established through several provisions in the EU ETS Directive 2003/87/EC and the two abovementioned Regulations. These characteristics are described in the following section.

### 3.1.1 ETS Directive

While the ETS Directive 2003/87/EC[60] does not define the legal status of allowances, several articles refer to characteristics typical of property or administrative rights.

Article 3(1)(a) defines an allowance as the 'allowance to emit one tonne of carbon dioxide ($CO_2$) equivalent' during a specified period and which shall be valid only for the purposes of meeting the requirements of the ETS Directive 2003/87/EC and transferable only in accordance with the provisions of the ETS Directive 2003/87/EC.

This provision seems to refer to an authorisation, licence or right to emit which has been established for compliance with regulatory obligations, a concept closer to that of an administrative right. It remains unclear, however, whether the issuance of allowances can be considered an authorisation, a licence or the recognition of a right to emit limited by the general cap and the amount of allowances held by operators. The term 'allowance' does not necessarily mean 'right', although it is so reflected in other language versions of the Directive, with 'quota autorisant à emettre' in the French version of the Directive, 'quota di emissioni' defined as 'il diritto di emettere' in Italian, 'Licença de emissão' defined as a 'licença de emitir' in Portuguese, and 'derecho de emisión' defined as 'derecho a emitir' in Spanish. Article 3 of the ETS Directive 2003/87/EC provides each allowance with a common denomination (1 tonne carbon equivalent) and a recognition of its transferability, which are characteristics of a property right[61].

Article 9 of the ETS Directive 2003/87/EC has set out the process for the establishment of an EU-wide quantity of allowances issued each year (the cap), which shall decrease in a linear manner. The Member States allocate a limited number of allowances to national installations of specific industrial sectors for free on the basis of Article 10a (determining transitional harmonised rules for free allocation), which is further developed by uniform free allocation rules embedded in Commission Decision 2011/278/EU (Benchmarking Decision 2011/278/EU)[62], stating that free allocation shall decrease each year by equal amounts. Another method of acquiring emission allowances is through the auctioning process set up under Article 10 of the ETS Directive 2003/87/EC and the Auctioning Regulation 1031/2010.

While allocated for free, the allowances are granted by administrative authorities of the Member States, which thus retain a certain degree of control over that allocation. Again, this is characteristic of an administrative right, where the Competent Authorities have decision-making power. This interpretation was supported by the CJEU in cases C-503/07[63] and Case C-6/08[64] relating to phase II of the EU ETS. The Court posited that it is not possible to derive from the objectives of the ETS Directive 2003/87 (read in the light of recital 5 in the preamble, from criterion 5 in Annex III, or from any other provision of that Directive) **a guarantee for the operators of installations that a particular allocation method will be applied to them, much less that they will obtain a particular**

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[60] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2016, establishing a system for greenhouse gas emission allowance trading within the community.
[61] Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop', *Journal for European Environmental & Planning Law*, 2005, Vol.2(2), p. 125.
[62] Commission Decision of 27 April 2011 determining transitional Union-wide rules for harmonised free allocation of emission allowances pursuant to Article 10a of Directive 2003/87/EC of the European Parliament and of the Council, 2011/278/EU, OJ L 130, 17.5.2011, pp. 1–45.
[63] ECLI:EU:C:2008:207.
[64] ECLI:EU:C:2008:356.

**quantity of greenhouse gas (GHG) emission allowances**. The contested decision was of general application and not of individual concern[65]. In Case C-6/08, the CJEU found that the **quantities planned for allocation by a Member State to certain installations in its National Allocation Plan (NAP) are for guidance only**. A Member State can thus decide to make individual allocations of allowances at levels different to those set out in its NAP, as it is only required to observe the overall emission ceilings and the allocation methods contained in its NAP and as approved by the Commission[66]. **Before being issued, installations do not have any right to have a specific number of allowances allocated to them**. While the harmonised rules may provide for a method to estimate the allowances to be allocated to an installation, the jurisprudence states that they would be considered solely a guidance.

Article 10 of the ETS Directive 2003/87/EC specifies that all allowances not allocated free-of-charge (or placed in the Market Stability Reserve) must be auctioned by the Member States. It further states that the design of the auctions must ensure access for small and medium enterprises. This provision not only ensures non-discriminatory access, it also provides certain rules for its administrative control. The CJEU clarified that neither Article 10 nor any other provision of the ETS Directive 2003/87/EC expressly restrict the power of Member States to adopt policy measures, such as **price controls on the markets** for goods or essential resources, or to determine the manner in which the value of the allowances allocated free-of-charge to producers is to be passed on to consumers. Such measures must not neutralise the principle that some allowances are allocated free-of-charge, nor may they undermine the objectives of the ETS Directive 2003/87/EC[67]. These rules point to consideration of the allowances as administrative rights under the control of the authorities. Other provisions provide for similar administrative controls.

Article 4 of the ETS Directive 2003/87/EC sets out the requirement that every installation carrying out an activity covered by that Directive must hold a GHG emission **permit**. Article 6 of the ETS Directive 2003/87/EC further specifies the conditions for and content of that permit. The need for an operating permit as a prerequisite to carrying out an activity covered by the EU ETS is characteristic of an administrative right of allowances.

According to Article 12(1) of the ETS Directive 2003/87/EC, the allowances can be freely exchanged and should be surrendered according to the verified emissions produced each year. The GHG emission permits shall contain, among other things, an obligation to surrender allowances. This is an obligation of regulatory compliance which is linked to their administrative legal nature. Article 12(1) of the ETS Directive 2003/87/EC also provides that the allowances can be transferred between persons within the EU or between persons within the EU and persons in third countries where the allowances are recognised under the linking provision of Article 25 of the ETS Directive 2003/87/EC. Trade is thus restricted outside the EU and rules only apply in the territory where the trading in allowances may take place. Again, this is characteristic of an administrative right.

Under Article 16 of the ETS Directive 2003/87/EC, allowances have an economic value. Apart from the price that an allowance holds on the market, an ‘administrative penalty’ is assigned to each due allowance. If a holder does not follow the obligation to surrender allowances reflecting emissions, the authority must impose a penalty of EUR 100 per emitted tonne of $CO_2$ that was not matched by a

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[65] Case C-503/07, 8 April 2008, Saint-Gobain Glass Deutschland GmbH v Commission, (Para 76).

[66] Case C-6/08, 19 June 2008, US Steel Košice s.r.o. v Commission of the European Communities, (Paras 63-68).

[67] Joint cases C-566/11, C-580/11, C-591/11, C-620/11 and C-640/11, 17 October 2013 Iberdrola SA and Others. Ref Prelim. Ruling: Spain.

surrendered allowance. The payment of the excess emissions penalty does not release the operator from its obligation to surrender allowances.

Other provisions reflect the administrative control of certain aspects of the EU ETS and these need to be taken into account when assessing the legal nature of the allowances. In its Article 20, the ETS Directive 2003/87/EC introduces a central administrator, which maintains an independent transaction log recording the issue, transfer and cancellation of allowances. The administrator is required to conduct an automated check on each transaction in the registries through the independent transaction log to ensure that there are no irregularities in the issue, transfer and cancellation of allowances. Where irregularities are detected, the Member State(s) concerned will be informed and no further transaction can take place in respect of the allowances concerned until the irregularities have been resolved.

The extent of that administrative right is limited by other provisions that point to the legal nature of allowances as property subject to **private law**. Under Article 19 of the ETS Directive 2003/87/EC, any person can hold allowances individually identifiable through the Union Registry. This Article refers to the need to register allowances in the Union Registry in specific accounts administered by the Member State, and to register the allocation, surrender and cancellation of allowances[68]. It requires the Union Registry to be accessible to the public and to contain separate accounts to record the allowances held by each person to whom and from whom allowances are issued or transferred. This implies that the transfer requires consent between the parties involved, as well as a change in the Union Registry's records (following the procedure established in the Registry Regulation 389/2013 adopted on the basis of Article 19 paragraph 3 of the ETS Directive 2003/87/EC). In the past, before the introduction of the Union Registry, the seller could request the authority in control of the account to transfer allowances from his account in the Member State registry to the account of the buyer. As of phase III of EU ETS, the Union Registry does this automatically in the name of the account holder/representatives. Although the account holder/representatives may ask the national administrator to carry out the transfer, this is not a legal requirement.

Under Article 12 of the ETS Directive 2003/87/EC, allowances are exclusive and individualised, they are not to be transferred or surrendered by anyone other than the holder of the allowance (the entry in the Union Registry is presumed to be correct, see also below under the Registry Regulation 389/2013), which are characteristics of property rights. Article 12 of the ETS Directive 2003/87/EC also establishes that allowances can be cancelled at the request of the holder, implying a certain power of discretion on the part of the holder. While in past phases allowances were issued for a particular period, after the 2018 review of the ETS Directive allowances in the accounts of private entities are valid indefinitely, e.g. beyond the end of the trading period in which they were issued. For the second phase, the ETS Directive was amended to allow for an automatic exchange of the allowances in the account of private entities with allowances valid for the next trading period (Article 13 ETS Directive 2003/87/EC)[69], which is in line with the characteristics of a property right.

[68] Like Article 19 ETS Directive 2003/87/EC, Article 4(3) refers to the obligation to register allowances.

[69] Article 13 ETS Directive 2003/87/EC under the Commission proposal for a Directive amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, COM/2015/0337 - 2015/0148 (COD) states that '*Allowances issued from 1 January 2013 onwards shall be valid indefinitely. Allowances issued from 1 January 2021 onwards shall include an indication showing in which ten-year period beginning from 1 January 2021 they were issued, and be valid for emissions from the first year of that period onward.*'

It can be concluded from the ETS Directive 2003/87/EC, that allowances have both elements that characterise them as administrative rights, and elements (such as their consideration as 'transferable', 'identifiable' and 'available in limited quantities') which seem to be characteristic of property rights. However, the characteristics of administrative rights are linked to the allowances being allocated for free, the amount of which declines every year.

### 3.1.2 Registry Regulation

Registry Regulation 389/2013 was adopted following the revision of the ETS Directive 2003/87/EC in 2009 and in response to the first incidents of VAT fraud and theft[70]. It establishes a single Union Registry, operated by the Commission, replacing the individual Member State registries but taking on the administrative role of the national authorities. The Registry Regulation 389/2013 lays down the general, operational and maintenance requirements for the Union Registry.

The definition of allowances under Article 3(7) and (8) of the Registry Regulation 389/2013 refers to the definition of allowances under Article 3(1)(a) and Article 3c(2) of the ETS Directive 2003/87/EC. While the question of whether the allowances are an administrative right or property remains at the discretion of individual Member States, certain characteristics of allowances can be derived from the text of the Registry Regulation 389/2013, which may provide useful information in determining their legal nature.

Recital (8) Registry Regulation 389/2013 specifies that 'as allowances […] exist only in **dematerialised form** and are **fungible**, the title to an allowance […] should be established by their existence in the account of the Union Registry in which they are held. Moreover, to reduce the risks associated with the reversal of transactions entered in a registry, and the consequent disruption to the system and to the market that such reversal may cause, it is necessary to ensure that allowances […] are fully fungible. In particular, **transactions cannot be reversed, revoked or unwound**, other than as defined by the rules of the Registry, after a moment set out by those rules. Nothing in this Regulation should prevent an account holder or a third party from exercising any right or claim resulting from the underlying transaction that they may have in law to recovery or restitution in respect of a transaction that has entered a system, such as in case of fraud or technical error, as long as this does not lead to the reversal, revocation or unwinding of the transaction. Furthermore, **the acquisition of an allowance […] in good faith should be protected**.'

While most aspects deriving from the Registry Regulation 389/2013 suggest characteristics of the allowances as **property subject to registry, other elements point to characteristics of administrative** rights. A more detailed analysis is presented below.

#### 3.1.2.1 Legal nature of the allowances: their creation and unique unit identification code

The rules establishing that allowances are **issued by public authorities** point to their definition as administrative or regulatory rights. Article 14 Registry Regulation 389/2013 on the creation of allowances states that the central administrator 'may create an EU Total Quantity Account, […] as

[70] See, for example, Euractiv, 'Great carbon theft may have netted EUR 28m of permits', 21 January 2011. Available at: http://www.euractiv.com/section/climate-environment/news/great-carbon-theft-may-have-netted-28m-of-permits/

appropriate, and shall create or cancel accounts and allowances as made necessary by acts of Union law […]'. The Commission is the authority instructing the administrator to create a number of allowances in total equivalent to the number determined in accordance with Article 2(1) of Commission Decision 2010/670/EU (Article 41(2) Registry Regulation 389/2013). According to Article 53 Registry Regulation 389/2013 with respect to free allocation, the central administrator shall ensure that the Union Registry transfers general allowances automatically from the EU Allocation Account in accordance with the relevant national allocation table to the relevant open or blocked operator holding account, having regard to the modalities of the automatic transfer specified in the data exchange and technical specifications.

However, this provision shows that allowances exist from the moment they are in the Union Registry, before they are transferred into the accounts of trade participants where they are treated similarly to any property. The fact that the allowances are subject to registration in the Union Registry places them closer to consideration as property. Based on the intangibility of the allowances, Gorzelak concludes that the record of the Union Registry for the creation of emission allowances acts as the carrier[71], thus the inclusion of the allowances in the Union Registry reflects characteristics linked to their nature as **intangible property rights**.

Each allowance is assigned a unique unit identification code upon its creation (Article 41(3) Registry Regulation 389/2013). This unique unit identification code provides them with an identifiable character which is appropriate to **private property**. However, as a consequence of the theft of allowances, and because in some jurisdictions stolen allowances were identifiable from their serial numbers, these identification codes are no longer displayed in the Union Registry. Rather, they are now anonymous to everyone other than national and central administrators (see Article 83 and Article 110 of the Registry Regulation 389/2013), which may provide them on request to the national competent authority. This limits the risk in trading and establishes greater legal certainty for good faith buyers, despite perhaps creating the impression that emission allowances are not identifiable thus their legal nature as property is less clear cut. The fact that it is technically possible for the administrator (and in some instances the national authorities) to distinguish each emission does not mean that they are non-fungible, much like the fact that serial numbers on banknotes have no impact on their fungibility. It has been argued that the status of a given asset is ultimately determined by its treatment by market participants. Accordingly, 'assets may be fungible if they meet specified and objective measurements and are regarded by market participants as fully equivalent'[72]. For the trading partners involved in the EU ETS, the assignment of the unique unit identification code is irrelevant in relation to the allowances' fungible character. The code is thus merely an administrative measure and does not affect the legal nature of the allowance[73]. However, their fungible character is related to their nature as property rights.

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[71] Gorzelak, K., 'The legal nature of emissions allowances following the creation of a Union Registry and adoption of MiFID II—are they transferable securities now?', p. 383.
[72] *Ibid.*
[73] *Ibid.*

#### 3.1.2.2 EU transaction log

Article 6 of the Registry Regulation 389/2013, together with Article 20 of the ETS Directive 2003/87/EC, establishes a European Union Transaction Log (EUTL) in the form of a standardised electronic database to record the issue, transfer and cancellation of allowances[74]. A 'transaction' is defined in Article 3(14) Registry Regulation 389/2013 as 'a process in the Union Registry that includes the transfer of an allowance, a Kyoto unit, an annual emission allocation unit or a portion of the credit entitlement from one account to another account'. The European Court of Auditors is critical of the fact that, despite the centralisation of the registry, Member States remain solely responsible for opening, managing and updating accounts in their national sections of the Union Registry[75]. It has also stated its dissatisfaction with the fact that the Union Registry does not register price or financial information relating to transactions. As a consequence, national regulators cannot obtain a full picture of any cross-border transaction, even if transactions might be suspicious[76]. The Commission has no supervisory powers in this area, making the issue of cooperation between national regulators even more important in ensuring that the trading of emission allowances is subject to an adequate level of supervision, and that the potential for abuse is kept to a minimum. This is further in line with Recital 25 Registry Regulation 389/2013, which reinforces the need to apply adequate and harmonised requirements to the opening of accounts, authentication and access rights in order to protect the security of information held in the integrated registries system and to avoid fraud. However, these issues of lack of financial information relating to transactions have no bearing on the legal nature of the allowances, nor do the proposed solutions to harmonisation requirements depend on their consideration as either property or administrative rights.

In an attempt to address this issue, the Registry Regulation 389/2013 references the Anti-Money Laundering Directive 2005/60/EC, reflecting the integrated regime created by the legislator to ensure that information on the allowances is shared, as they fall under the regulatory system addressing money laundering and terrorist financing (Article 98 Registry Regulation 389/2013)[77]. Again, this issue is not affected by the legal nature of allowances. Nevertheless, relevant legislation has been adopted to provide a solution to the issues identified.

#### 3.1.2.3 Legal nature of allowances and their transactions in the Union Registry

One of the most important provisions on the legal characteristics of an EU ETS allowance is Article 40 of the Registry Regulation 389/2013. This describes allowances as ***fungible, dematerialised, tradable instruments***, reflecting the way in which such allowances can be used. The dematerialised nature of allowances is a characteristic that is applicable to both property and administrative rights. As described in Section 4.1.2, tangible and intangible property share common characteristics which are different from administrative rights. A fungible nature is more closely linked to assets or objects of property rather than rights. The use of the term 'instrument' alongside such characteristics seems to

[74] http://ec.europa.eu/clima/policies/ets/registry/index_en.htm
[75] European Court of Auditors, Special Report No 6, 'The integrity and implementation of the EU ETS', Publications Office of the European Union, 2015, p. 19.
[76] *Ibid.*, p.24.
[77] See analysis of criminal legislation later in this report.

point to property rather than administrative rights. Article 40 has been criticised for providing only a functional definition of 'allowances' and 'Kyoto units' while overlooking the core question of whether an emission allowance is a property right, personal (administrative) right or something else[78].

A crucial aspect of the legal nature of the allowances lies in the definition of the allowance holder's rights. The best way to provide legal certainty to the **holder's rights** is by registering the allowances. Article 40 provides that the Union Registry constitutes *prima facie* and **sufficient evidence** of title over an allowance. The use of the term 'title' over an allowance could reflect either the title over a property or a right. Any recovery or restitution obligations that may arise under national law in respect of an allowance shall only apply to the allowance in kind. They are not related to any tangible carrier[79]. A transaction becomes final and irrevocable upon its completion. 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 Union Registry, no law, regulation, rule or practice on the setting aside of contracts or transactions shall lead to the unwinding in the registry of a transaction that has become final and irrevocable under this Regulation (Article 40(3)). The right to claim back the same amount of allowances of the same kind is not affected. An allowance can be substituted by any other allowance in case of a legal claim. In addition, an allowance can only be surrendered once (Article 67(3) Registry Regulation 389/2013).

Article 40 of the Registry Regulation 389/2013 refers to the **right of pursuit**. It states that an account holder or a third party shall not be prevented from exercising any right or claim resulting from the underlying transaction that they may have in law, including recovery, restitution or damages, in respect of a transaction that has become final in the Union Registry, e.g. in case of fraud or technical error, as long as this does not lead to the reversal, revocation or unwinding of the transaction in the Union Registry (Article 40(3). This provision provides for the right of 'reivindicatio' (see Section 4.1.2.) of allowance holders, which tends to be a characteristic of a property right. Section 3 of this Regulation refers to the means of acquisition of these rights, i.e. auction, free-of-charge allocation or transaction.

A purchaser and holder of an allowance acting in good faith shall acquire title to an allowance regardless of any defects in the title of the transferor (Article 40(4) Registry Regulation 389/2013). Buyers in good faith thus acquire full entitlement to the purchased allowances. This interpretation is supported by the provisions that preclude the reversal, revocation and unwinding of a transaction in the Union Registry, which would protect the rights of a purchaser of a stolen allowance. While these provisions do not directly address the rights of a victim of theft of an allowance, they provide that it shall not prevent the taking of legal action (including action for damages or other compensation) against the fraudulent party outside the context of the Registry Regulation 389/2013[80]. The definition of good faith is subject to the national law of the Member States. Given the fungible nature of allowances, in cases of theft, breach of contract or insolvency of the account holder, the claim cannot be directed at a specific allowance.

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[78] Interview with the Financial Markets Law Committee (FMLC), 21 March 2017.
[79] Gorzelak, K., 'The legal nature of emissions allowances following the creation of a Union Registry and adoption of MiFID II—are they transferable securities now?', p. 383.
[80] Article 40(3) para 3, and as discussed in the interview with the FMLC on 21 March 2017.

These provisions establish the appropriate system to ensure that the rights of allowance holders are properly protected according to the principles of legal certainty that govern any registry of private property rights.

The exception to this rule is established under Article 70 of the Registry Regulation 389/2013, where the reversal of a transaction is possible but only if '… an account holder or a national administrator acting on behalf of the account holder unintentionally or erroneously initiated a transaction for the surrender or the deletion of allowances or for the exchange of international credits', and the appropriate procedure must be followed in such circumstances. The reversal procedure is determined in detail in Article 70 of the Registry Regulation 389/2013.

Similarly, according to Article 53(4) of the Registry Regulation 389/2013 an operator can perform transfers returning excess allowances to the EU Allocation Account where the central administrator has made a change to the national allocation table of a Member State to correct for an over-allocation of allowances to the operator, and the competent authority has requested the operator to return such excess allowances.

However, an allowance can only be surrendered once (Article 67(3) Registry Regulation 389/2013) and emission allowances are surrendered through a process specified in detail in Article 67 (1)a Registry Regulation 389/2013.

These provisions point to the allowances having the nature of a **property right whose use is controlled by the holder for compliance or trading**. Gorzelak states that the inherent link between emission allowances and their record at the stage of surrender clearly make emission allowances similar to transferable securities, under 'wide apprehension theory'[81]. This means that 'the possession of the carrier of the right is indispensable when the right is being exercised'. This stresses the characteristic of a property right which may be used as a financial instrument. These provisions limit the competent authorities'' capacity to correct, cancel or reverse a transaction of allowances while providing legal certainty to the rights of the holder, irrespective of whether the allowance is considered a property or an administrative right. They reinforce the consideration that it is not technically possible for the competent authority to cancel allowances in a discretionary manner.

Article 32 of the Registry Regulation 389/2013 states that if there is a positive balance of allowances on an account that is to be closed, the administrator shall ask the account holder to specify another account to which the remaining allowances shall be transferred. If the account holder does not respond to the administrator's request within 40 working days, the administrator shall transfer the allowances and Kyoto units to its national holding account. The fact that the transfer of allowances must be approved by the account holder implies the characteristic of a property right of the allowance.

Article 39 on the execution of transfers of allowances states that all transactions within the EU ETS not initiated by an external trading platform require an out of band confirmation to the Union Registry before the transaction can be initiated. A transaction shall only be initiated where an additional authorised representative (or another account representative, where appropriate), whose approval is required pursuant to Article 23(3), has confirmed the transaction out of band (i.e. via text message, token or any other channel that is independent of the first communication channel). Although this

[81] Gorzelak, K., 'The legal nature of emissions allowances following the creation of a Union Registry and adoption of MiFID II—are they transferable securities now?', p. 383.

provision may seem to point to the representative having rights in the allowance, it is in fact simply a security measure that has no bearing on the legal nature of the allowances.

Some critics point out that it is unclear which legislation would apply to cross-border transfers which are not regulated at EU level. However, the definition of the legal nature of the allowances as either a property or an administrative right would not clarify this point[82].

#### 3.1.2.4 Transfer of title in case of insolvency or theft

Following the cyber-attacks (hacking, phishing, etc.) in 2008, the Registry Regulation No 1193/2011 of 18 November 2011 (one of the predecessors of the current Registry Regulation 389/2013) was revised. The revision introduced new provisions imposing a waiting time of 26 hours on all transactions in order to allow any account holder to request the national administrator to cancel a transaction suspected to be fraudulent. Today, these provisions are reflected in Article 39 of Registry Regulation 389/2013.

The consideration of allowances as property is emphasised by the second part of Article 39 of the Registry Regulation 389/2013 which states that if an account representative **suspects that a transfer was initiated fraudulently**, the account representative may request the administrator to cancel the transfer on his behalf before the transfer is communicated for completion. This requires the approval of the account representative. The account representative's rights and decision power on the transfer of the allowance point to its consideration as property.

As Gorzelak states, with respect to transfer of title in cases of **theft** of allowances, 'if such transfers could be declared void or revoked, one could argue that the existence of emission allowances is not fully dependent on records in the accounts in the Union Registry, as a void record would not lead to the cancellation (annulment) of affected emission allowances. However, the removal of the effects of emission allowances theft does not involve the cancellation of finalised records, but it does involve a record of a reverse transaction; hence the bond between emission allowances and their carrier (in the form of a record in the account in the Union Registry) is regarded as inherent, as in the case of transferable book-entry securities in many jurisdictions'[83]. This could be regarded as a characteristic of the allowances' legal nature as property.

The transfer of title in cases of **insolvency** is linked to the question of ownership of the account, and whether it is owned by the installation or the owner of the installation. It depends on whether the allowance accounts are considered as linked to the installation or, rather, the property of the owner of the company operating the installation. In some countries, the liquidator may accept the sale of an installation without the account with allowances, considering them the property of the owner. In those cases, as the installation's operator/company is bankrupt, the debts are not paid but the owner keeps the allowances and can sell them on the market. This may be against Article 25(5) Registry Regulation 389/2013, which clearly states that the '…account holder of an operator holding account may only sell or divest of its operator holding account together with the installation linked to the operator holding account.' By analogy, Article 7 of the ETS Directive 2003/87/EC states: 'Where there is a change in

[82] Interview with the FMLC, 21 March 2017.
[83] Gorzelak, K., 'The legal nature of emissions allowances following the creation of a Union Registry and adoption of MiFID II—are they transferable securities now?'

the identity of the installation's operator, the competent authority shall update the permit to include the name and address of the new operator.' In the same way as the installation holds the permit, so too does it hold the account in the Union Registry and the allowances it contains. The Registry records reflect the history of emissions of the installation and, in case of insolvency, the ownership of the installation should be sold together with a transfer of the operator's holding account pertaining to the installation and the allowances within. This is an indication of the allowances being considered an asset of the company or operator of the installation and therefore subject to property law. However, the fact that the legislation considers the allowances to be linked to the installation or to the owner provides no relevant information on their legal nature.

### 3.1.3 Auctioning Regulation

Auctioning Regulation 1031/2010 establishes rules on the timing, administration and other aspects of the auctioning of allowances under the ETS Directive 2003/87/EC. Since 2013 (the start of phase III), auctioning has become the default method of allocation of allowances. Article 4(1) of the Auctioning Regulation 1031/2010 states that 'allowances shall be offered for sale on an auction platform', which reinforces the idea that allowances are **tradable**. As with the ETS Directive 2003/87/EC and the Registry Regulation 389/2013, the Auctioning Regulation 1031/2010 includes certain provisions which introduce legal characteristics of allowances.

As observed by Mace, 'where tradable units are issued by States as part of an environmental regulatory scheme, they are in the nature of an administrative grant'[84]. On the other hand, the characteristics introduced by the Registry Regulation 389/2013 are to a large extent those of a property subject to registration. Similarly, the Auctioning Regulation 1031/2010 sets up rules which are closer to those governing auctioning a property, or even a financial instrument, traded on the market at the discretion of the holder. The Auctioning Regulation 1031/2010 requires those allowances that were not allocated free-of-charge to be auctioned, prohibiting the use of other means to allocate them, and states that Member States cannot withhold or cancel allowances not allocated for free instead of auctioning them. This is a limitation of the administrative power of the competent authority in order to ensure the implementation of the ETS Directive 2003/87/EC's objectives.

The Auctioning Regulation 1031/2010 includes several provisions which grant allowances the characteristics of a **property right**. For example, successful bidders should be able to trade the allowances they have been allocated in the auction before these allowances are delivered (Recital 41). This is possible due to the **intangible character** of the allowances, and provides more flexibility and freedom to the owner in respect of the legal certainty necessary in any market transaction. In addition, the Auctioning Regulation 1031/2010 includes the option to impose a maximum limit on a single bidder, as a share of the total volume of allowances to be auctioned in individual auctions or in a given calendar year (Recital 50). This characteristic is a limitation to the property right as per the market rules.

The Auctioning Regulation 1031/2010 establishes that allowances can be auctioned either as two-day spot or five-day futures (Article 4). Some provisions refer to the allowances used as securities (collateral). Collateral is defined by Article 3(1)(38) of the Auctioning Regulation 1031/2010 as the

[84] Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop', *Journal for European Environmental & Planning Law*, 2005, Vol.2(2), p.124.

forms of **collateral security** referred to in Article 2(m) of the Settlement Finality Directive 98/26/EC[85], including any allowances accepted as security by the clearing or settlement systems.

The auction platform should ensure the implementation of adequate collateral and any other risk management processes necessary to ensure that auctioneers receive full payment for the allowances auctioned at the clearing price. In line with Article 28 of the Auctioning Regulation 1031/2010, the auction process should be able to ensure the management of the collateral needed to cover any transaction risks (including any margin), provided by the auctioneer or bidders, pursuant to Articles 49 and 50 of the Auctioning Regulation 1031/2010. These provisions treat the allowances as property which may be used to guarantee a debt pending their delivery.

Recital 46 of the Auctioning Regulation 1031/2010 specifies that when the auctioned products are financial instruments this would enable the auctioneer and bidders alike to benefit from the regulatory framework applicable to financial markets. MiFID II ensures that this framework is applicable to all allowances auctioned.

Article 7(4) to (6) Auctioning Regulation 1031/2010 stresses the characteristic of allowances being a property right subject to market rules because of the way in which the auction clearing price, volume of bids and resolution of tied bids are governed.

The characteristic of a **property right subject to trade in the market** is strengthened by Article 22 and Article 24 Auctioning Regulation 1031/2010. In the context of the appointment of the auctioneer/auction monitor, paragraph 5 of Article 22 makes it clear that the allowances to be auctioned on behalf of a Member State shall be withheld from auction whenever that Member State does not have a duly appointed auctioneer in place.

Issues arising in relation to the **allowances within the market** were regulated accordingly as they emerged. Articles 36 to 42 of the Auctioning Regulation 1031/2010 and the Market Abuse Regulation 596/2014[86] forbids market manipulation and insider information (Article 7(c) of the Market Abuse Regulation 596/2014). The Market Abuse Directive 2014/57/EU on criminal sanctions for market abuse[87] introduced new provisions to deter such behaviour. Chapter X of the Auctioning Regulation 1031/2010 is superseded by Market Abuse Regulation 596/2014 as of 1 January 2018, at which time it was immediately applicable to auctioning of spot emission allowances. A common auction platform mitigates the risk of participants using auctions as a vehicle for money laundering, terrorist financing, criminal activity or market abuse (Recital 7 Auctioning Regulation 1031/2010). In defining these terms (Article 3 (17-19), the Auctioning Regulation 1031/2010 refers to the definitions used in the Anti-Money Laundering Directive 2015/849/EU[88] Article 55 of the Auctioning Regulation 1031/2010

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[85] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ L 166, 11.6.1998, pp. 45–50. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536675342507&uri=CELEX:01998L0026-20140917

[86] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (Market Abuse Regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, OJ L 173 12.6.2014, p. 1. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536677455937&uri=CELEX:02014R0596-20160703.

[87] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (Market Abuse Directive), OJ L 173, 12.6.2014, pp. 179–189. Available at:
https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536677651021&uri=CELEX:32014L0057

[88] Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC, OJ L 141, 5.6.2015, pp. 73–117. Available at:

also requires the notification of money laundering, terrorist financing or criminal activity. The national competent authority must therefore monitor and take the necessary measures to ensure that an auction platform complies with the customer due diligence requirements contained in Article 19 and Article 20(6) of the Auctioning Regulation 1031/2010.

The Article 45 provisions on consequences of late or non-payment confirm and establish certain characteristics of the allowances. The allowances will only be delivered to the successful bidder (or its successors in title) if the entire sum due is paid to the auctioneer. In cases of non-compliance by the notified due date, the bidder or its successor is in default of payment and can be charged with one or both of the following: interest for each day beginning with the date on which payment was due and ending on the date on which payment is made, at an interest rate set out in the contract appointing the auction platform concerned, calculated on a daily basis; or a penalty, which shall accrue to the auctioneer less any costs deducted by the clearing system or settlement system. Where a successful bidder is in default of payment, either the central counterparty must intervene to take delivery of the allowances and effect payment of the sum due to the auctioneer, or the settlement agent shall apply collateral taken from the bidder to effect payment of the sum due to the auctioneer. Lastly, in the event of a failure of settlement, the allowances shall be auctioned at the next two auctions scheduled on the auction platform concerned.

Article 46 of the Auctioning Regulation 1031/2010 on the transfer of the auctioned allowances states that they shall be transferred through the Union Registry prior to the opening of a bidding window, into a nominated holding account, to be held in escrow by the clearing system or settlement system acting as custodian, until delivery of the allowances to successful bidders or their successors in title.

In brief, it can be concluded that the Auctioning Regulation 1031/2010 establishes certain rules for the functioning of the auction of allowances in the carbon market and therefore points to their characterisation as intangible property, similar to a financial instrument.

## 3.2 *Financial legislation*

### 3.2.1 MiFID II

According to point (11) of Annex I, Section C of MiFID II, the list of financial instruments includes ‘emission allowances’. This Directive is applicable as of 3 January 2018[89] to allowances traded by professional traders, trading venues and large EU ETS compliance buyers, and has expanded the scope to trading for immediate delivery (spot trading).

Designating allowances as **financial instruments** under MiFID II clarifies how they should be treated and the financial legislation that applies. The inclusion of allowances was justified by the fact that Directive 2004/39/EC (MiFID I) did not consistently cover all segments of the European carbon

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https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536680073594&uri=CELEX:32015L0849

[89] Originally foreseen on 3 January 2017, its entry into application was postponed until 3 January 2018, due to the technical implementation challenges highlighted by the European Securities and Markets Authority (ESMA), national competent authorities (NCAs) and stakeholders (https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid_en#mifid-2-and-mifir).

market - in particular, its rules did not apply to spot emission allowances (traded for delivery at an immediate agreed date). For example, trading venues only offering contracts for spot trade in emission allowances were not covered by MiFID I but since the beginning of 2018 have needed to get a MiFID II authorisation in accordance with their specific profile. The scope of application of MiFID II provisions has been extended to cover primary and secondary spot trading of emission allowances in order to ensure appropriate regulation and oversight of the spot carbon market, as well as to bring consistency to the regulatory framework between the commodity contracts and physical derivatives, as well as between the primary and secondary markets.

The framework for trading in financial instruments that is applicable to emission allowances includes the Market Abuse Directive 2014/57/EU and Market Abuse Regulation 596/2014, MiFID II and Regulation (EU) No 600/2014 on Markets in Financial Instruments (MiFIR)[90]. This framework protects market integrity by introducing greater security for anyone dealing with emission allowances via a trading venue, through a more robust level of oversight, without negative impacts on the carbon market's purpose, i.e. to achieve GHG emission reductions in a cost-effective manner. However, as described in Sections 6 and 7 of this report, the Financial Collateral Directive 2002/47/EC (FCD) does not link its own definition of financial instruments to the definition under MiFID II, thereby excluding emission allowances from its scope[91].

In principle, the definition of emission allowances as financial instruments implies their characterisation with elements typical of a **property right**. The legislative framework described above reinforces this assumption, ensuring protection for owners of allowances considered their property.

Some provisions of MiFID II should be carefully assessed. For example, compliance traders, as well as certain other entities trading emission allowances, are exempt from obtaining a MiFID II authorisation (Article 2(1)(j)(i) of MiFID II) when such persons are dealing in emission allowances or derivatives on their own account. It should be noted that the European Court of Auditors has stated that there is a risk to the market integrity if such entities abuse the exemption introduced by MiFID II by engaging in trading activities not covered by their exemption. The European Court of Auditors also points out that the MiFID II exemption for compliance trading entities might be abused by parties trying to acquire installations for the purpose of buying and selling spot emission allowances without a MiFID II licence. The exemption basically means that those persons dealing on their own account in emission allowances are not covered by MiFID II and therefore do not need to go through the vetting process entailed with being MIFID authorised before they can deal in emission allowances in a trading venue. Although **it does not affect the legal nature of allowances**, this matter is further explored and discussed in Section 7 in response to the concerns expressed by the European Court of Auditors from both a legal and practical point of view.

A range of benefits are expected from the application of EU financial market rules to emission allowances covering all segments of the carbon market, i.e. increased legal security, transparency, efficiency, safety (through minimisation of the risk of market abuse) and consistency. These benefits may have both positive and negative impacts on the main categories of market players, bearing in mind that different regimes may apply, e.g. licensing and possible exemptions provided for in MiFID

[90] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, pp. 84–148).

[91] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, Section 9.1, 2015.

II, and specific information disclosure requirements under the Market Abuse Directive 2014/57/EU and Market Abuse Regulation 596/2014.

Despite classifying emission allowances as financial instruments (i.e. by listing them as a new class of financial instruments in Annex I Section C of MiFID II) for the purposes of market oversight, EU financial market rules **have not affected the legal nature of emission allowances treatment** under national law, nor have they affected their accounting treatment according to recognised standards.

### 3.2.2 Security interests on allowances and treatment of insolvency

Given that allowances have considerable economic value, their legal treatment must also consider whether or not they can be given as security or collateral (or otherwise embedded) and the legal principles applicable to the granting of such third party rights. The legal nature of the allowances might affect or be affected by their use as securities, as this points to their consideration as property whose use is under the control of the account holder. However, this is undermined by the fact that securities cannot be registered in the Union Registry.

According to a recent study, the use of emission allowances by compliance users as collateral for trading activity would be a more productive and efficient rather than simply holding them dormant in their balance sheets or accounts[92].

According to the Auctioning Regulation 1031/2010, allowances can be treated as collateral. For example, before an auction takes place for a two-day spot or five-day future transaction, bidders or their clearing members are required to post collateral in respect of their prospective bids (Article 49 of the Auctioning Regulation 1031/2010). In addition, the auctioneer is to give allowances as collateral to be held in escrow, with the clearing system or settlement system acting as custodian of the allowances until delivery is made (Article 50 of the Auctioning Regulation 1031/2010). Member States may also submit collateral in respect of the auctioning of futures, which will be released and replaced by allowances held in escrow by the clearing system or settlement system acting as custodian.

Past problems, such as the theft of allowances, have undermined the spot market and increased the perceived risk to clearers of holding allowances as collateral[93]. The decline in the price of allowances implies that the value of those allowances as collateral is reduced, while their price volatility exacerbates the perception of risk.

Although the transition to the Union Registry has substantially reduced the security problems and the perception of risk associated with holding or trading allowances as collateral, the stability of the Registry still needs to be demonstrated[94]. While the Registry Regulation 389/2013 does not allow for the registering of security interests *strictu sensu* for emission allowances, the ability to initiate a transaction can be made contingent on the approval of one or more creditors as ‘additional authorised representatives’ (Article 23 paragraph 3 of the Registry Regulation 389/2013), offering a practical way to restrict the ability of an allowance holder to dispose of the allowances without the consent of the

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[92] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, Section 9.2.3.
[93] *Ibid.*
[94] *Ibid.*

creditor[95]. The concept of additional authorised representatives, however, was created for a different purpose and, in practice, the account holder could avoid limitations on its competence because the control of the third party (which is securing its interest) is tied to the account rather than to the allowances themselves. In addition, a number of transactions are exempt from the requirement for additional representatives' approval. For instance, Article 23 paragraph 3(a) of the Registry Regulation 389/2013 excludes 'trusted accounts' which include, *inter alia*, accounts belonging to the same account holder (Article 26 paragraph 2 of the Registry Regulation 389/2013)[96].

Likewise, the Registry Regulation 389/2013 contains a provision to ensure that an operator's holding account is only sold or divested with the installation linked to that account (Article 25(5) of the Registry Regulation 389/2013), complemented by a requirement to update the operating permit where there are changes to the identity of an installation's operator (Article 7 of the ETS Directive 2003/87/EC).

However, the Auctioning Regulation 1031/2010 does not regulate insolvency of the allowance owner using allowances as collateral. A related question concerns the categorisation of allowances for the purpose of insolvency law, including the transfer of title of the allowances to a registry when entities enter insolvency or bankruptcy and the allowances are not liquidated alongside the assets of the insolvent installation. Material legal questions and relevant procedures are largely governed by domestic private law and insolvency provisions of the Member States, although secondary EU legislation also sets out substantive stipulations on specific issues. These provisions and their limitations are referred to in Section 3.1.2 of this report under the Registry Regulation 389/2013 description. However, this issue does not affect the legal nature of the allowances.

Two dedicated acts of secondary EU legislation may also be important in establishing security interests and treatment of insolvency: **Financial Collateral Directive 2002/47/EC** and **Settlement Finality Directive 98/26/EC**. Both acts are described in greater detail below and in Section 7. However, it is worth mentioning here that the Financial Collateral Directive 2002/47/EC's exclusion of allowances presents a barrier to their use as collateral. The Financial Collateral Directive 2002/47/EC offers certain protection to the collateral **taker in an insolvency situation**, such as the elimination of the order of payment of creditors or the restrictions that would impede the realisation of financial collateral (Article 8). It also enables the collateral taker to sell, appropriate or apply the value of the financial collateral towards the discharge of the collateral giver's obligations on an enforcement event. Some authors interpret this to mean that market participants face potential legal uncertainty in relation to emission allowances used as collateral either by way of title transfer or by way of security interest[97].

**Regulation (EU) 2015/848** on insolvency proceedings[98], the 'Insolvency Regulation 2015/848', targets the general harmonisation of insolvency rules across the EU but, as it does not have any material bearing on the nature and treatment of allowances, it is not described here.

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[95] *Ibid.*
[96] *Ibid.*
[97] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, Section 9.2.5.
[98] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, OJ L 141 5.6.2015, p. 19. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1536832977352&uri=CELEX:02015R0848-20180726

It can be concluded that the fact that allowances can be used as securities suggests they are considered property whose use is under the control of the account holder.

### 3.2.3 Financial Collateral Directive

It is important to consider the relationship between the EU legislation on financial instruments and the use of collateral. The Auctioning Regulation 1031/2010 establishes that allowances can be auctioned as financial instruments, either as two-day spots or five-day futures (Article 3), some of which entail **collateral**.

With the adoption of the Financial Collateral Directive 2002/47/EC (FCD), the EU established the legal framework for limiting credit risk in financial transactions through the provision of securities and cash as collateral. Collateral is the asset provided by a borrower to a lender to minimise the risk of financial loss to the lender in the event of the borrower failing to meet in full its financial obligations to the lender[99]. As the rules governing the use of collateral across the EU were previously complex and heterogeneous, the creation of a harmonised EU-wide framework for the use of collateral was envisioned as a priority measure under the Financial Services Action Plan on a single market for financial services[100].

The Financial Collateral Directive 2002/47/EC achieves greater integration of the EU financial markets by simplifying the collateral process, improving legal certainty in the use of collateral and reducing risks for market participants. In particular, it facilitates the taking of financial collateral by abolishing (almost entirely) any formal requirements – such as registration – for its 'creation, validity, perfection, enforceability or admissibility in evidence', and stipulating that collateral only be evidenced in writing or in a legally equivalent manner (Article 1 paragraph 5, Article 3 paragraph 1 and 2). Likewise, enforcement of collateral is facilitated by allowing immediate realisation of the collateral within or outside insolvency proceedings in the event of default (Article 4).

Financial Collateral Directive 2002/47/EC applies its own definition of 'financial instruments'[101], thus classifying allowances as financial instruments within the meaning of MiFID II is not sufficient to bring them within the scope of the Financial Collateral Directive 2002/47/EC. Rather, the scope of Financial Collateral Directive 2002/47/EC is limited to collateral arrangements where at least one of the parties is a public sector body, central bank or financial institution (Article 1 paragraph 2) and, more importantly, covers only collateral in the form of a financial instrument, cash or credit claim (Article 1 paragraph 4a). Financial Collateral Directive 2002/47/EC does not extend its legal protection to financial collateral arrangements using allowances.

The use of allowances as collateral is possible under the current legal framework but is not widespread due to security concerns and the perception that it is high-risk. Despite the fact that few market

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[99] European Commission, Press Release IP/01/464 of 30 March 2001. Available at: http://europa.eu/rapid/press-release_IP-01-464_en.htm?locale=en

[100] Financial Services: Implementing the framework for financial markets: Action Plan, COM(1999)232, 11 May 1999.

[101] The definition of 'financial instrument' in Article 2 para. 1e of Directive 2002/47/EC encompasses 'shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing.'

participants currently accept or provide allowances as collateral[102], extension of Financial Collateral Directive 2002/47/EC safeguards to allowances would afford greater legal certainty to allowance holders and those parties accepting allowances as collateral (such as some clearing houses), potentially lowering opportunity costs for debtors and increasing the market value of allowances. It would, however, require an amendment to the Financial Collateral Directive 2002/47/EC[103].

As indicated in Section 3.2.2, the extension of the Financial Collateral Directive 2002/47/EC to cover allowances could have an impact on the protection of collateral providers or takers in the auctioning context, not only in insolvency situations but also for other cases such as the enforcement of security or the definition of legal title and the applicable law (for further analysis see Section 7).

### 3.2.4 Settlement Finality Directive

An essential part of an effective settlement system is instilling confidence in participants that they are receiving full legal and beneficial ownership or title to the relevant asset or payment at the point of settlement. For the market in allowances, this includes being 'able to point to the time when transfers of allowances or payments in relation to settlement of any allowance or allowance derivatives trade become final and irrevocable', mitigating the risk of, *inter alia*, the insolvency of one of the parties or institutions through which the allowances or cash was transferred[104]. Here, the Settlement Finality Directive 98/26/EC plays a useful role in affording greater certainty to parties to allowance transactions and their settlement. Adopted in 1998, it seeks to reduce the systematic risk associated with participation in payment and securities settlement systems, particularly the risk linked to the insolvency of a participant in such a system.

Settlement Finality Directive 98/26/EC applies to payment and securities settlement systems, as well as to any participant in such a system, and to collateral security provided in connection with participation in such a system (Articles 1 and 2). It guarantees that transfer orders and netting remain legally enforceable in the event of insolvency (Article 3), stipulates that transfer orders become irrevocable from the moment defined by the rules of the settlement system (Article 5), and precludes the retroactive effect of insolvency proceedings, defining the moment of opening of such proceedings (Articles 6 and 7). It also protects the right to collateral security provided in connection with a settlement system against the insolvency of the participant or party who provided the collateral (Article 9).

As far as settlement of security transfers is concerned, Settlement Finality Directive 98/26/EC restricts its scope to financial instruments[105] as defined by MiFID I, thereby excluding spot trading in allowances. With the changes adopted under MiFID II, the safeguards afforded by Settlement Finality Directive 98/26/EC extends to transfers of allowances between the accounts of EU ETS market participants, allowing them to benefit from the same level of settlement protection as cash and other financial instruments. This is particularly relevant for auction platforms in the EU ETS, which is connected to at least one clearing or settlement system pursuant to the Auctioning Regulation

[102] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, p. 57.
[103] *Ibid.,* p. 54.
[104] *Ibid.*, p. 38.
[105] Article 2h of the SFD: '"securities" shall mean all instruments referred to in section B of the Annex to Directive 93/22/EEC' which was repealed by MiFID I and further repealed by MiFID II.

1031/2010 (Recital. 32). It is also intended to protect collateral takers in the secondary market for allowance derivatives[106].

## 3.3 EU legislation to deal with criminal activity, including VAT

Allowances have been directly and indirectly subject to EU criminal legislation, thereby giving an indication as to their legal characteristics. The following analysis focuses on four main legal instruments: the VAT Directive 2006/112/EC, the Market Abuse Regulation 596/2014, the Market Abuse Directive 2014/57/EU and the Anti-Money Laundering Directive 2015/849/EU.

Rules on the taxation and accounting of allowances and related transactions are largely defined at national level, in keeping with the distribution of legislative powers between the EU and its Member States. As a result, they vary considerably across the EU. Efforts to harmonise the relevant legal frameworks have so far been limited to value added tax (VAT), where coordination is an important part of the Single Market and more streamlined cross-border trade in goods and services. These efforts are described in greater detail below.

### 3.3.1 VAT Directive

Each Member State collects VAT at different stages in the supply chain, which is remitted to the national tax authorities, with a small share allocated to the EU in the form of a levy. To facilitate cross-border trading, a common VAT system was put in place in 1977 to eliminate turnover taxes (which distorted competition and hindered the free movement of goods) and to remove fiscal checks and formalities at internal borders[107].

The sale and transfer of allowances are subject to VAT, as they constitute a taxable supply of services under Article 9 of the VAT Directive 2006/112/EC. The initial free allocation of allowances by Member State authorities is not subject to VAT, as these institutions act in a public function within the meaning of Article 4(5) of the VAT Directive 2006/112/EC[108]. Although the VAT Directive 2006/112/EC establishes a harmonised VAT framework for the EU, Member States apply the rules differently in practice, resulting in some heterogeneity.

In order to determine whether or not allowances would fall within the scope of VAT, the VAT Committee[109] discussed the characteristics of allowances and the circumstances under which they are transferred or auctioned[110]. The VAT Committee's various discussions on allowances over the years are relevant to understandings of the legal nature of allowances.

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[106] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, pp. 39 et seq.

[107] Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment.

[108] None of the exemptions provided for in Article 13 of Directive 77/388/EEC can be applied to these transfers of allowances.

[109] The VAT Committee is a special advisory group on VAT, in which Member States and the European Commission are represented. Although it aims to promote the uniform application of the VAT Directive, it is solely an advisory committee and cannot take legally binding decisions but only give guidance on the application of the VAT Directive.

[110] VAT Committee, Question concerning the application of EU VAT provisions: VAT treatment of greenhouse gas emission allowances, Working Paper No 901, taxud.c.1(2016)2049491, April 2016, p. 4.

According to Article 2(1) of the VAT Directive 2006/112/EC specific transactions shall be subject to VAT: a supply of goods or the supply of services within the territory of a Member State by a taxable person acting as such; the intra-Community acquisition of goods for consideration within the territory of a Member State by a taxable person acting as such, or a non-taxable legal person in specific circumstances; and the import of goods.

In 2004[111], the VAT Committee unanimously agreed that the transfer of allowances when made for consideration by a taxable person constitutes a taxable supply of services falling within the scope of the VAT Directive 2006/112/EC[112]. None of the exemptions provided for by the VAT Directive 2006/112/EC[113] could be applied to these transfers of allowances. According to the VAT Committee t**he transfer of allowances is therefore a taxable supply of services in the context of the application of the VAT legislation.**

In 2010[114], the VAT Committee 'almost unanimously' agreed that the auctioning of allowances by Member States under the ETS Directive 2003/87/EC (revised by Directive 2009/29/EC) shall constitute an economic activity within the meaning of Article 9 of the VAT Directive 2006/112/EC, and that the supply of such allowances shall be regarded as a supply of services. It also 'almost unanimously' agreed that where a public body is acting as the seller (auctioneer) in an auction, it shall be regarded as a taxable person in respect of this transaction.

Article 24 of the VAT Directive 2006/112/EC defines a 'supply of services' as any transaction which does not constitute a supply of goods. Article 14 of the VAT Directive 2006/112/EC defines the 'supply of goods' as the transfer of the right to dispose of tangible property as owner. It can be inferred that **the transfer of allowances does not constitute the transfer of the right to dispose of tangible property as owner.** Pursuant to Article 25 of the VAT Directive 2006/112/EC, a supply of services may consist in one of the following transactions: (a) the assignment of intangible property, whether or not the subject of a document establishing title; (b) the obligation to refrain from an act, or to tolerate an act or situation; (c) the performance of services pertaining to an order made by, or in the name of, a public authority or in line with the law.

The VAT Committee agreed that the transfer of allowances falls within the scope of Article 25a) and Article 56(a) of the VAT Directive 2006/112/EC on the supply of miscellaneous services, 'which refers to the place of supply of "*transfers and assignments of copyrights, patents, licences, trademarks and similar rights"* supplied to a non-taxable person who is established outside the Community'. From this, it can be inferred that **the supply of an [allowance] is seen as an 'assignment of intangible property'**, classified as a service pursuant to Article 25(a) of the VAT Directive 2006/112/EC'[115]. **An allowance is therefore seen as an intangible property in the context of EU VAT rules**.

In 2008, cases of EU VAT fraud began to emerge in the context of the transfer of allowances, and this issue is discussed further in Section 6.2.1.

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[111] Guidelines resulting from the 75th Meeting of 14 October 2004, taxud/16/07/05-480.
[112] Article 9(2) of Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment [present Articles 44 and 59(a) of the VAT Directive].
[113] Article 13 of Directive 77/388/EEC [present Articles 132 and 135 of the VAT Directive].
[114] Guidelines resulting from the 91st Meeting of 10-12 May 2010, taxud.c.1(2011)280394-678.
[115] VAT Committee, 2016, p. 5 [emphasis in the original text].

### 3.3.2 Market Abuse Regulation

In addition to Articles 36 to 42 of the Auctioning Regulation 1031/2010 on market abuse, the entry into force of Market Abuse Regulation 596/2014 saw the prohibition of market manipulation and insider information with allowances (Article 7(c) of the latter). Generally, the Market Abuse Regulation 596/2014 establishes a common regulatory framework for insider dealing, the unlawful disclosure of inside information and market manipulation (market abuse) in order to ensure the integrity of financial markets in the EU and enhance investor protection and confidence in those markets[116].

The Market Abuse Regulation 596/2014 applies to various types of financial instruments, such as those admitted to trading on a regulated market, those traded on a multilateral trading facility (MTF), or on an organised trading facility (OTF), etc.[117]. The Market Abuse Regulation 596/2014 clearly provides that allowances fall within its scope as a consequence of the classification of allowances as financial instruments[118]. The Market Abuse Regulation 596/2014 also applies to 'behaviour or transactions, including bids, relating to the auctioning on an auction platform authorised as a regulated market of [allowances] or other auctioned products based thereon'[119].

Article 3(19) of the Market Abuse Regulation 596/2014 provides that an allowance means an allowance as described in point (11) of Section C of Annex I to MiFID II. More importantly, the Market Abuse Regulation 596/2014 gives an indication of some of the characteristics of allowances.

Pursuant to Article 6(3), the Market Abuse Regulation 596/2014 does not apply to the activity of a Member State, the Commission or any other officially designated body, or of any person acting on their behalf, in respect of allowances and undertaken in pursuit of the Union's climate policy in accordance with the ETS Directive 2003/87/EC. Recital 21 clarifies that, pursuant to the ETS Directive 2003/87/EC, the Commission, Member States and other officially designated bodies are, *inter alia*, responsible for the technical issuance of allowances, their free allocation to eligible industry sectors and new entrants, and the development and implementation of the Union's climate policy framework more generally, which underpins the supply of allowances to compliance buyers of the EU ETS. In the exercise of those duties they may access price-sensitive, non-public information and they may need to perform certain market operations in relation to allowances. In order to preserve the ability of these public bodies to develop and implement the Union's climate policy, their activities - insofar as they are undertaken in the public interest and explicitly in pursuit of that policy and concerning allowances - should be exempt from the application of the Market Abuse Regulation 596/2014. However, such an exemption should not extend to cases in which those public bodies engage in conduct or in transactions which are not in the pursuit of the Union's climate policy or when persons working for those bodies engage in conduct or in transactions on their own account[120].

Article 7(c) of Market Abuse Regulation 596/2014 provides that, in relation to allowances or associated auctioned products, *inside information* shall comprise 'information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more such instruments, and

[116] Article 1 of VAT Directive 2006/112/EC.
[117] Article 2(1) of Market Abuse Regulation 596/2014.
[118] Recital 21of Market Abuse Regulation 596/2014.
[119] Article 2(1) of Market Abuse Regulation 596/2014.
[120] Recital 21of Market Abuse Regulation 596/2014.

which, if it were made public, would be likely to have a significant effect on the prices of such instruments or on the prices of related derivative financial instruments'.

Article 8(1) Market Abuse Regulation 596/2014 provides that insider dealing arises where a person possesses privileged information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates. In relation to allowances or other auctioned products based on allowances and held pursuant to the Auctioning Regulation 1031/2010, the use of inside information shall also comprise submitting, modifying or withdrawing a bid by a person for its own account or for the account of a third party. It can therefore be inferred that an allowance is a financial instrument that can be acquired or disposed of like a property.

The Market Abuse Regulation 596/2014 also governs disclosure requirements. Pursuant to Article 17(2), an allowance market participant shall disclose inside information concerning allowances which it holds in respect of its business, including aviation activities, as specified in Annex I to Directive 2003/87/EC or installations within the meaning of Article 3(e) of that Directive which the participant concerned, or its parent undertaking or related undertaking, owns or controls or for the operational matters of which the participant, or its parent undertaking or related undertaking, is responsible, in whole or in part.

The provisions of the Market Abuse Regulation 596/2014 set out the rules for allowances which reflect the characteristics of property.

### 3.3.3 Market Abuse Directive

Market Abuse Directive 2014/57/EU complements the Market Abuse Regulation 596/2014 by establishing minimum rules for criminal sanctions for insider dealing, for unlawful disclosure of inside information and for market manipulation[121].

Similarly, to the Market Abuse Regulation 596/2014, the Market Abuse Directive 2014/57/EU applies to various types of financial instruments, such as those admitted to trading on a regulated market, those traded on an MTF, or on an OTF, etc. It also applies to behaviour or transactions, including bids, relating to the auctioning on an auction platform authorised as a regulated market of allowances or other auctioned products based thereon, including when auctioned products are not financial instruments, pursuant to the Auctioning Regulation 1031/2010[122]. Article 2(5) of the Market Abuse Directive 2014/57/EU also provides that an allowance means an allowance as described in point (11) of Section C of Annex I to MiFID II.

Pursuant to Article 3(5) of the Market Abuse Directive 2014/57/EU, in relation to auctions of allowances or other auctioned products based thereon that are held pursuant to the Auctioning Regulation 1031/2010, the use of inside information shall also comprise submitting, modifying or withdrawing a bid by a person for its own account or for the account of a third party. An allowance can thus be the subject of a bid.

Similar to the provisions of the Market Abuse Regulation 596/2014, the Market Abuse Directive 2014/57/EU seems to consider allowances as a property traded and/or part of the market.

[121] Article 1(1) Market Abuse Directive.
[122] Article 1(2) Market Abuse Directive.

### 3.3.4 Anti-Money Laundering Directive

Anti-Money Laundering Directive 2015/849/EU aims to prevent the use of the EU's financial system for money laundering and terrorist financing[123]. The Directive implements a risk-based legal framework that aims to counter new threats and achieve consistency across all Member States. It also focuses on the promotion of financial stability within the internal market by protecting the proper functioning and integrity of its financial systems and economic prosperity, as well as reducing regulatory cross-border complexities.

The Anti-Money Laundering Directive 2015/849/EU does not refer to allowances. However, it obliges specific natural or legal persons participating in financial or corporate transactions (Article 2(1)) to respect certain customer **due diligence measures to prevent the risk of money laundering on financial markets**[124]. As a result of allowances being classified as financial instruments, the persons directly involved in the trade of allowances, such as intermediaries in the spot carbon trade, thus fall within the scope of the Anti-Money Laundering Directive. 2015/849/EU.

Pursuant to Article 1(3), the following conduct, when committed intentionally, shall be regarded as money laundering:

(a) the conversion or transfer of property, knowing that such property is derived from criminal activity or from an act of participation in such activity, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such an activity to evade the legal consequences of that person's action;

(b) the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of, property, knowing that such property is derived from criminal activity or from an act of participation in such an activity;

(c) the acquisition, possession or use of property, knowing at the time of receipt that such property was derived from criminal activity or from an act of participation in such an activity; […]

It can be deduced that an allowance is a property and that when it derives from a criminal activity or from an act of participation in activities in the context of money laundering (conversion, transfer, concealment, disguise, acquisition, possession, use) it should be subject to the relevant legislation. Article 3(3) of the Anti-Money Laundering Directive 2015/849/EU defines property as 'assets of any kind, whether corporeal or incorporeal, movable or immovable, tangible or intangible, and legal

[123] Article 1(1) Anti-Money Laundering Directive.

[124] The Anti-Money Laundering Directive 2015/849/EU applies to the following entities: 1) credit institutions; 2) financial institutions; 3) auditors, external accountants and tax advisors; 4) notaries and other independent legal professionals, where they participate, whether by acting on behalf of and for their client in any financial or real estate transaction, or by assisting in the planning or carrying out of transactions for their client concerning the buying and selling of real property or business entities; managing of client money, securities or other assets; opening or management of bank, savings or securities accounts; organisation of contributions necessary for the creation, operation or management of companies; creation, operation or management of trusts, companies, foundations, or similar structures; 5) other trust or company service providers; 6) estate agents; 7) other persons trading in goods to the extent that payments are made or received in cash in an amount of EUR 10,000 or more, whether the transaction is carried out in a single operation or in several operations which appear to be linked; 8) providers of gambling services.

documents or instruments in any form including electronic or digital, evidencing title to or an interest in such assets.'

Pursuant to its Article 3(4), criminal activity means any kind of criminal involvement in the commission of specific serious crimes, such as drug-related crime and corruption, or offences punishable by deprivation of liberty, a detention order for a maximum of more than one year or a detention order for a minimum of more than six months, including tax crime. As a result, the Anti-Money Laundering Directive 2015/849/EU covers the laundering of proceeds from VAT fraud in the context of allowances transactions or following allowances theft.

It should be noted that for the functioning of the Union Registry and the auctioning of emission allowances, a tailored regime is established by Article 98 of the Registry Regulation 398/2013 and Article 55 of the Auctioning Regulation 1031/2010 with regard to these types of criminal activities, and this regime is different to that set out by the Anti-Money Laundering Directive 2015/849/EU. The former provide for specific requirements for the notification of suspected money laundering, monitoring and adoption of the measures necessary to ensure compliance with customer due diligence requirements.

## 3.4 Article 345 TFEU

Article 345 TFEU states that '[t]he Treaties shall in no way prejudice the rules in Member States governing the system of property ownership'.

This provision plays an important role in determining the vertical competence of the EU in respect of property law issues. The objective of the Article, as well as its semantic and historical interpretation, is useful in assessing its role here. From a historical point of view, the provision can be traced back to the Schuman Declaration of 9 May 1950. It was first included in the European Coal and Steel Community Treaty (Article 83) and was included, unmodified, in the Euratom Treaty (Article 91), the European Economic Community Treaty (Article 222), the Treaty Establishing the European Community/Union (Article 222, now 295) and finally the Treaty on the Functioning of the European Union (Article 345). Despite its long history, considerable uncertainty and lack of clarity remain on its scope, meaning and content. Nor is it always interpreted consistently[125]. Over time, the provision has been used, for example, to question EU competence to adopt EU legislation that would influence property law issues[126].

The Commission itself seems to consider that the allowances should not be classified by the EU as property rights (or otherwise) because EU law should not regulate aspects of allowances related to property law. In its response to the European Court of Auditors on this issue, the Commission stated that 'in accordance with Article 345 of the TFEU, under Union law, property law is the prerogative of the Member States. This is all the more so in relation to mandating the creation of property rights at

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[125] Akkermans, B. and Ramaekers, E., 'Article 345 TFEU (ex Article 295 EC), Its Meanings and Interpretations', *European Law Journal*, Vol. 16, No 3, May 2010, pp. 292–314 (at p.292).
[126] Examples for both interpretations are included in Akkermans, B. and Ramaekers, E. (at p.292).

EU level with respect to a class of assets where there are no pre-existing property rights in the Member States as the Court has found'[127].

The Commission considers the existence of a specific property law regime of trading assets to be very much the exception rather than the rule for the vast majority of assets exchanged, including financial instruments. However, this does not mean that the normal principles of national contract and property law do not apply to transactions in such assets. The ETS Directive 2003/87/EC and its implementing legislation govern all of the important legal characteristics relating to the exercise of rights over allowances. Rights to hold, transfer, surrender and cancel allowances are fully guaranteed by the ETS Directive 2003/87/ EC and are equally fully supported by the Union Registry within which they can be exercised[128].

The Commission compares the regime applicable to allowances to that applicable to the money held in a bank account and specifies that 'there is, for example, no specific legal regime for money held in a bank account. As such the account holder does not own the money in its account, but merely has a legal claim to it, yet this has not precluded the development of financial markets based on money not only within the EU but worldwide'[129]. Added to that is the fact that there is EU legislation regulating financial markets, with no question of EU competence. The Commission therefore considers that in the current situation and with no further legal action, 'legal interests are duly protected and allowances can be contested as civil matters in national courts'[130].

However, it is not clear that Article 345 of the TFEU prevents the adoption of EU law to regulate certain aspects of concepts with characteristics of property rights. This interpretation does not seem to be the original intention of the legislation, as evident from the placing of the provision in the Treaties. In the EEC Treaty, the provision was part of the General and Final Provisions and was not a central and fundamental provision of the Treaty where competences are defined. The same is true of its placement within the TFEU. Nor was it intended to be a 'safeguard' or limitation to act, as these restrictions were listed under the chapters on policies in the Treaty[131].

Following that interpretation, some authors believe that the provision does not 'concern the content of the right of ownership, nor its objects of a right of ownership'[132]. It does not mean that property law cannot be regulated through European law, as there is EU legislation dealing with property law[133], together with CJEU judgements which deal directly and indirectly with property law[134]. The Treaty Article does not prohibit EU involvement in property issues but merely limits the impact of potential new EU legislation so that it does not undermine Member States' systems of property ownership[135].

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[127] European Court of Auditors, The integrity and implementation of the EU ETS, 2015, p. 60. Available at: https://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf
[128] *Ibid.* p. 60.
[129] *Ibid.*
[130] *Ibid.*
[131] Article 5 TEU; Articles 3, 4 and 6 TFEU.
[132] Akkermans, B. and Ramaekers, E. (at p. 292).
[133] Financial Collateral Directive 2002/47/EC as amended by Directive 2009/44/EC.
[134] Case C-367/98, Commission v Portugal [2002] ECR I-4731, para 48. See also Case C-483/99, Commission v France [2002] ECR I-4781, para 44, Case C-503/99, Commission v Belgium [2002] ECR I-4809, para 44, Case C-302/97, Klaus Konle v Republik Österreich [1999] ECJ I-3099, and Joined Cases C-515/99, C-519/99 to C-524/99 and C-526/99 to C-540/99, Hans Reisch and others v Bürgermeister der Landeshauptstadt Salzburg and others [2002] ECR I-2157; See also Akkermans, B. and Ramaekers, E.
[135] Akkermans, B. and Ramaekers, E. (at p. 292).

Under Joint cases C-105/12 to 107/12, this provision was interpreted by the CJEU as an expression of the principle of neutrality of the Treaties in relation to the rules in Member States governing the system of property ownership by which the Treaties do not preclude, as a general rule, the nationalisation or privatisation of an undertaking[136]. The Court stated that it does not mean that rules governing the system of property ownership in the Member States are not subject to the fundamental rules of the TFEU, which include, *inter alia*, the prohibition of discrimination, freedom of establishment and the free movement of capital[137]. It concludes that Article 345 TFEU must be interpreted as covering rules entailing the prohibition of privatisation, such as those related to the electricity or gas sectors[138].

This interpretation is in line with the semantic interpretation of the Article. The provision was originally drafted in French and warrants looking at the original version to determine its scope and content. In that version it is phrased as '[l]es traités ne préjugent en rien le régime de la propriété dans les États membres'. Acknowledging that all language versions of the Treaty are equally authentic, one can still argue that the French version of 'préjuge' is more neutral than the English version of 'prejudice', which carries negative connotations of damage or detriment. Looking at other language versions of the Treaty, it can be argued that the more neutral phrasing is the intended and prevalent one.

In fact, as suggested by the CJEU in the case *Commission v Portugal*: '[Article 345 TFEU] merely signifies that each Member State may organise as it thinks fit the system of ownership of undertakings whilst at the same time respecting the fundamental freedoms enshrined in the Treaty'[139].

Akkermans and Ramaekers thus conclude that 'Article 345 TFEU, formerly Article 222 EEC, is an Article that limits, but not does prevent, the application of the EC Treaty as a whole to the way in which rules of a Member State deal with the right of ownership of undertakings'. This provision does not confer any exclusive powers on either the EU or the Member States to deal with property law. Rather, the Article confirms the neutrality of the EC Treaty in respect of questions of private or state ownership of companies[140]. The same authors conclude that '…the Article does not concern the content of the right of ownership, nor the objects of a right of ownership. It therefore does not form an obstacle to the development of a European property law'[141].

[136] Joint cases C-105/12 to 107/12, request for preliminary ruling from Hoge Raad der Nederlanden para 29.
[137] *Ibid.*, para 36.
[138] *Ibid.*, para 48.
[139] Case C-367/98, C*ommission v Portugal* [2002] ECR I-4731, para 28.
[140] Akkermans, B. and Ramaekers, E. (at p. 308).
[141] Akkermans, B. and Ramaekers, E. (at p. 292).

# 4 Analytical overview of the legal nature of allowances

## 4.1 Property law

### 4.1.1 Definition of property rights

The definition of ‘property right’ is not consistent across the EU. Despite some ongoing projects aiming to harmonise property law in Europe[142], the EU continues to abstain from action in this domain.

There are several theories for the definition of such a ‘dangerously slippery word'[143] as ‘property right’. On the one hand, realist theory (unanimously accepted until the 19th century) identified a property right as a direct and immediate power over a thing. Third parties cannot lawfully intervene to seize such a thing without the consent of the owner. The personalist theory further developed this approach and considered a property right owed by a person or persons – the property right holder(s) – towards everybody else (*erga omnes*). The prevailing theory now is a synthesis of these two. It defines a property right as the direct and immediate power of using, enjoying and disposing of a thing[144], which is imposed on third parties and members of the legal community[145] as an expression of an ownership right[146]. It includes the ability to accumulate, hold, rent or sell such property.

While credit claims can be freely created by parties under their freedom to contract, in line with the principle of ‘*numerus apertus*’[147], property rights have to be previously **defined by law** based on the principle of ‘*numerus clausus*’ which means that the parties cannot create other property rights in addition to those provided for by law. The law of property prescribes those who may legitimately control property rights[148], which may vary broadly between property rights. The following rights are traditionally considered in respect of property:

**1. Access:** the right to enter a defined physical area and fully enjoy its non-subtractive benefits;

**2. Withdrawal:** the right to obtain resource units or products of a resource system;

**3. Management**: the right to regulate internal use patterns and to transform the resource by making improvements;

**4. Exclusion**: the right to determine who will have access rights and withdrawal rights, and how these rights may be transferred;

**5. Alienation**: the right to sell or lease management and exclusion rights;

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[142] For example the ongoing project under the direction of Christian von Bar from the University of Osnabrück (Germany).
[143] Low, K. F. K. and Lin, J., ‘Carbon Credits as EU Like It: Property, Immunity, Tragi$CO_2$medy?’, *Journal of Environmental Law*, 2015, p. 387.
**[144]** Liberal Fernandes, F., Direitos Reais em Timor Leste: Uma Introdução, October 2015, p. 18.
[145] Ostrom, E. and Hess, C., Private and Common Property Rights, Workshop in Political Theory and Policy Analysis, Indiana University, 2007. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1304699 (accessed 28 October 2016), citing Commons (Commons, J.R., *Legal Foundations of Capitalism*, Madison: University of Wisconsin Press, 1968); in respect of ’enforceability’.
[146] *Ibid*., p. 19.
[147] The only exception is unilateral legal businesses.
[148] Low, K. F. K. and Lin, J., ‘Carbon Credits as EU Like It: Property, Immunity, Tragi$CO_2$medy?’, *Journal of Environmental Law*, 2015, p. 389.

Each of these rights (or a set thereof) can be independently assigned to different individuals according to their positions, as shown in Table below[149].

‘**Claimants’** hold the operational rights of access and withdrawal, together with a collective-choice right of managing a resource. ‘**Proprietors’** hold the same access, withdrawal and management rights (direct and immediate power), but they also have the right to determine who may access and harvest from a property. Finally, ‘**owners’** hold the same access, withdrawal, management and exclusion rights, together with the right of transferring a good in any way they see fit, provided it does not harm the physical attributes or uses of other owners[150].

**Table 1**
**Bundles of Rights Associated with Positions**

| | Owner | Proprietor | Claimant | Authorized User | Authorized Entrant |
|---|---|---|---|---|---|
| Access | X | X | X | X | X |
| Withdrawal | X | X | X | X | |
| Management | X | X | X | X | |
| Exclusion | X | X | | | |
| Alienation | X | | | | |

*Source:* E. Ostrom and Schlager (1996, p. 133).

The differences between these types of property lie in the **transferability** of the rights, but also their **flexibility** and their **elasticity.** Indeed, the ownership right may be subject to contraction for the formation of new rights and may then be expanded later, when the minor property rights are extinct. This also shows that the characterisation of a thing as a ‘property right’ does not mean that its scope is pre-determined, since it can include some or all of the above rights[151].

### 4.1.2 *Property rights characteristics of EU ETS allowances*

#### 4.1.2.1 EU ETS allowances as property rights

In general, the object of **property rights** is anything that may satisfy, directly or indirectly, the need of the human person. It must have **autonomous existence** (i.e. be separate from the individual)[152] and able to be **exclusively appropriated**[153]. These characteristics need to be nuanced for allowances, which are exclusively appropriated by companies or natural persons but have only a certain degree of autonomous (separable) existence, given their intangible nature.

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[149] Ostrom, E. and Hess, C., Private and Common Property Rights, Workshop in Political Theory and Policy Analysis, Indiana University, 2007. Available at: http://surface.syr.edu/cgi/viewcontent.cgi?article=1024&context=sul (accessed 28 March 2017).
[150] *Ibid*., pp. 13–14.
[151] Low, K. F. K. andLin, J., ‘Carbon Credits as EU Like It: Property, Immunity, Tragi$CO_2$medy?’, *Journal of Environmental Law*, 2015, p. 385.
[152] Renderings are excluded from the object of property rights.
[153] Ostrom, E. and Hess, C., Private and Common Property Rights, Workshop in Political Theory and Policy Analysis, Indiana University, 2007. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1304699 (accessed 28 October 2016); Liberal Fernandes, F., Direitos Reais em Timor Leste: Uma Introdução, October 2015, pp. 21-22.

Property rights may be classified as both **tangible and intangible property rights**. Whereas goods or land are tangible objects of property, claims or ideas (including intellectual property[154]) are intangible objects. The distinction between tangible and intangible objects of property rights is very relevant in relation to allowances as they are intangible or dematerialised instruments (Article 40 Registry Regulation 389/2013). Emission allowances were expressly characterised as 'intangible property' in the ruling issued by the High Court of England and Wales in *Armstrong v Winnington*[155]. While intangible property is inseparable from the legal rights created by a legal system (the right itself is the property), tangible property may be separated from the legal rights to it[156]. In this context, the need to define the legal nature of allowances appears critical for some authors: if the legal rights to a thing are protected differently across Member States, this will not change the thing itself. However, if the right itself is the property and changes upon transfer across borders, this may present problems[157].

Once the allowances are allocated for free to an operator or obtained through auctioning or trading, they may be considered to be the property and thus regulated by property law, with specific characteristics, such as being **clearly defined, identifiable, personal, unique and subject to exclusive ownership or use that is irrevocable**[158]**.**

The object of the property may be **transferable (held, sold or bought by anyone)** without unnecessary oversight by public authorities and, while third parties cannot interfere with this property, **they may have rights registered in it**[159]. In this sense, the allowances are transferable and subject to registration but not the rights linked to it, such as the securities which cannot be registered in the Union Registry (although could be subject to a private contract and transferred on that basis). The **management right** (direct and immediate power) of the holder of allowances is quite broad and is similar to that of a property right holder. Property right holders are free to use the thing in any manner they please, which may involve onerous or gratuitous **disposal, destruction or abandonment**. Article 12 of the ETS Directive 2003/87/EC suggests that allowances can be cancelled at the request of the holder, showing a certain power of discretion on the part of the holder.

Tradable emission rights are often considered property rights, as they can be **freely alienable and tradable** (similar to any property). According to Article 40 of the Registry Regulation 389/2013, allowances are **fungible and tradable.** Some Member States consider them movable assets or commodities, which can be used as securities or financial instruments.

Another common feature between property rights and allowances is the issue of the **registry**. Property rights are sometimes subject to registration, which is compulsory for specific goods (namely valuable goods, such as cars, ships and real estate). For such goods, the registry has constitutive effectiveness, i.e. it is a condition of existence of the property right as such. Similarly, Article 19 of the ETS Directive 2003/87/EC and Article 4(3) of the Registry Regulation 389/2013 refer to the need to ensure

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[154] According to some legal systems (e.g. Portugal), the regime for tangible things may nevertheless apply. See Articles 1123 and 1362 of the Portuguese Civil Code.

[155] *Armstrong DLW GmbH v Winnington Network Ltd* [2012] EWHC 10.

[156] Low, K. F. K. and Lin, J., 'Carbon Credits as EU Like It: Property, Immunity, Tragi$CO_2$medy?', *Journal of Environmental Law*, 2015, pp. 382, 402; See also Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop', *Journal for European Environmental & Planning Law*, 2005, Vol.2(2), p. 124, who refers to allowances on the one hand, 'and the rights that attach to these units' on the other.

[157] Low, K. F. K. and Lin, J., 'Carbon Credits as EU Like It: Property, Immunity, Tragi$CO_2$medy?', *Journal of Environmental Law*, 2015, pp. 378, 382.

[158] Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop', *Journal for European Environmental & Planning Law*, 2005, Vol.2 (2), p. 125.

[159] *Ibid*.

an accurate accounting of allowances. According to Article 40(2) of the Registry Regulation 389/2013, '[t]he dematerialised nature of [an allowance] shall imply that the record of the Union Registry shall constitute *prima facie* and sufficient evidence of title over an [allowance]',[160] demonstrating that for allowances, too, there is a registry that defines and delineates their existence. The possibility of being included in the Union Registry also shows that the object of both property rights and allowances is identifiable.

Like other property rights, allowances can be classified according to different characteristics, such as their **duration** (currently permanent but used to be temporary) and **flexibility** (i.e. they may be subject to restrictions by other property rights)[161]. Property rights may be subject to **restrictions**, i.e. some are **perpetual** while others expire. Allowances can be both perpetual and temporary. Indeed, Article 3, *lit*. a) taken together with Article 13 of the ETS Directive 2003/87/EC, shows that allowances were designed as **temporary** from the start (as they relate to emissions that can occur only during a specific period and they are surrendered annually). In addition, the validity of the allowances was limited to the emissions trading period. However, the recently adopted Directive 2018/410/EU amending the ETS Directive 2003/87/EC[162] establishes that the allowances, once issued, will be valid indefinitely (see Section 3.1.1).

The allowances may be considered property, as Article 3(3) of the Anti-Money Laundering Directive 2015/849/EU defines property as 'assets of any kind, whether corporeal or incorporeal, movable or immovable, tangible or intangible, and legal documents or instruments in any form including electronic or digital, evidencing title to or an interest in such assets'. Article 98 of the Registry Regulation 398/2013 and Article 55 of the Auctioning Regulation 1031/2010 refer to this Directive but establish tailored anti-money laundering regimes for the functioning of the Union Registry and auctioning of allowances.

Another characteristic of **property rights** is that they can be **opposed to everyone** due to their *'erga omnes*' effect, while credit claims, for example, can be opposed only to the respective debtors (rights *in personam*)[163]. This means that everyone other than the property right holder[164] must abstain from practising any act which may prevent or hinder the exercise of the holder's property right. This is called 'universal passive obligation'[165], the infringement of which leads to an obligation of reparation[166]. A consequence of this is the 'right of pursuit', including the possibility of claiming it from a third acquirer[167] (*reivindicatio*[168]). The holders of allowances have a right which may be imposed on everyone and is similar to the characteristic of property rights.

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[160] Low, K. F. K. and Lin, J., 'Carbon Credits as EU Like It: Property, Immunity, Tragi$CO_2$medy?', *Journal of Environmental Law*, 2015, p. 402.
[161] Neher, P.A., Ragnar, A. and Mollett, N., *Rights-Based Fishing*, Kluwer Academic Publishers (Dordrecht/Boston/London), p. 82.
[162] Article 13 of Directive 2003/87/EC as amended by Directive 2018/410 of 14 March 2018. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02003L0087-20180408&qid=1536055866531&from=en
[163] For the distinction between rights *in rem* and rights *in personam*, see Low, K.F.K. and Lin, J., 'Carbon Credits as EU Like It: Property, Immunity, Tragi$CO_2$medy?', *Journal of Environmental Law*, 2015, p. 387.
[164] Van Erp, S., From 'classical' to modern European property law?, p.3. Available at: http://ssrn.com/abstract=1372166 (accessed 28 October 2016).
[165] Liberal Fernandes, F., Direitos Reais em Timor Leste: Uma introdução, October 2015, p. 15.
[166] *Ibid*., p. 17.
[167] Exceptions are made for those cases where the third acquirer registered the asset, in which case the principle of legal certainty demands that the right of the third acquirer prevails.
[168] Van Erp, S., From 'classical' to modern European property law? pp.11-12. Available at: http://ssrn.com/abstract=1372166 (accessed 28 October 2016).

Property rights do not **extinguish** over time and lack of use, unlike credit claims which usually expire after a few years, in the interest of certainty and security in legal traffic. However, both property rights and credit claims may be extinguished on performance of the obligation. In line with the nature of property rights, allowances are not extinguished by lack of use although they must be surrendered annually according to verified emissions. In accordance with Article 13 of the ETS Directive 2003/87/EC as amended by Directive 2018/410/EU[169] from 2021 allowances are of indefinite duration).

#### 4.1.2.2 Acquisition, restriction and suppression of property rights

Property rights can be acquired through contract, acquisitive prescription, occupation, and accession through inheritance. Similarly, allowances can be acquired by auctioning - default method (Article 4, no. 1 of the Auctioning Regulation 1031/2010), through free-of-charge allocation granted by the competent authority under Articles 4 and 10 of the ETS Directive 2003/87/EC 2003/87/EC and the Registry Regulation 389/2013 (Section 3, Chapter 2, Title II), as well as by a purchase on the secondary market with or without a record in the Union Registry. Free allocation has been progressively decreasing[170], with the free allocation to manufacturing industry going from 80% in 2013 to 30% by 2020 and the power sector unable to receive free allowances[171].

Despite the variety of means by which they can be acquired, property rights are not absolute: once assigned, they can be **restricted or suppressed** for reasons of a private or public nature. Public restrictions correspond to circumstances where public entities require the assets on a temporary or permanent basis, due to a public interest and against the payment of compensation (Article 17 of the Charter of Fundamental Rights of the EU).

The question remains as to the ongoing relevance and adequacy of the concept of property, in particular whether or not it accurately encompasses new objects, such as emission rights or 'right to pollute' or the use of common public resources. While there is no EU legislation defining the legal nature of allowances, there are several pieces of legislation which include characteristics of **allowances** (see Section 3 above).

#### 4.1.2.3 Rights of the holder when EU ETS allowances are considered property rights

Article 3, *lit*. a) of the ETS Directive 2003/87/EC provides the first indications of the legal nature of allowances. An allowance is defined as an allowance 'to emit one tonne of carbon dioxide equivalent during a specified period'. The holder of allowances has a limited licence or right to pollute and thus has the **right to access** non-subtractive benefits, as outlined above. The operator cannot obtain other pollution units free-of-charge in addition to those allocated, as the purpose of the system is to limit the number of allowances. It can, however, buy them through auction or trading. Other actors may obtain

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[169] Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments.
[170] https://ec.europa.eu/clima/policies/ets/allowances_en (accessed 30 November 2016).
[171] Except for those granted for the modernisation of the power sector in some Member States under Article 10c of the ETS Directive 2003/87/EC.

the right to access the benefits of the allowances owner by buying them through auction or trading with allowances holders.

It is important to distinguish two types of allowance holders: operators of stationary installations or aircraft operators with compliance obligations under the ETS Directive 2003/87/EC; and the voluntary participants in the EU ETS, e.g. financial intermediaries.

Once granted or bought, operators may decide on the use of the allowances, whether to surrender them according to the $CO_2$ emissions, sell or transfer them, or even cancel them (**right of management**), and the circumstances of such sale (**right of exclusion**). However, the EU ETS does not allow operators to leave or be excluded from the system as it is a regulatory scheme which determines those required to comply with certain obligations. This means that once an operator becomes an EU ETS allowance holder with compliance obligations, there is no right of withdrawal from the system. However, allowances can be held by anybody who freely decides to buy and enter into the EU ETS or leave it by selling or cancelling their allowances. The extent of the right to withdraw therefore depends on the type of holder. In addition, even though allowance holders may sell their allowance rights, they lack the authority to participate in the decisions concerning operational rules[172], i.e. allowance allocations. It is the competent authority for each Member State which decides the quantity of allowances allocated to each operator for free, based on the common EU rules of Benchmarking Decision 2011/278/EU. The total quantity of allowances (cap) for a given period and the volumes to be auctioned are governed by the ETS Directive 2003/87/EC, implying that allowance holders have subsequent **alienation rights**.

From the overall analysis of allowances in light of the characteristics of property rights. it can be concluded that the nature of allowances shares significant similarities with property rights and may be subject to property law.

## *4.2* Administrative law

While the ETS Directive 2003/87/EC does not expressly refer to the legal nature of allowances, an early draft proposal of the Directive defined allowances as '**administrative authorisations**'. The Legal Service of the Commission rejected this definition, deeming it to conflict with the principle of subsidiarity[173]. Some Member States (e.g. Bulgaria, Poland and Hungary) recognise the allowances' administrative legal nature, defining them as intangible rights linked to an administrative or regulatory decision by the State or competent authority. This characterisation raises interesting questions as to whether or not allowances have an administrative nature.

Allowances may be considered a licence or right (to emit a certain amount of $CO_2$ during a specific period) when they are granted for free, as it can **be limited by a public authority's decision beyond the private holder's discretion**. This is not only supported by the terminology used by the different versions of the ETS Directive 2003/87/EC (as described in Section 3.1.1) but also by the actual

[172] Schlager, E. and Ostrom, E., 'Property rights regimes and natural resources: A conceptual analysis', *Land Economics*, 68, p. 252.

[173] Pohlmann, M., 'The European Union Emissions Trading Scheme' in Freestone, D. and Streck, D. (eds.), *Legal Aspects of Carbon Trading,* Oxford University Press, 2009, p. 350.

functioning of the emissions trading system, whose objective is to reduce emissions to a level imposed by the public authorities and under the EU ETS regulatory framework[174].

As mentioned above, within the EU ETS, central authorities transfer tradable emission allowances via free-of-charge allocation or auction. Since 2013, auctioning is the primary method of transferring allowances. Free-of-charge allocations can be based either on the historical emissions of the participating entity ('grandfathering') which avoids high initial costs, or on benchmarking (the method currently used) according to performance indicators for the emissions generated by a product in a given sector, thereby rewarding efficient installations. When the **allowances are issued by the State as part of a regulatory scheme** such as the EU ETS, they may be considered an administrative (or regulatory) right (to emit) recognised to ensure implementation of a regulatory framework.

Free allocation is considered to preserve 'the international competitiveness of Europe's industries' and prevent so-called 'carbon leakage'[175], based on the assumption that higher costs (derived from the payment of $CO_2$ emissions) would harm competitiveness. Allowances could be considered as **allocated in the public interest**[176] of environmental protection, while also protecting the rights and legitimate interests of persons. This reflects a traditional characteristic of administrative rights, which typically aim to reach this same balance[177].

The allocation of allowances for free is made within a specific regulatory framework provided by Benchmarking Decision 2011/278/EU. This framework regulates the allocation of allowances in a way that provides incentives for reductions in GHG emissions and energy efficient techniques, with a starting point of 10% of the average performance of most efficient installations in a sector or subsector in the EU in 2007-2008.

Within the EU-wide cap on GHGs, and in accordance with Benchmarking Decision 2011/278/EU, public authorities grant operators a certain number of allowances for free, according to regulatory measures. These can be used for compliance (to be surrendered according to operators' annual verified emissions) or for trade (if the operators manage to reduce their emissions). The public authorities also monitor and verify the emissions produced and the amount of allowances surrendered. The system foresees that the total number of allowances will decrease progressively, based on a linear emission reduction factor applied every year. The fact that number of allowances decreases, setting the path for the effective reduction of emissions – itself the objective of the EU legislation - brings the allowances close to administrative rights[178]. However, the administrative power or control is limited:

- Administrative rights such as allowances are no longer limited in time[179] although operators are required to surrender the amount of allowances corresponding to their verified emissions per year. According to the new version of Article 13 of the ETS Directive 2003/87/EC as amended by

[174] European Commission,'EU ETS Handbook', available at: https://ec.europa.eu/clima/sites/clima/files/docs/ets_handbook_en.pdf (accessed 30 November 2016), p. 16.
[175] Borkent, B.; Gilbert, A; Klaassen, E; Neelis, M.; Blok, K., *Dynamic allocation for the EU Emissions Trading System. Enabling Sustainable growth. Final Report*. ECOFYS, available at: http://www.ecofys.com/files/files/ecofys-2014-dynamic-allocation-for-the-eu-ets.pdf (accessed 1 December 2016).
[176] Vieira de Andrade, J.C., *Lições de Direito Administrativo*, Universidade de Coimbra, 2014, p. 10.
[177] Ibid., p. 21.
[178] Ferreira de Faria adds expiration ('caducidade'), annulment and revocation (Ferreira de Faria, E., 'Curso de Direito Administrativo Positivo', 6th ed., Del Rey, Belo Horizonte, p. 290).
[179] For further details, see section 4.2 on ETS allowances compared to private rights, above.

Directive 2018/410/EU[180], once issued the allowances are valid indefinitely (see Section 4.1.1).

- Once allocated, allowances cannot, in principle, be cancelled or claimed back by the authorities. Similarly, the authorities have little discretion to intervene in relation to the cap or the linear emission reduction factor. While a power of intervention would be justified on the grounds of environmental effectiveness, such administrative power is limited in order to preserve legal certainty. For example, the market stability reserve, established by Decision 2015/1814 and which will start operating from 1 January 2019, aims to address and manage the over-allocation and surplus of allowances. It simultaneously aims to increase the resilience of the European regime by adjusting the number of allowances to be auctioned, according to the market circumstances.
- The market stability reserve is meant to operate in an 'automatic manner', on the basis of pre-determined criteria and conditions, which will effectively reduce the discretionary power of the Commission during its implementation, while increasing the overall transparency and effectiveness of the EU ETS[181].

The determination of the nature of allowances has practical implications whenever they are subject to claim for return, reversal of a transition or cancellation by public authorities[182]. Whether allowances are considered property rights or administrative rights, their holders may **freely transfer** allowances without arbitrary interference from government or regulatory authorities, provided they comply with the legal requirements pertaining to private or public law.

For example, in cases of an erroneous allocation of allowances by the national administrator, the reversal of the allocation should be done in the exercise of administrative power (Article 70(4) Registry Regulation 389/2013), which should follow the requirements established under national public law[183]. If, however, the allowances were considered property, such reversed allocation might be considered an expropriation or a fraudulent transaction that would need to be dealt with under property law[184]. However, the ultimate consequences might be similar. In most Member States, the individual subject to the expropriation has the right to compensation based on the constitutional right to protection of property. A similar right to compensation might be linked to the loss of the allowances as administrative rights affected by an administrative decision.

However, as mentioned in Section 3, reversal of a transaction under Article 70 of the Registry Regulation 389/2013 is possible only if '… an account holder or a national administrator acting on behalf of the account holder unintentionally or erroneously initiated a transaction for the surrender or the deletion of allowances or for the exchange of international credits', and the appropriate procedure must be followed in such circumstances. The reversal procedure is determined in detail in Article 70.

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[180] Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02003L0087-20180408&qid=1536055866531&from=en

[181] Borghesi, S. and Montini, M., 'The Best (and Worst) of GHG Emissions trading systems: comparing the EU ETS with its followers', *Frontiers in Energy Research*, July 2016.

[182] For further aspects of the importance of this distinction, see Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop', *Journal for European Environmental & Planning Law*, 2005, Vol. 2(2), p. 125.

[183] For more details, see ff. section.

[184] *Ibid.*, no 160.

Similarly, according to Article 53(4) of the Registry Regulation 389/2013, an operator who received an over-allocation can perform transfers returning excess allowances to the EU Allocation Account, where the central administrator has made a change to the national allocation table of a Member State to correct for an over-allocation of allowances to the operator and the competent authority has requested the operator to return such excess allowances.

In a recent CJEU preliminary ruling (C-321/15, ArcelorMittal), the Advocate General (AG) of the case argues that the surrender of wrongly allocated emission allowances cannot be treated as expropriation or as the irregular reversal of an administrative act[185]. The AG suggests that under EU law emission allowances allocated in breach of the ETS Directive 2003/87/EC cannot be classified as property forming part of the assets of an operator for the purposes of the guarantees inherent in the fundamental right to property recognised in Article 17 of the Charter of Fundamental Rights[186] or as an authorisation to emit. According to Article 12 of the ETS Directive 2003/87/EC, as well as Article 53(4) and Article 70(4) of the Registry Regulation 389/2013, claiming back of allocated allowances or reversing transactions is not possible unless they have been transferred 'unintentionally or erroneously'[187].

The CJEU ruling on the same case does not define the nature of the allowances but, rather, states that the allowances issued after an operator has ceased the activities performed by the installation to which those allowances relate, without informing the competent authority beforehand, cannot be classified as emissions 'allowances' within the meaning of Article 3(1)(a) of the ETS Directive 2003/87 [188].

## 4.3 Overview of national approaches

Member State national approaches show a degree of divergence in their handling of the legal nature of allowances. Where the allowances are issued and granted for free by Member States as part of an environmental regulatory system such as the EU ETS, they may be considered, by their nature, administrative rights. However, once they are allocated to an operator for compliance or for trading, they assume the nature of a private property. Similarly, when they are auctioned they appear to have the characteristics of property.

Depending on the national context, their legal nature may be considered a property tradable under national rules, or an administrative right, or a mix whereby they are considered regulatory/administrative rights yet may also be used as security (linked to a private property). The classification has consequences for the rights that a holder may assert over the allowances in terms of the security interests they hold, their treatment for tax or accounting purposes, upon insolvency and installation closure, or their coverage as financial instruments.

Several Member States (e.g. Germany, Estonia, Greece and Portugal) decided not to define the legal nature of allowances. Similarly, Slovenia, Sweden and the UK have not defined the legal nature of the allowances but refer to them according to the EU legislation, as fungible, dematerialised and tradable

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[185] http://publications.europa.eu/en/publication-detail/-/publication/3d9ac471-4287-11e6-af30-01aa75ed71a1/language-en/format-HTML/source-search

[186] Opinion of Advocate General Campos Sánchez-Bordona delivered on 5 July 2016 (1) Case C-321/15 b ArcelorMittal Rodange et Schifflange SA v Grand Duchy of Luxembourg.

[187] C-321/15 ArcelorMittal Rodange and Schifflange, ECLI:EU:C:2017:179.

[188] *Ibid.*

instruments. However recent jurisprudence in the UK points to the consideration of allowances having the legal nature of property rights[189].

Several national legal systems recognise the **dual nature** of the allowances. Polish legislation considers allowances to be a tradable property right which can be used as financial instruments (collateral) while maintaining their administrative law nature. In Bulgaria, those allowances allocated for free are considered state grants while those that are traded are considered to be assets similar to property[190]. Hungarian legislation considers allowances to be **rights** with a property value that are dematerialised, immaterial and transferable[191]. Here, the allowances can (also) be owned by the state (Article 12(2) of Act CCXVII of 2012)[192], thus the free allocation of allowances is state aid and should be treated under the relevant legal framework.

Other Member States' legislation recognises allowances as **property**. Cyprus, Latvia, the Netherlands, Portugal and Spain, among others, consider allowances an asset, good or commodity of intangible or undifferentiated nature, which are subject to property rights. France considers them a tangible asset materialised in the account of the holder on the register, while Denmark defines them as chattel in the companies' accounts, which are exempt from taxation when allocated for free and whose acquisition costs can be deducted by the buyer from tax purposes. While Italy considers them a commodity, Austria, Croatia, Finland, Ireland and Romania define them as financial instruments subject to property rights. Despite the different approaches to property law by the different European traditions, all can be seen to share a 'classical' model of property law, the characteristics of which were described above[193.]

The information on the national approaches is summarised in Table 3 below, which highlights the significant differences in Member State approaches.

**Table 3. Member States' national approaches to the legal nature of allowances**

| **Property** | **Administrative right with property character (Double nature)** | **No definition** |
|---|---|---|
| CY, FI, LT, ES: intangible assets or undifferentiated goods | PL: allowances are tradable property rights which can be used as financial instruments (collateral) while maintaining their administrative law nature | EE, EL, PT, SI, SE |
| FR: tangible asset materialised in the account of the holder on the register | BG allowances allocated for free are considered State grants while those that are traded are considered assets similar to property | |
| DK: chattel in the companies' accounts which are exempt from taxation when allocated for free and whose acquisition | HU considers allowances to be rights with a property value that are dematerialised, immaterial and | UK, although jurisprudence points to consideration of allowances as property |

[189] See the UK case *Armstrong DLW GmbH v Winnington Network Ltd* [2012] EWHC 10 (Ch), which considered allowances a 'property right of some sort'.
[190] Information from MSs' Report on Article 21 of ETS Directive 2003/87/EC on the legal nature of allowances, as attached to the tender specifications
[191] Art 12. Act No. CCXVII of 2012 on the participation in the EU ETS and in Effort Sharing (http://njt.hu/cgi_bin/njt_doc.cgi?docid=157827.328179)
[192] *Ibid.,* Article 13.
[193] Van Erp, S., From 'classical' to modern European property law? Available at: http://ssrn.com/abstract=1372166 (accessed 28 October 2016).

| costs can be deducted by the buyer from tax purposes | transferable | rights |
|---|---|---|
| IT: commodity | | |
| AT, HR, FI, IE and RO define them as financial instruments | | |

## 4.4 Conclusion

EU ETS allowances have elements of both public/administrative rights and private property rights. They may be considered administrative rights issued by public authorities to private holders that can use them for compliance and are subject to state control whereby the authorities are required to monitor and verify emissions and number of allowances to be surrendered. Once the allowances are allocated to an operator or obtained through auctioning or trading, private holders have a certain degree of freedom in deciding how to use the allowances received, auctioned or bought, excluding others from interfering with their property, and using them by either holding or transfer. They may be considered property and are thus regulated by property law, as they have specific characteristics, such as being clearly defined, identifiable, personal, unique and subject to exclusive ownership or use that is irrevocable[194]**.** They are freely alienable, transferable without unnecessary oversight by public authorities, of dematerialised nature and subject to registration.

[194] Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop'. *Journal for European Environmental & Planning Law*, 2005, Vol.2 (2), p. 125.

# 5 Legal analysis of selected Member States' legislation

## 5.1 Methodology

This section presents a detailed comparative legal analysis of the treatment of allowances according to the provisions of the relevant national legislation in Belgium, Germany, France, Poland and the UK. These Member States were selected for the scale of their trade in allowances and their relevance to the current set up of the EU ETS and the primary market.

The provisions and rules applicable in each of these five Member State have been identified, using the legal definition of allowances each has adopted. The legal analysis distinguishes between three broad approaches taken by Member States in relation to the legal nature of EU ETS allowances: a) tangible assets subject to property rights/law which enables them to be used as securities for financial instruments; b) licence or administrative right to emit GHGs, which holds allowances to be an intangible asset with certain characteristics of property (dual nature); or c) no definition of the legal nature of the allowances.

The legal analysis is based on the information provided by the national reports developed for each of the selected Member States. It entailed a review and legal analysis of the relevant legislation, literature review and desk research, and interviews with relevant authorities in the Member States either by phone or email. The analysis covers the classification of allowances in each national legal system, the description of the characteristics implied by such classification, and the consequences of their legal nature in terms of liquidity of the market and legal certainty. The analysis also examines the transfer of title of allowances and the extent to which the establishment of security interests over the allowances is possible under each jurisdiction, the consequences of using the allowances as financial instruments, their treatment by taxation and accounting law, and in cases of insolvency, fraud or other serious crime.

The legal analysis identifies similarities and differences in the regimes of the selected Member States (to the degree of detail required by the thematic analysis in Section 6). The analysis covers the following elements:

- Classification of allowances as property rights (*in rem, in personae*), as administrative rights or *sui generis* rights, and the description of the characteristics derived from such classification;
- Transfer of title over allowances;
- Impact of the classification of the allowances on liquidity of the market in allowances;
- Impact of such classification on legal certainty in relation to possible administrative discretion to cancel allowances, claim allowances back in case of free allocation, or withdrew allowances from the market;
- Extent to which the establishment of security interests is possible under each jurisdiction;
- Treatment of allowances as financial instruments in compliance with MiFID II, including the status of transposition;
- Treatment of allowances for taxation and accounting;
- Treatment of allowances in cases of insolvency, theft, fraud or other serious crime.

## 5.2 Classification of the allowances and overview of characteristics in the selected Member States

Questions asked in order to identify the classification of allowances:

- What is the legal nature of the allowances in the Member State (property rights, administrative rights, regulatory rights)? Is the legal nature of allowances recognised in the national legislation?
- What are the characteristics of the allowances deriving from their classification under the national system?
- Is there any other applicable legislation?
- What are the national court cases where the legal nature of allowances has been dealt with and what are the key findings in relation?
- What are the (legal) consequences of the legal nature of allowances in terms of legal certainty, security and flexibility of the EU ETS market?

### 5.2.1 Legal nature of EU ETS allowances

#### 5.2.1.1 What is the legal nature of the allowances according to the legal order of the selected Member States?

The five selected Member States have established different approaches in classifying allowances, not all of which recognise the legal nature of such allowances in their national legislation. Most of the five Member States include a definition of allowances similar to that of the EU ETS legislation. The Member States analysed (except France) do not define the legal nature of allowances. Belgium, the UK and France attribute characteristics of a property right to the allowances, while the legislation in Poland and Germany includes elements of both property and administrative rights.

For example, in **Germany,** neither the Emission Trading Act (*Treibhausemissionshandelsgesetz*, TEHG) which implements the EU ETS regime, nor any other act, contains an explicit statement on the legal nature of emission allowances. In Germany, an allowance is defined as '*Berechtigung*' in the TEHG, more specifically in § 3 Nr. 3: The allowance is the right/authorisation ('*Befugnis*') to emit a ton of $CO_2$ equivalent within a certain period of time. In the German legal literature, arguments are made for their public nature and private nature, as well as for a 'hybrid' nature with elements of both. As of November 2016, § 7 para. 5 TEHG did not recognise the emission allowances or securities as financial instruments and continued to exclude them from the scope of both relevant financial market acts (the German Securities Trading Act (*Wertpapierhandelsgesetz*, WpHG) and the German Banking Act (*Kreditwesengesetz*, KWG)). Since 2018, following MiFID II transposing obligations, the legislation has been amended and emission allowances are included as 'financial instruments' under the § 2(4) No. 5 WpHG and are therefore covered by the Banking Act (§1(11) No 9 KWG. In 2012, the highest German administrative court (*Bundesverwaltungsgericht*, BVerwG, 10.10.2012, 7 C 9/10) reviewed the German act allocating allowances for the 2008-2012 commitment period (*Zuteilungsgesetz* 2012, ZuG 2012). It considered whether or not the national authority's decision to assign fewer allowances than requested infringed (*inter alia*) the claimant's rights of property (Article 14 German Constitution, *Grundgesetz* (GG)). The Court based the right of property on the fact that the claimant was the owner of the emitting facilities. However, it did not argue that emission allowances themselves constituted property.

The situation is similar in **Poland.** Even though an emission allowance is defined in Article 3(22) of the Law of 12 June 2015 on the trading scheme for GHG emission[195] (the EU ETS Law), this definition is quite vague and does not provide a direct answer on the legal nature of allowances. This is also true of all other pieces of Polish legislation. According to the Polish definition, an emission allowance is an entitlement to introduce to the ambient air an equivalent of carbon dioxide which (this entitlement) is issued in the framework of the GHG emission trading system and used for settling (calculating) the amount of emissions in that system and which may be disposed of in accordance with the rules set out in law.

However, this definition implies that an emission allowance is of a public/administrative nature. The realisation of the entitlement to introduce to the ambient air an equivalent of carbon dioxide requires certain actions from the public authority, e.g. the emission allowances are generated and managed in the framework of the national GHG emission trading system administered by public authorities, the operator is required to have an emission permit issued by public bodies. The definition also indicates that emission allowances may be 'disposed of' within the emission trading system and according to the applicable law. The term 'disposed of'' is vague and possibly covers all management activities related to allowances, including trade, transfer, surrender, limitation, encumbrance, etc. Since allowances are not tangible goods but can be transferred by certain instruments of civil law, they have characteristics of intangible property rights. Equally, as they may be subject to limitation or encumbrance (they may be 'disposed of'), they can be treated as securities. The definition also indicates that they can be pledged as collateral[196].

According to the judgment of the Voivodship Administration Court in Warsaw of 23 June 2001 (No IV SA/Wa 824/14) and the judgment of 24 June 2014 (No IV SA/Wa 822/14), an emission allowance shall be understood as a unit that specifies the amount of allowable emissions, and an entity who has rights to this unit can sell it, transfer to another entity and, above all, can use it to settle its own emissions, which will result in a 'surrender'. The definition of the 'allowance' fails to determine its legal nature. An allowance is a 'virtual' security (i.e. not materialised in a relevant document). Allowances are given the character of a financial instrument within the meaning of the Act of 29 July 2005 on Law on financial instruments' trading. In addition, allowances are property rights acquired against a payment. Emission allowances may thus be seen as public administrative/regulatory rights with characteristics of both tradable intangible property rights and financial instruments, which may be used as collateral or securities[197].

The legal nature of allowances is defined in **French** law. According to Article L.229-15 of the Environment Code (last modified by Ordinance no 2012-827 of 28 June 2012): '*The GHG emission allowances issued to the operators of facilities authorised to emit these gases or aircraft operators are personal properties exclusively materialised by being listed on the account of their holder in the national register mentioned in Article L. 229-16. They are negotiable, transmissible by transfer from*

[195] http://www.kobize.pl/uploads/materialy/prawo/akty_prawne_PL/ustawa.SHE.2015.1223.pdf.

[196] http://ecomanager.pl/kradzieze-uprawnien-do-emisji-co2/, Gorzelak, K., Uprawnienia do emisji jako przedmiot obrotu i zabezpieczeń, Praca doktorska przygotowana pod kierunkiem
prof. dr hab; Chłopeckiego, A., available at:
https://depotuw.ceon.pl/bitstream/handle/item/971/UPRAWNIENIA%20DO%20EMISJI%20-%20PRACA%20DOKTORSKA%20(wersja%20ostateczna).pdf?sequence=1.

[197] Kłaczyńska, K., *Prawne konsekwencje kradzieży uprawnień do emisji $CO_2$ – wybrane zagadnienia*, http://www.cire.pl/item,51971,14,5,6,0,171270,0,prawne-konsekwencje-kradziezy-uprawnien-do-emisji-co2---wybrane-zagadnienia.html#komentarz, confirmed by an interview with a representative from the Polish Ministry for Environment, ETS Department.

*account to account, and confer identical rights upon their holders. They may be transferred as soon as they are issued, subject to the provisions of Article L. 229-18'.* According to these provisions, allowances are movable assets (or chattel) in French law. They may be transferred after they are issued and listed in the holder's registry account where private property is materialised. As of 3 January 2018, allowances may also be considered financial instruments for the application of certain provisions of the Financial and Monetary Code as amended by Ordinance no 2016-827 of 23 June 2016 transposing MiFID II into French Law (see Section 6 below).

In **Belgium,** the Flemish Decree of 15 April 1995 containing general provisions of environmental policy[198] and the Ordinance of 2 May 2013 containing the Brussels Code for Air, Climate and Energy[199] define an 'allowance to emit' ('*emissierecht*') in the same manner as the ETS Directive 2003/87/EC, i.e. as a 'transferable right to emit one tonne of $CO_2$-equivalent GHG emissions during a specific period or trade period'. The Walloon Climate Decree[200] does not contain a separate definition of an allowance but takes a similar approach, using the term 'quota'. There is no further indication of the legal nature of allowances under Belgian legislation, nor does the legal literature contain a single clear legal qualification of an emission allowance. A distinction is often made between the legal nature of the right to emit $CO_2$ and the allowance for emitting $CO_2$. This lack of clarity is noted in the 2008 advice from the Commission for Accounting Norms on the accounting rules for GHG allowances[201]. The Commission states that the legal qualification of GHG allowances is still contested. Some scholars consider the emission allowance to be a property right at a place in the atmosphere where a tonne of $CO_2$ is emitted, while others hold it to be the manner in which a debt is paid, created by the EU ETS, and which can only be redeemed by means of allowances. In that case, the allowances would be a sort of currency. Others consider the allowance to be an intangible movable property right ('*onlichamelijke zakelijke roerende rechten*')[202]. Finally, some argue that the emission allowances are a right *sui generis*.

In an advisory opinion issued in September 2016 for Case C-453/15, AG Wathelet held that 'in Belgium there is no statutory definition of the legal nature of allowances, but they are considered to be intangible movable property'. However, the AG notes that the property rights are, in this particular case, regulated under Belgian law. Interviews with the competent authority in Belgium were less certain in respect of the legal nature of the emission allowances in the country. Overall, an emission allowance may be considered an intangible movable property right under Belgian Civil law, although specific requirements would apply (as set out in law), due to the particular characteristics of the EU ETS and the purpose of the allowances in this context. A case brought before the Belgian Constitutional Court in 2006[203] by n.v. Cockerill Sambre and s.a. Arcelor, requesting the annulment of the transposing Decree of ETS Directive 2003/87/EC in the Walloon Region, provides some clarity about the legal nature of emission allowances. The Court concluded that the operator of an installation

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[198] https://navigator.emis.vito.be/mijn-navigator?woId=60986

[199] http://www.ejustice.just.fgov.be/cgi_loi/change_lg.pl?language=nl&la=N&cn=2013050209&table_name=wet

[200] http://environnement.wallonie.be/legis/air/air074.html

[201] Commissie voor boekhoudkundige normen, 'Boekhoudkundige verwerking van broeikasgasemissirechten', CBN Advies 179/1 van 26 November 2008 (Update November 2008), http://www.cnc-cbn.be/files/advice/link/NL_179-1%20NL%20ADVIES%20179-01%20CBN.pdf

[202] Richelle, I., 'Emission Trading: Accounting Tax Regime in Belgium', *Bulletin for International Taxation*, August/September 2008, 418; Geldhof and Hommez, 'handel in schone en vuile lucht: groenestroomcertificaten en verhandelbare emissierechten vanuit kikvorsperspectief', TBH, 2004, 830.

[203] Arbitragehof 7 June 2006, no 92/2006, BS 23 June 2006.

is *not yet the owner of the emission rights allocated to them when these have not yet been issued*. The Court went on to say that not issuing, for a new period of one year, the allowances that have been allocated to an installation, cannot be considered an expropriation in the sense of Article 16 of the Belgian Constitution. Once issued, the emission right becomes a tradable good as, in the wording of the Belgian legislation and Article 12 of the ETS Directive 2003/87/EC, any person, natural or legal, may own emission allowances and these may be transferred in accordance with the rules established in this legislation. The Court concluded that the legislator was allowed to require emission rights to be revoked when the activity ceases. The Court added that Article 1 of the First Protocol to the European Treaty for Human Rights does not change this reasoning, as the Treaty allows States to apply the laws it considers necessary to supervise the use of property in accordance with the public interest. This reasoning is also introduced in the legislation applicable to the 2nd commitment period, and the judgment provides some interpretation of the legal nature of the allowance. While not explicitly qualifying emission allowances as a property right, the Court implicitly recognised that this qualification would be relevant for emission allowances under Belgian law.

The **UK** has not adopted any measures defining the legal status of allowances. However, the case of *Armstrong v Winnington*[204] dealt with the issue of the precise nature of an allowance and established allowances as property as a matter of common law. The Court considered an allowance to be 'property' since '*It is definable as the total sum of rights and entitlements conferred on the holder pursuant to the EU ETS. It is identifiable by third parties; it has a unique reference number. It is capable of assumption by third parties, and it is transferable. It has permanence and stability, since it continues to exist in a registry account until it is transferred out either for submission or sale and is capable of subsisting from year to year*.' With regard to its precise nature and characterisation as property, it was noted that the current state of the law has not developed to the point where something existing only in electronic form is equated with a physical thing of which actual possession is possible. Applying the three-fold test identified in *re Celtic Extraction Ltd* [2001] Ch 475, it concluded that an allowance is 'intangible property' for the following reasons: firstly, there is a statutory framework which confers an entitlement on the holder of an allowance to exemption from a fine; secondly, the allowance is an exemption which is transferable under the statutory framework; and thirdly, the allowance is an exemption which has value. While the *Celtic Extraction* case concerned whether licences granted pursuant to the Environmental Protection Act 1990 fell within the meaning of 'property' as specifically defined in various statutes, the court in *Armstrong v Winnington* held that the reasoning applies equally to the characteristics of property in common law, as in the case of emission allowances. Accordingly, an allowance constitutes 'property' and is 'intangible property'. Holders of emission allowances need to be able to exercise their exclusion entitlement against private third parties to assert ownership in allowances and trade them, thereby ensuring market functionality[205].

[204] Armstrong DLW GmbH v Winnington Networks Ltd [2012] EWHC (Ch) 10.
[205] http://etheses.lse.ac.uk/719/1/Manea_Instrumentalising_property_2013.pdf, p. 235.

#### 5.2.1.2 What are the legal consequences of the legal nature of EU ETS allowances for legal certainty, security and flexibility of the EU ETS market?

The consequences for legal certainty, security and flexibility stemming from the legal nature of allowances are not directly and explicitly regulated in most jurisdictions. However, general rules and principles of law are applicable.

In **Poland**, for example, various regulations within Polish civil, financial, administrative and criminal law are applicable to emission allowances, even if their applicability is neither specifically nor explicitly prescribed. In this context, doubts may arise as to the applicability of certain general provisions to allowances, depending on the various interpretations available. It should be noted that, together with the transposition of MiFID II, allowances are expressly treated as financial instruments in the jurisdictions, removing all doubt as to the applicable legislation[206].

Some Member States have reported that the characteristics of the allowances 'trigger' the applicability of other national legislation. Defining the legal treatment of allowances in national law could allow for a clearer classification under the national system. In this way, their legal treatment would provide insight into their legal nature, rather than the other way around.

The treatment of emission allowances in **German** national law involves the application of the following laws, in addition to the TEHG provisions:

- German Basic Law / Constitution (*Grundgesetz*, GG): Article 14 paragraph 1 grants protection to property but does not further define it. Extensive case law from the Highest German Constitutional Court (*Bundesverfassungsgericht*, BVerfG) gives more guidance on what constitutes 'property' under this provision. In brief, the constitutional provision of Article 14 GG allows the legislator to create boundaries to the use of property by law and protects the owner against deprivation by the state.
- German Civil Code (*Bürgerliches Gesetzbuch*, BGB): this provides the general framework for classification as 'property'. It does not itself define property, nor does it explicitly refer to allowances. It also provides the legal basis for the transfer of property and for its use as a (transferable) security.
- Financial legislation (see Section 7 below): Of particular relevance are the Securities Trading Act (*Wertpapierhandelsgesetz*, WpHG), covering market participants and describing their obligations with regard to transparency, including publicity, information, conduct and organisation, and the Banking Act (*Kreditwesengesetz*, KWG), covering solvency of financial institutions and prudence of conduct.

In **Belgium** the situation is similar. According to legal literature, allowances may be considered intangible movable property rights. If this interpretation is followed, the provisions of the Civil Code (*Burgerlijk Wetboek*) would apply to emission allowances. Article 16 of the Belgian Constitution provides protection against expropriation. The Belgian Companies Code (*Wetboek van Vennootschappen*) would be relevant for aspects relating to the treatment of emission allowances following a transfer of (parts of) undertakings. However, none of these pieces of legislation explicitly

[206] As confirmed in an interview with a representative from the Polish Ministry for Environment, ETS Department.

refer to allowances. The only certainty under the Belgian system is that emission allowances are considered a financial instrument, as regulated by the Law of 2 August 2002 on the supervision on the financial sector and financial services[207].

By contrast, **French** law defines allowances as personal property, which can be regarded as movable assets. Allowances are thus subject to the rights and obligations applicable to assets, in particular intangible movable assets which are nevertheless materialised in registry accounts (as provided by the Civil Code), including for transactions (contract law) and security interests (collateral provisions) and, where applicable, by the Financial and Monetary Code and the General Regulation of Financial Markets for oversight purposes. The lack of clear interpretation of 'where applicable' generated some degree of legal uncertainty but has recently been clarified (see Section 6 below). Where the seller and the buyer are professional traders, or in cases of insolvency, particular provisions of the Commercial Code may also apply to contractual arrangements (including collateral) or to the bankrupted entity/person. The clarity of the definition and categorisation of allowances provides a certain legal framework, with defined rights and obligations on the holder.

French law assigns clear property rights to the holder only once the allowances are delivered and registered in the holder's registry account. Until then, operators cannot claim ownership rights. In its 17 February 2016 ruling (case n° 383771 Smurfit Kappa), the State Council (the highest administrative Court in France) ruled that the NAP does not create rights for the operators to either be granted allowances or to receive the allocated volume of allowances for the period covered by the plan. However, the State Council recognised that the implementation of NAPs by the annual Minister of Environment's orders allocating the allowances can generate rights to the holder, in particular the right to receive the stated volume of allowances. Nothing, however, prevents the Minister from amending such an annual ministerial order, even a posteriori, in order to rectify operator error in reporting its GHG emission for the previous year. The case, which started in 2010, led the legislator to improve the legal framework and regulate those exceptional cases where the operator is delivered undue allowances (see Article L.229-11-1 of the Environmental Code, and Section 4 below). The French legal framework establishes that there is no possibility for public authorities to force expropriation of allowances in the name of public interest because the legal framework for expropriation does not apply to intangible movable assets, except for patents of national security interests (Article L.613-20 of the Intellectual Property Code), assets necessary for the army (Law of 11 August 1936), and maritime cultural goods (Law n° 89-874, of 1 December 1989). This provides legal certainty for both operators and public CAs.

In conclusion, allowances can be characterised as having certain elements of property. Other than France, none of the Member States examined have legislation that explicitly refers to allowances, creating some degree of legal uncertainty.

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[207] Wet van 2 augustus 2002 betreffende het toezicht op de financiële sector en de financiële diensten.

### 5.2.2 Transfer of title and transfer in cases of insolvency, theft or fraud

Questions asked about the transfer of title/transfers in cases of insolvency, theft or fraud:

- How is the transfer of the title/allowances done and what evidence acts as proof to be recognised?
- Depending on the legal nature (public/private property) of allowances, what is the applicable legislation to the transfer of titles?
- What are the different remedy instruments provided for by Member States to claim the transfer of the legal title in cases of insolvency, theft or fraud?

#### 5.2.2.1 Transfer of title/allowance: applicable legislation and procedures for transfer

Emission allowances take the form of an electronic instrument that is transferable automatically by electronic means within the Union Registry. On the primary market, allowances may be transferred through auctions on stock exchanges (European Energy Exchange (EEX) and ICE Futures Europe (ICE))[208] which are governed by specific rules of the Auctioning Regulation 1031/2010 and contractual rules that must be followed by the parties involved. On the secondary market, emission allowances may be sold and bought via two main channels: stock exchange and transactions outside of the stock exchange (over-the-counter) on the basis of agreements between interested parties (see Section 5.2.5. on security issues). Like the primary market, rules set up for a given stock exchange (ICE/ECX, EEX, NYMEX, NASDAQ OMX Commodities), including contractual rules, apply and must be fulfilled by the parties. With regard to transactions outside the stock exchange, the contractual provisions governing the transfer of allowances is subject to the law of the Member States, in the absence of EU-wide regulation.

The transfer of allowances between two private actors and based on the decision of the holder points to the allowances being considered property. All Member States apply the rules under both the Registry Regulation 389/2013 (which is directly applicable) and the national private property law regime applicable to the transfer of allowances, again pointing to the consideration of allowances as property rights.

Under **German** law, the contractual obligation must be viewed independently of the transfer of property. The contract provides the legal basis and justification for the 'passing on' of rights. Thus, the contractual obligations are considered under 'regular' civil contract law that also applies to rights (§§ 433, 453 BGB). The transfer of allowances is regulated in § 7 para. 3 s. 2 TEHG, and requires consent between the parties involved (following the regular Civil Code (BGB) rules, such as §§ 104ff., 134, 138, 164ff. BGB), as well as a change in the registry's entry (following § 17 TEHG and the Registry Regulation 389/2013). At the request of the seller, allowances are transferred through the Union Registry from the seller's to the buyer's account. This transfer is ensured by the central administrator (Article 65 Registry Regulation 389/2013). German law gives special regard to the 'publication' of registry entries (§ 7 para. 4 s. 1 TEHG): this means that the holder of an allowance acknowledged in the Union Registry is deemed to be the rightful owner for the purposes above. Similar to the provisions in the Registry Regulation 389/2013, the benefit provided by the Union Registry as proof of

[208] European Energy Exchange (EEX) and ICE Futures Europe (ICE).

ownership is not granted to the receiving party of a transaction where he is aware of an incorrect entry in the Union Registry (as bona fide buyers are protected by the Registry Regulation 389/2013). Those elements seem to point to emission allowances being accorded property rights, given their reference to the transaction of allowances between two private parties.

In **Poland** there are no specific regulations on the transfer of allowances, thus the general provisions of the Civil Code[209] are applicable (purchase, exchange, donation, etc.)[210]. In accordance with Article 155 § 2 of the Civil Code, if an identifiable object is the subject of a transfer of ownership agreement, transfer of the possession of the object in question under the consent and control of the owner is also required. Although not explicitly stated in the legislation, allowances can be considered identifiable objects in the meaning of Article 155 § 2 of the Civil Code, and the entry in the relevant account in the Union Registry can be considered such transfer of possession[211]. A relevant entry in an account in the Union Registry thus acts as a proof of the transfer. Polish legislation follows EU law, whereby allowances cannot exist in isolation from their account in the Union Registry. Until the entry in the account, the entity/person that has purchased allowances may be considered as entitled, not to the emission allowances but, rather, in respect of the expectancy rights related to the allowances purchased[212]. In accordance with Article 510 of the Civil Code, the ownership of securities (allowances are considered securities in Poland) is transferred on the basis of an agreement (sales/exchange/donation/etc.) between the interested parties. Since allowances may be used as, or considered, securities, certain provisions of the Law on financial instruments trading[213] should be considered[214]. In particular, Article 7(2) of the Law on financial instruments trading specifies that securities are transferred from the moment of their entry in the securities account. Although not explicitly stated in the legislation, in the case of emission allowances this would be an entry in a relevant account in the Union Registry. Similarly, the elements related to transfer of allowances between parties points to their consideration as property.

Finally, allowances can be transferred in the case of purchase of an installation by a new operator. In accordance with Article 61(1) of the Polish ETS Law, the seller of an installation loses the right to dispose of the allowances allocated to that installation on the day the title to the installation is transferred.

The **Belgian** legislation relating to the Union Registry and transposing the ETS Directive 2003/87/EC provides little information on the transfer of emission allowances. The regional legislation merely specifies (in relation to the transfer of allowances and as a direct transposition of the ETS Directive 2003/87/EC) that emission allowances are transferable by and to persons within the EU and third countries, provided that the EU has concluded agreements with those third countries on the mutual recognition of emission rights. The legislation also specifies that an allowance may only be

[209] Ustawa z dnia 23 kwietnia 1964 r. - Kodeks cywilny, OJ 1964 No 16 item 93. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU19640160093

[210] Stoczkiewicz, M., The Emission Trading Scheme in Polish Law. Selected Problems Related to the Scope of Derogation from the General Rule for Auctioning in Poland, *Yearbook of Antitrust and Regulatory Studies* (UW) 2011, No 4, s. 102. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1962074.

[211] Information obtained from the Ministry of Environment, ETS Department.

[212] *Ibid.*

[213] Ustawa z dnia 29 lipca 2005 r. o obrocie instrumentami finansowymi, OJ 2005 No 183 item 1538, as amended. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20051831538

[214] Gorzelak, K., Uprawnienia do emisji jako przedmiot obrotu i zabezpieczeń, Praca doktorska przygotowana pod kierunkiem prof. dr hab; Chłopeckiego, A., available at: https://depotuw.ceon.pl/bitstream/handle/item/971/UPRAWNIENIA%20DO%20EMISJI%20-%20PRACA%20DOKTORSKA%20(wersja%20ostateczna).pdf?sequence=1., p. 144.

surrendered when the annual emissions report has been verified. The transfer of emission allowances is linked to the verification of the yearly $CO_2$ emissions report, i.e. the holder of the emission allowances may not surrender these allowances until the annual emissions report has been verified and approved by the contracting authorities.

Given the uncertainty of the legal nature of emission allowances, the legal framework does not provide a clear answer about the legislation applicable to the transfer of titles. Nevertheless, some assumptions can be made and the provisions that may be of relevance can be identified in Belgian civil and insolvency law. The concrete application of such provisions and specificities to the transfer of emission allowances within the framework of the EU ETS will continue to be further determined by the courts as questions of legal interpretation arise.

The contractual aspects of the underlying agreement on the transfer of emission allowances and other property related aspects (e.g. relating to the transfer of allowances following insolvency) may be considered under the provisions of Belgian civil law. Book II of the Belgian Civil Code regulates property and restrictions to property rights, while its Book III regulates contractual arrangements. The contractual commitment between two parties on the sale or other transfer of emission allowances is therefore likely to be covered by the Civil Code.

In order to conclude a valid commitment, the Belgian Civil Code requires the consent of the engaging party, its capacity to engage, an agreed subject as content for the commitment, and a valid cause (Article 1108). In its Article 1109, the Civil Code specifies that consent is not valid when it is obtained through error, violence or deceit.

Consequences of the transfer of the company or a branch of the company and the treatment of emission allowances as part of such a transaction would be subject to company law, as set out in the Belgian Company Code.

The Cooperation Agreement on the Belgian Registry of 18 June 2008 implements the internal organisational arrangements between the federal authorities and the three regions in Belgium in relation to the Union Registry (though it initially included provisions relating to the Belgian Registry). It explicitly refers to the previous version of the Registry Regulation 2216/2004 and states that it ensures the implementation in Belgium of the registry-related aspects of the EU ETS[215]. Any emission allowances issued in Belgium are registered by the administrator for each specific regional authority (i.e. the Flemish Government, the Walloon Government or the Government of the Brussels-Capital Region). The Union Registry, therefore, contains a party debit account for the Competent Authority, which is used for the issuing and receiving of emission allowances from the operators. Four such accounts are set up in Belgium, one for the centralised management of emission allowances and one for each of the three regions. For every installation participating in the EU ETS, a Competent Authority and a party debit account will be designated, which will be used for transactions between the installation and the Competent Authorities of the region where the installation is located.

Every installation will have an operator debit account, within which emission allowances for a specific trading period will be registered when issued. These debit accounts may also be opened by other persons, such as, for example, intermediaries. Emission allowances are transferred between these two

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[215] Samenwerkingsakkoord tussen de Federale Staat, het Vlaamse Gewest, het Waalse Gewest en het Brussels Hoofdstedelijk Gewest van 18 juni 2008 betreffende de organisatie en het administratief beheer van het gestandaardiseerd en genormaliseerd registersysteem van België overeenkomstig Richtlijn 2003/87/EG van het Europees Parlement en de Raad en Beschikking 280/2004/EG van het Europees Parlement en de Raad, B.S. 18 July 2008.

types of accounts, similar to a bank transaction. As noted by the Belgian Registry administrator, the only evidence for a transaction is the movement between the two accounts.

The underlying agreement for a transaction, for example specifying the economic or monetary value of the transaction, is a private agreement between parties. The content of such agreement is not made available to the Competent Authority. Neither the publicly available information nor the interview carried out for this study were able to provide more concrete information about the content of such agreements. The underlying agreement is however, likely to be subject to the provisions of the Belgian Civil Code, therefore pointing to the characterisation of allowances as a property right.

In **France,** allowances are intangible movable assets, which are the personal private property of their holders. The transfer of titles is done through contractual arrangements, whether standardised or not, even when allowances are considered financial instruments for the application of certain provisions of the Financial and Monetary Code. The contract law contained in the Civil Code (‘*Livre des Obligations’*) applies to the transfer of titles, with the Commercial Code (*Code de Commerce)* eventually applying, if both the buyer and the seller are traders. Both the title and the allowance are transferred simultaneously through the Union Registry. The French legislation provides for the characterisation of EU ETS allowances as property rights. The security of transactions was reinforced considerably in 2011, through the following rules:

- The double validation of manual transactions is compulsory since January 2011.
- The authentication of the holder of the account in order to access the account was reinforced by the obligation to enter a single code sent by SMS (SMS solution). Since September 2016, national administrators apply codes generated by a ‘token’ key.
- Each transfer is traced in the system, acting as evidence of the operation. This can be generated by the system at the request of the holder or the authorised representative, and used as confirmation.
- At the end of the 26-hour deadline, the transfer becomes irrevocable, in accordance with the principle established by Article 37 of the Registry Regulation 389/2013.

Like Germany, Poland and Belgium, the **UK** has no specific regulations for the transfer of allowances. However, on the basis of the *Armstrong* definition of emission allowances as intangible property, it is likely they would be treated as such under common law.

The proprietary restitution claim brought by Armstrong hinged on the idea that legal and equitable title to the stolen allowances remained with Armstrong. By contrast, the alternative claim for unconscionable receipt of trust property creates the impression that the thief gets legal title to the allowances whilst equitable title remains with Armstrong. Morris J. held that ‘some form of de facto legal title was obtained by the fraudster’ as he was to be ‘as in possession of the allowances’. Logically, therefore, the accuracy of one of these positions is fatal for the other. Either title did pass to the thief or it did not. The dispute was decided on this basis, with the Court finding that Armstrong should succeed in its proprietary claim because Winnington's bona fides defence could be defeated by Winnington's notice or absence of good faith. By not classifying the type of legal intangible property right constituted by an allowance, Morris J. avoided any detailed analysis of how legal title in such property passes.

#### 5.2.2.2 What are the different remedy instruments provided in Member States to claim the transfer of the legal title in cases of insolvency, theft or fraud?

For cases of insolvency, the **German** legal framework does not provide a clear answer. As stated above with reference to § 7 para. 4 TEHG, the entrance in the Union Registry 'constitutes' the right to authorise transactions unless the receiving party is aware that the registry is incorrect. This means that if the receiving party acts in good faith, transfers can also be valid if ordered by a person (only) entitled to do so by the registry entry. The TEHG does not include any provision specifically dealing with cases of insolvency. The general Insolvency Act (*Insolvenzordnung,* InsO) creates the framework for cases of insolvency and its § 91 para. 1 includes a provision stating that once the insolvency proceedings commence, rights on insolvency assets cannot be acquired. However, § 91 para. 2 InsO specifies that this provision is without prejudice to certain BGB provisions on real estate (and laws with respect to rights on ships and aircrafts). These provisions generally allow such a transaction unless the content of the register specifies a restriction (in this case the limitation of potential transfers of title by the insolvency). The TEHG does not provide a parallel provision (compared to the laws on rights on ships and aircrafts) but it has been argued that this constitutes an oversight by the legislator that should be remedied by equivalent treatment of emission allowances[216].

In **Poland**, this is provided for in the Code of Civil Procedure[217]. While this remedy is not specifically prescribed in relation to allowance fraud, it is inferred from the general rules of Polish civil law. In addition, the Polish Criminal Code has no specific provisions on fraud relating to the transfer of allowances. As such, the general rules of the Criminal Code (e.g. Article 286 of the Criminal Code regulating fraud) and the Code of Criminal Procedure also apply in this context[218].

For cases of revocation of a transfer agreement, it is not possible to request the reversal of a transaction that has become final and irrevocable. This is in line with Article. 40 point 3, indent 3 of the Registry Regulation 389/2013. Where an operator becomes insolvent, the account with emission allowances joins the bankruptcy estate and, as such, the installation cannot be sold by the liquidator without this account. According to Article 62 of the Bankruptcy Law[219], the bankruptcy estate comprises all assets of the bankrupt entrepreneur which belong to him on the day the bankruptcy decision is issued, as well as all assets acquired during the bankruptcy proceedings. This enumeration also (indirectly) covers all property rights belonging to the bankrupt entrepreneur[220]. Since emission allowances are considered a type of intangible property right, they become part of the bankruptcy estate and are not covered by the exclusions set out by Article 63–67a of the Bankruptcy Law. However, it should be noted that in accordance with Article 70(1) of this law, properties, claims and other property rights (including emission allowances) transferred by the bankrupt individual to the creditor in order to secure the debt are exempt from the bankruptcy estate.

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[216] Windel in Jaeger, InsO – Großkommentar, 2007 (Wolfram Henckel and Walter Gerhardt, eds.), 2nd volume (§§ 56-102), § 81 para. 71.

[217] Ustawa z dnia 17 listopada 1964 r. - Kodeks postępowania cywilnego, OJ. 1964 No 43 item 296. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU19640430296.

[218] Information obtained from the Ministry of Environment, ETS Department; Questionnaire concerning implementation of Directive 2003/87/EC. Available at: http://cdr.eionet.europa.eu/Converters/run_conversion?file=pl/eu/emt/envv0qgnq/pl.xml&conv=527&source=remote

[219] Ustawa z dnia 28 lutego 2003 r. Prawo upadłościowe i naprawcze, Dz.U. 2015, poz.233. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20150000233

[220] https://mfiles.pl/pl/index.php/Masa_upad%C5%82o%C5%9Bciowa

Finally, there are certain preventative measures that can be taken. For example, in most cases, the transactions in the Union Registry shall have 26 hours of delay (from the time of initiating the transfer to its finalisation). It is not possible in practice to hold the national administrator (KOBIZE) of the Union Registry liable for fraud or problems relating to the technical operability of the Registry system. The European Commission provides the software and related infrastructure and KOBIZE is not bound by any contract with the Commission in this regard[221].

While the Civil Code in **Belgium** lists several causes for nullifying a commitment, it is not possible to annul a transaction from the Union Registry, except through immediate revocation within 26 hours, as established by the EU legislation. In the absence of case law, the application of the existing legal requirements to the particular issue of emission allowances and their reclamation under general Belgian civil law requirements is unclear and will have to be further determined by the courts.

For insolvency, the legal remedies of the EU Insolvency Regulation 2015/848 apply. For theft and fraud, the criminal sanctions established in the Criminal Code apply, possibly accompanied by a compensation claim for damages. In the latter cases, the means of reclaiming allowances is not clear. A phishing case was brought before the Belgian Court of first instance, concerning the confidentiality of the whereabouts of the stolen allowances and the names of the operators from whom they were stolen. However, the judgment did not address any remedies for claiming back the legal title of phished allowances.

Whenever a transaction is suspected of being fraudulent, or if a theft is believed to have been executed through the Union Registry, the national **French** administrator (Caisse des Dépôts et Consignations) is empowered to prevent the transfer from taking place. Preventative measures are also put in place by the national administrator to detect possible fraudsters, in particular through comprehensive 'know your customer' checking.

Given that the transfer of legal title is governed by contract law, remedial measures for loss or damage in case of theft/fraud rely on the possibility of the buyer proving the contractual liability of the seller, eventually supported by any legal proceeding for criminal prosecution. In cases of insolvency, allowances are regarded either as an asset or a debt, depending on whether they were to be used by the bankrupt seller (including for further transfers) or if there was an accounting provision, as regulated by the Commercial Code (*Code de Commerce*). The possibility for the buyer to claim the transfer of title or obtain compensation for the loss depends on a number of factors, including declaring the debt obligation to the authorised liquidator and his preferential ranking compared to other creditors.

In the **UK**, a number of remedies are available to claim a monetary judgment in cases of fraudulent transfer of EU ETS allowances. In the case of *Armstrong v Winnington*, which concerned the fraudulent transfer of allowances by a third party, there were three mutually alternative causes of action or legal bases for claim. The first two were common law personal claims for restitution: 1) that Armstrong (the claimant) has a proprietary restitution claim to vindicate its continuing legal title to the allowances; 2) that regardless of title to the allowances, Armstrong had a common law restitution claim based on the defendant's unjust enrichment in respect of the allowances; and 3), a personal claim arising in equity that the defendant is personally liable to the claimant on the basis of 'conscionable' (or knowing) receipt of trust property.

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[221] Information obtained from the Ministry of Environment, ETS Department.

In cases of insolvency, the Financial Markets Law Committee (FMLC) expects that any UK emission allowances registered on a Union Registry account of an insolvent entity would be treated as part of the property of that insolvent entity, capable of similar disposal by the liquidator or other insolvency practitioner[222].

### 5.2.3 Liquidity of the market

Questions asked regarding the liquidity of the market:

- How does the legal nature of allowances impact the liquidity of the market?
- What are the consequences of Member States' definitions of the legal nature of allowances for cross-border trade?
- Is there any applicable national legislation/provision to facilitate/ensure the liquidity of the market?

#### 5.2.3.1 How does the legal nature of allowances impact the liquidity of the market?

The European Court of Auditors report[223] states that in order to function well, the EU carbon market, like any other, needs sufficient liquidity. It recommends analysing whether more clarity and legal certainty on the definition of the legal nature of emission allowances would support the liquidity of the emissions market and the creation or protection of security interests in allowances.

To date, the national experts have not identified any evidence to suggest that the lack of definition of the legal nature of emission allowances could be considered responsible for reduced liquidity in the carbon market. As the liquidity of the market depends on supply and demand, it is more likely to be affected by demand shocks leading to excessive volume in the market, which reduces the need for operators to trade in the carbon market.

The European Court of Auditor's report and the **Belgian** authorities have both highlighted the national registry administrator's lack of access to information about the private conditions of the underlying agreements between companies regulating the transfer of emission allowances, or the legal counsels involved in the development of such transactions. In its response to the European Court of Auditors report, the Commission confirmed that the Union Registry does not contain financial information, thus data in the Union Registry would be of limited use in supervising financial transactions. Although such lack of access to information could have an influence on the confidence of traders and therefore on the liquidity of the market, no such effect was identified by any of the stakeholders consulted.

In **Belgium,** the competent authority noted that the market fraud of some years ago had a far greater impact on market liquidity than the lack of definition of the legal nature of the allowances.

In **France,** the classification of allowances as movable assets provides for certainty in respect of the allowances transferred and the mechanisms to transfer them, and ensures that transactions can be

[222] Financial Markets Law Committee, 'Emissions Allowances: creating legal certainty', Issue 116. Available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/116e.pdf, p. 35.
[223] European Court of Auditors, Special Report No 6, *The integrity and implementation of the EU ETS*, Publications Office of the European Union, 2015. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

secured through security interests. No evidence was found to suggest that the legal certainty in France has affected the liquidity of the market either in France or in the EU generally.

Some authors in the **UK** claim that the unclear nature of emission entitlements has significant consequences for the regulatory success of the EU ETS. The flexibility of emission entitlements creates uncertainty about the holders' rights and thus about the precise scope of those rights[224]. This can be a disincentive for participation in the emissions market and lead to issues of low pricing. Additionally, the FMLC views the clarification of the nature of emission entitlements as an important means of encouraging viability of the market, whose effectiveness can be impeded by lack of certainty in the legal categorisation of the entitlements, contrary to the purpose for which the EU ETS was established[225]. From a UK perspective, similar to France, the classification of allowances as intangible property affords an increased level of certainty with regard to the applicable rules and regulations, which in turn is likely to increase the liquidity of the market.

The experts in **Poland** found no evidence to suggest that the lack of definition of the allowances had an impact on the liquidity of the market. Authors believe that since EU ETS allowances may be 'disposed of' or traded by the owner (as the law regulating allowances states)[226] and there are no further specific limitations, liquidity of the market is assured. No further information was identified.

#### 5.2.3.2 What are the consequences of Member States' definitions of the legal nature of the allowances for cross-border trade?

The national experts did not identify any consequences for cross-border trade which could be triggered by the lack of definition of the legal nature of allowances. In the **UK**, the *Armstrong v Winnington* case evidence that trade in allowances between a company with registered offices in Germany and another with its offices in England can be carried out successfully, indicated that the UK definition of allowances as intangible property does not hinder cross-border trade.

### 5.2.4 Legal certainty

Questions asked about legal certainty:

- What are the issues regarding the current EU ETS that affect legal certainty?
- What is the effect of the non-harmonised legal nature of the allowances on legal certainty?
- What is the impact of the (lack of) definition of EU ETS allowances in terms of legal certainty?
- Is there an administrative power/capacity to cancel/transfer allowances recognised in the national legislation?
- Have the authorities in the respective Member States exercised any power to reclaim allowances in case of free allocation? Is there a description of any such case and the legal basis for it?

[224] http://etheses.lse.ac.uk/719/1/Manea_Instrumentalising_property_2013.pdf, p. 41.

[225] Financial Markets Law Committee, Emissions Allowances: Creating Legal Certainty, 2009. Available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/116e.pdf, pp. 15-16.

[226] Ustawa z dnia 12 czerwca 2015 r. o systemie *handlu* uprawnieniami do *emisji* gazów cieplarnianych, http://isap.sejm.gov.pl/DetailsServlet?id=WDU20150001223

#### 5.2.4.1 What are the issues regarding the current EU ETS that affect legal certainty?

The national experts identified several issues affecting legal certainty, although not all of these are directly linked to the definition of allowances. For example, as mentioned above, the **Belgian** registry administrator noted that it does not have access to the conditions underlying the transactions in the EU ETS, such as for example the price paid for an emission allowance in the private agreement between two undertakings. This lack of transparency protects the privacy of commercial transactions but raises issues of legal certainty as it makes it difficult in practice to detect *ex officio*, for example, cases of fraud. No issues were identified as arising from the lack of clear definition of the legal nature of emission allowances in legislation.

The fact that the legal nature of allowances is clearly established by **French law** and that property rights can be recognised only once allowances are inscribed in their holder's Union Registry account are important elements in strengthening legal certainty and preventing disputes about ownership rights and related consequences. The **French** expert highlighted that the previous system (where two different regimes co-existed for allowances considered financial instruments depending on whether they were allocated for free or through auctioning, with forward or future contracts ) was perceived by some market players as a source of legal uncertainty. However, now that the Financial and Monetary Code has clarified how its provisions apply to allowances in light of transposition of MiFID II, this uncertainty has been removed. In addition, some elements of the provisions relating to the cancellation, transfer and reversal of the transfer of allowances are little understood by some market players, particularly that allowances are personal property with an economic value. However, it is important to note that there is no possibility for public authorities to force expropriation of allowances in the name of public interest because expropriation does not apply to intangible movable assets under French law (except in very few cases that do not apply here).

The **UK** expert highlighted the issues inherent in the EU ETS creation of allowances which are then left to be defined and valued by the private market, making the environmental objective of the EU ETS dependent on the success of the emissions market. In addition, it cannot be said with any certainty if the system provides adequate protection and enforceability for security interests over emission allowances. This uncertainty places a significant limitation on an important commercial use for emission allowances and may ultimately impact on the incentive to trade allowances in the market[227].

The **Polish** expert highlighted the absence of any specific provisions explicitly regulating the legal nature of EU ETS allowances in Poland. The relevant legislation refers to the general rules of Polish civil, administrative, financial and criminal law. In this context, doubts may arise as to the applicability of certain general provisions to allowances, depending on the interpretation taken. However, following the transposition of MiFID II, allowances are to be expressly treated as financial instruments, removing doubts as to the applicable legislation[228].

[227] http://etheses.lse.ac.uk/719/1/Manea_Instrumentalising_property_2013.pdf, p. 103.
[228] Interview with a representative from the Polish Ministry for Environment, ETS Department.

#### 5.2.4.2 What is the effect of the non-harmonised legal nature of the allowances on legal certainty?

The **French** national expert posited some potential effects of non-harmonisation in cases of theft, fraud or insolvency between Member States who invest allowances with a different legal nature or who have no definition of allowances. These effects included complexity of legal basis, administrative burden and the associated costs of prosecuting and launching legal proceedings. However, none of the experts identified any such instances or any associated additional costs or administrative burden in respect of the legal nature of allowances.

In Belgium, the authorities noted that different forms are required by the Member States for the trading of allowances, suggesting that this might benefit from certain harmonisation. Again, this is not linked to the definition of allowances.

It was suggested that a system based on a mandatory cap without trade would reduce the administrative burden and cost of management. However, there is no evidence that the harmonised definition of the legal nature of the allowances would affect the operational costs or administrative burden of the EU ETS.

#### 5.2.4.3 What is the impact of the (lack of) definition of EU ETS allowances in the respective Member States in terms of legal certainty?

At the time of adoption of the **French** legislation transposing the ETS Directive 2003/87/ EC, there were some concerns about the possible consequences of the classification of allowances as financial instruments. Thus, the first transposing measures of the ETS Directive 2003/87/ EC introduced a new provision in the Financial and Monetary Code, recognising that only forward or future contracts related to allowances would be regarded as financial instruments and be subject to the provisions of the Code.

In the so-called 'Prada report' (2010, published at the Documentation Française), a number of concerns were again expressed about the classification of allowances as financial instruments, in particular the fact that their characteristics were different and that they were therefore subject to different legal regimes. For the purposes of transposing MiFID II into French law, the legislator decided not to explicitly classify allowances as financial instruments but, rather, to introduce references to the allowances in all relevant provisions of the Financial and Monetary Code, in accordance with MiFID II. Ordinance no 2016-827 of 23 June 2016 clarified how the Financial and Monetary Code should apply to allowances in light of the transposition of MiFID II. This Ordinance does not classify allowances as 'financial instruments' but instead refers to the provisions regulating allowances in France, namely Articles L.229-5 and L.229-7 of the Environment Code. As the Financial and Monetary Code refers to allowances, the relevant provisions thus apply to allowances, thereby ensuring complete and correct transposition of ETS Directive 2003/87/EC, e.g. Title II, Book IV and Title III, Book V of the Code). It could be argued that such a legal framework does not apply to allowances defined as movable assets, which precludes some provisions of the French Financial and Monetary Code ensuring the protection of the good will buyer's rights, due to the theory of appearance laid down in Article L.211-16 of the Code ('*Nul ne peut revendiquer pour quelque cause que ce soit un titre financier dont la propriété a été acquise de bonne foi par le titulaire du compte-titres dans lequel ces titres sont inscrits.*'). However, such provision would apply through the direct effect of the Registry Regulation 389/2013.

In the other Member States, no evidence was found to suggest specific impacts on legal certainty as a result of the lack of definition of allowances. In Belgium, several issues have appeared which required

legal interpretation by the Belgian courts relating to the legal nature of the allowances. A 2009 case of phishing brought before the Belgian courts was ultimately joined with a German case, removing the need for a judgment in Belgium. The decision of the Belgian Constitutional Court was resolved without the need to clearly identify the legal nature of the emission allowances under Belgian law, although it indicated that the provisions of the Civil Code could be applied to resolve outstanding interpretation issues if necessary. The lack of definition is not believed to have a major impact on legal certainty.

#### 5.2.4.4 Is there an administrative power/capacity to cancel/transfer allowances recognised in the national legislation? Have the authorities in the respective Member States exercised any power to reclaim allowances in case of free allocation?

This question specifically addresses allowances allocated free-of-charge to the respective holders by the Competent Authority as part of its administrative regulatory power.

Under Article 12 paragraphs 3 and 4, and Article 13 paragraph 2 of the ETS Directive 2003/87/EC, allowances are cancelled by the responsible authority (in Germany, for example, the *Deutsche Emissionshandelsstelle*, DEHSt) four months after the end of a trading period or any time at the request of their holder (e.g. Germany § 7 para. 2 TEHG).

As described above (see Section 3.1.2), Article 53(4) of the Registry Regulation 389/2013 allows and sets the rules for returning of allowances in case of over-allocation to an operator. Similarly, Article 70 of the Registry Regulation 389/2013 provides the possibility for reversal of certain transactions.

In **Germany**, the allocation of free allowances is an administrative act by the responsible emission trading authority (DEHSt), as a part of the German Federal Environmental Agency (*Umweltbundesamt*, UBA) and follows the legal procedures set out by §§ 9, 10, 14 TEHG and the national allocation regulation for the respective trading period, the most recent of which is the *Zuteilungsverordnung 2020* (ZuV 2020). Accordingly, allowances allocated for free can be claimed back with an administrative act under certain conditions. The TEHG itself provides an 'opening clause' in its § 9 para. 4 to the application of the Administrative Procedures Act (*Verwaltungsverfahrensgesetz*, VwVfG). In its § 9 para. 6, the TEHG refers specifically to the general provisions of §§ 48, 49 VwVfG to withdraw unlawful administrative acts, mostly in the case of illegal conduct by the beneficiary (§ 48), or – under very limited circumstances – even lawful conduct. § 9 para. 6 TEHG adds, however, that such withdrawal is subject to a specific reason to withdraw the allocation in the case of adjusting to European legislative changes. In addition, the auctioning of allowances (§ 8 TEHG) follows the Auctioning Regulation 1031/2010 and is carried out in Germany by EEX, which also functions as the common auction platform on behalf of 25 other Member States. Trading participants need a permit from the German Financial Market Regulator (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) to submit an offer to the auction (on their own account or on behalf of a client). This permit can be revoked via the same general provisions of the VwVfG (see above), or where trading entities do not comply with the requirements of conduct under Article 59 para. 5 of the Auctioning Regulation 1031/2010 (§ 8 para. 4 TEHG). However, while trading takes place in a regulated setting, the auctioning of allowances is conducted under general civil law. This is a major difference from the administrative allocation of allowances described above. The necessity of a trading permit (or a possible revoked permit) is not linked to the validity of the allowances themselves *per se*. In Germany, there are no other national provisions that grant these administrative powers.

According to Article 8(7) of the **Polish** ETS Law, the public body (KOBIZE) in charge of administering the EU ETS in Poland implements the judgments of courts or other public bodies in respect of: (i) the disposal of emission allowances kept in the accounts within the Union Registry; or (ii) limitation of the right of the owner of the account to dispose of those allowances. In this framework, KOBIZE could be considered to have the capacity to transfer allowances recognised in the national legislation. In accordance with Article 18 of the Polish ETS Law, if the amount of emission allowances allocated to the operator's account exceeds the amount to which it is due, the operator is required to transfer back (return) the excessive emission allowances. This procedure is also applicable in the circumstances described in Article 53(4) of the Registry Regulation 389/2013. The procedure is the following: KOBIZE sends a relevant notice to the operator, which is required to return the excessive emission allowances within 14 days. Where the excessive emission allowances are not returned within 14 days, KOBIZE informs the Ministry for Environment. The Minister subsequently takes a decision on the return of an amount, determined on the basis of a unit price of emission allowances, corresponding to an average price of emission allowances listed on the stock exchange ICE / ECX and EEX in the secondary market spot on the last day that trading of emissions took place and preceding the date of the decision of the Minister of Environment, and corresponding to the EURO – PLN exchange rate published by the National Polish Bank on the day preceding the date of the decision (Article 18(6) of the Polish ETS Law). This amount is subject to tax, in accordance with Chapter III of the Tax Law[229]. The payment of this amount is subject to administrative enforcement by KOBIZE (competency of KOBIZE on the basis of Article 8(7) of the Polish ETS Law) in accordance with the Enforcement Proceedings in Administration[230].

In **Belgium,** Article 21 of the Cooperation Agreement on the Registry requires the registry administrator to implement every instruction received from a competent authority in respect of the voluntary cancellation of a part of the total quantity of emission allowances remaining on the party's debit account. The CAs in question are those from the regions in which the installations are located. Transfers between accounts, including that party's account and the authority account, are similarly administered by the registry administrator, under Articles 18-20 of the Cooperation Agreement. The instructions for the transfer of allowances may come either from the competent authority of one of the regions or from the holder of the debit account.

In the 2006 case, n.v. Cockerill Sambre and s.a. Arcelor[231], the Constitutional Court authorised the Competent Authorities not to issue the emission allowances to an operator which had discontinued the production activity of its installation, where the relevant allocation was included in the NAP table but not yet effective (the issuance was not yet carried out). The Court concluded that the emission rights could be revoked when the activity was discontinued and that this decision would not be considered an expropriation in the sense of Article 16 of the Belgian Constitution. Since 2006, the situation of unduly issued emission allowances has been explicitly included in legislation. In the Flemish Region, the 2013 modification to the Decision[232] on transferable emission allowances introduced a new Article

[229] Obwieszczenie Marszałka Sejmu Rzeczypospolitej Polskiej z dnia 8 kwietnia 2015 r. w sprawie ogłoszenia jednolitego tekstu ustawy – Ordynacja podatkowa, OJ 2015 item 613. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU19971370926.

[230] Ustawa z dnia 17 czerwca 1966 r. o postępowaniu egzekucyjnym w administracji, OJ 1966 No 24 item151. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU19660240151.

[231] Arbitragehof 7 juni 2006, nr. 92/2006, BS 23 June 2006.

[232] Decision of the Flemish Government of 20 April 2012 on transferable emission allowances for fixed installations and the use of flexible mechanisms (Besluit van de Vlaamse Regering van 20 April 2012 inzake verhandelbare emissierechten voor

55 regulating this situation. Article 55/2 of the Decision states that when emission rights are unduly issued, the Competent Authority will determine the amount of unduly issued emission rights within two years of their issuance. The Competent Authority shall inform the operator of the installation of the quantity of emission rights concerned and the reasons or their undue issuing. Following the notification, the Competent Authority will instruct the registry administrator to deduct the amount of these emission allowances from the next issuing of allowances to the operator of the same installation. Where this is not possible, the Competent Authority will claim back the equivalent amount of unduly issued emission allowances from the operator of that installation. The Decision defines 'unduly issued emission allowances' as the positive difference between the amount of emission allowances issued on the basis of the allocation decision and the amount of emission allowances allocated on the basis of the decisions referred to in Articles 46(2), 50(2) and 54(2) of that Decision. These decisions concern the adaptation of the allocation decision for several reasons, such as the discontinuation of the activities (regulated in Article 43 of the Decision) or the changes due to a significant reduction in capacity. The allocation of allowances may also be adapted to reflect a change in situation.

According to Article 62 of the 2012 Decision of the Flemish Government on emissions trading, emission allowances issued for the second and third commitment period[233] will be cancelled at the request of the person in possession of the allowances, or when surrendered according to Article 4(10)(1)(2) of VLAREM II, i.e. following the annual surrendering of emission allowances corresponding to the emissions of the installation in the preceding year. An equivalent provision is included in the legislation of the Walloon and Brussels-Capital Regions.

In **France,** authorities have already exercised this power, as proceedings have been launched to reclaim excess allowances delivered in error, e.g. the 17 February 2016 judgment of the State Council (*Conseil d'Etat*), the highest administrative court (No 383771). Return and reversal situations are addressed by the Registry Regulation 389/2013, which applies directly in France. The procedure established by Article 53 of the Registry Regulation 389/2013 has been successfully implemented by the French national administrator (*Caisse des dépôts et consignations*). Recently, the law was amended to introduce a new Article L.229-11-1 in the Environment Code (see below) in order to allow the Competent Authorities to instruct the operator to return excess allowances delivered in error and, where such an instruction is denied, to allow the national administrator to automatically take over the excess allowances and impose a fine on the operator.

### 5.2.5 Use of EU ETS allowances as security interest

Questions about EU ETS allowances treated as securities:

- Is it possible to use EU ETS allowances as security interests in the Member States? Is it possible to use security interests to secure the transfer of legal title? What types of security interest are most commonly used by market players?
- Depending on the legal nature (public/private property) of allowances, how are security interests enforced and treated in case of insolvency, theft, fraud or other serious crime? What is the applicable

broeikasgassen voor vaste installaties en de inzet van flexibele mechanismen), published in the official journal on 10 May 2012.

[233] The Flemish legislator uses the term second commitment period for the period from 1 January 2013 to 31 December 2020 (contrary to the phase reference used by the Commission for implementation of the ETS). Any reference to the second commitment period thus relates to Phase III of the EU ETS.

legislation?
- Are there precedents in case law related to the respective Member States?
- What is the legislation applicable to insolvency in transboundary cases affecting securities over EU ETS allowances?

#### 5.2.5.1 Is it possible to use EU ETS allowances as security interests (to secure the transfer of legal title) in the Member States? What types of security interest are most commonly used by market players?

The use of EU ETS allowances as security interests is not regulated in the same manner in the five Member States examined here. While the national legislation in Belgium and Germany does not treat EU ETS allowances as securities, they can be used as securities in both Poland and France. In the UK, the issue is not clarified in law and practical problems can prevent the use of EU ETS allowances as security interests. Under the EU legal framework, establishing security interest over allowances is not prohibited. Recent studies indicate[234] that Article 23(3) of the Registry Regulation 389/2013 implicitly provides for the limited possibility to secure the interest of a third party over allowances by nominating this third person as an 'additional authorised representative' to the account in the Union Registry where the allowances are held. Thus, the permission of this third party would be required to perform any transaction involving these allowances in his debtor's account in the Union Registry.

In **Germany,** the TEHG (as the legal act implementing the ETS Directive 2003/87/EC) does not specify the possibility of using emission allowances as security interests. The question is thus addressed by the acts governing securities under German law and a determination of whether or not they could be applied to emission allowances. The German Civil Law Code (BGB) provides the general framework for the use of securities. In § 1273 para. 1 BGB, the law allows, in principle, the creation of a lien on rights. It generally applies the provisions on using goods such as EU ETS allowances as liens, with a few exceptions. However, the creation of a lien on a right follows the rules for its transfer (§ 1274 para. 1 BGB). The transfer of emission allowances requires both consent and a change in the emission trading registry (§ 7 para. 3 s. 2 TEHG). The second requirement is thus not fulfilled, as the Registry Regulation 389/2013 does not offer the option to register security interests to emission allowances.

However, for the primary market in EU ETS allowances (i.e. auctioning), Article 50 of the Auctioning Regulation 1031/2010 requires the auctioneer to give emission allowances as collateral. The appointed auctioneer EEX, as well as its clearing house (European Commodity Clearing (ECC)), are based in Germany. The ECC uses a system of 'separate internal inventory accounts' to enable auctioneers to fulfil the obligations under the regulation for primary market auctions[235]. The allowances in these accounts are held as collateral to cover the potential risks to the clearing house in following the ECC's obligation to transfer auctioned allowances to successful bidders.

In **Belgium,** it is not possible to use allowances as security interests. While the qualification of emission allowances as a property right would, in theory, enable the establishment of a security over

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[234] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, Section 9.2.6.

[235] European Commodity Clearing, ECC Clearing Conditions, Release 0037a, https://www.ecc.de/blob/61084/888c94cfa702f56eaebff78618bb938d/ecc-clearing-conditions-data.pdf

such allowances, the authorities interviewed noted that this was not the case for emission allowances, which are not recognised under the relevant legal framework.

In **Poland,** on the other hand, allowances may be used as security interests. The Law of 12 June 2015 on the trading scheme for GHG emissions allows for disposal of allowances[236]. According to the Polish legislation, disposal shall mean not only transfer but also limitation or encumbrance. Several different types of securities can be imposed in order to secure a transfer of a legal title. Possible types of securities that may be established on the allowance are: security transfer of title [of ownership][237], pledge[238], and registered pledge[239]. Probably the most commonly used form would be the security transfer, where title of ownership of the allowances is transferred in order to secure something, e.g. sales transaction. Where claims from the secured transaction are not fulfilled, the title of ownership of the security stays with the creditor and there is no need for court proceedings to execute the security[240].

In addition, in Poland, the consideration of EU ETS allowances as financial instruments allows for the establishment of a financial pledge as a security interest. The financial pledge is regulated by the Act on several financial securities[241]. The financial pledge is another kind of security interest but, crucially, may be only established on the subjects indicated by the Act on several financial securities[242]. Subjects of such pledges are limited and may only be established to secure claims (i) of financial nature, or (ii) in which the subject of the claim is a financial instrument. The financial pledge does not require any specific form of agreement. The subject on which the financial pledge is established may be sold to satisfy the secured claim, without the need for enforcement proceedings.

The situation is similar in **France**, where it is possible to use particular security interests to secure the transfer of legal title of allowances as intangible movable assets, through dedicated collateral ('nantissement'). The securities may be used both for selling allowances as personal property in accordance with the provisions of the Civil Code (Articles 2333 and following), or as financial instruments (MiFID II), in line with the provisions of the Financial and Monetary Code (Article L.211-20). Such collateral can apply either to the title itself or to the debt obligation alone. It is worth noting that the beneficiary of the debt obligation can retain the allowances for as long as the debt obligation remains unpaid.

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[236] Ustawa z dnia 12 czerwca 2015 r. o systemie *handlu* uprawnieniami do *emisji* gazów cieplarnianych, http://isap.sejm.gov.pl/DetailsServlet?id=WDU20150001223

[237] The security transfer of a title is not explicitly regulated but the possibility to establish such a security is interpreted from the general rules of the Civil Code, especially from the rule on the freedom of contracting. The security transfer is a contract to which rules regulating sales contracts apply. This kind of contract is also indicated (but not regulated in detail) in the Bankruptcy Law, therefore the possibility to establish such a security shall not be questioned. See also Article 84 item 2 of Bankruptcy Law, Ustawa z dnia 28 lutego 2003 r. Prawo upadłościowe i naprawcze, Dz.U. 2015, poz. 233, available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20150000233

[238] Pledge is regulated by the Civil Code - Division IV 'Pledge', Articles 306 – 335. Ustawa z dnia 23 kwietnia 1964 r. - Kodeks cywilny, OJ 1964 No 16 item 93. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU19640160093

[239] Registered pledges are regulated by the Act on Registered Pledges and the Registry of Pledges dated 6 December 1996, Journal of Laws of 1996, No. 149, item 703.

[240] Gorzelak, K., Uprawnienia do emisji jako przedmiot obrotu i zabezpieczeń, Praca doktorska przygotowana pod kierunkiem
prof. dr hab; Chłopeckiego, A., available at: https://depotuw.ceon.pl/bitstream/handle/item/971/UPRAWNIENIA%20DO%20EMISJI%20-%20PRACA%20DOKTORSKA%20(wersja%20ostateczna).pdf?sequence=1., p. 173.

[241] Ustawa z dnia 2 kwietnia 2004 r. o niektórych zabezpieczeniach finansowych, Journal of laws of 2016, item 891. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20160000891

[242] *Ibid.*

In the **UK,** the use of allowances as security interests is not clarified by law. However, based on the EU legislation, the FMLC[243] has highlighted the importance of establishing whether or not EU allowances can support the existence of security rights for the functionality of the emissions market. The conclusion reached in *Armstrong v Winnington* (that emission allowances grant their holders rights in intangible property which is capable of supporting the existence of equitable interests) indicates that other types of third party interests can conceptually exist over allowances, notably security interests. On the basis *of Swift v Dairywise Farms Ltd.*[244] *(*which addressed the question of whether EU milk quotas were property that could be held on trust), the court held in *Armstrong v Winnington* that allowances were closely analogous with milk quotas and therefore similarly capable of supporting the existence of equitable interests. The analogy lay in the exemption that the respective instruments conferred on their holder: a milk quota represented an exemption from a levy on milk production that would otherwise be payable, while an emission allowance exempted its holder from a fine under the EU ETS for producing emissions. In *Swift v Dairywise Farms* it was stated that a milk quota had commercial value and legal effect, meaning that a trust could be imposed where equity so required.

Significant uncertainty remains in respect of whether or not such security interests can be adequately protected and enforced in order to lend them genuine legal and commercial value[245]. While it follows that securities can be granted over emission allowances as a form of property, a study on the Interplay between EU ETS Registry and Post Trade Infrastructure[246] identified a number of practical issues: firstly, ensuring that the security interest is 'perfected' by registration; secondly, ensuring that the interest of the beneficiary of the charge is protected vis-à-vis purchasers; and thirdly, ensuring that the charge takes effect as a fixed (as opposed to a floating) charge. While UK law enables a security interest to be registered (which serves to ensure that the interest of the beneficiary of a charge is protected vis-à-vis purchasers by deeming them to have been placed on notice), the Union Registry does not include any system to record the existence of security interests in emission allowances, meaning that title could be transferred or security granted without a third party having actual or deemed notice of the prior security interest. In order to ensure that a fixed charge is obtained and maintained over emission allowances, the beneficiary of that charge must be able to demonstrate an adequate degree of 'control' over the emission allowances. However, there are significant practical difficulties in showing control over dealings in emission allowances and control over the proceeds of sale of those emission allowances[247].

**Examples of common forms of security interests used by market players**

In the **UK**, common forms of security for financial instruments include:

- Certified shares and debt securities: it is possible to take a legal mortgage but, as this involves transferring the legal title of the securities to the mortgage (or its nominee), there are legal and practical disadvantages.
- Equitable mortgages and fixed charges are therefore more common.
- Dematerialised registered shares: if the chargor holds an account with Euroclear UK & Ireland (CREST), it is possible to take either legal or equitable security over shares held in the CREST

[243] Emissions Allowances: Creating Legal Certainty.
[244] Swift v Dairywise Farms Ltd. [2000] 1 WLR 1177.
[245] Emissions Allowances: Creating Legal Certainty.
[246] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015.
[247] *Ibid.,* at Section 9.2.6.

account.

Indirectly held financial instruments: if shares or debt securities are held indirectly, the nature of the chargor's interest in them will dictate the security interest the chargor may grant. However, it is common to take a fixed or floating charge over the chargor's propriety interest in the securities account in which the relevant securities are held (and any related cash account), plus an assignment of (or charge over) the security provider's rights under its investment or custody agreement with its intermediary.

In **France**, dedicated collateral ('nantissement') for securing intangible movable assets is the most frequent form of security interest.

In **Poland**, the most commonly used form is the security transfer of ownership, as enforcement is easiest here. The ownership title is already transferred to the creditor, removing the need for further enforcement proceedings.

#### 5.2.5.2 Depending on the legal nature (public/private property) of allowances, how are security interests enforced and treated in cases of insolvency, theft, fraud or other serious crime? What is the applicable legislation?

The five Member States examined use different mechanisms and legislation to enforce security in cases of insolvency or criminal activities.

For bankruptcy, enforcement procedures are prescribed by the **Polish** Bankruptcy Law, including enforcement of debts secured by the security interests. The creditors whose credit is secured by security interest are treated differently than others, with the general rule being that these types of creditors are satisfied by sums resulting from sale of the subject of the security. If a debt is secured by a pledge on the allowance, the subject of the pledge shall be sold and the sum resulting from this sale will cover the secured debt. Any sums remaining after such sale are then transferred to the bankruptcy estate[248].

In Polish law, security interests are not established on one particular allowance, described and identified, but on the number of allowance units owned. So, for example, if theft or fraud was aimed at only part of the allowances owned by a person establishing a security interest, the security shall be still effective on the same amount of allowances owned by that person.

The situation is similar in **France**, where different legislation applies depending on the risk to be secured: theft and fraud are covered by the Civil and Criminal Codes, whereas insolvency cases are covered by the bankruptcy procedures provided for in the Commercial Code. It is worth noting that collateral can apply to allowances irrespective of whether or not an account in the Union Registry is required but based on some other type of publication (see Articles 2337 and 2338 of the Civil Code).

In the case of the insolvency of a **UK** entity, the assets of which included emission allowances registered in an account in the Union Registry, the FMLC expects 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[249].

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[248] Article 336 of Bankruptcy Law, Ustawa z dnia 28 lutego 2003 r. Prawo upadłościowe i naprawcze, Dz.U. 2015, poz. 233. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20150000233

[249] http://www.fmlc.org/uploads/2/6/5/8/26584807/116e.pdf, pp. 3-5.

#### 5.2.5.3 What is the legislation applicable to insolvency in transboundary cases affecting securities over EU ETS allowances?

There are three key statutory cross-border insolvency regimes in the **UK**: the EU Insolvency Regulation 1346/2000[250], the Cross-Border Insolvency Regulations 2006[251] and the provisions relating to cooperation between courts in the Insolvency Act 1986. Common law principles may also apply. All form part of national law.

The Cross-Border Insolvency Regulations 2006 implement the United Nations Commission on International Trade (UNCITRAL) Model law on Cross-Border Insolvency in the UK. They provide a basis for judicial cooperation where the EU Insolvency Regulation does not apply. More specifically, they provide for recognition of foreign insolvency proceedings in Britain and access to British courts for foreign insolvency practitioners and creditors. They also provide for cooperation between courts of different jurisdictions and for coordination of cross-border insolvency proceedings. The Insolvency Act 1986 contains provisions for cooperation and assistance in relation to corporate insolvency between the courts of UK jurisdictions, as well as other designated countries with whom the UK has enacted equivalent reciprocal arrangements. These are complimentary to the Cross-Border Insolvency Regulations 2006. As these are applicable to insolvency proceedings generally, specific provision is not made for insolvency cases affecting securities over allowances.

In **Poland**, insolvency in transboundary cases is regulated by the Bankruptcy Law[252] (Article 378), which is consistent with EU Insolvency Regulation 1346/2000.

### 5.2.6 Financial instruments

Questions asked about EU ETS allowances treated as financial instruments:

- Are there any problems in relation to the timely transposition and full implementation of MiFID II and MiFIR in the respective Member States?
- What is the transposing legislation of MiFID II? Does it recognise the EU ETS allowances as financial instruments or is this done under other specific national legislation?
- What are the practical implications of using allowances as financial instruments for carbon trading transactions? What is the applicable legislation?
- How are transboundary claims handled?

#### 5.2.6.1 Are there any problems in relation to the timely transposition and full implementation of MiFID II and MiFIR in the respective Member States?

MiFID II places allowances within the scope of financial instruments, as defined by its Annex I.C. In the preamble to this Directive (Recital 11), it is clear that in classifying them as financial instruments

[250] Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160 30.6.2000, p. 1.

[251] Statutory Act 2006 No. 1030. Available at: https://www.legislation.gov.uk/uksi/2006/1030/contents/made

[252] Ustawa z dnia 28 lutego 2003 r. Prawo upadłościowe i naprawcze, Dz.U. 2015, poz. 233. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20150000233

the objective was to reinforce the integrity and safeguard the efficient functioning of the carbon market, including comprehensive supervision of trading activity. The implementation deadline of MiFID II was postponed by one year and came into force in January 2018.

In **Germany** the transposition of some parts of the European financial market regulation was implemented by a first Financial Market Regulation Implementation Act (*1. Finanzmarktnovellierungsgesetz*, FiMaNoG, focusing on Market Abuse Regulation 596/2014 and the Market Abuse Directive 2014/57/EU implementation – see Section 8 below), which entered into force in July 2016. A draft of the second Financial Market Regulation Implementation Act (2. FiMaNoG), focusing on MiFID II and MiFIR implementation, was released by the German Ministry of Finance (BMF) on 29 September 2016. Since 2018, following MiFID II transposing obligations, the legislation has been amended and emission allowances are included as 'financial instruments' under the § 2(4) No. 5 WpHG and are thus covered by the Banking Act (§1(11) No 9 KWG).

The transposition process in **Poland** was recently updated, with the Act amending the Financial Instruments Trading Act and certain other acts being adopted on 1 March 2018. This legislation was adopted after the analysis of the national legislation for this project was carried out.

On 23 June 2016, the UK voted to leave the EU. On 29 March 2017, the UK government formally notified the European Council of its intention to leave the EU, beginning the two-year period to negotiate its exit under Article 50 of the TEU. Uncertainty about the legislative impact of Brexit, including MiFID II, will continue until the exact terms of the exit negotiation are finalised and published. On 24 June 2016, the Financial Conduct Authority (FCA) confirmed in a press release that EU law will remain applicable to UK firms until any changes are made, which is a matter for the UK government and Parliament. The FCA instructed UK firms to continue to abide by their obligations under UK law, including those derived from EU law.

#### 5.2.6.2 What is the transposing legislation for MiFID II? Does it recognise the EU ETS allowances as financial instruments or is this done under other specific national legislation?

Most Member States have amended their existing financial legislation in order to transpose the provisions of MiFID II.

In **Germany**, the transposition of MiFID II and MiFIR is ensured by the second Financial Market Regulation Implementation Act (2. FiMaNoG, see above). It aims for a direct implementation of the European acts' requirements into the relevant German legislative acts, mainly the German Securities Trading Act (*Wertpapierhandelsgesetz*, WpHG) and the Banking Act (*Kreditwesengesetz*, KWG). With regard to emission allowances, Article 13 (of the draft legislation) specifically removes an existing provision in the German Emissions Trading Act (TEHG). The removal of this provision aims to directly transpose the requirement of MiFID II Annex 1 C (11). At the same time, the term of emission allowances has been included *expressis verbis* in the 'financial instruments' definitions of these two acts (in a new § 2 para. 4 No. 5 WpHG, and new § 1 para. 11, s. 1 No. 9 KWG, respectively). In addition, the German legal system has been amended in relation to the regulation of financial instruments. The first of two implementing acts (1. FiMaNoG, which entered into force on 30 June 2016) covers the transposition of the Market Abuse Directive 2014/57/EU, as well as the adaptation of national laws to Market Abuse Regulation 596/2014, Regulation No 909/2014 (CSDR) and Regulation No 1286/2014 (PRIIP). The second (2. FiMaNoG) was only introduced as a draft in November 2016.

**In the UK,** MiFID II is transposed primarily through the architecture of the Financial Services and Markets Act 2000 (FSMA) in the same way as the initial MiFID. This involves a combination of secondary legislation and Financial Conduct Authority (FCA) rules. However, MiFID II, unlike its predecessor, imposes some obligations on market participants who are neither authorised persons nor recognised investment exchanges. Specific provisions will be required for these persons as they do not readily fall into the existing FSMA structure and the FSMA does not grant the Financial Conduct Authority powers to make rules in respect of such persons. The FCA document on MiFID II implementation – Consultation Paper I (CP15/43), December 2015, contains four draft statutory instruments:

- The draft Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016. The draft instrument: (i) designates the Financial Conduct Authority, Prudential Regulation Authority and the Bank of England as competent authorities for the purposes of MiFID II and MiFIR. The Financial Conduct Authority will be principally responsible for the supervision of compliance with MiFID II and MiFIR, but it affects the organisational requirements of a number of banks and all of the major investment firms supervised by the Prudential Regulation Authority, and also impacts central counterparties who are authorised and supervised by the BoE; (ii) provides for the exercise of the optional exemptions in Article 3(1)(a) to (c) of MiFID II; (iii) creates the position limit regime; (iv) imposes obligations on certain persons who do not hold Part 4A FSMA authorisation in relation to algorithmic trading, provision of direct electronic access services, acting as a general clearing member, and the synchronisation of business clocks; (iv) amends FSMA provisions as required, as a consequence of the wider transposition; (v) amends the Financial Services and Markets Act 2000 (Recognition Requirements) Regulations 2001; and (vi) makes consequential amendments to other statutory instruments made under FSMA.
- The draft Financial Services and Markets Act 2000 (Data Reporting Services) Regulations 2016. This draft instrument provides for regulation of the UK regime, which requires persons operating data reporting services (as set out in Section D of Annex I to MiFID II) to be so regulated. It requires persons providing such services to be authorised by the FCA and imposes obligations on them accordingly. It also provides for the administration and enforcement of the regime, which will be undertaken by the Financial Conduct Authority.
- The draft Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2016. The draft instrument amends the FSMA (Regulated Activities) Order 2001 (RAO) to: (i) provide that operating an OTF is a regulated activity; (ii) provide that structured deposits are within the scope of certain specified activities; (iii) make emission allowances a specified investment; (iv) make options and futures specified investments in certain circumstances involving alternative investment fund managers; (v) transpose the Article 2 MiFID II exemptions; and (vi) make consequential amendments to the Regulated Activities Order (RAO).
- The draft Financial Services and Markets Act 2000 (Qualifying EU Provisions) (Amendment) Order 2016. This draft instrument amends the Financial Services and Markets Act 2000 (Qualifying EU Provisions) Order 2013 to make MiFIR a qualifying EU provision for various parts of FSMA to ensure that the Financial Conduct Authority and Prudential Regulation Authority have the appropriate powers to perform their roles arising from MiFIR.

MiFID I was transposed in **Belgium** by the Law of 2 August 2002 on the supervision on the financial sector and financial services[253]. Despite a 2007 broadening of the definition of 'effects', it did not cover allowances. The new MiFID II, which recognises EU ETS allowances as financial instruments, was transposed in Belgium by the Law of 27 June 2016 amending the law on the financial sector and financial services[254] and the Law of 25 October 2016 on the statute and supervision of trading companies and containing other provisions[255]. The amended Law of 2002 on the financial sector and financial services transposes the definition of financial instruments as including 'options, futures, swaps, forward rate agreements and other derivative contracts relating to climatic variables, freight tariffs, emission allowances, inflation rates and other official economic statistics which shall be settled in cash or may be settled in cash upon the request of one of the parties, (unless the reason is default or another event resulting in the termination of the agreement), as well as any other derivative contract relating to assets, rights, obligations, indices and measures other than those mentioned under 1° (i.e. effects) which have the characteristics of other derivative financial instruments whereby particular consideration is given to whether they are traded on an regulated market or MTF, are cleared and settled through recognised clearing houses or are subject to regular "margin calls" (request for additional securities)', in accordance with MiFID II, in a literal manner. This ensures that allowances are considered financial instruments and are covered by the legislation on financial transactions.

In **France,** the first measures transposing the original ETS Directive 2003/87/EC, adopted in October 2003, recognised that forward or future contracts trading allowances could be regarded as financial instruments in accordance with paragraph 6 of Article L.211-1, II of the Financial and Monetary Code, in line with the MiFID framework[256]. Since the release of the 'Prada report' on the regulation of carbon markets (2010, published in La Documentation Française), the legislation has been changed. New provisions have been introduced in the Financial and Monetary Code, in particular the following Article L.421-1 as modified by the Law No 2010-1249 of 22 October 2010, to ensure that regulated financial markets could become meeting places for supply and demand of allowances:

An unofficial translation of Article L.421-1 reads:

'I. - A regulated market in financial instruments is a multilateral facility which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments in accordance with non-discretionary rules, in a way that results in contracts in respect of the financial instruments admitted to trading under its rules and systems, and which functions regularly in accordance with the provisions applicable to it.

II. - A regulated market in financial instruments as defined in paragraph I may also bring together or facilitate the bringing together of multiple third-party buying and selling interests - in accordance with non-discretionary rules - in respect of the GHG emission quotas described in Article L. 229-15 of the Environmental Code and the other units referred to in Chapter IX of Part II of Book II of said code.

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[253] Wet van 27 June 2016 tot wijziging, met het oog op de omzetting van richtlijn 2013/50/EU en de tenuitvoerlegging van verordening 596/2014, van de wet van 2 August 2002 betreffende het toezicht op de financiële sector en de financiële diensten, van de wet van 16 June 2006 op de openbare aanbieding van beleggingsinstrumenten en de toelating van beleggingsinstrumenten tot de verhandeling op een gereglementeerde markt en van de wet van 2 May 2007 op de openbaarmaking van belangrijke deelnemingen in emittenten waarvan aandelen zijn toegelaten tot de verhandeling op een gereglementeerde markt en houdende diverse bepalingen, en houdende diverse bepalingen, O.J. 1 July 2016.

[254] *Ibid.*

[255] Wet van 25 October 2016 op het statuut van en het toezicht op beursvennootschappen en houdende diverse bepalingen.

[256] Ordinance on the regulation of financial instruments markets (Ordonnance no 2016-827 du 23 juin 2016 relative aux marchés d'instruments financiers).

A regulated market in financial instruments as defined in paragraph I may also bring together or facilitate the bringing together of multiple third-party buying and selling interests - in accordance with non-discretionary rules - in respect of assets appearing on a list determined in a decree issued after consultation with the Authority of Financial Markets (AMF)'.

MiFID II was transposed in France by Ordinance no 2016-827 of 23 June 2016. Under this Ordinance, allowances are not classified as 'financial instruments'. However, as explained above, Ordinance no 2016-827 refers to the provisions regulating allowances in France, namely Articles L.229-5 and L.229-7 of the Environment Code. This Code refers to certain provisions of the Financial and Monetary Code which therefore apply to allowances where relevant, to ensure complete and correct transposition of the ETS Directive 2003/87/EC, (e.g. Title II, Book IV and Title III, Book V of this Code (see point below)).

In **Poland,** no (draft) transposing legislation existed at the time of writing this report. In light of the MiFID II content, the Polish Law on financial instruments' trading[257] was amended in March 2018, with the transposing legislation accepting allowances as financial instruments.

#### 5.2.6.3 What are the practical implications of using allowances as financial instruments for carbon trading transactions?

The **UK** FCA has observed that emission allowances are covered under MiFID II in four, sometimes overlapping, ways[258]. These observations are also relevant for the other four Member States. According to the FCA:

- Article 6(5) of the Auctioning Regulation 1031/2010 deems as an investment service or activity the reception, transmission and submission of a bid for a financial instrument (the 'five-day future' auction product) on an auction platform by an investment firm to which MiFID applies, or a CRD credit institution.
- The Auctioning Regulation 1031/2010 also regulates bids for allowances in the form of two-day spot contracts.
- An option, future, swap, forward rate agreement or any other derivative contract relating to emission allowances is included as a derivative under Section C4 of Annex I to MiFID II where it may be settled physically or in cash.

The FCA notes that there is 'no explanation about how all this overlapping legislation fits together' but itself views their operation in the following way:

- An emission allowance auctioned as a five-day future or a two-day spot contract is regulated under the Auctioning Regulation 1031/2010.
- The five-day future auction product is a financial instrument and is regulated under MiFID II as it is included under Sections C4 and C11 of Annex I to MiFID II.
- The two-day spot contract product is also a financial instrument. It is included under Annex I, Section C11 and is therefore also regulated under MiFID II.

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[257] Ustawa z dnia 29 lipca 2005 r. o obrocie instrumentami finansowymi, OJ 2005 No 183 item 1538, as amended. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20051831538

[258] Markets in Financial Instruments Directive II Implementation, Consultation Paper I (CP15/43), December 2015, pp. 267-268.

- An emission allowance (including when auctioned) will not fall within Section C11 of Annex I of MiFID II.
- The Auctioning Regulation 1031/2010 covers the reception, transmission and submission of a bid. This corresponds to the MiFID activities of reception and transmission of orders in relation to one or more financial instruments, execution of orders on behalf of clients and dealing on its own account.
- The Auctioning Regulation 1031/2010 provides certain exemptions for aircraft operators and others. These exemptions continue to apply irrespective of whether or not a MiFID II exemption is available, but only for bidding activities covered by the Auctioning Regulation 1031/2010.
- The MiFID II activities that apply to a product covered by the Auctioning Regulation 1031/2010 are not limited to the MiFID II activities listed in paragraph (5) of this list.

All of the MiFID II investment services and activities apply to emission allowances auctioned as financial instruments. Therefore, advising on bids for emission allowances auctioned as a five-day future, for example, is covered by MiFID II.

The **Belgian** Law of 2 August 2002 on the financial sector and financial services regulates financial instruments, including (since August 2016) emission allowances. Since 2016, the Belgian Financial Services and Markets Authority (*Autoriteit voor Financiële Diensten en Markten*, FSMA), as the supervisory authority for the financial markets and transactions of financial instruments, is also responsible for ensuring that transactions of emission allowances comply with the Belgian legislation on financial instruments. In line with the requirements from MiFID II, market intermediaries will now need a licence and will be subject to compliance with business rules. The trading venue would need to become a regulated market, MTF or OTF and comply with MiFID II requirements. In Belgium, the 2002 Law established the conditions and business conduct requirements for regulated markets and trading facilities. The trade transparency requirements of MiFID II are also made applicable to emission allowances, in line with the requirements of the Directive.

The **French** national expert noted that bringing allowances and their derivatives under the same legal framework aligned the spot market with those aspects applicable to the derivatives market. Together, MiFID II and market abuse rules provide a comprehensive framework for trading, while preserving the integrity of the carbon market. It introduces greater security and prevents fraudulent activity, without interfering with the purpose of the carbon market, i.e. to reduce GHG emissions in a cost-effective manner.

**Poland's** legislative changes will enable the establishment of a financial pledge on allowances. This may be considered a security, thereby making it easier to enforce.

### 5.2.7 Taxation and accounting (excluding criminal activity/law)

Questions about taxation and accounting (excluding criminal activity/law):

- Depending on their legal nature, how are allowances treated in taxation legislation in the respective Member States? What is the applicable legislation?
- Depending on their legal nature, how does VAT apply to allowances, including for cross-border transactions?
- How are allowances treated in accounting legislation in the respective Member States? What is the applicable legislation?
- Do market players use international accounting standards, such as the International Accounting Standards Board (IASB), to implement the applicable legislation?
- Would harmonised accounting standards or guidelines facilitate the trading of allowances and reduce transaction costs?

#### 5.2.7.1 Depending on their legal nature, how are allowances treated in taxation legislation in the respective Member States? What is the applicable legislation?

According to an individual decision of the **Polish** tax authorities[259], the initial free allocation of allowances by the Polish Competent Authority does not trigger a tax obligation on the part of the operator to whom the allowances are allocated. This is because such an allocation of allowances shall not be considered as income in the meaning of Article 12 paragraph 1 point 2 of the Law on income tax from legal entities[260] (i.e. it shall not be considered as a taxable gratuitous benefit provided to the operator by the public authority). It should be noted that this interpretation is based on the individual decisions of Polish tax authorities, as Polish legislation does not directly regulate this issue.

A taxable income will be created in the case of sales of emission allowances by an operator, whereby the price resulting from the sales agreement will constitute the taxable income (for income tax purposes). Article 12, paragraph 3 of the Law on income tax from legal entities[261] states that income related to an economic activity accrued in a given fiscal year shall be considered the due income, even if it has not yet been physically received by the entrepreneur (in that fiscal year). In accordance with Article 12, paragraph 3a of the Law on income tax from legal entities[262], the invoice date shall be considered the date of creation of the income[263]. In Poland, income tax for legal entities is payable at a rate of 19%.

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[259] Tax interpretation decision no 1472/ROP1/423-359/06/RM, available at: http://interpretacja-podatkowa.pl/interpretacja/pokaz/93-podatek-dochodowy-od-osob-prawnych/94-przedmiot-i-podmiot-opodatkowania/95-przychody/69502-emisja-przychody-nieodplatne-swiadczenie-nieodplatne-uprawnienie.html; tax interpretation decision no PD.423-76/06, available at: http://msp.money.pl/akty_prawne/interpretacje-podatkowe/podatek;dochodowy;od;osob;prawnych,1189,68359.html.

[260] Obwieszczenie Marszałka Sejmu Rzeczypospolitej Polskiej z dnia 30 maja 2014 r. w sprawie ogłoszenia jednolitego tekstu ustawy o podatku dochodowym od osób prawnych, OJ 2014 item 851.

[261] *Ibid.*

[262] *Ibid.*

[263] Tax interpretation decision no IBPBI/2/423-1006/11/PP. Available at: http://interpretacja-podatkowa.pl/interpretacja/pokaz/93-podatek-dochodowy-od-osob-prawnych/94-przedmiot-i-podmiot-opodatkowania/95-przychody/196428-pochodne-instrumenty-finansowe-uprawnienie-emisja-zarachowanie.html

In accordance with a 26 January 2016 judgment of the Voivedeship Administrative Court in Warsaw[264], the value of acquired emission allowances reported to be surrendered shall be treated as the operational cost of the main business activity of the operator and should be considered as a cost in reaching an income which is directly related to the income of the operator (in Polish: *kosztyuzyskaniaprzychodówbezpośredniozwiązane z przychodami*). As such, it is covered by the regulations laid down in Article 15 paragraph. 4, 4b, 4c of the Law on income tax from legal entities[265].

Article 15, paragraph 4 of the Law on income tax from legal entities states that the costs of getting an income through activities incurred in the years preceding the fiscal year and in the fiscal year, are deductible in the fiscal year when the income corresponding to these costs has occurred, subject to paragraph 4b and 4c. In Poland, emission allowances are considered intangible assets. According to Article 8(1) of the VAT Law[266], the transfer of intangible assets is considered a provision of services. According to Article 17(1) point (8), the buyer of the emission allowances is the entity that is charged with the tax (import of services). Similarly, in EU cross-border transactions, the country of the buyer is where the VAT should be levied (in accordance with the general rule of export of services, as well as Article 28b of the VAT Law[267] on the place of provision of services).[268] In Poland, the VAT for transactions relating to emission allowances is payable at a rate of 22% and no reductions are foreseen.

In **Belgium,** VAT is due on the transaction of emission allowances, not on the issuance of the allowances. The transfer of emission allowances is considered a provision of services under Article 18(1), °7 of the Code on Value Added Tax[269]. This was confirmed in administrative decision E.T. 109.133, issued on 16 March 2005. A rebate for administrative costs is also foreseen in the legislation. Article 239 of Programme Law of 27 December 2004 (*Programmawet van 27 December 2004*), foresees the introduction of a yearly indexed rebate of EUR 0.1 per freely allocated emission allowance for the owners of an operator debit account in the national registry for emission allowances. The rebate is intended to cover personnel expenses, legal and financial expertise and advice, promotional costs and other costs for the authorities resulting from the purchase of emission allowances via flexibility mechanisms or participation in carbon funds[270].

The capital gain (or loss) (gross method) or the profit (net method) from the sale of allowances are part of the taxable income of the undertaking, within the meaning of Article 24 (1) (1°) of the Income Tax Code (CIR 1992).

The **French** system is similar. Capital gains or losses from transactions on allowances are subject to ordinary taxation law and should be included in the calculation of corporate taxes, in accordance with

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264 III SA/Wa 1007/15.

265 Obwieszczenie Marszałka Sejmu Rzeczypospolitej Polskiej z dnia 30 maja 2014 r. w sprawie ogłoszenia jednolitego tekstu ustawy o podatku dochodowym od osób prawnych, OJ 2014 item 851.

266 Ustawa z dnia 11 marca 2004 r. o podatku od towarów i usług, OJ 2004 No 54 item 535. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20040540535

267 *Ibid.*

268 http://www.podatki.abc.com.pl/czytaj/-/artykul/obrot-uprawnieniami-do-emisji-gazow-cieplarnianych-a-podatek-od-towarow-i-uslug , http://www.cire.pl/pokaz-pdf-%252Fpliki%252F2%252Fnow_zas_rozlicz_vat.pdf

269 Wetboek van de belasting over de toegvoegde waarde, van 3 July 1969. Consolidated version available at: http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=e154233d-dc0e-4c0f-9bbf-afc79e797448#findHighlighted

270 Category 25-1 of the table introduced by means of the Organic Law of 27 December 1990 on the establishment of budgetary funds (Organieke wet van 27 December 1990 houdende oprichting van begrotingsfondsen).

the provisions laid down by the General Tax Code (*Code General des Impôts,* CGI). VAT is applicable to the acquisition of EU ETS allowances, and is payable by the buyer.

In **Germany**, the VAT legislation (*Umsatzsteuergesetz*, UStG)[271] applies to transactions of allowances but not to the initial free-of-charge transfer.

The UStG applies *inter alia* to 'other performances' (*sonstige Leistungen*, § 1 para. 1 Nr. 1 UStG). These performances include the provision, transfer or exercise of patents, copyright, trademark rights and other rights (§ 3a para. 4 sentence 2 Nr. 1 UStG). Since emission allowances are considered rights in Germany (as outlined earlier), they are also covered by the UStG when traded. This was held by the Federal Ministry of Finance (*Bundesfinanzministerium*, BMF) in 2005[272] and was *de facto* confirmed by the legislator.

The free allocation of allowances in Germany does not trigger a tax obligation. The TEHG gives the task of allocation to the Emission Trading Authority at the public Federal Environmental Agency (*Umweltbundesamt*), §§ 9, 19, 20 TEHG. The agency is a legal entity under public law and does not constitute an entrepreneur within the UStG (§ 2b para. 1 UStG) since it is acting in its capacity as a public authority[273].

There is no specific **UK** tax legislation on the direct tax treatment of the emissions trading system and, unlike the tax authorities of a number of other Member States, the UK tax authorities (Her Majesty's Revenue and Customs, HMRC) have not published any formal guidance in this area. Notwithstanding this, the guidance provided by existing standards suggests that when allowances are received from a government body, the allowances are recognised as an asset with nominal (i.e. nil) value and thus the acquisition of allowances by way of a grant from a government entity does not give rise to any UK tax consequences. The asset is surrendered at the end of the compliance period and written off at that time. Corporation tax will be payable when the allowances are released to the profit and loss account. By contrast, if allowances are purchased pursuant to an emission reduction purchase agreement ('ERPA'), then the prevailing view is that such purchased allowances are recognised on the balance sheet at cost. Relief is available as a deduction against trading profits, again in accordance with the accounting treatment. It should be noted that the HMRC manuals provide specific guidance confirming that the costs incurred in the **purchase** or trading of allowances are deductible expenses. HMRC has also confirmed that any income arising from the **sale** of allowances allocated to installations is taxable, while the income arising from the sale of surplus allowances (unused) is not subject to petroleum revenue tax.

In relation to the allowances **acquired through auctioning**, while a UK company may choose to purchase allowances by entering into an ERPA directly, it may prefer to indirectly acquire allowances (for several reasons). In this scenario, an orphan Special Purchase Vehicle (SPV) may be used – either acting as a principal or as the agent of the principals. Alternatively, the use of various financial instruments - such as swaps, options and forwards – may also be considered. An ERPA itself does not fall within the specific UK tax rules in the Corporation Tax Act 2009 relating to derivatives. However, other transactions may well fall within this legislation (such as a cash settled derivative contract for

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[271] *Umsatzsteuergesetz* (UStG) in der Fassung der Bekanntmachung vom 21. Februar 2005 (BGBl. I S. 386), das zuletzt durch Artikel 17 des Gesetzes vom 23 Dezember 2016 (BGBl. I S : 3234) geändert worden ist.

[272] BMF-Schreiben vom 02.02.2005 – IV A 5 S 7100 – 16/05, in BStBl 2005 I S. 494, Umsatzsteuerliche Beurteilung des Emissionshandels für Treibhausgase.

[273] *Ibid.*

hedging the risk of carbon credit price movement). Whether or not the purchase of allowances is subject to corporation tax will not depend on the legal nature of the allowances but, rather, on the exact structure of the arrangements, and these should be considered when a structured product is being considered[274].

#### 5.2.7.2 Depending on their legal nature, how does VAT apply to allowances, including for cross-border transactions?

After the incidents of so-called carousel fraud (see Section 6.2.1 for a detailed analysis), the VAT Directive 2006/112/EC was amended in March 2010 to provide an option for all Member States to introduce a reverse-charge. The VAT Directive 2006/112/EC has the effect of extending the period of validity of the reverse-charge for carbon credits from 30 June 2015 to the end of 2018. All five of the selected Member States have put the reverse-charge in place.

**Belgium** applies the reverse-charge mechanism for domestic transactions involving emission allowances[275]. Article 20 of KB No. 1 on VAT has implemented the mechanism in the Belgian legal system on VAT since 18 January 2010.

The situation is similar in **France,** where VAT is applicable to the acquisition of allowances and is payable by the buyer. After the carousel fraud on VAT, France decided to apply the VAT reverse-charge procedure as an anti-fraud measure designed to counter criminal attacks on the French VAT system by means of sophisticated fraud (see Article 283-2septies CGI).

In the **UK,** a zero VAT rate for emission allowances was introduced on 31 July 2009 as an interim measure to halt rapidly escalating missing trader (carousel) fraud in this area, pending agreement of a common EU-wide counter-measure. From 1 November 2010, the Value Added Tax (Emission Allowances) Order, SI 2010/2549 abolished the zero rate for transactions in emission allowances for GHGs in the UK, as supplies of emission allowances were then subject to a reverse-charge. HMRC's view, as expressed in VAT Notice 741, is that cross-border trading in emission allowances or instruments falls within Schedule 5, Value Added Tax Act 1994, and that VAT is therefore chargeable in the jurisdiction to which the recipient belongs.

**Poland** has also applied the reverse-charge since 2011. According to Article 8(1) of the VAT Law[276], the transfer of intangible assets is considered a provision of services. According to Article 17(1) point 8, the buyer of the emission allowances is the entity that is charged with the tax (import of services). Similarly, in EU cross-border transactions, the country of the buyer is the location for the VAT levy (in accordance with the general rule of export of services, as well as Article 28b of the VAT Law[277] on

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[274] https://www.mayerbrown.com/files/Publication/39e2d3fc-58a2-4e4d-b205-7d34c1236931/Presentation/PublicationAttachment/3ba1ab3d-b6ab-4fdd-8a5b-ab8276516a0d/ART_CASHMAN_HUTCHINSON_JUN10_TAXATION.PDF

[275] Article 20ter KB no. 1 van 29 December 1992 met betrekking tot de regeling voor de voldoening van de belasting over de toegevoegde waarde.

[276] Ustawa z dnia 11 marca 2004 r. o podatku od towarów i usług, OJ 2004 No 54 item 535. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20040540535

[277] *Ibid.*

the place of provision of services)[278]. In Poland, the VAT on transactions concerning emission allowances is payable at a rate of 22%, with no reductions foreseen.

Similarly, **Germany** implemented the reverse-charge mechanism on 1 July 2010[279] in § 13b para. 2 Nr. 6 UStG on the place of provision of services. Here, the tax is to be paid by the buyer together with the invoice, at the latest at the end of the month following the transaction.

#### 5.2.7.3 How are allowances treated in accounting legislation in the respective Member States? What is the applicable legislation?

**Poland**, in accordance with the Statement of the Committee for Accounting Standards on the accounting treatment of allowances for GHG emissions[280], granted rights to emissions that are covered by the definition of intangible assets within the meaning of Article 3(1) point 14 of the Accounting Act[281]. According to this, intangible assets shall mean property rights that are acquired by an entity, considered to be fixed assets, and which are suitable for economic use, with an expected economic life longer than one year, intended for use by the entity. Rights to emissions shall be recognised in accounting books of the operator at the date of acquisition (including allocation, i.e. the date of their registration in the operator's account), at the purchase price, and presented in the financial report (balance sheet) as a separate item in the group of intangible assets and legal rights, irrespective of their purpose (own use or other disposal). For each installation, a separate qualitative and quantitative report on allocated and acquired emission allowances shall be compiled and kept. The main applicable legislation is the Accounting Act[282].

In 2008, the **Belgian** Commission for Accounting Standards (*Commissie voor Boekhoudkundige Normen*, CBN) issued an updated advisory note on the accounting of emission allowances by establishments participating in the EU ETS. The note presents two possible accounting methods for emission allowances: the gross method and the net method. According to the gross method, allowances allocated or received shall be accounted for as intangible assets (*immateriële vaste activa or immobilisations incorporelles*). The Commission notes that the description of intangible assets in Article 95 of the Royal Decree of 30 January 2001 implementing the Company Code seems to cover emission allowances and these should thus be recorded in a separate account under this heading. The allowances shall be valued at their purchase price. If they were obtained at a lower value than their real value (e.g. free-of-charge), they shall be valued at their real value, with the difference between the purchase cost and the real cost recorded under 'other earnings'. The undertaking shall, at the end of the year, create a provision to surrender emission allowances to the regions, reflecting the emissions of $CO_2$ during the preceding year. The amount of the provision shall correspond to the amount of emission allowances to be surrendered, either against their starting value or, where the emissions

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[278] http://www.podatki.abc.com.pl/czytaj/-/artykul/obrot-uprawnieniami-do-emisji-gazow-cieplarnianych-a-podatek-od-towarow-i-uslug , http://www.cire.pl/pokaz-pdf-%252Fpliki%252F2%252Fnow_zas_rozlicz_vat.pdf

[279] Gesetz zur Umsetzung steuerlicher EU-Vorgaben sowie zur Änderung steuerlicher Vorschriften (EU-Vorgabenumsetzungsgesetz) vom 8.4.2010 (BGBl. I S. 386).

[280] http://www.mf.gov.pl/c/document_library/get_file?uuid=ab6b3fe5-c25f-43f7-a994-5f2dec9366aa&groupId=764034

[281] Obwieszczenie Marszałka Sejmu Rzeczypospolitej Polskiej z dnia 22 czerwca 2016 r. w sprawie ogłoszenia jednolitego tekstu ustawy o rachunkowości, OJ 2016 item 1047. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20160001047&min=1.

[282] Obwieszczenie Marszałka Sejmu Rzeczypospolitej Polskiej z dnia 22 czerwca 2016 r. w sprawie ogłoszenia jednolitego tekstu ustawy o rachunkowości, OJ 2016 item 1047. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20160001047&min=1.

exceed the allowances held, their real value at the end of that period. The provision shall be recorded against a cost corresponding to the effective emissions of the undertaking on that date. The fines for failure to surrender allowances to the regions do not constitute deductible business expenses and are included in ineligible expenditure.

The gross method is most suitable for industrial undertakings in the EU ETS which intend to participate in the emission market. For the net method, on the other hand, the CBN considers the EU ETS to have no impact (either to increase or decrease) on the assets of the undertaking, as the allowances only enable undertakings to continue their operations. It is assumed that the freely allocated emission allowances should generally correspond to the allowances to be surrendered and that undertakings will use the emission market only nominally. As a consequence, emission allowances allocated to an undertaking will not be considered assets of the undertaking and will only be mentioned in the notes on the annual account. Only the purchase or sale of allowances will be recorded as a cost or revenue in the profit and loss account. The use of the net method was further explained in a new advisory opinion of the CBN in January 2012. The advice covers situations in which the undertaking has an excess of emission allowances. When the undertaking intends to sell the allowances during the next year – and only in those cases - these may be transferred and considered immovable assets of the undertaking.

In **France**, rules on the accounting for GHG emission allowances and similar units are developed by a dedicated national public authority, the Accounting Standard National Authority (*Autorité des Normes Comptables*, ANC), under Regulation ANC no 2014-03, which takes into account allocation modalities for Phase III of the EU ETS. It provides for two different regimes, depending on how the allowances are used ('production' model versus 'trading' model):

- Production (installations): allowances are recorded in inventory accounts (at the purchase value, or zero for the free allocation);
- Allowances are subtracted from stocks when $CO_2$ is emitted, in return for a production charge;
- In case of a shortage of allowances: recognition of a liability (the subsequent purchase of allowances puts an end to the liability);
- Trading (intermediaries): allowances are recorded at their acquisition cost;
- If the current value is less than their carrying amount, the latter is reduced to the present value through an impairment;
- Gains and losses are recognised in the income statement.

Specific rules have been adopted by the National Council of Standardisation of Public Accounts (*Conseil de Normalisation des Comptes Publics*, CNOCP) for the accounting of allowances allocated to public institutions (see *Avis no 2015-02 du 15 janvier 2015 relatif à la nouvelle norme 21 sur les quotas d'émissions de gaz à effet de serre du futur Recueil de normes comptables pour les établissements publics*).

In the **UK,** there does not appear to be any generally accepted accounting standard relating to allowances. However, it was anticipated that an entity considering allowances to be intangible assets accounted for in accordance with financial reporting standards (FRS 10) would recognise these initially at fair value[283]. In 1997, the Accounting Standards Board issued its accounting standard FRS 10 (on goodwill and intangible assets), ensuring that reporting entities charged purchased goodwill and

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[283] Financial Reporting Standards.

intangible assets to their profit and loss accounts in the period in which they were depleted. This standard, together with the old UK generally accepted accounting principles (GAAP) FRSs, was withdrawn for reporting periods starting on or after 1 January 2015. Topics within the charging of intangible assets and goodwill are covered by Section 18 of FRS 102, the Financial Reporting Standard applicable in the UK and the Republic of Ireland under new UK GAAP.

In **Germany**, the treatment of emission allowances under accounting rules was clarified early on by the Federal Ministry of Finance (*Bundesfinanzministerium*, BMF) for the acquisition of allowances free-of-charge and for acquisition against payment[284]. This procedure is also described in the German report on Article 21 of the ETS Directive 2003/87/EC[285]. Given the focus of this study on the issue of the legal nature of allowances, it is sufficient here to stress that the basic principles in both trade law and fiscal law state that allowances are assigned to current assets as intangible assets, and both types of provisions have the same impact on profit.

Allowances acquired free-of-charge need to be reflected in the balance sheet as profit neutral (resulting, for instance, in EUR 0 on the tax balance sheet). The provision of § 6 para. 4 Income Tax Law (*Einkommensteuergesetz*, EStG)[286] that requires the reflection of the value of free-of-charge assets in the balance sheet does not apply here, due to the origin of the assets from a public authority.

As intangible assets, emission allowances acquired against payment need to be included with the costs of purchase (see § 6 para. 1 Nr. 2 EStG for the fiscal side)[287]. The obligation to surrender allowances needs to be reflected by a liability on the balance sheet. In the case of insufficient allowances in the account, the balance sheet must show a reserve for contingencies (§ 249 para. 1 sentence 1 Commercial Code (H*andelsgesetzbuch*, HGB), together with § 5 para. 1 EStG).

#### 5.2.7.4 Do market players use international accounting standards, such as IASB, to implement the applicable legislation?

In **Poland**, according to Article 10(3) of the Accounting Act[288], in matters not regulated by the provisions of the Accounting Act, economic operators may, in the first instance, adhere to national accounting standards issued by the Committee for Accounting Standards. Where there is no relevant national accounting standard, economic operators may use international accounting standards. In accordance with National Accounting Standard no 7[289], accounting standards and statements issued by the Committee for Accounting Standards shall be considered national accounting standards. The Committee for Accounting Standards issued a statement on the accounting treatment of allowances for

[284] BMF-Schreiben vom 06.12.2005 – IV B 2-S 2134a-42/05, in BStBl 2005 I S. 1046, Ertragsteuerliche Behandlung von Emissionsberechtigungen nach dem Gesetz über den Handel mit Berechtigungen zur Emission von Treibhausgasen; as amended by BMF-Schreiben vom 07.03.2013 – IV C 6-S 2134-a/07/10003, in BStBl. 2013 I S. 275.

[285] For the collected input of all Member States in the EU ETS Article 21, see the database of the EEA, http://www.eea.europa.eu/data-and-maps/data/application-of-the-emissions-trading

[286] Einkommensteuergesetz in der Fassung der Bekanntmachung vom 8. Oktober 2009 (BGBl. I S. 3366, 3862), das zuletzt durch Artikel 9 des Gesetzes vom 23. Dezember 2016 (BGBl. I S. 3191) geändert worden ist.

[287] For further information on accounting rules, see, for instance, Bemmann, A., Die Behandlung des Emissionshandels in der Handels- und Steuerbilanz, 2013, or Völker-Lehmkuhl, K., Praxis der Bilanzierung und Besteuerung von $CO_2$-Emissionsrechten, 2006.

[288] Obwieszczenie Marszałka Sejmu Rzeczypospolitej Polskiej z dnia 22 czerwca 2016 r. w sprawie ogłoszenia jednolitego tekstu ustawy o rachunkowości, OJ 2016 item 1047. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20160001047&min=1.

[289] Uchwała nr 7/10 Komitetu Standardów Rachunkowości z dnia 20.04.2010 r. Available at: http://www.przepisy.gofin.pl/przepisy,4,16,181,1431,,20100728,uchwala-nr-710-komitetu-standardow-rachunkowosci-z-dnia.html#P47323

GHG emissions[290]. As this statement is considered a national accounting standard, it must be used by economic operators, who may not, therefore, use international accounting standards in this regard[291]. In accordance with Article 55(5) of the Accounting Act[292], however, there are two types of economic operators legally obliged to use international accounting standards: issuers of securities in the meaning of EU Regulation 1606/2002; and banks.

In **Belgium,** the advisory opinion of the CBN recommends using the gross or net method (as outlined above). It points out that the gross method more closely follows the reasoning adopted by the IASB in International Financial Reporting Interpretations Committee (IFRIC) 3, which has since been withdrawn (see below for the UK).

In **France,** despite the fact the ANC is mandated to provide advice and contribute to the development of International Financial Reporting Standards under the auspices of the IASB, most market players use the national accounting standards, as there are still some differences between the 'production model' and IAS 38. Some convergence towards the 'net liability approach' was noted.

In the **UK,** the IASB's IFRIC issued an interpretation (IFRIC 3 Emission Rights) on the accounting for emission rights under a 'cap-and trade' emission rights scheme in December 2004. The interpretation applied to financial reporting periods beginning on or after 1 March 2005, with earlier adoption encouraged, so that it could be implemented for the beginning of Phase I of the EU ETS, which was the main driving force behind the development of the interpretation. The IFRIC 3 interpretation met with considerable opposition and was withdrawn in June 2005. In its withdrawal notice, the IASB affirmed that IFRIC 3 was an appropriate interpretation of the international financial reporting standards (IFRS) literature but acknowledged that in following existing IFRSs, IFRIC 3 created unsatisfactory measurement and reported mismatches.

The UK has since adopted the IFRS for small and medium-sized enterprises (SMEs) standard, as FRS 102 *The Financial Reporting Standard applicable in the UK and the Republic of Ireland* but with significant modifications:

- Added an option in Section 17 to revalue property, plant and equipment and, similarly, added an option in Section 18 to revalue certain intangible assets;
- Added an option in Section 18 to capitalise development costs when specific criteria are met;
- Changed the presumption in Section 18 of a 10-year useful life for amortisable intangible assets, including goodwill, when a reliable estimate cannot be made to amortisation over a maximum of five years;
- Added an option in Section 18 to capitalise borrowing costs on qualifying assets;
- Required merger accounting (pooling) for combinations of entities under common control;
- Non-cash distributions to owners do not have to be measured at fair value;
- Added an accrual accounting option for government grants;
- Required a timing difference approach to deferred income taxes, rather than a temporary difference approach;
- Permitted the historical cost model for all biological assets;

[290] http://www.mf.gov.pl/c/document_library/get_file?uuid=ab6b3fe5-c25f-43f7-a994-5f2dec9366aa&groupId=764034
[291] http://www.poradnikksiegowego.pl/artykul,93,8570,nowelizacja-krajowego-standardu-rachunkowosci-nr-7.html
[292] Obwieszczenie Marszałka Sejmu Rzeczypospolitej Polskiej z dnia 22 czerwca 2016 r. w sprawie ogłoszenia jednolitego tekstu ustawy o rachunkowości, OJ 2016 item 1047. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20160001047&min=1

- Made numerous other changes to allow accounting treatments that exist in FRSs at the transition date that align with IFRS standards as adopted by the EU.

### 5.2.8 Allowances as the subject of criminal activity (VAT fraud, theft, money laundering, market abuse)

Questions about allowances as the subject of criminal activity (VAT fraud, theft, money laundering, market abuse):

- What is the applicable legislation and how are the EU ETS allowances treated when they have been the subject of criminal activity such as VAT fraud, theft, money laundering, market abuse?
- What are the legal consequences of such criminal acts? Are criminal sanctions sufficiently deterring or dissuasive?
- Have any issues been identified in relation to the different treatment by Member States of criminal activities in relation to the EU ETS allowances, such as VAT fraud, theft, money laundering, market abuse?

#### 5.2.8.1 What is the applicable legislation and how are the EU ETS allowances treated when have been subject of criminal activity such as VAT fraud, theft, money laundering, market abuse?

Other than Market Abuse Regulation 596/2014 and the transposing legislation of the Anti-Money Laundering Directive 2015/849/EU, most Member States have no specific legislation that regulates issues relating to allowances in cases of fraud, theft, money laundering or market abuse. The general rules of criminal law, tax law and competition protection are applicable. Problems have been identified mainly in relation to VAT, where at least six Member States did not put in place the VAT reverse-charge mechanism until recently.

In **Germany,** the legal framework was modified to ensure transposition of the Anti-Money Laundering Directive 2015/849/EU with regard to the administrative sanctions under the German Anti-Money Laundering Act[293]. The Market Abuse Regulation 596/2014 replaced a number of previously existing national provisions. Some changes were implemented via the 1. FiMaNoG (see above), e.g. the German Securities Trading Act[294]. Otherwise, VAT fraud, the theft of emission allowances, and money laundering are covered by the general rules of criminal law (i.e. various sections of the German Penal Code). VAT fraud is also covered by the general rules of tax law (i.e. provisions of the German Tax Code (*Abgabenordnung*, AO), and the German VAT Act (*Umsatzsteuergesetz*, UStG)).

**VAT fraud** occurs where there is failure to comply with the general obligation to file (correct) tax returns. The criminal behaviour is directed towards the state, not a (private) individual, and is covered by the general German Tax Code (§ 370 AO), on tax evasion (*Steuerhinterziehung*). In cases where tax returns are filed correctly but the VAT is never actually paid, another provision in the German VAT Act (§ 26c) is applicable. Since the criminal conduct here consists of not paying the due (and correctly filed) taxes, it is dealt with as a misdemeanour.

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[293] Geldwäschegesetz (GwG) vom 13 August 2008 (BGBl. I S. 1690), das zuletzt durch Artikel 7 des Gesetzes vom 11 April 2016 (BGBl. I S. 720) geändert worden ist.

[294] Wertpapierhandelsgesetz, (WpHG) in der Fassung der Bekanntmachung vom 9 September 1998 (BGBl. I S. 2708), das durch Artikel 1 u. 2 des Gesetzes vom 30 June 2016 (BGBl. I S. 1514) geändert worden ist.

**Typical VAT fraud** includes a number of participants, for instance a company for the cross-border sales (and return of sold goods at the end of a cycle), the 'missing trader' reducing the sales price (thus generating illegal revenue for the VAT fraud), several buffer companies that decrease the traceability of sales by authorities, and finally the distributor that completes the transaction with a cross-border sale. Each of these participants, where they are aware of the illegal activity (or have good reason to suspect it) can face criminal charges for their contributions. For instance, the individuals behind a 'missing trader' could also face additional charges under the German Penal Code (*Strafgesetzbuch*, StGB): § 129 covers the creation of criminal organisations (*Bildung krimineller Vereinigungen*), which applies if the creation of a structured association (with a certain level of organisation) can be proven and traced back to the individual.

- The violation of provision § 370 AO can result in a sentence of up to five years in prison, or a fine. In specific cases, for instance particularly high tax evasion, or the use of counterfeit receipts or documents, the level of criminal sentence increases from at least six months up to 10 years in prison (without the option of a fine).
- In severe cases of § 129 StGB, in which a whole organisation is set up and maintained to conduct criminal activities, its supporters can be sentenced to up to five years in prison, or a fine.
- A violation of § 26c UStG constitutes a misdemeanour and is sanctioned with a fine of up to EUR 50,000.

Under German law**, theft** is conducted by breaching another individual's right to **tangible property** and incorporating it (at least temporarily) into another sphere of influence. It is covered under the regular German criminal legislation, including in particular §§ 242 ff. of the Penal Code (*Strafgesetzbuch*, StGB), which covers theft in various forms. However, the **theft of emission allowances** is defined as an unlawful transfer of emission allowances to another account. This involves unauthorised access to account information, followed by its use. The transfer itself could constitute computer fraud (*Computerbetrug*), § 263a StGB, which covers, *inter alia,* the unauthorised use of data or other unauthorised influence in the course of data processing.

Given the many possibilities to gain illegal access to relevant data, a number of provisions could apply to the unlawful acquisition of data (before its actual use) [295]:

- Forgery of data intended to provide proof (*Fälschung beweiserheblicher Daten*), § 269 StGB, including the forging of identities to obtain sensitive (account) information;
- Data espionage and phishing (*Ausspähen und Abfangen von Daten*), §§ 202a, 202b StGB, which cover the illegal acquisition of data for personal accounts, in particular phishing activities; and
- Data tampering and computer sabotage (*Datenveränderung und Computersabotage*), §§ 303a, 303b StGB, which focuses on interference with data processing operations and could include (Distributed) Denial of Service (DDoS) attacks or the distribution of malware.

[295] For the distribution of such cybercrimes in Germany in 2015 (overarching and not specifically for emissions trading), see: Bundeskriminalamt (Federal Criminal Police Office), Cybercrime – Bundeslagebild, 2015, pp. 4f. Available at: https://www.bka.de/SharedDocs/Downloads/DE/Publikationen/JahresberichteUndLagebilder/Cybercrime/cybercrimeBundeslagebild2015.html

The legal consequences are as follows:

- For computer fraud: up to five years imprisonment, or a fine. Increased criminal sanctions in severe cases are covered by the link in § 263 para. 2 StGB that applies § 263 paras. 2-7 StGB: In particularly serious cases the penalty can be set between six months and 10 years of imprisonment (thereby excluding fines), which also applies if the criminal conduct resulted in large losses by the victims (courts estimate this to be begin around EUR 50,000) and the criminal activities were conducted at a commercial level;
- For forgery of data: the same as for computer fraud, i.e. up to five years, or a fine, which is increased in severe cases to six months to 10 years (§§ 269 para. 3, 267 paras. 3 and 4 StGB);
- For data espionage and phishing: up to three years, or a fine (§ 202a para. 1 StGB), or up to two years, or a fine (§ 202b StGB), respectively;
- For data tampering and computer sabotage: up to two years, or a fine (§ 303a para. 1 StGB), or up to three years, or a fine (§ 303b StGB), the latter of which can be increased in severe cases to up to five years, or a fine.

In German legislation, **money laundering** is specifically addressed by two different acts: the German Anti-Money Laundering Act (*Geldwäschegesetz,* GwG)[296], which focuses on the prevention of money laundering; and the (general) German Criminal Code (*Strafgesetzbuch*, StGB)[297].

The GwG does not provide for any criminal sanctions but allows fines for administrative offences up to EUR 100,000 (§ 17 para. 2 GwG). The new legislation transposing the fourth EU Anti-Money Laundering Directive 2015/849/EU)[298] has not yet been implemented into German law at the time of this report (January 2017). The German Federal Ministry of Finance released a first draft of the implementing act on 15 December 2016[299]. It aims to reorganise the offences in § 52 GwG, add new offences and increase the maximum pecuniary sanctions to up to EUR 1 million, or twice the financial benefit that resulted from the offence, in line with Articles 58 and 59 Anti-Money Laundering Directive 2015/849/EU and Articles 17 and 18 of the Fund Transfer Regulation (FTR)[300].

Criminal sanctions for money laundering, on the other hand, are included in § 261 StGB. This provision links the sanctions to concealing the origin of 'unlawful acts'. It lists a number of provisions for criminal behaviour (largely felonies and a number of misdemeanours), the benefits of which are potential objects of the money laundering. For instance, if the previously committed act constituted a felony or one of the listed misdemeanours (including tax evasion committed on a commercial basis or

[296] German Money Laundering Act of 13 August 2008 (BGBl. I p. 1690), last amended by Article 7 of the Law of 11 April 2016 (BGBl. I S. 720).
[297] German Criminal Code in the version promulgated on 13 November 1998 (BGBl. I p. 3322), last amended by Article 1 of the Law of 24 September 2013 (BGBl. I p. 3671) and with the text of Article 6(18) of the Law of 10 October 2013 (BGBl. I p. 3799).
[298] Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC.
[299] Referentenentwurf eines Gesetzes zur Umsetzung der Vierten EU-Geldwäscherichtlinie, zur Ausführung der EU-Geldtransferverordnung und zur Neuorganisation der Zentralstelle für Finanztransaktionsuntersuchungen, 15 December 2016. Available at: http://www.bundesfinanzministerium.de/Content/DE/Downloads/Gesetze/2016-12-15-geldwaescherichtlinie.pdf;jsessionid=2B42A2A1C0CB043A3B43BD74DF15CE1A?__blob=publicationFile&v=2.
[300] Regulation (EU) 2015/847 of the European Parliament and of the Council of 20 May 2015 on information accompanying transfers of funds and repealing Regulation (EC) No 1781/2006

as a gang, under § 370 AO), the sentence for money laundering is imprisonment from three months to five years (excluding the possibility of a fine). In serious cases, the penalty can be increased to six months to 10 years (§ 261 para. 4 StGB), such as where the act is committed on a commercial basis, or by a member of a gang with the purpose of continued money laundering.

§ 261 para. 5 StGB also covers money laundering by people who were unaware of the fact due to gross negligence, but limits the penalty in such cases to two years, or a fine.

Neither the GwG nor the StGB includes any special sanctions for money laundering conducted within the emission trading system. Only § 16 GwG mentions emission trading directly, allowing the responsible authorities to take the appropriate measures and give administrative orders to comply with Article 55 paragraph 1 of the Auctioning Regulation 1031/2010 [301]. This provision, however, focuses on compliance with customer due diligence requirements.

For **market abuse**, the relevant EU legislation (the Market Abuse Regulation 596/2014[302]) is directly applicable in the Member States, replacing a number of existing national provisions. Via the 1. FiMaNoG[303], several changes were implemented in June 2016, e.g. in the German Securities Trading Act (*Wertpapierhandelsgesetz,* WpHG)[304].

§ 12 WpHG links the Market Abuse Regulation 596/2014 specifically to emission allowances as defined in § 3 Nr. 3 TEHG. The list of the administrative offences in § 39 para. 3d Nr. 2 WpHG now includes violations of Article 15 of the Market Abuse Regulation 596/2014which is itself complemented by Article 12 paragraphs 1 and 2 of the Market Abuse Regulation 596/2014 with regard to activities and behaviour on the emission market.

The maximum fine for violations under this provision is EUR 5,000,000 (§ 39 para. 4a sentence 1 WpHG) if directed at a natural person. The maximum is increased for legal entities, to a maximum of EUR 15,000,000 or 15% of the previous fiscal year's total turnover (§ 39 para. 4a sentence 3 WpHG), whichever is the higher.

In **Poland,** the general rules of criminal law and tax law are applicable. As the Criminal Code[305] prescribes, a criminal activity is a forbidden action or omission that is generally accepted as socially harmful or dangerous, defined and forbidden by the law. In order to be treated as a crime, the criminal action must also be threatened with a punishment. Crimes in respect of VAT and other public instruments are detailed in the Criminal Fiscal Code[306]. Market abuse is regulated by the rules of the Market Abuse Regulation 596/2014 and the Law on financial instruments' trading[307] (which should have been amended by the Act of 10 February 2017 on amendment of the Law on financial

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[301] Commission Regulation (EU) No 1031/2010 of 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and of the Council establishing a system for greenhouse gas emission allowances trading within the Community.

[302] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC.

[303] First law amending financial market regulations under European legislation of 30 June 2016 (BGBl. I p. 1514).

[304] German Securities Trading Act in the version of the promulgation of 9 September 1998 (BGBl. I p. 2708), last amended by Articles 1 and 2 of the Law of 30 June 2016 (BGBl. I p. 1514).

[305] Ustawa z dnia 6 czerwca 1997 r. Kodeks karny, Journal of laws of 2016 item 1137, available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20160001137

[306] Ustawa z dnia 10 września 1999 r. Kodeks karny skarbowy, Journal of laws of 2013, item 186, available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20130000186

[307] Ustawa z dnia 29 lipca 2005 r. o obrocie instrumentami finansowymi, OJ 2005 No 183 item 1538, as amended: available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20051831538

instruments trading and other acts[308] (the legislation process is pending, with the Act being assessed by the Senate)), implementing provisions of the Market Abuse Directive 2014/57/EU and the Market Abuse Regulation 596/2014 into Polish legislation.

In general, the allowances would be treated like any other subject of theft, market abuse, VAT fraud or money laundering, without specific regard to their legal nature.

The situation is similar in **Belgium,** where there are no specific requirements dealing with the fraud, theft or money laundering of emission allowances. General requirements and sanctions are established in Belgian criminal law for each of these crimes. In addition, VAT fraud is subject to criminal sanctions, as set out in the Code on VAT, Chapter XI, Articles 70 to 74ter[309]. The sanctions include imprisonment and/or pecuniary fines of up to EUR 500,000[310]. The law of 11 January 1993 on the prevention of the use of the financial system for money laundering and the financing of terrorism established sanctions for money laundering. The establishments covered by the Law on financial services (which now applies to emission allowances as financial instruments) are subject to these provisions. Money or assets are considered to be of illegal provenance when they result from specifically listed activities in Article 5, such as fraud to the detriment of financial interests (of the European Communities), serious fiscal fraud, trading crimes, theft, fraud or breach of trust. Article 40 of this law establishes a range of sanctions applicable to establishments engaged in money laundering. The Belgian Criminal Code penalises fraud and theft. Article 41bis of the Criminal Code establishes the amounts of fines for legal persons. Confiscation of the object of a crime which has served the purpose of committing the crime, or of property gains obtained from the crime are regulated in Article 42 of the Criminal Code. Specific confiscation measures are foreseen in Article 43quater in relation to serious fiscal crime. Trading in stolen goods is subject to separate sanctions in Article 505 of the Criminal Code. The amended law of 2002 on the financial sector and financial transactions was amended in 2016 to implement the Market Abuse Regulation 596/2014. The law designates the Authority for Financial Services and Market (*Autoriteit voor Financiële Diensten en Markten*, FSMA) as the competent authority for enforcing the provisions of the Market Abuse Regulation 596/2014 in Belgium. In 2016, the FSMA adopted a circular, 'Practical Instructions on the Abuse of Power Regulation'[311], containing instructions in relation to the notification and reporting obligations for emitters under the Market Abuse Regulation 596/2014. The maximum penalties and administrative fines for infringement of the Market Abuse Regulation 596/2014 are established in Article 36 of the law.

In **France,** VAT fraud, theft, money laundering and market abuse are ordinary offences under criminal law, supplemented by some provisions of the Financial and Monetary Law which do not provide for special treatment for transactions in respect of allowances. Exceptions are the new market abuse provisions transposing the new Market Abuse Directive 2014/57/EU into French law. These introduce specific carbon-related elements (definition of inside information, tailored inside information, disclosure duty, complete coverage of primary market/auctioning, etc.). However, these provisions do not apply in relation to prosecution or sanctions. VAT fraud on allowances' transactions has been

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[308] http://orka.sejm.gov.pl/proc8.nsf/ustawy/1097_u.htm
[309] Code of 3 July 1969 on the tax on added value (*Wetboek van 3 juli 1969 van de belasting over de toegevoegde waarde*).
[310] The amount for fines set out in Belgian legislation shall be multiplied by a factor based on the indexation rate. The indexation factor is currently six, therefore all administrative and criminal fines established in Belgian legislation shall be multiplied by six.
[311] Circulaire FSMA_2016_08 dd. 18/05/2016 (update 13 December 2016), *Praktische instructies en ESMA-richtsnoeren bij de marktmisbruikverordening*, http://www.fsma.be/nl/Supervision/fm/ma/mm/circmedprak.aspx

systematically prosecuted before the criminal courts on the basis of Article 313-1 of the Criminal Code punishing the offence of fraudulent acquisition, defined by Article 313-1 as '*the act of deceiving a natural or legal person by the use of a false name or a fictitious capacity, by the abuse of a genuine capacity, or by means of unlawful manoeuvres, thereby to lead such a person, to his prejudice or to the prejudice of a third party, to transfer funds, valuables or any property, to provide a service or to consent to an act incurring or discharging an obligation'*.

Money laundering is defined by Article 324-1 of the Criminal Code as the following: '*Money laundering is facilitating by any means the false justification of the origin of the property or income of the perpetrator of a felony or misdemeanour which has brought him a direct or indirect benefit. Money laundering also comprises assistance in investing, concealing or converting the direct or indirect products of a felony or misdemeanour*.' Money laundering is punishable by up to five years' imprisonment and a fine of up to EUR 375,000. Money laundering, as well as fraudulent acquisition, is punishable by up to five years' imprisonment and a fine of up to EUR 375,000 (natural person) or EUR 3,750,000 (legal person). Sanctions are increased to up to 10 years' imprisonment and a fine of EUR 1 million when offences are committed by an organised group.

Theft is defined, generally, in Article 311-1 of the Criminal Code, as the fraudulent appropriation of a thing belonging to another person. Theft is punishable by up to three years' imprisonment and a fine of up to EUR 45,000, but sanctions can be increased to up to 15 years' imprisonment and a fine of up to EUR 150,000 depending on the circumstances in which the crime was committed, e.g. in an organised group, with violence, etc.).

With the adoption of Law no 2016-819 of 21 June 2016, France transposed the Market Abuse Directive, strengthening the criminal sanctions for market abuse in national law. Using the margin of discretion offered to Member States by the Directive, France adopted a more stringent and repressive regime, which goes beyond the minimum requirements set out by EU law, by imposing the maximum level of sanctions equally on all market abuse offences (insider trading, illegal disclosure of privileged information, market manipulation).

Articles L. 465-1 to L. 465-3-5 of the Financial and Monetary Code provides for the following maximum sanctions:

- Five years' imprisonment (previously two years) and a fine of up to EUR 100 million (previously EUR 1.5 million for insider trading and EUR 150,000 for the illegal disclosure of privileged information);
- When committed in organised groups, the sanction is increased to up to 10 years' imprisonment (Article L. 465-3-5, II);
- For legal persons: a fine of EUR 500 million (the highest level of fine in the OECD) and/or up to 10 times the benefits gained, as well as a prohibition on exercising the activity in which offences were committed.

The **UK** VAT reverse-charge procedure is an anti-fraud measure designed to counter criminal attacks on the UK VAT system by means of sophisticated fraud. Only those compliance market credits which can be used to meet obligations under the EU ETS are subject to the reverse-charge mechanism. These currently comprise EU allowances, some Certified Emission Reductions (CER) and some Emission Reduction Units (ERU), as defined in the ETS Directive 2003/87/EC. The relevant law relating to the reverse-charge mechanism on specified goods and services is set out in:

- Section 55A of the Value Added Tax Act 1994 (as amended);
- Sections 65 and 66 of the VAT Act 1994 (in relation to penalties with regard to the Reverse-Charge Sales List (RCSL));

- Regulations 23A-23D of Part IV of the VAT Regulations 1995 (in relation to the RCSL) (as amended);
- Value Added Tax (Section 55A) (Specified goods and services and excepted supplies) Order 2010;
- Value Added Tax (Section 55A)(Specified Goods and Services and Excepted Supplies) Order 2014.

The UK anti-money laundering regime is primarily covered by:

- The Proceeds of Crime Act 2002 (as amended by the Crime and Courts Act 2013 and the Serious Crime Act 2015);
- The Anti-Money Laundering Regulations 2007;
- The Terrorism Act 2000 (as amended by the Anti-Terrorism, Crime and Security Act 2001, the Terrorism Act 2006 and the Terrorism Act 2000 and Proceeds of Crime Act 2002 (Amendment) Regulations 2007).

The principal objective of the UK legislation is to prevent the UK's financial system from being used for money laundering and terrorist financing purposes.

The UK transposed the Market Abuse Directive 2003/6/EC[312] into national law in Part 8 of the Financial Services and Markets Act (2000) (FSMA). Seven types of behaviour can amount to market abuse, ranging from insider dealing to distortion and misleading behaviour, i.e. giving a false or misleading impression of supply or demand or otherwise distorting the market in an investment. Unsurprisingly for such a new market, there are some areas of the carbon market that may fall outside existing cross-border financial services regulation. For example, as the Market Abuse Directive only applies to financial instruments, existing market abuse provisions do not extend to auctioned emission allowances that take the form of two-day spot transactions.

#### 5.2.8.2 What are the legal consequences of such criminal acts? Are criminal sanctions sufficiently deterring or dissuasive?

The sanctions for criminal acts in respect of the EU ETS allowances in the Member States range from the imposition of fines to restriction of liberty/imprisonment. As established above, they derive from general criminal legislation. A decision on whether or not the criminal sanctions are sufficiently dissuasive is a matter of individual assessment for each Member State.

In **France**, there is a consensus among all market players that the strong sentences imposed on fraudsters have been successful as a deterrent. In addition, they believe that the reverse-charge mechanism is the right approach to avoid such offences insofar as the VAT money no longer circulates. The State is entitled to claim compensation for losses resulting from fraud. For instance, in July 2016, the Criminal Court of Paris (*32ème Chambre du tribunal correctionnel de Paris*) sentenced a number of fraudsters to imprisonment for up to eight years, with fines of up to EUR 3.75 million (organised group involved in the famous 'Nathanaël' case of carousel VAT fraud from allowances transactions between 2008 and 2009). In addition, they were jointly sentenced to pay compensation of EUR 283 million to the State in compensation for losses resulting from such fraud. This ruling follows previous judgments ruled in the 'Nathanaël' case in 2011. France has expressed its wish to include

[312] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation, OJ L 96, 12.4.2003, pp. 16–25.

such fraud, in particular when it has transboundary implications, in the scope of the future Directive on the fight against fraud against the Union's financial interests by means of criminal law (COM/2012/0363 final - 2012/0193 (COD), currently under discussion in Council and Parliament) in order to allow effective legal action of such serious offences. It is acknowledged by both public authorities (including the *Caisse des Dépôt et Consignations* in its capacity as national administrator) and market players (such as BlueNext) that the carousel VAT fraud system in 2008 could not have been anticipated because of the newness of the carbon market at that time.

The situation is similar in **Belgium.** While there is no specific regulation for fraud in respect of emission allowances, it is believed that the criminal sanctions established in Belgian legislation are a sufficient deterrent.

By contrast, the sanctions in **Poland** may not be dissuasive enough, compared to fines provided for in legislation in other countries[313]. Opinion holds that the current regulations on sanctions are insufficient when compared to the benefits from criminal activities, especially in respect of VAT fraud[314]. It is estimated that the state budget loses billions of PLN every year due to general VAT fraud, which is a serious problem in Poland[315]. As of 1 March 2017, the Criminal Code was amended in respect of criminal sanctions for such acts. The most important amendment is the provision of longer imprisonment, with sentences up to 25 years' imprisonment. The period of imprisonment shall be determined according to the amount of VAT subject to fraud[316]. Experts expect this amendment to deter fraud for substantial sums of money[317]. Nevertheless, at the time of this report, KOBIZE has not been informed of any case of VAT fraud, money laundering or theft regarding allowances, meaning that its application in practice cannot be assessed yet.

Chapter 14 of the Act on EU ETS trading ('Administrative penalties') does not provide for any specific fines for theft, VAT fraud, market abuse or money laundering. This confirms that allowances shall be treated like any other subject of crime and the general rules of criminal law or tax law shall apply. Qualification of a crime or a tax crime depends on the facts of the specific case. In general, the Polish Criminal Code prescribes three general types of punishment: fine, restriction of liberty and imprisonment. A fine can be in a specific amount or designed as an amount of daily rates. The latter means that the court first decides how many daily rates shall be paid (from 10 to 540), and then decides the amount of the daily rate (from PLN 10 to 2,000), depending on income, personal and family circumstances. Restriction of freedom can last from one to 24 months, during which time the convicted person cannot change their permanent address without consent from the court, is obliged to perform the imposed work (20 to 40 hours a month or 10 to 25% of earnings), and is obliged to report on their fulfilment of the punishment. Imprisonment lasts from one month to 15 years[318]. In most cases of criminal activities such as fraud, crimes against markets or money laundering, a punishment of imprisonment (of various lengths) is imposed. For example, the most basic forms of money laundering are punishable by imprisonment from six months to eight years. Where an offence is committed in cooperation with others, the penalty typically consists of imprisonment for between one and 10 years.

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[313] http://energetyka.wnp.pl/surowe-kary-wiezienia-za-oszustwa-w-handlu-uprawnieniami-co2,277234_1_0_0.html
[314] http://www.money.pl/gospodarka/wiadomosci/artykul/przestepstwa-gospodarcze-vat-faktury,43,0,2133803.html
[315] http://www.rp.pl/Prawo-karne/301309985-Surowsze-kary-za-wyludzanie-VAT.html#ap-1
[316] Criminal Code, http://isap.sejm.gov.pl/Download?id=WDU19970880553&type=3
[317] http://www.rp.pl/Przestepczosc/302209878-Mniej-spraw-za-VAT-Efekt-surowych-kar.html#ap-3
[318] Ustawa z dnia 6 czerwca 1997 r. Kodeks karny, Journal of laws of 2016 item 1137. Available at: http://isap.sejm.gov.pl/DetailsServlet?id=WDU20160001137

For the most part, criminal legislation in the **UK** prescribes only maximum penalties for offences. The courts have a substantial degree of discretion when sentencing, and relevant factors will vary from case to case. However, the gravity of the offence, the past criminal record of the accused and the need for sanctions and/or deterrence are all factors that are taken into account. Fines are imposed according to the standard scale of fines for offences, set out below for each jurisdiction:

**Table 4: UK scale of fines for offences.**

| Scale | England & Wales | Northern Ireland | Scotland | Gibraltar |
|---|---|---|---|---|
| 1 | GBP 200 | GBP 200 | GBP 200 | GBP 200 |
| 2 | GBP 500 | GBP 500 | GBP 500 | GBP 400 |
| 3 | GBP 1,000 | GBP 1,000 | GBP 1,000 | GBP 1,000 |
| 4 | GBP 2,500 | GBP 2,500 | GBP 2,500 | GBP 4,000 |
| 5 | Unlimited | Unlimited | GBP 5,000 | GBP 10,000 |

The Fraud Act 2006, which is applicable to England, Wales and Northern Ireland, introduced a new general offence of fraud into the English criminal law system. Under this Act, a person found guilty of fraud is liable: (a) on summary conviction, to imprisonment for a term not exceeding 12 months or a fine not exceeding the statutory maximum (or both); (b) on conviction on indictment, to imprisonment for a term not exceeding 10 years or to a fine (or both).

A number of offences also apply under the VAT Act 1994. If any person is knowingly concerned in, or takes steps with a view to, the fraudulent evasion of VAT by him or any other person, he shall be liable: (a) on summary conviction, to a penalty of the statutory maximum or three times the amount of the VAT, whichever is the greater, or to imprisonment for a term not exceeding six months, or both; or (b) on conviction on indictment, to a penalty of any amount, or to imprisonment for a term not exceeding seven years, or both.

In England and Wales, the offence of theft carries a sanction of imprisonment for up to seven years, while in Northern Ireland and Gibraltar, sentences of imprisonment of up to 10 years can be imposed. Scotland has the common law offences of theft, embezzlement and reset, for which the sanction is left to the discretion of the court.

The Proceeds of Crime Act 2002 sets out the primary offences related to money laundering, which apply to England, Wales, Northern Ireland and Scotland. These include the offence of concealing (Section 327), involvement in arrangements (Section 328), acquisition, use and possession of criminal property (Section 329), failure to disclose (Sections 330, 331 and 332), and tipping off (Section 333). A person found guilty of an offence under Section 327, 328 or 329 is liable: (a) on summary conviction, to imprisonment for a term not exceeding six months, or a fine not exceeding the statutory maximum, or both; or (b) on conviction on indictment, to imprisonment for a term not exceeding 14 years, or a fine, or both. Further offences are set out in the Money Laundering Regulations 2007, for breach of the requirements of those Regulations.

In the UK, the sanctions set out above are considered to be effective, proportionate and dissuasive, as they provide for both fines and imprisonment and allow for the case to be taken on summary procedure or indictment depending on the gravity of the offence.

In **Germany**, the deterrent or dissuasive effect can only be described in general terms within the scope of this study. The criminal sanctions (imprisonment or monetary fines) of the relevant provisions (as described above) describe a range which gives the courts discretion to specify the sanction within these limits. For an individual case, aspects such as willingness to cooperate (in a useful way) with the authorities, the severity of the conduct, and damages are taken into consideration. For monetary fines, the German system distinguishes between two components to determine the specific sum: the personal (financial) circumstances of the perpetrator (usually the available income per month divided by 30) which determines a 'fee per day' (*Tagessatz*) and the personal level of guilt of the perpetrator then determines the amount of days, which are multiplied by the fee per day. The maximum monetary fine for a criminal offence is thus not determined in absolute numbers but depends on the individual's personal capabilities. The deterrent effect of judgments in cases of emission trading cannot be inferred solely from the available range of penalties.

For administrative sanctions such as § 30 TEHG (enforcement of the obligation to surrender offences), however, different principles apply. As preventative administrative measures, they aim to impose an additional incentive to follow the legal requirements. While this might also include a deterrent effect on other market actors, it does not include the implication of (criminal) guilt[319].

Other important considerations for the deterrent effect are the level and intensity of prosecution of the offences in the emission trading market, as well as the public visibility of the procedures (including the potential to damage public image). For instance, the main criminal procedures on VAT fraud by, *inter alia,* Deutsche Bank employees were publicised both nationally and internationally[320].

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[319] See, for instance, the Highest Federal Administrative Court (Bundesverwaltungsgericht, BVerwG v. 20.02.2014, Az. 7 C 8.12, para. 23 on the previous provision of § 18 TEHG on the sanctions for not surrendering allowances.

[320] Matussek, K., 'Seven Ex-Deutsche Bank Mangers Guilty in $CO_2$ Tax-Fraud Case', Bloomberg, 13 June 2016. Available at: https://www.bloomberg.com/news/articles/2016-06-13/seven-ex-deutsche-bank-managers-convicted-in-c02-tax-fraud-case (updated: 24 January 2017).

# 6 Issues related to the legal nature of allowances

## 6.1 Legal certainty

The EU ETS established in 2005 is based on a progressive reduction in the amount of allowances in the market, thereby creating scarcity and investing the allowances with economic value. The EU ETS can only be effective if the cap determined by the regulator is set at a level that is lower than 'business as usual' emission levels. A well-functioning mechanism contributing to the achievement of the environmental objectives requires the market to be safe and attractive for compliance and for buyers who do not have an obligation under the ETS Directive 2003/87/EC. Investors' confidence in the market requires the stability and legal certainty provided by appropriate market regulation of the emission trading system.

As described in Section 2, the current legal framework does not define the legal nature of allowances. They have elements of both administrative rights and private property rights and those elements are reflected in the legislation. Article 3(1)(a) of the **ETS Directive 2003/87/EC** seems to refer to a concept closer to a transferable administration right or authorisation to emit established for compliance with regulatory obligations. Other pieces of legislation such as Article 40 of the EU Registry Regulation 389/2013 describe the allowances as **fungible, dematerialised, tradable instruments,** which places them closer to an asset regulated as a property. The EU ETS allowances have been designated **financial instruments** under MiFID II and are regulated under financial services legislation. However, the rights of the allowance holders are not always clear.

This section analyses the issue of legal certainty.

The European Court of Auditors states in its report that the operation of the emission market would be improved by greater certainty over the EU-wide definition of allowances. It points out that the lack of legal certainty at EU and Member State level, and the different approaches taken, means that legal problems arising are dealt with on a case-by-case basis. The European Court of Auditors believes that greater clarity on the legal definition of allowances could be beneficial to the functioning of the market[321]. However, it does not clarify how such a harmonised definition would solve the issues identified in the assessment of the implementation of the EU ETS, or whether the recent changes in the EU financial legal framework and the harmonisation on the consideration of allowances as financial instruments represents a solution.

At this point it is useful to present the opinion of some authors in relation to the impact derived from lack of definition of the legal nature of the allowances at EU level and the resulting legal uncertainty.

Some authors consider certain issues in EU ETS implementation to be linked to technical issues (such as the security of the national registries prior to the creation of the Union Registry), while other types of issues can be explained by the lack of definition of the legal nature of the allowances and the failure to fully understand both the legal nature of intangible property and the way in which registers operate

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[321] European Court of Auditors, Special Report No 6, *The integrity and implementation of the EU ETS,* 2015, p. 25. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

[322]. In that context, some authors claim that the absence of a legal definition of allowances at EU level and the case-by-case approach to providing legal solutions to emerging issues has triggered the fragmentation of the regulatory framework applicable to allowances, thereby generating legal uncertainty for companies trading in the EU ETS[323].

In 2011, after the fraud and theft cases, Sartor argued that the lack of a uniform definition of the legal status of EU ETS allowances and the lack of a harmonised approach across countries, together with the European Commission's claim to have no mandate to coordinate and publish a list of allegedly stolen allowances, led to market participants losing confidence in the value of allowances traded in the market[324]. Sartor warned that if fraud was not adequately addressed, it could fundamentally affect the stability of the EU ETS as a market.

The national experts analysing the situation in the selected Member States identified several issues affecting legal certainty, although not directly linked to the definition of allowances. The underlying agreement for a transaction (for example specifying the economic or monetary value of the transaction) is a private agreement between parties. The content of such an agreement is not made available to the CA. It has been noted that since national registry administrators do not have access to the conditions underlying the transactions in the EU ETS, it is difficult in practice to detect *ex officio* cases of fraud. However, this is not related to the lack of clear definition of the legal nature of the emission allowance.

An additional issue is the legal uncertainty stemming from the different interpretation of the impact of Article 345 TFEU, on whether the EU has competence to adopt legislation clarifying the legal nature of the allowances. The Commission considers that in accordance with Article 345 of the TFEU, under Union law, property law is the prerogative of the Member States. This is all the more so in relation to mandating the creation of property rights at EU level with respect to a class of assets where there are no pre-existing property rights in the Member States. The CJEU considers it an expression of the principle of neutrality of the Treaties in respect of questions of private or state ownership of companies[325]. Some authors hold that this provision does not confer any exclusive powers to deal with property law to the EU or the Member States. Instead, they follow the CJEU's interpretation about the neutrality of the Treaty in respect of questions of private or state ownership of companies[326] and further state that it does not prohibit EU involvement in property issues but merely limits the impact of potential new EU legislation so that it does not undermine Member States' systems of property ownership[327]. Those same authors conclude that the Article '…does not concern the content of the right of ownership, nor the objects of a right of ownership. It does not therefore form an obstacle to the development of a European property law'[328].

[322] Low, K.F.K. and Lin, J., 'Carbon Credits as EU Like It: Property, Immunity, TragiCO2medy?', 2015; The European Union Emissions Trading Scheme, in Freestone, D. and Streck, A., *Legal Aspects of Carbon Trading*, Oxford University Press, 2009.
[323] *Ibid.*
[324] Sartor, 2011, pp. 3-4.
[325] Joint cases C-105/12 to 107/12 request for preliminary ruling from Hoge Raad der Nederlanden para 29.
[326] Akkermans, B. and Ramaekers, E., at p. 308.
[327] Akkermans, B. and Ramaekers, E. at p. 292.
[328] *Ibid.*

### 6.1.1 Legal uncertainty due to the flexibility of regulations

The desk research carried out within the framework of this study demonstrated the scarcity of literature dealing specifically with the legal uncertainty triggered by the lack of definition of the legal nature of the allowances. While some authors (see the section above) believe that such legal uncertainty has negative consequences on the functioning of the EU ETS and the carbon market, others argue that the uncertainty is a necessary consequence of the nature of Directives which provide for objectives but leave the definition of attainment to the Member States. Flexible environmental regulations which give Member States discretion to find the lowest-cost method to implement the mandatory target, necessarily result in a higher level of uncertainty. This has led to a degree of questioning among stakeholders on the effectiveness and efficiency of flexible legislation establishing the carbon trading system.

According to Preston and Sandberg, since its inception the EU ETS has been characterised by a relatively high level of policy uncertainty[329], both from a technical legislative point of view but also from a policy perspective and social support. Establishing the EU ETS has not been an easy task and required compromises. Ultimately, this uncertainty is reflected in the legislation, in particular on certain rules and implementation procedures, for example regarding the legal nature of the EU ETS allowances.

The legal nature of the EU ETS allowances may be considered a property, an administrative right for regulatory purposes, or a combination of the two. Allowances are auctioned and traded for value, implying a transfer of property rights. However, where the allowances are transferred through free allocation, the situation may be viewed differently. Free allocation is based on an administrative decision and companies may be considered to have an administrative right rather than a property right. While the European Court of Auditors proposes that the allowances be explicitly defined, there is no evidence that the issues linked to allowances would be resolved with the definition of the legal nature of the allowances.

The CJEU does not define the legal nature of the allowances in its ruling on the ArcelorMittal case (C-321/15, published in 2017)[330], but states that the allowances issued after an operator has ceased the activities performed by the installation to which those allowances relate, without informing the Competent Authority beforehand, cannot be classified as emission allowances within the meaning of Article 3(1)(a) of the ETS Directive 2003/87. In this case, the AG stated that there was no need to define the legal nature of the EU ETS allowances and that it was sufficient to determine if the allocation complied with the existing legislation.

### 6.1.2 Legal uncertainty regarding trading of allowances

Different jurisdictions regulate trading differently depending on their classification of allowances as either administrative rights, commodities, or financial instruments. Differing views of allowances' legal nature and whether they can be regarded as property for the purposes of regulatory takings, or the treatment of competing claims to the same allowances, may create obstacles to trade.

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[329] Preston, P. and Sandberg, J., 'Constraining or Enabling Green Capability Development? How Policy Uncertainty Affects Organizational Responses to Flexible Environmental Regulations', *British Journal of Management*, 2016.

[330] Judgment of Case C-321/15, published on 8 March 2017.

A 2005 expert meeting on the legal nature of emission reductions agreed that a degree of uncertainty and speculation exists in the EU ETS market in respect of the specific legal nature of emission reductions and allowances, and the rights that attach to these units[331]. Where tradable units are issued by Member States as part of an environmental regulatory system, they are in the nature of an administrative grant. However, once allocated to the operator of an installation for compliance purposes, or held or transferred to a private company for trading, they assume certain characteristics of private property. While some argue that common property rights facilitate transferability and protection against arbitrary confiscation, others hold that national level recognition of allowances as private property poses difficulties for regulatory systems. These systems require flexibility to create or cancel units in order to manage a cap-and-trade system whose effectiveness is based on the scarcity of the allowances, or even to suspend allowances that have been improperly allocated. Still others argue that the distinction may comfortably co-exist[332].

It is acknowledged that even where allowances are characterised as property for private law purposes, the nature of this property may be unclear, for example, due to their differences in treatment when considered tangible or intangible property or the possibility for legal titles on allowances to be secured through contracts. It is therefore questionable whether or not there is a need to explicitly define the legal nature of allowances. The US SOx emission trading system, for example, does not explicitly define the traded units but is nevertheless successful[333]. The experts at the 2005 workshop believed that no harmonisation of national legislative systems was necessary to define the nature of the allowances. Rather, they agreed that the specific nature of these units depends on the legal context in which the question is posed. In some jurisdictions it might be more important to clearly define one allowance, while for others it was sufficient to give the allowance the characteristics of property without the need for explicit definition.

Ultimately, for the market to operate, the allowances must be recognised as irrevocable and freely transferable, rather than an express declaration that they constitute property. A clear legal framework applicable to the EU ETS allowances might be more relevant and effective than the definition of their legal nature. Nevertheless, the characterisation and treatment of these units under tax law or financial services regulation and accounting standards may have an impact on the development of the emission trading market if treatment in one country conflicts significantly with treatment in another country. These aspects are discussed below and in Sections 6.4 and 6.5 of this study.

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[331] Mace, J.M., The legal nature of Emission Reductions and EU Allowances: Issues addressed in an International Workshop, 2005.

[332] *Ibid.*

[333] *Ibid.*

### 6.1.3 Legal uncertainty regarding the legal rights *vis à vis* other private persons

Assuming that allowances are regarded as being subject to property rights, their dematerialised character results in their consideration as intangible property, where the right itself is the property (as opposed to property rights over tangible things)[334].

It is important to provide legal certainty for market participants in respect of their legal rights vis-à-vis other private persons, given that it is impossible to ensure that no illegal activity occurs. The legal framework applicable to the EU ETS allowances has been developed on a case-by-case basis, triggered by the issues and activities around the carbon market. Within that framework, the legislation establishing the Union Registry is a critical element providing legal certainty in relation to the holder's title on the allowances in relation to other persons.

The Union Registry ensures a degree of certainty, fulfilling the role of registries of any property, but it was further strengthened with the new rules of the Registry Regulation 389/2013[335]. As described in Section 3.1, the Registry Regulation 389/2013 introduced provisions defining the EU ETS allowances as fungible, dematerialised, tradable instruments, reflecting the way in which such allowances can be used. However, the dematerialised nature of EU ETS allowances is a characteristic that is applicable both to property and to administrative rights. Article 40 has been criticised for providing only a functional definition of 'allowances' and 'Kyoto units' without addressing the core question of whether an emission allowance is a property right, personal (administrative) right or something else[336].

Article 40(2) states that the registry record provides prima facie and sufficient evidence of title to an allowance. The allowances exist as electronic records on an account. They get to the account through traceable and recorded means. The registry is therefore the primary means for the protection of an intangible property. However, some consider the registry unnecessary for the existence of intangible property, instead believing that the registry simply evidences title to that property337.

The differentiation between possession and ownership in this respect seems relevant (see Section 3.5 for more detail on the context of the allowances used as security interest). In summary, if ownership and possession are considered separable (similar to renting a vehicle or residential building, for example), each party would enjoy certain rights against all persons, generally set out through the contractual agreement between the parties, and the applicable provisions of civil law on property (such as a claim of *rei vindicatio*). However, since allowances are immaterial and created by administrative fiat, the ability to separate ownership from possession is not readily apparent. In view of the immaterial nature of allowances and the provision of Article 40(2) of the Registry Regulation 389/2013, it could be argued that registration/possession in a registry account is a pre-condition of ownership/title. However, this would imply that in situations where a custodian manages a holder's account, the custodian takes ownership. Article 40 of the Registry Regulation 389/2013 does not provide certainty in those cases, thus, in order to facilitate custody or storage by a party other than the allowance owner, a contractual arrangement is needed, without an accompanying transfer of

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[334] Mace, J.M., The legal nature of Emission Reductions and EU Allowances: Issues addressed in an International Workshop, 2005.
[335] See Section 3.1.2.
[336] Interview with FMLC, 21 March 2017.
[337] Mace, J.M., The legal nature of Emission Reductions and EU Allowances: Issues addressed in International Workshop 2005

allowances to the custodian. Such an arrangement would not contradict Article 40(2) of the Registry Regulation 389/2013 if it is interpreted that this provision allows for exceptions from the presumption of title. The analysis of the five Member States does not provide a clear answer to the question. Under the current legal situation, legal certainty is only ensured if the transfer of title implies a transfer of possession, or if the custodian is provided with *de facto* control over allowances, based on relevant contractual arrangements (see section 6.5.1 of this study).

Transactions are subject to property law and the law of the contract may be changed with the consent of the parties. The lack of information on the financial elements of the transaction - and therefore of administrative control capacity by the national CAs - has been raised as an issue affecting legal certainty.

This situation warrants a solution that provides a higher degree of legal certainty.

The use of the phrase 'in kind' in the first sentence of this provision has also been criticised for creating uncertainty. FMLC believes that it is reasonable to interpret the phrase as *in specie*, but such an interpretation would appear to be at odds with the intent of the Article, which concerns fungibility, recovery and restitution obligations.

Article 40(3) of the Registry Regulation 389/2013 prevents any rectification of the records supporting the defence of good faith established by Article 40(4) of the Regulation. The transactions cannot be reversed, revoked or unwound, unless provided for by the rules of the Union Registry. However, the holder's right is respected, as the Registry Regulation 389/2013guarantees that an account holder or a third party shall not be prevented from exercising any right or claim resulting from the underlying transaction that they may have in law, including recovery, restitution or damages, in respect of a transaction that has become final in the Union Registry. Given the fungibility of the allowances, the recovery or restitution is applied to the allowance in kind, and the remedy to a loss of allowances is based on the requirement to execute a new transaction. In order to instil confidence in market participants, the registry rules have been completed such that where the Union Registry could not conclusively ascertain the title, the rules enabling remedy or rectification have been harmonised. The right to claim back the same amount of allowances of the same kind is not affected. An allowance can be substituted by any other allowance in case of a legal claim. In addition, an allowance can only be surrendered once (Article 67(3) Registry Regulation 389/2013).

#### 6.1.4 Legal uncertainty linked to the change of financial regulatory framework

Recognition of the allowances as financial instruments under MiFID II provides for legal certainty in respect of their status and their applicable legislation, as highlighted by some of the national experts analysing the situation in selected Member States. However, the precise impact remains to be seen. This is particularly true in relation to the relevant rights and obligations of natural and legal persons, including the potential additional burdens (administrative burden, reporting obligations) that MiFID II

may impose on market participants[338]. The majority of the companies surveyed expect to reduce or cease $CO_2$ spot trading or $CO_2$ trading in general once MiFID II enters into force[339].

The lack of a harmonised approach to the legal nature of allowances means that they are treated differently in different jurisdictions, potentially affecting the validity and predictability of any security arrangements involving such allowances.

The issues triggered by this approach (i.e. a legal framework developed on a case-by-case basis when a particular issue emerges) involve the use of allowances as collateral, as well as the regulatory legislation applicable to them. This can seriously impede their efficiency and restrict access to or increase the cost of capital and financial services, thereby limiting collateral-based transactions in the EU market.

Currently, the legal framework governing the EU ETS imposes limitations on the type of collateral arrangements available to allowance holders seeking to use these as security. For example, most rules on collateral and security interests at national or EU level consider them real or personal property given as collateral. This creates uncertainty in those Member States that do not classify allowances as property. In addition, the legal framework in some Member States requires a formal act of registration before the security interest can be perfected[340]. The legal architecture created by the Registry Regulation 389/2013 does not currently allow for registration of limited interests (including security interest) in allowances.

The European Court of Auditors stated that greater clarity on the legal definition of allowances would be beneficial to the functioning of the market, as the allowances would become more attractive to voluntary participants, for example by supporting the ability to create and protect secure and enforceable security interests (third party legal rights). There are some (limited) cases where security interests over allowances have been established (see Section 5.2.5 for an analysis of the relevant legal framework).

A practical approach suggested to protect third party interests within the legal framework of the Registry Regulation 389/2013 involves designating the secured party as an 'additional authorised representative', whose approval will then be required for certain transactions[341]. However, this does not resolve all aspects of the issue (see Section 5.2.5), including the applicable law, as Article 11 of the Registry Regulation 389/2013 states that 'accounts shall be governed by the laws and fall under the jurisdiction of the Member State of their administrator and the units held in them shall be considered to be situated in that Member State's territory.'

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[338] The concern about additional costs was also expressed in an interview conducted on 27 June 2017 with a legal adviser to the European Federation of Energy Traders (EFET), a legal adviser to the International Emissions Trading Association (IETA), and a senior associate at Reedsmith LLP.

[339] Glock, D., 'Access to Trading Venues and Intermediary Traders in the EU ETS', unpublished draft (produced as part of an ongoing project for the German Emissions Trading Authority, with publication expected in late 2017). The concern about firms exiting the market due to MiFID II requirements was also expressed in the interview conducted on 27 June 2017 with a legal adviser to the European Federation of Energy Traders (EFET), a legal adviser to the International Emissions Trading Association (IETA), and a senior associate at Reedsmith LLP.

[340] See, for example, the requirements for the creation of a security interest pursuant to § 1274 para. 1 of the German Civil Law Code, discussed in Section 5.1.5.1, Interim Report I.

[341] Article 23 para.3 Registry Regulation 389/2013.

A recent study included a proposal to extend the protections of the Financial Collateral Directive 2002/47/EC to emission allowances[342], which does not require registration even in those Member States which have traditionally required it. The current wording of the Financial Collateral Directive 2002/47/EC does not extend its legal protections to financial collateral arrangements involving allowances, as the Directive applies its own definition of 'financial instruments' (see Section 3.5 of this report). Several commentators suggest that the inclusion of allowances in Annex I, Section C of Directive 2014/65/EU (MiFID II) is not sufficient to ensure that allowances used as collateral fall within the scope of the Financial Collateral Directive 2002/47/EC.[343] However, this might be solved by amending the Financial Collateral Directive 2002/47/EC to refer directly to the financial instruments listed in Annex I, Section C MiFID II.

While Article 3(1)(38) of the Auctioning Regulation 1031/2010 expressly states that the collateral required from bidders or the auctioneer under Articles 49 et seq. can include 'any allowances accepted as security by the clearing system or settlement system', this provision is limited to this very specific set of circumstances and does not extend to other situations.

Finally, there is legal uncertainty in relation to the use of allowances as collateral or determining title in the event of insolvency[344]. The challenges deriving from the lack of a harmonised definition of the legal nature of the allowances increase in a situation of insolvency[345] (see Section 5.2.5 for further discussion).

[342] See, Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, European Commission, Publications Office of the European Union, 2015, Section 9.1 and 9.2.3; Interview notes with EEX on the legal nature of EU ETS allowances, 15 March 2017, Sec. 2.
[343] *Ibid.*
[344] *Ibid,* Section 9.2.3.
[345] FMLC, Response to the EU ETS Stakeholder Consultation Survey dated 15 October 2013, Letter of 18 February 2014, p.2.

## 6.2 Liquidity of the market for emission allowances

The European Court of Auditors report recommended greater clarity and **legal certainty** with respect to the definition of the legal nature of these allowances in order to support the **liquidity of the emission market** and the creation or protection of security interests in allowances[346].

According to Article 4 of MiFID II, a **liquid market** is ‘a market for a financial instrument or a class of financial instruments, where there are ready and willing buyers and sellers on a continuous basis’. MiFID II also lists criteria to assess the liquidity of a market, such as the frequency and size of the transactions, number and type of market participants, and the average size of spreads, taking into account the specific market structures of the particular financial instrument or of the particular class of financial instruments.

Some authors define a functional market as ‘a liquid market, with the following requirements: continuous sufficient supply and demand; enough market parties; and minimal market restrictions’[347]. In particular, a ‘…market with multiple participants (in particular, beyond those solely with compliance obligations) [enhances] the likelihood that the price signal generated by trading is a reliable indicator for investment decisions’[348].

In essence, a market is liquid if any prospective buyer (seller) can expect to find a number of prospective sellers (buyers) at any time, so that the price formation is a clear expression of the balance of aggregate supply and aggregate demand at any given point in time, rather than a reflection of the market power of the respective parties active on the market at a particular moment.

Liquidity of the market for emission allowances has not been a major concern in the EU ETS, in contrast to other emerging EU ETS’ (particularly in Asia), as a liquid market for EU allowances emerged within the opening years of emission trading[349]. Liquidity remains high, with plenty of active market participants, high transaction volumes, a healthy competition of trading platforms, established trading formats, and a broad range of trading services and products, from spot trading to futures[350]. The marketplaces for EU ETS allowances are well established, with the EEX and the ICE the two major carbon exchange platforms performing the primary auctions and facilitating secondary market trades, as well as the ECX, NYMEX, NASDAQ OMX Commodities. Trading volumes at these exchanges and in over-the-counter transactions increased continuously until 2013, reaching a peak of more than eight billion allowances. Since then, while the financial value of the traded volume has

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[346] European Court of Auditors, Special Report No 6, ‘The integrity and implementation of the EU ETS’, Publications Office of the European Union, 2015. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

[347] de Jong, C. and Walet, K., ’Compliance Strategies in the US Acid Rain Programme’, in: *A Guide to Emissions Trading: Risk Management and Business Implications,* (edited by de Jong, C. and Walet, K.), London: Risk Books, 2004, pp. 201–218, at p. 204.

[348] Hedges, A., ‘The Secondary Market for Emissions Trading: Balancing Market Design and Market Based Transaction Norms’, in: *Legal Aspects of Carbon Trading: Kyoto, Copenhagen and Beyond* (edited by Freestone, D. and Streck, C.), Oxford: Oxford University Press, 2009, pp. 310–334, at p.311.

[349] Ellerman, D. and Joskow, P.L., 'The European Union’s Emissions Trading System in Perspective', Washington, D.C., Pew Center on Global Climate Change, May 2008, 16. Available at: https://www.c2es.org/document/the-european-unions-emissions-trading-system-in-perspective/

[350] Nield, K. and Pereira, R., 'Financial Crimes in the European Carbon Markets', in *Research Handbook on Emissions Trading*, Research Handbooks in Climate Law, Edward Elgar Publishing, 2016, p. 195.

remained largely constant at around EUR 40 billion annually, the transaction volume has contracted to below five billion allowances in 2015[351].

The European carbon market is well diversified. A number of actors are active on the market, including financial sector companies, utilities, industrial firms and service providers (such as brokers, trading companies and consulting companies). They trade a portfolio of different units in different venues. To serve the hedging needs of utilities in particular, financial institutions offer a number of derivatives (futures and options) in addition to spot trading. As a result, a liquid and transparent market has developed, providing for sufficient supply and demand at any given point in time to form a real-time carbon price. This is an achievement in its own right, as establishing a liquid market with transparent price formation and high trading volumes can be a challenge[352].

There have been some instances of financial players leaving the market in emission allowances entirely by closing their carbon trading desks or scaling back their engagement. Such cases were originally observed in the wake of the various fraud cases in 2008-2011, and again more recently, with trading houses readjusting their strategies and reconsidering their engagement.

Several factors have contributed to this development:

- Firstly, the substantial surplus that has built up on the market for EU allowances, along with the fact that other markets (in particular CERs, ERUs) have effectively dried up. While it may seem paradoxical that liquidity is endangered because there are too many allowances on the market, the reality is that the surplus means that a number of emitters have sufficient reserve to cover their compliance needs and are not therefore active on the market. The resulting (consistently) low carbon price, paired with lower price dynamics, means that there were fewer gains to be made for intermediaries or investors, who then exited the carbon market, or simply avoided it entirely. Other elements that could drive trading activity – such as an international link with another major trading system – are not currently in place.
- Secondly, the change in financial market regulation, in particular through MiFID II and the classification of allowances as financial instruments, triggered some expectations of potential uncertainty. The precise impact of these changes on the EU allowance market liquidity or on a reduction in the number of market participants due to fear of additional burdens that MiFID II may impose on market participants (administrative burden, reporting obligations) and on smaller companies, in particular, remains to be seen[353]. For example, as of December 2016, of 4,430 active market participants on the EU carbon markets and registered for carbon trading at ICE and EEX, only four were registered as an regulated market in the registry of European Securities and Markets Authority (ESMA), five as an MTF, and eight as a Systematic Internaliser[354]. A poll of selected companies active on the carbon market revealed considerable uncertainty about whether

[351] European Commission Report on the functioning of the European carbon market, COM(2017) 48 final, 1.2.2017.

[352] ThomsonReuters, Carbon Market Monitor, 11 January 2016. It should be noted that the emerging Asian ETS are much younger, therefore market liquidity may improve over time; in addition, they operate in a very different regulatory environment, for example, the trading behaviour of utilities.

[353] *Ibid*., p. 224. The concern about additional costs was also expressed in an interview conducted on 27 June 2017 with a legal adviser to the European Federation of Energy Traders (EFET), a legal adviser to the International Emissions Trading Association (IETA), and a senior associate at Reedsmith LLP.

[354] Systematic Internalisers (SIs) are institutions large enough to match client orders internally or against their own books (unlike a broker crossing network, which may route orders between a number of institutions). They are defined in MiFID II as an investment firm which, '*on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF'*.

and how they might be affected by MiFID II. The majority of the companies surveyed, however, anticipate reducing or ceasing allowance spot trading or indeed allowance trading in general once MiFID II enters into force[355]. The cost of obtaining a MiFID II licence is one consideration; a 2011 impact assessment by the European Commission estimates the average cost of obtaining such a licence at EUR 500,000 to EUR 1.5 million for an investment firm, plus annual costs of EUR 150,000. For smaller companies with revenue below EUR 3 million, these costs are lower but still significant, at EUR 100,000 one-off costs and EUR 30,000 annual costs[356].

- Thirdly, in some cases, there is a fear of reputational risk, of being associated with what had come to be seen as a murky and suspicious market in the aftermath of the fraud events between 2008 and 2011. This may have prompted certain players to leave the market, most evidently in the case of Deutsche Bank, which was heavily compromised in the VAT fraud scandals. There is limited anecdotal evidence to support the assertion that this has emerged as a wider phenomenon[357] (see the statement to this effect by the Belgian Competent Authority).

Unfortunately, there is no solid evidence of the scale and relative importance of these considerations, although there was anecdotal evidence of intermediaries reducing their activity or withdrawing entirely from the EU carbon market[358]. This creates a stronger impetus to re-evaluate factors that inhibit investor confidence and thus liquidity, such as the unclear legal status of EU allowances (European Court of Auditors)[359]. It has been argued that the lack of a uniform definition of the legal nature of emission allowances between Member States could potentially create an obstacle to trade and impact the liquidity of the market. Jurisdictions regulate trading differently depending on their classification of allowances as either administrative rights, commodities, or financial instruments. This results in discrete views of allowances' legal nature and thus their treatment as property for the purpose of regulatory takings, or assessment of competing claims to the same allowances.

While the resulting uncertainty is acknowledged[360], the impact of this uncertainty on trading activity (and ultimately the liquidity of markets) is less obvious. Irrespective of their legal nature when issued by the regulator, once allowances are allocated to the operator of an installation, or held or transferred to a private company for trading, they assume certain characteristics of private property.

On the question of whether the lack of a common legal definition of allowances has impeded the liquidity of the market, two views can be distinguished:

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[355] Glock, D., 'Access to Trading Venues and Intermediary Traders in the EU ETS', unpublished draft (produced as part of an ongoing project for the German Emissions Trading Authority, publication expected in late 2017. The concern about firms exiting the market due to MiFID II requirements was also expressed in the interview conducted on 27 June 2017 with a legal adviser to the European Federation of Energy Traders (EFET), a legal adviser to the International Emissions Trading Association (IETA), and a senior associate at Reedsmith LLP.
[356] ICIS, 'Implications of MiFID II for the EU ETS', *Carbon Markets Almanac*, 2015.
[357] Nield, K. and Pereira, R., 'Financial Crimes in the European Carbon Markets', in *Research Handbook on Emissions Trading*, Research Handbooks in Climate Law, Edward Elgar Publishing, 2016, p. 207.
[358] Among others, Deutsche Bank, Credit Agricole, MF Global and Cantor shut their carbon desks in 2012/2013; Mercuria Trading followed in 2015. Morgan Stanley, JP Morgan and Barclays have reduced their activity. See, for example, Carbon Pulse: 'Mercuria shutters London-based emissions trading desk –sources', available at: https://carbon-pulse.com/14648/; http://www.carbontradewatch.org/articles/common-concerns-to-scrap-the-eu-ets.html
[359] European Court of Auditors, Special Report No 6, 'The integrity and implementation of the EU ETS', Publications Office of the EU, 2015.
[360] Mace, J.M., The legal nature of Emission Reductions and EU Allowances: Issues addressed in an International Workshop, 2005.

- The optimistic view is based on the observation that, as yet, the unclear legal nature of EU ETS allowances has not significantly impeded market liquidity. In fact, the European carbon market has functioned well, despite this having been identified as a potential issue for more than a decade. While there are factors that might undermine market liquidity (e.g. the oversupply as discussed above), the unclear legal nature of EU allowances is among the least important. This view is held by many stakeholders and experts interviewed, with the Belgian Competent Authority, among others, stating it explicitly.
- A more cautious take maintains that the smooth functioning and healthy development of the EU ETS allowance market should not be interpreted as a guarantee that nothing could go wrong. Rather, unresolved legal issues continue to pose a threat, and, if it leads to litigation, could require significant changes to commercial practices[361]. Similarly, the FMLC argued in 2009 that ‘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’[362]. It went on to express its concern that, unless clarified at the European level, the uncertain legal nature of allowances could significantly impede the development of the European carbon market[363].

A more prudent position would be to assume that a clarification on a common legal definition would at least eliminate a potential threat to market liquidity. This argument was raised by both the French and British experts contacted for this study (among others), who pointed out that the classification of allowances as intangible property increased the level of certainty in relation to the applicable rules and regulations, thereby increasing market liquidity.

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[361] Manea, S., 'Instrumentalising Property An Analysis of Rights in the EU Emissions Trading System', London School of Economics and Political Science, 2013, p. 93.
[362] Financial Markets Law Committee, 'Emissions Allowances: Creating Legal Certainty', London: Bank of England, October 2009, p. 15.
[363] *Ibid*., p. 5.

## 6.3 The legal nature of EU ETS allowances in the context of criminal activities related to the EU ETS

In 2013, Interpol identified carbon trading crime as a new and emerging type of environmental and financial crime[364]. Carbon trading was the world's fastest growing commodity market[365]. Given the large amount of money invested, the immaturity of regulations and security systems, and the lack of oversight and transparency, criminals eagerly exploited weaknesses and gaps in carbon markets for their own benefit[366].

The EU ETS, one of the largest and most established carbon markets in the world, has been targeted by a number of criminal activities, including VAT fraud, allowance theft and cybercrime. In 2011, Europol estimated that carbon credit fraud in the EU attracted the increasing interest of criminal groups due to lower levels of perceived risk involved[367]. Carbon-related crimes have led to important financial losses for Member States (e.g. losses in tax revenue), investors' loss of confidence in the EU ETS (with the associated risk of insufficient liquidity of the market), and the risk of limited environmental benefits of the EU ETS.

Following the emergence of fraudulent practices in the context of the EU ETS, the EU adopted various measures to eliminate the risk of criminal activities and enhance the integrity and the security of the EU ETS. Such measures included the adoption of a VAT reverse-charge mechanism, the creation of the Union Registry and the adoption of stricter due diligence rules to manage accounts, and the insertion of provisions to deter money laundering and other financial crimes, including in the context of auctioning of allowances.

Significantly, the EU decided to bring allowances into the scope of the new Markets in Financial Instruments Directive (MiFID II). From 3 January 2018, allowances are classified as financial instruments[368]. This classification aims 'to reinforce the integrity and safeguard the efficient functioning of [spot secondary] markets, including comprehensive supervision of trading activity'[369]. As a result of their classification as financial instruments[370], allowances fall into the scope of the market abuse framework, including the Market Abuse Regulation 596/2014 and the Market Abuse Directive 2014/57/EU, as well as other Regulations and/or Directives linked to MiFID II[371]. This approach is in line with the various calls for the harmonisation of the legal nature of allowances at EU level[372]. Since the creation of the EU ETS, commentators have claimed that the absence of a legal

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[364] Interpol, *Guide to Carbon Trading Crime*, 2013, p. 11.
[365] Interpol, 2013, p. 6.
[366] Interpol, 2013, p. 11; Funk, M., 'The hack that warmed the world', *Foreign Policy,* 2015. Available at: http://foreignpolicy.com/2015/01/30/climate-change-hack-carbon-credit-black-dragon/ (viewed on 31 January 2017).
[367] Europol, *OCTA 2011: EU Organised Crime Threat Assessment*, 2011, p. 8.
[368] New date of application of MiFID II. See Directive (EU) 2016/1034 of the European Parliament and of the Council of 23 June 2016 amending Directive 2014/65/EU on markets in financial instruments.
[369] Recital 11.
[370] It should be pointed out that derivatives based on allowances were already financial instruments and were therefore regulated under MiFID and the Market Abuse Directive in phases I and II of the EU ETS (2005-2012). See European Court of Auditors, 2015, p. 20.
[371] For instance, Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC (Money Laundering and Terrorist Financing Directive).
[372] For instance, see Prada, M., *La régulation des marchés du $CO_2$, Rapport de la mission confiée à Michel Prada, Inspecteur général des Finances honoraire*, La Documentation Française, 2010, p. 76.

definition of allowances creates legal uncertainty for companies obliged to trade on the EU ETS, leads to the fragmentation of the regulatory framework applicable to allowances, and increases the risk of criminal activity[373].

This section presents a discussion of the legal nature of allowances in the context of the specific criminal activities that have targeted trade in the EU ETS allowances, including through VAT schemes. It describes those measure that have already been adopted and proved effective in addressing issues relating to the functioning of the EU ETS.

### 6.3.1 VAT fraud

As described under Section 3.3.1, the VAT Committee agreed that transfers of allowances would be subject to VAT[374]. The sale and transfer of allowances are subject to VAT, as they constitute a taxable supply of services under Article 9 of the VAT Directive. The initial free allocation of allowances by Member State authorities is not subject to VAT, as these institutions are acting in a public function within the meaning of Article 4(5) of the VAT Directive[375]. Although this Directive establishes a harmonised VAT framework for the EU, Member States apply the rules differently in practice, resulting in some heterogeneity.

The transfers of allowances in cross-border transactions between Member States have raised questions regarding VAT accrual and the possibility of double or no taxation. In 2008, cases of EU VAT fraud began to emerge in the context of the EU ETS, especially when transfers of allowances were made from one Member State to another on the secondary spot market[376].

It should be pointed out that EU VAT fraud is not specific to the EU ETS. Originally, this fraud was committed in specific sectors where high-value transactions apply to easily transportable goods (e.g. mobile phones, computer microchips). EU VAT fraud is usually referred to as the missing trader intra-community fraud (MTIC)[377]. The essential elements of MTIC are that 'a taxable person ('missing trader') acquires goods from another Member State free of VAT, has an obligation to self-assess and remit VAT and does not'[378]. There are different types of MTIC: 'Sometimes it is a simple linear fraud (acquisition fraud), while at other times the supply (goods or service) circles round-and-round

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[373] In 2011, Sartor argued that fraud, if not adequately addressed, could potentially affect the stability of the EU ETS as a market in fundamental ways: 'Since the legal status of an EU ETS emissions allowance is neither clear nor harmonised across countries, and since the European Commission claimed to have no mandate to coordinate and publish a list of allegedly stolen allowances, market participants were left feeling nervous about trading. In general, if participants do not have confidence in the value of what they are trading in any market, liquidity can quickly evaporate and prices can become volatile. This is why it is important that the causes of fraud in the EU ETS are adequately addressed and the confidence of market participants restored before too long.' See Sartor, 2011, pp. 3-4.

[374] Efstratios, P., 'Halting the Horses: EU Policy on the VAT Carousel Fraud in the EU Emissions Trading System', *EC Tax Review*, Vol 1, 2012, pp. 39-51, at p. 41.

[375] None of the exemptions provided for in Article 13 of Directive 77/388/EEC can be applied to these transfers of allowances.

[376] For instance, in the UK, see *R v Dosanjh and others* [2013] EWCA Crim 2366. In France, various individuals and companies have been found guilty of VAT fraud (Nathanael in 2012; Keslassy in 2013). See also Cour des Comptes, 2012, *Rapport public annuel 2012*, pp. 147-196; Robert, A., 'Deux Français et un Polonais suspects de fraude sur le $CO_2$ encourent de Lourdes peines', *EurActiv.fr*, 2016, viewed on 31 January 2017 at : http://www.euractiv.fr/section/justice-affaires-interieures/news/deux-francais-et-un-polonais-suspects-de-fraude-sur-le-co2-encourent-de-lourdes-peines/

[377] Ainsworth, R., 'The Morphing of MTIC Fraud: VAT Fraud Infects Tradable $CO_2$ Permits', *Boston University School of Law*, Working Paper No 09-35, 2009. Available at: http://www.bu.edu/law/faculty/scholarship/workingpapers/2009.html (viewed on 31 January 2017).

[378] *Ibid.*

(carousel fraud), and yet other times there are highly complex pattern of contra-trading where transactions are structured to disguise trading patterns[379].'

MTIC in the context of the EU ETS does not fit the normal pattern. Instead of focusing on high value, easy to transport goods, the fraud 'uses *securities* (options) classified as *services*'[380]. Europol describes 'carbon credit fraud' in Europe as follows: '[T]he purchase of [allowances] from countries not liable to VAT on these transactions and their subsequent resale in countries liable to VAT, with the aim of reclaiming the VAT amount payable to the state concerned'[381]. More precisely, the process can be described as involving 'fraudsters setting up an account in one country and buying allowances from a seller in another country but not paying VAT on the purchase price. The fraudsters then resold the allowances with VAT added onto the price in a domestic transaction. However, instead of paying the VAT collected from the new customer to the State, the fraudster would pocket the VAT and disappear. Moreover, if the end customer was a business, it could claim a tax refund from the State for the VAT charged on the sale. Thus, the State ended up paying out tax refunds for tax money that it never received in the first place'[382].

Observers have suggested that VAT fraud has had impacts on the functioning of the EU ETS as a whole and its effectiveness as an emission reduction tool[383]. VAT fraud schemes have inflated spot trading volumes, with the consequence of distorting effect in the spot market carbon price signal[384]. In 2011, Europol estimated that EU VAT fraud in the context of the EU ETS accounts for an estimated EUR 5 billion in damage to EU taxpayers each year[385]. Northwest Europe has been hardest hit by this type of fraud (including France[386], the Netherlands, Denmark, Italy and the UK)[387].

In response to the so-called 'carousel fraud', the domestic reverse-charge accounting rule was introduced in 2010[388] to rectify the situation by requiring the payment of VAT by the person to whom the goods and services are supplied, thereby limiting fraud[389]. The rule applies to the transfer of

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[379] Ainsworth, R., 'VAT Fraud and Triangulation', *Boston University School of Law*, Working Paper No 12-52, 2012, p. 1. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2186474 (viewed on 31 January 2017).
[380] Ainsworth, 2009 [emphasis originally in the text].
[381] Europol, 2011, p. 29.
[382] Sartor, O., 'Closing the door to fraud in the EU ETS', *CDC Climat Research*, Climate Brief no 4, 2011, p. 1. Available at: http://www.cdcclimat.com/IMG/pdf/11-02_climate_brief_4_-_closing_the_door_to_fraud_in_the_eu_ets.pdf (viewed on 31 January 2017).
[383] Nield, K. and Pereira, R., 'Financial crimes in the European carbon markets' in Weishaar, S.E. (ed), *Research Handbook on Emissions Trading*, Edward Elgar, 2016, p. 199.
[384] *Ibid*.
[385] Europol, *Carbon Credit Fraud Causes More Than 5 Billion Euros Damage for European Taxpayer*, 2009. Available at: https://www.europol.europa.eu/newsroom/news/carbon-credit-fraud-causes-more-5-billion-euros-damage-for-european-taxpayer (viewed on 31 January 2017); Europol, 2011, p. 29.
[386] The French Cour des Comptes (Court of Auditors), the supreme body for auditing the use of public funds in France, estimated that France lost EUR 1.6 billion in tax revenue as a result of VAT fraud on the EU ETS between September 2008 and June 2009. See Cour des Comptes, 2012, p. 153.
[387] Europol, 2011, p. 29.
[388] Council Directive 2010/23/EU amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse-charge mechanism in relation to supplies of certain services susceptible to fraud.
[389] The measures taken by the EU to prevent VAT fraud on the EU ETS are described in detail in Section 5.2.2.1.

allowances, ERUs or CERs for compliance with EU ETS[390]. The European Court of Auditors has, however, recently criticised incomplete transposition of the reverse-charge rule[391].

### 6.3.2 EU ETS allowance theft

Since 2010, national registries linked to the EU ETS have been confronted by various cases of allowance theft. These crimes involved unauthorised entities hacking into national electronic registers, using methods such as phishing, theft of personal information or identity theft and Trojan horses[392], and initiating the transfer of allowances into other accounts. Interpol suggested that the weaknesses in the Internet security of registries have allowed criminals to steal allowances[393]. Some of these cyber-attacks have led to the theft of millions of allowances. For instance, in January 2011, the national registries in a number of Member States (including Austria, Romania, Czech Republic, Greece and Italy) were attacked and millions of allowances were stolen and resold into the EU ETS. Observers pointed out that '[these] circulating stolen allowances have had significant market-wide effects on market confidence and trade liquidity due to the legal uncertainties associated with inadvertently purchasing them'[394]. Within the EU ETS system, each allowance is allocated a unique unit identification code. However, at the time of the allowance thefts, these codes were only visible to the owners of allowances. As a result, market participants were unable to identify whether the allowances they were purchasing had been stolen. This uncertainty on the market led to lawsuits before national courts of Member States and the CJEU.

In several cases relating to allowance theft, national and European courts discussed the legal nature of allowances. In *Armstrong v Winnington*[395] before the English and Wales High Court, Winnington, a British company, bought allowances which had been stolen from Armstrong, a German company, from the German registry as the result of a phishing email fraud. Armstong sought a wide variety of remedies against Winnington, the recipient of the stolen allowances. The legal question at the heart of the dispute was as follows: 'If a third-party steals Armstrong's property and sells it to Winnington, does Armstrong have a claim against Winnington for the property or its value, and if so, what is the legal basis of Armstrong's claim and what defence, if any, does Winnington have against such a claim?' This case, as well the case *Celtic Extraction,* is analysed in detail in Section 5.2.1.

Similarly, in *Holcim SA v European Commission*[396]*,* an unauthorised person unlawfully accessed the accounts of Holcim (a leading cement manufacturer) in the Romanian registry and stole 1.6 million allowances. The allowances were transferred to accounts in Italy and Lichtenstein. Holcim was able to recover 600,000 allowances diverted to Lichtenstein but not the one million remaining, which were

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[390] See ICAEW, 'VAT – businesses trading in emissions allowances', available at: http://www.ion.icaew.com/TaxFaculty/post/VAT---businesses-trading-in-emissions-allowances.

[391] European Court of Auditors, 'The integrity and implementation of the EU ETS', Luxembourg: Publications Office of the European Union, 2015, p. 21. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

[392] 'Phishing' is a type of IT fraud whereby fraudsters disguise themselves as a legitimate and trustworthy entity in an electronic communication to fool unsuspecting targets into providing access to sensitive or valuable data such as usernames, passwords, and credit card details. Phishing emails may contain links to websites or documents infected with malware, such as computer viruses, Trojan horses, etc.

[393] Interpol, 2013, p. 23.

[394] Nield, K. and Pereira, R., 'Financial crimes in the European carbon markets' in Weishaar, S.E. (ed), *Research Handbook on Emissions Trading*, Edward Elgar, 2016, p. 203.

[395] [2012] EWHC 10 (Ch).

[396] Judgment of 18 September 2014 in Case T-317/12 Holcim (Romania) SA v European Commission; Judgment of 7 April 2016 in Case C-556/14 P Holcim (Romania) SA v European Commission.

worth EUR 15 million at that time. Holcim asked the Commission to request national registries to freeze the stolen allowances and block the accounts through which the allowances had passed. Following the Commission's refusal, Holcim brought an application against the Commission before the CJEU, raising the Commission's liability for fault for the damage sustained by Holcim because of the Commission's refusal to disclose information concerning the stolen allowances and to prohibit all transactions involving these allowances[397]. The CJEU rejected the plea of liability on the part of the EU, as the harm was caused by a lawful act and the damage alleged by the appellant was not, 'in any event', unusual or special.

The CJEU has held that '[allowances] were introduced under ETS Directive 2003/87/EC and Regulation 2216/2004. Those measures establish obligations in respect of legal or natural persons coming within their scope, that is those persons carrying out activities referred to in the Annex I to ETS Directive 2003/87/EC. [Allowances] are therefore instruments which were created solely by EU legislation and are aimed, primarily, at those natural or legal persons. They therefore form part of those persons' assets, the use of which is likely to have a commercial logic'[398].

It should be pointed out that uncertainty in the legal nature of allowances has had repercussions for the remedies available for companies with a compliance obligation under the EU ETS who have been victims of theft.

In *Holcim*[399], the victim of allowances theft requested that the European Commission disclose the identity of holders of the accounts in which the stolen allowances appeared and block all national registries in which such allowances were registered. However, this request was rejected by the Commission, by various national courts and by the CJEU. For instance, in the Commission's view, '[t]he recovery of any allowances which are claimed to have been transferred fraudulently is a matter for national law and national law enforcement authorities' and '[t]he Commission has no powers to block any such allowances in a registry account as such allowances continue to represent legally valid compliance instruments'[400]. In this case, the rules governing the operation of the EU ETS limited the victim's opportunities to recover its stolen allowances or access information to recover them. In addition, uncertainty as to the legal nature of allowances seems to have created conflicting views on the stolen allowances and the course of action to remedy the theft. For instance, the Commission partly refused to take action since it continued to perceive the stolen allowances as 'legally valid compliance instruments'. The CJEU also referred to them as 'allowances allegedly stolen'. Interpol suggested that returning the stolen allowances to Holcim was complicated, due to their varied legal status across jurisdictions. Some jurisdictions required the holder to return the stolen credits to the legal owner at the holder's loss, while other jurisdictions allowed the buyer to keep them, with the original owner incurring the loss[401].

In *Armstrong*[402], it was unclear which types of claim (or causes of action), and therefore remedies, were available to the victim against the recipient of the stolen allowances. The High Court had firstly to rule on the legal nature of allowances in order to decide which claims and remedies were available

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[397] Holcim also filed an application against the Commission for damages on the basis of strict liability.
[398] *Ibid.,* paras 144-145.
[399] Judgment of 18 September 2014 in Case C-317/12 Holcim (Romania) SA v European Commission; Judgment of 7 April 2016 in Case C-556/14 P (Romania) SA v European Commission.
[400] Case C-317/12, para 28.
[401] Interpol, 2013, p. 22.
[402] Armstrong DLW GMBH v Winnington Networks Ltd.

to the victim. Ultimately, it held that the **victim's claim lay in receipt of trust property**, since an allowance was an intangible property. The victim was thus entitled to compensation for the stolen allowances.

### 6.3.3 Money laundering

Interpol defines money laundering as '[A]ny act to conceal or disguise the identity of illegally obtained proceeds to make them appear to have originated from legitimate sources. Illegally obtained funds are laundered using entities to disguise the true owner of money, and then moved around the globe using intermediaries and money transmitters. In this way, the illegal funds remain hidden and are integrated into legal business and into the legal economy'[403]. The Article 1(3) Anti-Money Laundering Directive definition is included in Section 3.4.3. above.

There are suspicions that the EU ETS might have been targeted by criminals seeking to launder proceeds from criminal sources[404]. Criminal trials in some Member States, such as France, have revealed the risk of money laundering involved in trading of allowances[405]. Observers have also suggested that abnormal spot volumes on the EU ETS may be a potential indicator of the occurrence of speculative trading linked to money laundering on the EU ETS[406].

In order to understand the role of legal nature of allowances in the context of money laundering, it is necessary to understand 1) the process of money laundering, and 2) the nature of the products being used during each phase of money laundering.

According to Interpol, money laundering usually occurs in three steps: '[F]irst, the proceeds of the crime (usually in the form of cash) is introduced into the financial system by some means ('placement'), the second involves carrying out complex financial transactions in order to camouflage the illegal source ('layering'), and the final step involves using those illicit funds for investments to acquire wealth ('integration')'[407]. The following fictitious example describes the three phases of money laundering (placement, layering and integration) [408] using the trade of allowances on the EU ETS:

'Company X is financed from dirty funds in Country C (that could be outside the EU […]). Company X opens a subsidiary (Company Y) in an EU country (Country B) that has a close economic relationship with Country C […] thereby transferring funds into the banking system inside the EU, accomplishing the **placement phase**. Company Y enters the energy brokerage business and opens an account with a carbon national registry. With the original dirty money Company Y buys allowances from a broker. Company Z, linked to Company Y, sells allowances through its account with a broker

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[403] Interpol, 2013, p. 20.

[404] Williams, C.C., 'A burning desire: The need for anti-money laundering regulations in carbon emissions trading schemes to combat emerging criminal topologies', *Journal of Money laundering Control*, vol 16, no 4, 2013, pp. 298-320, at p. 308; Frunza, M-C., *Fraud and Carbon Markets: The Carbon Connection*, Routledge, 2013, p.71.

[405] For instance, in France, see Cass Crim, 3 June 2015, No. 15-81741. This case involves money laundering through the sale of allowances on BlueNext. See also Boisseau, L., 'Escroqueries, blanchiment et détournement au procès de la fraude à la TVA sur le $CO_2$', *Les Echos*, 2011. Available at: http://www.lesechos.fr/13/10/2011/LesEchos/21037-152-ECH_escroqueries--blanchiment-et-detournement-au-proces-de-la-fraude-a-la-tva-sur-le-co2.htm (viewed on 31 January 2017).

[406] Frunza, M-C., 'Aftermath of the VAT Fraud on Carbon Emissions Markets', *Journal of Financial Crime*, vol 20, no 2, 2012, pp. 222-236.

[407] Interpol, 2013, p. 21.

[408] Not all money laundering mechanisms necessarily involve these three phases.

on an organised carbon exchange (e.g. BlueNext). The selling order of Company Z is executed through a series of buffer brokers, aimed to cut the direct link between the exchange and Company Y, thereby transferring the allowances of Company Y from Country C to Country A, where the exchange is based. This achieves the **layering phase**. The proceeds of the sale on the exchange are delivered from a reputable bank based in Country A, thereby legalising the funds and accomplishing the **integration phase'**[409.] In this example, allowances were used during the layering phase. They were bought using so-called 'dirty money'. The criminals had the intention of hiding and confusing the source and ownership of the illegal funds. However, allowances may also be used during other stages of money laundering (placement and integration)[410].

The term 'money laundering' is misleading, as it gives the impression that only money is laundered. Actually, money laundering involves the movement of various types of products, ranging from money and other forms of funds or values to any types of property (land, shares, paintings, etc.). Their common characteristic is that they are proceeds deriving from criminal activity. Depending on the phase during which allowances are used in the money laundering process (placement, layering or integration), they might be considered differently.

Section 3.3 of this report provides an analysis of allowances under the Anti-Money Laundering Directive 2015/849/EU. From its Article 1(3), it can be deduced that **an allowance is a property subject to criminal activity, or to an act of participation in such activity when used in the context of money laundering (conversion, transfer, concealment, disguise, acquisition, possession, use).**

The 2005 Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism of the Council of Europe (the Warsaw Convention)[411] provides valuable guidance on the legal nature of allowances. Article 9 includes the definition of money laundering as included under Article 1(3) of the Anti-Money Laundering Directive (see Section 3.3.4 above).

The Warsaw Convention distinguishes between proceeds, property, and instrumentalities:

- Article 1(a) defines 'proceeds' as 'any economic advantage, derived from or obtained, directly or indirectly, from criminal offences. It may consist of any property as defined in Article 1(b)'.
- According to Article 1(b), 'property' includes 'property of any description, whether corporeal or incorporeal, movable or immovable, and legal documents or instruments evidencing title to or interest in such property'.
- Article 1(c) defines 'instrumentalities' as 'any property used or intended to be used, in any manner, wholly or in part, to commit a criminal offence or criminal offences'.

Article 5 on freezing, seizure and confiscation is particularly relevant to understandings of the legal nature of allowances in the context of money laundering. States Parties shall adopt measures to freeze, seize and confiscate:

- Property into which the proceeds have been transformed or converted;

[409] Frunza, 2013, pp. 72-73.
[410] For instance, Frunza explains that the MTIC can be easily used as a money laundering mechanism and this mechanism can include all three phases (Frunza, 2013, p. 72).
[411] Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism, CETS No 198. This convention entered into force in 2008. The EU has signed it but it is not ratified as yet.

- Property acquired from legitimate sources, if proceeds have been intermingled, in whole or in part, with such property, up to the assessed value of the intermingled proceeds;
- Income or other benefits derived from proceeds, from property into which the proceeds of crime have been transformed or converted, or from property with which the proceeds of crime have been intermingled, up to the assessed value of the intermingled proceeds, in the same manner and to the same extent as the proceeds.

It can thus be inferred that, at different phases of money laundering, allowances may be:

- **Proceeds of crime**. As such, they would be an economic advantage, derived from or obtained, directly or indirectly, from criminal offences. They may constitute any property of any description, whether corporeal or incorporeal, movable or immovable, and legal documents or instruments evidencing title to or interest in such property.
- Property into which the proceeds have been transformed or converted (placement).
- Property acquired from legitimate sources, if proceeds have been intermingled, in whole or in part, with such property, up to the assessed value of the intermingled proceeds (layering and integration).
- Instrumentalities. As such, they would be any property used, or intended to be used, in any manner, wholly or in part, to commit a criminal offence or criminal offences.

An analysis of the risk of allowances being used in any of the money laundering phases was outside the scope of this study.

#### 6.3.4 Market abuse

Once allowances are classified as financial instruments, they fall under the EU legal framework on market abuse. As a result, market manipulation, insider dealing, and unlawful disclosure of non-public information occurring in the context of allowances transactions are clearly prohibited under EU law. It is important to note that, to date, there has been no clear indication of market abuse taking place on the EU ETS.

Market Abuse Regulation 596/2014 introduced a specific definition of inside information for allowances. According to Article 7(1)(c), in relation to emission allowances or auctioned products based thereon, inside information comprises 'information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more such instruments, and which, if it were made public, would be likely to have a significant effect on the prices of such instruments or on the prices of related derivative financial instruments'. Pursuant to Article 12(2)(e), market manipulation is defined as 'the buying or selling on the secondary market of emission allowances or related derivatives prior to the auction held pursuant to the Auctioning Regulation 1031/2010 with the effect of fixing the auction clearing price for the auctioned products at an abnormal or artificial level or misleading bidders bidding in the auctions'.

## 6.4 Taxation and accounting (excluding criminal activity/law)

As described in Section 3.3 of this report, the treatment of allowances under **taxation and accounting** rules has largely remained within the purview of the Member States. This reflects the general distribution of powers between the EU and its Member States, which limits European action to oversight of compliance with EU law to and, to a lesser degree, harmonisation or coordination of Member State measures.

In areas of taxation and accounting where no harmonised European framework has yet been adopted, or where the EU lacks legislative competence, the majority of Member States nevertheless **follow similar principles**. For instance, the Member States surveyed for this report exempt allowances received free-of-charge from income taxation, but treat profits generated from transactions in the secondary market as a taxable event (see Section 5.2.7.1). Likewise, they classify allowances as intangible assets under domestic accounting standards, although the valuation of these assets in the accounts can differ: Germany and Poland value allowances at purchase price, while the UK and – in certain circumstances – France and Belgium apply fair or present value. Belgium allows allowance holders to choose between two different accounting approaches (see Section 5.2.7.3). As all five Member States examined here have adopted their own national standards or guidance, with international accounting standards – although acknowledged or invoked as examples – tending to play a **subordinate role** at best (see Section 5.2.7.4).

The survey of tax treatment of allowances in the Member States developed within the framework of this study reveals differences in:

- Classification of allowances for domestic tax law purposes: a deductible commodity, a depreciable intangible asset or a financial asset, depending on the purpose of purchasing and holding the allowance. Such differences affect the level and incidence of fiscal burdens on entities holding or transacting allowances, and can influence accounting practices.
- The taxation principle: taxation based on changes in market value during the fiscal year, even without a transaction (inventory or market value principle), or taxation only at the time of sale, based on differences between the purchase and sale price (realisation principle).
- Tax treatment of allowances allocated for free: recognition of allowances as taxable income at zero purchase cost, without deduction when surrendered or sold, or recognition of allowances as taxable income at market price, deducted from taxable income when surrendered or sold.
- Tax treatment of allowances originated as CDM or JI credits: whether or not to allow deductions for project expenses and changes in value of credits between origin and use or sale.
- Tax treatment of penalties for non-compliance: whether or not to allow their deduction[412].

[412] Copenhagen Economics, 'Tax Treatment of ETS Allowances: Options for Improving Transparency and Efficiency', *Taxation Studies from Directorate General Taxation and Customs Union*, No. 35, European Commission, 2010, p. 23.

**Table 5: Taxation and accounting treatment of allowances.**

| | Treatment for VAT purposes | Reverse-charge mechanism | Income taxation | Treatment for accounting purposes | International accounting standards |
|---|---|---|---|---|---|
| **Belgium** | Supply of services | Applied | Primary: No<br>Secondary: Yes | Intangible asset, valued at purchase price or fair market value | National standard, but international standards acknowledged |
| **France** | N.n. | Applied | Primary: N.n.<br>Secondary: Yes | N.n., valued at purchase price, with adjustment to present value | National standard, but international standards acknowledged |
| **Germany** | Supply of services | Applied | Primary: No<br>Secondary: n.n. | Intangible asset, valued at purchase price | National standard adopted |
| **Poland** | Supply of services | Applied | Primary: No<br>Secondary: Yes | Intangible asset, valued at purchase price | National standard adopted |
| **UK** | N.n. | Applied | Primary: No<br>Secondary: Yes (qualif.) | Intangible asset, valued at fair market value | Limited international standards guidance transposed |

The competence of the EU in relation to taxation is limited to '…forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition'. Any EU legislative act in this field requires its unanimous adoption by the Council through a special legislative procedure. Most taxation rules are taken at national level. The abovementioned differences in the **tax treatment** of allowances (notably in the definition and timing of taxable events) can increase the **transaction costs** faced by participants in cross-border transactions, for instance by necessitating additional legal counsel and tax advisory services. Lack of coordination of the tax treatment of allowances can also increase the risk of double taxation of cross-border transactions and may give rise to uncertainty on how allowances should be classified within the remit of existing double taxation agreements. On the margin, more favourable treatment of allowances under the fiscal rules of some Member States relative to others could result in **forum shopping** or **tax arbitrage** practices, for instance when multinational companies operating in several Member States strategically choose the location and timing of investment decisions or allowance transactions to maximise tax benefits such as immediate deductions and depreciation.

Although differences in accounting practices can have cash flow implications when allowances are held beyond a single compliance period[413], tax-optimising behaviour is not in itself illegal nor does it present an obvious challenge. Similarly, potential welfare losses from increased transaction costs or double taxation will not compare to the scale of damages arising from fraudulent exploitation of VAT loopholes in intra-community trade.

**Like taxation, accounting practices also differ** to some extent between Member States. While some definitions and principles are evenly applied across the five national jurisdictions surveyed here, there is greater heterogeneity across the broader EU in terms of how allowances are classified under accounting rules, with consequences for whether and when allowance purchase costs can be deducted,

[413] *Ibid.*, p. 9.

or whether allowances can be depreciated as a company asset[414]. Accounting implications stem from the different recognition of balance sheet items and their measurement, e.g. whether allowances should be presented on a net basis in financial statements, and how to determine their respective values[415]. Such **diversity of accounting practices** can impair the comparability and usefulness of financial statement information and generate legal uncertainty[416].

The challenges arising from the **heterogeneity of taxation and accounting rules** could be most directly addressed by **harmonisation** of regulatory frameworks at the EU level. It bears noting, however, that the EU has **very limited** competence – with stringent voting requirements – to promote harmonisation of tax frameworks across the Union. Rather than adopt formal legislation, a previous study set out three alternative recommendations to achieve a greater degree of coordination across Member States[417]:

- Adopting a set of best practice rules for taxation, outlining key taxation and accounting principles of a voluntary nature, along with coordinated treatment of allowances in the context of bilateral double taxation agreements. While this would only afford 'soft' harmonisation at EU level and would rely on cooperation between Member States to coordinate and implement adjustments to their domestic law, it could still serve to marginally reduce heterogeneity of tax treatment of allowances across Europe.
- Inclusion of tax and accounting treatment of allowances in the development of a Common Consolidated Corporate Tax Base (CCCTB) for businesses operating within the EU, which, if adopted, would mandate (or allow entities to opt for) taxation according to common rules rather than divergent national rules. Implementation of a CCCTB is being proposed through a Directive, necessitating successful passage of the legislative procedure in Article 115 TFEU and therefore unanimity in the Council, as well as consultation of the European Parliament and the Economic and Social Committee. As a potentially powerful lever to harmonise tax treatment of allowances across the EU, the political barriers to implementation are, accordingly, significantly higher.
- Specifying inclusion of allowances within the scope of Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States[418] (Interest and Royalty Directive 2003/49/EC). Income from transactions in allowances does not currently fall under the definition of 'interest' or 'royalties', and thus under the harmonised framework created by Directive 2003/49/EC for their taxation. Amending Directive 2003/49/EC to expressly include profits from transactions in allowances could promote harmonisation of their tax treatment at European level and, for example, prevent double taxation, albeit only for those companies and specific constellations covered by the Directive. The inclusion of such profits would run counter to the current

[414] *Ibid*., p. 9.

[415] Haupt, M. and Ismer, R., Emissions Trading Schemes under IFRS - Towards a 'True and Fair View', Berlin: Climate Policy Initiative, 2011, p. 6.

[416] See, generally, Lovell, H., Sales de Aguiar, T., Bebbington, J. and Larrinaga-Gonzalez, C., 'Accounting for Carbon', ACCA and IETA, 2010, p.6. Available at: http://www.ieta.org/ieta/www/pages/download.php?docID=3545 (last accessed on 10 April 2017).

[417] Copenhagen Economics, 'Tax Treatment of ETS Allowances: Options for Improving Transparency and Efficiency', *Taxation Studies from Directorate General Taxation and Customs Union*, No, 35, European Commission, 2010, pp. 14-15.

[418] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, p.49. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1537192317016&uri=CELEX:02003L0049-20130701

understanding of what constitutes 'interest' and/or 'royalties', and would be at odds with established definitions. Finally, the legislative procedure would require a unanimous vote by the Council.

These recommendations are discussed at length in the referenced report, including their respective benefits and shortfalls (see Section 9 of the present report).

## 6.5 Security interests on allowances and treatment of insolvency

By requiring emissions from covered sectors to be matched by a corresponding amount of allowances and then progressively limiting the number of allowances in the market, the EU ETS creates scarcity, which affords allowances **economic value**. When allowance holders – whether compliance entities or other market participants, such as financial intermediaries – enter **insolvency** or want to use assets as **security or collateral**, questions arise as to how allowances and their associated economic value will be treated under relevant EU and Member State law.

The **European Court of Auditors** has recommended adopting an 'express provision for the registration of security interests in allowances'. It further states that '[a]n express EU-level provision that emission allowances are capable of **supporting the existence of security interests**, and a registration mechanism for such interests' may increase the commercial value of emission allowances for market participants[419].

The specific questions which emerge in practice have already been described in greater detail in earlier sections of this report[420]. Instances where the eligibility of allowances to serve as **security interest or collateral** can become relevant, include giving allowances as security to obtain a loan, using deposited allowances to offset margin requirements on a trading platform, or using allowances as mandatory collateral in the auction process. In a situation of **insolvency**, the categorisation of allowances under relevant insolvency or bankruptcy law will be important, e.g. for allowances which are not liquidated alongside an insolvent installation.

As with the other issues discussed here, applicable rules are set out both in EU secondary law and in the legal frameworks of the Member States, depending on the degree to which the EU has made use of its shared competence. Given the evolving legal context for allowances, new questions and uncertainties have emerged which merit analysis and the exploration of potential solutions. This section attempts to do that, including a short recap of relevant legislation and analysis of legal issues for security interests and for insolvency.

### 6.5.1 Security interests and collateral

As the European Court of Auditors observed in its 2015 report, 'the operation of the emission market could improve if emission allowances were more commercially interesting for voluntary participants,

[419] European Court of Auditors, 'The integrity and implementation of the EU ETS', Luxembourg: Publications Office of the European Union, 2015, p. 25, para. 28. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

[420] See Sections 3.1.2.4, 3.2.2, 3.2.3, and 3.2.4 for an assessment of relevant EU law, and Sections 5.2.2.2 and 5.2.5 for an assessment of relevant Member State law.

for example by supporting the ability to create and protect secure and enforceable security interests'[421]. The principal benefit from the use of allowances as collateral would be **avoidance of opportunity costs** of having to raise collateral through traditional means, such as cash or debt securities. A recent study estimated the **savings** which might thus be achieved across the market at around **EUR 170 million a year**, with potential gains if allowance prices increase[422].

A variety of other factors may limit the use of allowances as collateral, including the lack of a liquid market, criminal or fraudulent activities, price volatility, and the presently low price of emission allowances. Stakeholder feedback affirmed that uncertainty about the **legal nature of allowances**, heterogeneous **insolvency rules** across the EU, and **lack of coverage** by the **Financial Collateral Directive 2002/47/EC** and the protections it sets out for collateral takers, have all had a major impact on collateral use[423].

Security interests and collateral are among the principal ways in which market participants **reduce transaction risk**, and lack of legal certainty can seriously impede their efficient use. This may, in turn, restrict access to, or increase the cost of, capital and financial services, and ultimately limit transactions that might otherwise have occurred on a collateralised basis.[424]. Broadly speaking, **security interests** are third party legal rights into realisable assets provided as **collateral** for the purposes of securing rights and obligations against default or other breaches of obligation in financial transactions[425]. Legally, it is important to **distinguish** the collateral – essentially the asset or property delivered by the collateral provider to secure an obligation to the collateral taker – from a mere security interest into that collateral. In the context of this report, the collateral would thus consist of the actual emission allowances, while a security interest would be a **limited interest** in those allowances.

This central distinction is mirrored in the two main types of **legal arrangements** used to secure the performance of an obligation to the collateral taker[426]:

- In the first approach, often referred to as a 'Title Transfer (Financial) Collateral Arrangement' (TTCA), the collateral provider transfers full ownership over the collateral itself. This means that the legal and beneficial interest in the assets is transferred entirely to the collateral taker as owner, subject to a contractual obligation on the part of the latter to return equivalent assets once the contractual arrangement ends or the secured obligations are met.
- The second approach, sometimes referred to as a 'Security Interest Collateral Arrangement' or 'Security Financial Collateral Arrangement', involves establishing the security interest by way of a pledge, lien or other limited interest (rather than full transfer of title) over the assets in question. This allows the latter to be appropriated towards fulfilment of certain obligations and made available to the secured party at the time of contractually defined enforcement events. Creation of the security interest may or may not require taking possession of the collateral. In many legal systems, limited interests over property require a formal act such as registration

[421] European Court of Auditors, 'The integrity and implementation of the EU ETS', Luxembourg: Publications Office of the European Union, 2015, p. 24, para. 25.
[422] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, p. 53.
[423] *Ibid*., p. 142.
[424] International Swaps and Derivatives Association, 'Collateral Arrangements in the European Financial Markets: The Need for National Law Reform', March 2000, p. 1. Available at: http://www.isda.org/c_and_a/pdf/NeedLawReform.pdf
[425] *Ibid*., p. 24, note 53; Article 2(m) Financial Collateral Directive 2002/47/EC.
[426] See, for example, Article 1(b) and (c) Financial Collateral Directive 2002/47/EC.

(sometimes referred to as 'book entry securities collateral') in order to be enforceable (sometimes referred to as 'perfection').

Each approach has **different legal conditions and legal implications**. Under a TTCA, for instance, the recipient becomes a full owner of the collateral and can thus deal with it freely. In the case of allowances, the secured party would be able to transfer or cancel these without requiring permission from the collateral giver (even though this may breach the conditions of the collateral arrangement and have contractual implications). By contrast, a mere security interest will afford only restricted use, given that the collateral taker may not deal with the assets until an enforcement event occurs. Differences can also arise in the event of **bankruptcy or insolvency** of the secured party: with full transfer of title, the collateralised assets become part of the insolvent estate of the collateral taker, while registration of a security interest means that the collateral provider retains title to the secured assets and these do not then form part of the insolvent estate of the secured party[427]. Finally, obtaining full ownership of collateral can give rise to **regulatory obligations for allowances**, such as the need to open and maintain a registry account in which to hold them.

The current legal framework governing the EU ETS imposes **limitations** on the types of collateral arrangements available to allowance holders looking to use these as security. Conventional rules on collateral and security interests tend to focus on **real or personal property** given as collateral, meaning that uncertainty about the legal nature of allowances and its varied treatment across Member States can become an obstacle to securing obligations though provision of allowances. This does not mean, however, that the current legal framework flatly disallows the use of allowances as collateral: Article 3(1)(38) of the **Auctioning Regulation 1031/2010** expressly states that the collateral required from bidders or the auctioneer under Articles 49 et seq. can include 'any allowances accepted as security by the clearing system or settlement system'[428]. With that provision, the Auctioning Regulation 1031/2010 seeks to manage transaction risk during the auctioning process, and allows the use of allowances to guarantee obligations between the bidder and the auctioneer pending payment or delivery of auctioned allowances[429]. The ability to use allowances as collateral for the purposes of the Auctioning Regulation 1031/2010 is, however, limited to a very specific set of circumstances and should not be read as extending to other situations.

Another important restriction applies to the creation of a security interest through a 'Security Interest Collateral Arrangement' rather than a TTCA. Not only will this type of security interest typically require the creation of a limited interest in a **property right** (thus limiting its availability in Member States that do not classify allowances as property), it also requires a formal act of registration in some jurisdictions before the security interest can be perfected[430]. As outlined in Section 3.1. the legal architecture created by the **Registry Regulation 389/2013** does not currently allow registration of

[427] Linklaters: 'Advantages/disadvantages of using title transfer and security collateral arrangements', March 2012. Available at: http://www.linklaters.com/Insights/Publication1386Newsletter/insurance-update-March2012/Pages/using-title-transfer-security-collateral-arrangements.aspx

[428] See the 'Template Escrow Agreement' contained in Annex 7 of the Tender Specifications for the Appointment of a Common Auction Platform, Ref. Ares(2016)2516039 of 31 May 2016. Available at: https://ec.europa.eu/clima/sites/clima/files/20160726tender_specifications_en.pdf

[429] For further details, see Section 3.1.3.

[430] See for example the requirements for the creation of a security interest pursuant to § 1274 para. 1 of the German Civil Law Code, discussed in Section 5.1.5.1. Likewise, security interests in allowances cannot be created in Romania and the Netherlands; see the interview notes with the FMLC on the legal nature of allowances, 21 March 2017, Section 4. The location of the registry account will determine the applicable law, see Article 11(5) of the Registry Regulation 389/2013, which states that 'accounts shall be governed by the laws and fall under the jurisdiction of the Member State of their administrator and the units held in them shall be considered to be situated in that Member State's territory.'

limited interests – including **security interest** – in allowances. A **practical approach** to protect third-party interests within the legal framework of the Registry Regulation 389/2013 could involve designating the secured party as an 'additional authorised representative', whose approval would then be required for certain transactions[431]. In addition to the fact that this would not necessarily meet the perfection requirements imposed on security interests in some Member States, this solution also suffers from significant functional limitations: third party control would be linked to the account, not the pledged allowances; certain transactions would be exempt from approval by the additional representative[432]; and, in the event of a default, the additional representative could not take ownership of the collateral without the acquiescence and participation of the allowance holder[433].

**Box 1: Issues of possession and custody**

Distinguishing possession and ownership of allowances is relevant here. Some arrangements pertaining to security interests, such as custody, assume the severability of the ownership right or title from the actual possession. With moveable or immovable goods, for instance, this regularly occurs when a tenant rents or leases property (such as a vehicle or residential building) from the owner and takes physical possession. As ownership and possession become separate, each party tends to enjoy certain rights against the other, many of which are set out contractually between the parties, and some of which are conferred *in rem* (such as a claim of *rei vindicatio*). As allowances are immaterial and created by administrative fiat, the ability to separate ownership from possession is not readily apparent.

Article 40(1) of the Registry Regulation 389/2013 stipulates that allowances are 'immaterial' instruments, and Article 40(2) further states that 'the record of the Union Registry shall constitute *prima facie* and sufficient evidence of title over an allowance'. In light of that provision, the question arises of whether allowances (whose legal nature is not uniformly defined, and in some cases is left uncertain, across Member States) see possession separated from ownership, given that possession is expressed by holding allowances in a registry account. In view of the immaterial nature of allowances and the fact that they are defined as administrative rights in some Member States, it could be argued that possession in a registry account is constitutive of title, or, in other words, that registration is a condition of ownership (see Section 4.1.2.1). If that were the case, and property and possession cannot be severed from one another, then an acquirer, such as a custodian, would automatically take ownership with registration. To facilitate custody or storage by a party other than the allowance owner, only auxiliary options would be available: full transfer of title over the allowances, combined with a contractual obligation to return ownership over the allowances when contractually specified conditions are met; a purely contractual arrangement without an accompanying transfer of allowances to the custodian through which, for instance, the custodian gains *de facto* control over the allowance owner's registry account; or the owner's control is restricted (e.g. through a locked sub-account).

If ownership and possession of allowances were to be separated, custody and storage could become possible without a change in ownership status. Such an arrangement would seem to contradict Article 40(2) of the Registry Regulation 389/2013, based on the presumption that the registry record of

[431] Article 23 para 3 Registry Regulation 389/2013.
[432] *Ibid*., Article 23 para. 3(a).
[433] For further detail and discussion, see Section 3.1.2.5 and 3.2.2.; see also the interview notes with EEX on the legal nature of allowances, 15 March 2017, Section 2.

allowances held in the account of a custodian provides evidence of title over said allowances but does not necessarily reflect the real owner. As Article 40(2) states that the registry record constitutes '*prima facie'* evidence only, it could conceivably be interpreted that the presumption would be broken by the proof of title and, therefore it allows for exceptions to the presumption of title. Given that the registry currently does not allow registration of restricted or limited interests, however, it would become a practical challenge for interested parties to ascertain the point at which possession and ownership of allowances diverge. In those Member States where allowances are categorised as administrative rights or their status is unclear, it is difficult to imagine a construction in which a party other than the right holder 'possesses' that right.

The uniform classification of allowances as financial instruments under MiFID II may support their treatment as property rights even in Member States which currently consider them administrative rights. However, the legal doctrine and case law in the five Member States surveyed here do not yet allow a clear answer to the question of whether possession and ownership of allowances can be severed. Consequently, only the custody options outlined above offer legal certainty at present, i.e. assuming the transfer of title along with possession, or creating an auxiliary solution involving *de facto* control over allowances, both coupled with corresponding contractual obligations.

In the actual market, the restrictions outlined have given rise to creative, but potentially vulnerable, arrangements based on **private law contracts.** For instance, the **clearing and settlement service provider** European Commodity Clearing AG (ECC)[434] has resorted to a legally complex solution in order to allow its clearing members to use deposited allowances against margin requirements in lieu of cash or pledged securities. In essence, the relevant legal framework is based on the private **clearing conditions** applicable between the clearing house and its members[435], and incorporates a system of separate internal inventory accounts to meet the obligations set out for primary market auctions under the Auctioning Regulation 1031/2010 [436]. Given that the ECC and its parent company, the EEX, handle the vast majority of transactions in the primary and secondary market, this construction is significant in practical terms. Outside of this specific and institutionalised relationship, however, market participants may be deterred from using emission allowances at scale in security arrangements until the legal status has been clarified and the perceived risk associated with emission allowances mitigated[437].

A recent study recommended extending the protections of the **Financial Collateral Directive 2002/47/EC** to emission allowances, in the expectation that this would afford greater legal certainty

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434 ECC is a clearing house for energy and other commodities traded on an exchange or via trade registration. It is a subsidiary of the European Energy Exchange AG (EEX).

435 See ECC, Clearing Conditions of European Commodity Clearing AG, Release 0037a, 1 April 2017, Section 3.1 para. 2 on the obligation to furnish collateral and parallel debt, together with Section 5.2.2 on principles of the establishment of margins for system clearing members, and Section 3.2.3 on trading participant collateral.

436 See Section 5.2.5.1.

437 See the interview notes with the FMLC on the legal nature of allowances, 21 March 2017, Section 4; FMLC, Response to the EU ETS Stakeholder Consultation Survey dated 15 October 2013, Letter of 18 February 2014, p. 2: 'Market participants are unwilling to use emissions allowances in security arrangements so long as their legal nature is uncertain'; European Court of Auditors, 'The integrity and implementation of the EU ETS', Luxembourg: Publications Office of the European Union, 2015, p. 25, para. 28, available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

and encourage the use of allowances in security arrangements[438]. With rules to simplify the collateral process and harmonise minimum requirements across the EU, the Financial Collateral Directive 2002/47/EC seeks to promote greater integration of European financial markets, improve legal certainty in the use of collateral, and reduce risk for collateral takers[439]. In particular, Article 3 of the Financial Collateral Directive 2002/47/EC removes the need for a formal act for 'the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement', meaning that provision of a security interest in allowances would no longer require registration, even in those Member States which have traditionally required it. In its current form, however, Financial Collateral Directive 2002/47/EC **does not extend** its legal protections to financial collateral arrangements involving allowances. As the Directive applies its own definition of 'financial instruments'[440], several commentators suggest that the inclusion of allowances in Annex I, Section C of Directive 2014/65/EU (MiFID II) **will not be sufficient** to ensure that allowances used as collateral fall within the scope of Financial Collateral Directive 2002/47/EC[441].

Whether potential changes to the legislation (chiefly, the Registry Regulation 389/2013 and Financial Collateral Directive 2002/47/EC) could help to address the limited use of allowances as collateral and help to leverage the economic benefits of using these otherwise dormant assets will be discussed in 'remedial measures'.

### 6.5.2 Insolvency

Another question relates to the classification of allowances for the purposes of **insolvency or bankruptcy law**. Of particular interest here are the rules governing title to allowances in a situation of insolvency, for instance when allowances in a registry account are not liquidated alongside the bankrupt or insolvent installation. In such cases, it will be a matter of law whether the registry account accrues to the owner of the installation or is linked to the insolvent installation itself and thus follows it - or its components - in the event of a liquidation or winding up[442].

At the EU level, **Insolvency Regulation 2015/848** aims to harmonise insolvency procedures across Europe but does not set out any material stipulations clarifying the role of allowances. Its provisions may be relevant in determining the applicable law and jurisdiction, but cannot offer substantive

[438] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, Section 9.1 and 9.2.3; Interview notes with EEX on the legal nature of allowances, 15 March 2017, Section 2.

[439] See European Commission, Financial Services: Implementing the framework for financial markets: Action Plan, COM(1999)232, 11 May 1999; for more detail on the provisions of Financial Collateral Directive 2002/47/EC, see Section 3.2.2.

[440] Rather than referring to the definitions set out in the MiFID regime, Article 2(1)(e) of Financial Collateral Directive 2002/47/EC specifies that 'financial instruments' refers to shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in, and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange, or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing'.

[441] See Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, p. 53; Interview notes with EEX on the legal nature of allowances, 15 March 2017, Section 2.

[442] For discussion, see Section 3.1.2.4.

guidance on the treatment of allowances during insolvency. In effect, as the FMLC affirmed in relation to predecessor legislation[443], the broader interface between proprietary and contractual effects of assignments of contractual rights was sufficiently controversial in the preceding negotiations to require deferral for future consultation[444].

Conversely, the **Registry Regulation 389/2013** does not expressly mention insolvency or bankruptcy, yet may help to determine the material outcome in a situation where an insolvent owner faces liquidation of one or more installations. Article 25(5) of the Registry Regulation 389/2013 stipulates that the 'account holder of an operator holding account may only sell or divest its operator holding account together with the installation linked to the operator holding account', suggesting that allowances are linked to the installation and should therefore accompany any sale in these circumstances. Domestic frameworks in some Member States reflect this interpretation[445], although not all stakeholders agree. According to the representatives from Reedsmith LLP and the European Federation of Energy Traders, while this outcome might help to avoid a situation in which an insolvent owner retains control over allowances while being relieved of having to service debt, it simultaneously departs from the common principle that assets should be linked to their owner and not to an administrative licence[446].

As the classification of allowances as financial instruments under MiFID II entered into force, the **Settlement Finality Directive 98/26/EC** applies to allowance transfers, extending the same level of protection to allowances that it offers to transactions in cash and other financial instruments. By allowing 'to point to the time when transfers of allowances or payments in relation to settlement of any EUA or EUA derivatives trade become final and irrevocable', this extended protection will also mitigate risks related to the insolvency of one of the parties or institutions through which the allowances or payment was transferred[447]. More specifically, Article 3 guarantees that transfer orders and netting remain legally enforceable in the event of insolvency, while Articles 6 and 7 preclude the retroactive effect of insolvency proceedings. Article 9, meanwhile, protects the rights to collateral security against the insolvency of the participant or party who provided the collateral.

Aside from these stipulations, however, substantive determinations concerning allowances are generally left to the **domestic insolvency regimes** of the Member States. Generally, treatment of allowances in the event of insolvency is closely linked to the legal nature afforded to these allowances under domestic law[448]. Despite this, an example described by the FMLC in a 2009 report illustrates that the lack of a harmonised framework on the treatment of allowances during insolvency can give rise to challenging legal questions in a cross-border context, especially between Member States which

[443] Specifically, the earlier Insolvency Regulation 1346/200/EC and Credit Institutions Winding Up Directive 2001/24/EC.
[444] FMLC, Emissions Allowances: Creating Legal Certainty. Legal assessment of lacunae in the legal framework of the European Emissions Trading Scheme and the case for legislative reform, 2009, p. 9, para. 2.9. Available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/116e.pdf
[445] See, for example, the insolvency rules applicable in Poland, as discussed in Section 5.1.2.2 of Interim report I.
[446] See interview notes with Reedsmith LLP, the European Federation of Energy Traders (EFET) and the International Emissions Trading Association (IETA) on the legal nature of allowances, 27 June 2017, Section 5.
[447] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, p. 38.
[448] In the UK, for instance, any registered emission allowances are treated as part of the property of the insolvent entity and can therefore be disposed of during liquidation; see FMLC, Emissions Allowances: Creating Legal Certainty. Legal assessment of lacunae in the legal framework of the European Emissions Trading Scheme and the case for legislative reform, 2009, pp. 11-12, para. 3.5. Available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/116e.pdf

have opted for different definitions of the nature of allowances as property rights or proprietary rights[449]. The next section describes some possible remedies.

[449] *Ibid*., p. 9, para. 2.9.

# 7 Consequences of treating emission allowances as financial instruments

This study analyses the consequences of treating emission allowances as financial instruments under EU law in relation to possible implications for their legal nature at national level. Emission allowances are listed among financial instruments by MiFID II (Annex I, section C), which is applicable since 3 January 2018. At the time of MiFID II's adoption in 2014, the expected benefits of this classification of emission allowances as financial instruments were: legal clarity; enhanced transparency; improved efficiency and safety (against market abuse); and consistency between financial and carbon markets.

After some preliminary remarks on MiFID II to put the relevant EU legislation into context, this section of the study is structured as follows:

- Sub-section 1 analyses the impacts of MiFID II provisions on the EU ETS now that emission allowances are classified as financial instruments, with a focus on the possible consequences of such classification on the legal nature of emission allowances in some Member States.
- Sub-section 2 discusses how the Auctioning Regulation 1031/2010 is impacted by MiFID II, and its interaction with the Market Abuse Regulation 596/2014.
- Sub-section 3 examines the interplay between the MiFID II classification of allowances and other EU financial market legislation applicable to MiFID II financial instruments, such as the Settlement Finality Directive (SFD) and the Financial Collateral Directive 2002/47/EC. It analyses the application of national legislation to emission allowances in respect of their legal nature as financial instruments, in particular the rules governing the creation, issuance, transfer, storage, custody and use as collateral of such instruments.

Following the 2008 financial crisis, G20 leaders committed to enforcing better regulation for markets and financial instruments, with EU heads of state and governments undertaking to amend their existing legislation on markets. Indeed, the growing distrust towards markets since 2008, together with the existing gaps in Directive 2004/39/EC on markets in financial instruments (MiFID I), underscored the need to amend this Directive and complete the EU legal framework on markets.

The EU legal framework for market reform needed to prioritise greater transparency, fairness and efficiency in financial markets, as well as including proper sanctions for market abuse, in order to discourage, deter and punish any behaviour deemed harmful to the proper functioning of transparent, efficient and integrated financial markets.

MiFID II was introduced on 15 May 2014 and repeals Directive 2004/39/EC (MiFID I) as of 3 January 2018. MiFID II sets out a market structure framework by shifting trading towards more structured marketplaces/regulated platforms, such as regulated markets, MTFs, OTFs and Systemic Internalisers. This Directive sets out very specific obligations for those four trading venues.

It was also crucial to specify the rights and obligations relating to the trade of financial instruments on regulated markets, MTFs or OTFs, particularly for investment firms operating both inside and outside the EU. The objective here was to protect investors and stabilise the financial system, ensuring pre and post-trade transparency. This objective will be met through controls on high-frequency algorithmic trading, the obligation for traders to report trading activities, and the implementation of harmonised administrative sanctions.

MiFID II also empowers the Member States' markets authorities, alongside the ESMA, to inform market players and ensure effective supervision of market trading activities.

## 7.1 Impact of MiFID II on EU ETS

Prior to the adoption of MiFID II, emission allowances were not treated as financial instruments (except in some Member States, such as Romania, through national measures transposing the EU ETS Directive 2003/87/EC). However, derivative contracts based on emission allowances were regarded as financial instruments (in accordance with MiFID I) and they had the same characteristics as any other derivative financial instruments, particularly when traded on a regulated market or MTF.

### 7.1.1 Emission allowances as financial instruments under MiFID II: what consequences for their legal nature?

MiFID II does not define financial instruments. A list in Annex I, Section C[450], however, catalogues different categories of financial instruments.

Emission allowances, which are referred to therein as 'any units recognised for compliance with the requirements of Directive 2003/87/EC' are listed in Annex I, Section C, point (11) of MiFID II as one category of financial instruments. Derivatives of emission allowances are covered by point (4) of that Annex.

Thus, options, futures, swaps or forward agreements, or any other derivatives contract for emission allowances as defined by the ETS Directive 2003/87/EC, are now to be regarded as financial instruments within the meaning of point (4) of Section C of Annex I to MiFID II. The inclusion of emission allowances extended the scope of MiFID II to cover all spot and derivative contracts on emission allowances concluded on the secondary market.

This classification of allowances as financial instruments raises the question of whether or not the application of MiFID II through relevant national implementing measures can help to clarify the legal nature of emission allowances at national level, particularly where they confer rights *in rem* or *in personae* or give rise to both types of rights.

Financial legislation does not provide any clarification on the legal nature of allowances, as financial instruments may take different legal forms and have different legal nature with different consequences. For example, the classification of financial instruments by MiFID II affects property law at national level. Annex I, Section C of MiFID II only lists different categories of financial instruments, with emission allowances identified as 'any unit recognised for compliance with the ETS Directive 2003/87/EC', which further defines them as 'an allowance to emit one ton of $CO_2$ equivalent during a specified period'. The classification of emission allowances as financial instruments clarifies the regulatory framework applicable to them, as all contracts, whether spot or derivatives, are covered by MiFID II provisions, and some market players are subject to some MiFID II requirements. However, this is without prejudice to the property rights that may be conferred upon their holders under national law.

[450] See Article 4 §1, (15) MiFID (consolidated version).

None of the selected Member States covered by the study[451] explicitly define the legal nature of emission allowances, with the exception of France:

- ✓ **France**: emission allowances are defined in the Environmental Code as personal property (intangible asset), which is property *in rem*. They are not explicitly classified as financial instruments but are referred to in all relevant provisions of the Financial and Monetary Code to ensure proper implementation of MiFID II provisions.
- ✓ **Belgium**: emission allowances are defined in the three Belgian regions' legislation implementing the ETS Directive 2003/87/EC as a 'transferable right to emit one ton of $CO_2$-equivalent GHG emissions during a specific period or trade period', which is the same definition as that provided in Article 3(1) of the ETS Directive 2003/87/EC. In the absence of a clear legal qualification under property law, there are different views on whether or not they are recognised as movable property.
- ✓ **Germany**: as in Belgium, emission allowances are defined as a right/authorisation to emit a ton of $CO_2$ equivalent within a certain period of time. They are considered to have a 'hybrid' nature, which is not legally defined by law. Initially, the national measures implementing MiFID II stipulated that emission allowances were not to be regarded as financial instruments but the legislation has since been amended to remove this, without any further specification.
- ✓ **Poland**: an emission allowance is an entitlement to introduce an equivalent of carbon dioxide to the ambient air, which (this entitlement) is issued in the framework of the EU ETS. However, Polish legislation considers these allowances a tradable entitlement which can be used as collateral, while having an administrative legal nature.
- ✓ **UK**: there is no statutory definition of the legal nature of emission allowances but they are considered property under Common Law, according to case law (Armstrong v Winnington). As property they can be used as financial instruments, thus MiFID applies.

For the implementation of MiFID II, the national legislation of the five selected Member States simply states that emission allowances are classified as financial instruments, or that they should be regarded as such for the implementation of the relevant provisions of MiFID II, but without providing further clarification on their legal nature.

Emission allowances are simultaneously subject to two different legal frameworks pursuing two different objectives (e.g. the EU ETS, which aims to reduce GHG emissions on the one hand and MiFID II/MiFIR and the market abuse regime, which aim to better regulate financial markets within the EU on the other hand). In taking account of their legal nature at national level, therefore, it is important to analyse the legal transfer of the title of emission allowances, as well as the means of proving title prior to and after such transfer, under both regimes.

In order to answer this question, it is necessary to examine the treatment of emission allowances at national level now that they are classified as financial instruments at EU level, in view of the fact that they could also be considered 'transferable securities' under Article 4(44) c), of MiFID II. Transferable securities are defined as follows:

[451] Other Member States' legislation recognises emission allowances as property, e.g. Cyprus, Finland, Lithuania and Spain, which define them as intangible assets or undifferentiated goods.

'*those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as: (...)*
*(c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.*'

For this analysis of the national measures transposing MiFID II, this section concentrates on three Member States: France, Belgium and Germany.

- **France**

As noted above, emission allowances are defined as 'personal property', conferring rights *in rem* to their holders. They are negotiable, may be transmitted by transfer from account to account, and confer identical rights upon their holders.

Property rights are recognised by the provisions of the French Civil Code, as follows:

- Article 544: Ownership is the right to enjoy and dispose of things in the most absolute manner, provided they are not used in a way prohibited by statutes or regulations.
- Article 545: No one may be compelled to yield his ownership, unless for public purposes and for a fair and prior indemnity.
- Article 546: Ownership of a thing, either movable or immovable, gives a right to everything it produces and that which is accessorily united to it, either naturally or artificially. That right is termed the 'right of accession'.

In French law, an emission allowance is a dematerialised instrument. However, according to Article L-229-15 of the Environmental Code, it becomes 'materialised exclusively by being listed on the account of the holder' in the Union Registry. This materialisation allows the recognition of property rights *in rem* attached to emission allowances.

When recorded in the Union Registry, such materialisation confers upon holders of allowances a presumption of property that is perfectly in line with the Registry Regulation 389/2013. In effect, Article 40(2) of the Regulation provides that the dematerialised nature of allowances '*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 of any other matter which is by this Regulation directed or authorised to be recorded in the Union Registry*'. Therefore, under French law, the record of emission allowances in the Union Registry is sufficient for the holder to prove title of his rights *in rem*, as well as for the transfer of title of such rights when they are transferred from one account to another within the Union Registry. However, such proof of title is without prejudice to other rights that may be attached to emission allowances, for instance *in rem* or *in personae* rights taking the form of a collateral security held by a creditor (see Section 7.4 below on collateral).

The question of the legal nature of emission allowances and the associated property rights applies when considering emission allowances as financial instruments for the purposes of implementing MiFID II. While emission allowances are not explicitly classified as financial instruments under French Law (see Article L.211-1 and D.211-1 of the Financial and Monetary Code), they are referred to in the Financial and Monetary Code provisions which are relevant for the implementation of MiFID II. Ordinance 2016-827 refers to the provision of the Environmental Code that defines the legal nature of allowances as personal property in order to specify the obligations of investment service providers when selling allowances (e.g. Article L.321-1 of the Financial and Monetary Code). This articulation

provides legal security that the property rights *in rem* attached to emission allowances traded as financial instruments remain subject to the provisions of the French Civil Code.

Under French law, emission allowances are not considered 'transferable securities' in accordance with Article 4(44) c) of MiFID II, for the following reasons:

- 'Transferable securities' are defined by the French Commercial Code (Article L.228-1) as '*financial securities within the meaning of Article L.211-1 of the Monetary and Financial Code, which grants identical rights by category'*, which does not make any direct reference to emission allowances.
- Even if, taken together, the Commercial Code and the Monetary and Financial Code cover transferable securities taking the form of negotiable dematerialised instruments, the Commercial Code regulates capital securities issued by joint stock companies, but not any kind of other security giving the right to acquire or sell transferable securities or giving rise to a cash settlement. This category of transferable securities is referenced in Article L.211-1 of the Monetary and Financial Code, where there is no mention of emission allowances.

Member States have some discretion in their classification of emission allowances as financial instruments. In French law, emission allowances are related to financial instruments to ensure the proper application of the relevant MiFID II provisions, and they should not be regarded as transferable securities for the implementation of the MiFID II framework. Since they are legally defined as personal property, the application of MiFID II neither affects the legal nature of emission allowances nor creates inconsistencies in their trade as financial instruments in accordance with MiFID II provisions. This ensures coherence between the two regimes at national level.

### Belgium

As noted above, emission allowances are defined in the three Belgian regions' legislation implementing the ETS Directive 2003/87/EC as a '*transferable right to emit one ton of $CO_2$-equivalent GHG emissions during a specific period or trade period*', thus mirroring Article 3(1) of the ETS Directive 2003/87/EC.

In the absence of a clear legal qualification under property law, there are different views on whether or not allowances can be recognised as movable property. However, as reported in the Task 1 report, the CAs of the three Belgian regions acknowledge that emission allowances are dematerialised instruments when transferred through the Union Registry.

With regard to the transfer of title, the provisions of the Registry Regulation 389/2013, in particular Article 40(2)[452], apply in the absence of certainty about the legal nature of emission allowances in Belgian law. As the Registry Regulation 389/2013 is directly applicable in the national legal systems of Member States, in Belgium the record of emission allowances in the Union Registry provides the only evidence of the holder's title over those allowances recorded in his account. Contractual arrangements made between the seller and the buyer may provide additional elements on a case-by-case basis to confirm if such evidence is sufficient or whether such proof can be reversed by other dedicated arrangements, such as the taking of a security collateral by the seller to guarantee the payment of the transaction by the buyer. Such contractual arrangements are governed by the Belgian

[452] Article 40(2) of the Registry Regulation 389/2013 states that '…the record of the Union Registry shall constitute *prima facie* and sufficient evidence of title over an allowance'.

Civil Code, which provides that the contractual agreements create effects between the contracting parties only and do not harm a third party (Article 1165). Nevertheless, creditors may exercise all the rights and actions of their debtors, with the exception of those exclusively attached to the person himself (Article 1166). Finally, it is always possible for a third party to invoke the existence of a contract to provide evidence of a fact (Article 1200) creating a legal situation that would be in its interest (Cassation com. 22 October 1991), e.g. a third party creditor or trustee. If such contractual arrangements can be annulled or enforced by a court decision, the national judge could, in theory, require the annulment of a transfer in the Union Registry and request the central administrator to enforce the judgement.

Emission allowances are now explicitly classified as financial instruments, under the Amended[453] Law of 2 August 2002, whose Article 2 defines 'financial instruments' by listing those categories set out in Annex I Section C of MiFID II, including emission allowances and derivative contracts (Article 2, 1° (k) and (d), respectively). It also defines 'transferable securities' (Article 2, 1°, (a) and 31°)[454] exactly as provided for in Article 4(44) of MiFID II, including with respect to 'any other securities' under point c). In other words, the classification of financial instruments made by MiFID II is literally transposed in Belgian law.

Member States have some discretion in their classification of emission allowances as financial instruments. In the absence of a statutory definition of the legal nature of emission allowances, they can be regarded as financial instruments, including 'transferable securities', for the purposes of implementing MiFID II and related requirements applicable to financial instruments.

In Belgium, financial instruments are regarded as movable assets and are thus subject to property law, the legal definition of which has itself evolved over time. For instance, the original version of Royal Decree No. 62 of 10 November 1967 on the promotion of the circulation of financial instruments (which introduced the possibility of creating securities accounts following the deposit of securities with a central securities depository (CSD) or an affiliated depository) stated explicitly that holders' accounts had a right *in rem* over the securities concerned, having in mind that the deposit is made on a 'fungible' basis. This Royal Decree has been amended several times to specify that the CSD, the affiliated depository and depositors have 'co-ownership' rights. This is expressly noted in the definition of 'financial instruments' in the Decree as amended (see its Articles 1bis, 3, 9 and 10), recognising their fungible nature. In effect, the deposit of securities in an account will not lead to a transformation of the rights of ownership (or other rights *in rem*) into a mere claim for the securities.

Irrespective of the securities concerned (immobilised, debt, monetary instruments, dematerialised public debt or private financial securities), the nature of the investors' rights to the dematerialised or immobilised securities held in an account with an intermediary, is similar across the different legal

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[453] Loi du 21 novembre 2017 relative aux infrastructures des marchés d'instruments financiers et portant transposition de la Directive 2014/65/UE; Loi du 25 octobre 2016 relative à l'accès à l'activité de prestation de services d'investissement et au statut et au contrôle des sociétés de gestion de portefeuille et de conseil en investissement.

[454] Law 2002, Article 2, 31° 'valeurs mobilières': les catégories de titres négociables sur le marché des capitaux (à l'exception des instruments de paiement), telles que:
a) les actions de sociétés et autres titres équivalents à des actions de sociétés, de sociétés de type partnership ou d'autres entités, ainsi que les certificats représentatifs d'actions;
b) les obligations et les autres titres de créance, y compris les certificats concernant de tels titres;
c) toute autre valeur donnant le droit d'acquérir ou de vendre de telles valeurs ou donnant lieu à un règlement en espèces, fixé par référence à des valeurs mobilières, à une monnaie, à un taux d'intérêt ou rendement, aux matières premières ou à d'autres indices ou mesures.

regimes. In all systems, the account represents a 'right *in rem'* in respect of the securities, albeit of an intangible nature.

This is not an absolute 'right *in rem'*, however, as it has a number of limitations. Firstly, it cannot be individualised to the extent that a multiplicity of securities' owners hold accounts in similar securities with the same intermediary. It is therefore specified that the account position represents an undivided right *in rem*, which is to be exercised against the intermediary who keeps the account, hence the qualification of 'co-ownership rights'. Secondly, account holders cannot exercise their rights '*erga omnes*' but only vis-à-vis certain persons, such as the CSD or the affiliated depository, a limitation that is typical of property classified as an '*in personae* right'. Interestingly, the exercise of the property rights on the securities (or other rights *in rem*) will only be possible against the intermediary with whom the account is held. Consequently, no rights can be exercised on the aggregate 'omnibus' account held by the intermediary with the CSD, nor directly against the issuer of the securities. However, exceptions to this rule are provided for in cases of insolvency or another default (*concursus creditorum*) affecting one of the actors in the system (see Section 3 below, on SFD/FCD related issues).

Even if they do not confer rights '*in rem'* in an absolute and full manner, the classification of financial instruments as property strengthens the idea that emission allowances may be regarded as intangible movable property now that they are classified as financial instruments by virtue of the Amended Law of 2002.

Such classification does not affect the presumption of proof of title over emission allowances offered by their record in the Union Registry, as per Article 40(2) of the Registry Regulation 389/2013. Transfer of title (and modalities to prove such transfer) over any financial instruments is governed by the provisions of financial market rules, which similarly apply to emission allowances under Belgian law.

As a result, the application of MiFID II does not affect the legal nature of emission allowances (which, are undefined in Belgian law) but, rather, clarifies that they can be subject to property rights as financial instruments. It is not yet possible to draw a definitive conclusion on their status as rights *in rem* or *in personae*. The classification as financial instruments actually reinforces the Registry Regulation 389/2013 by providing additional elements (resulting from the application of financial market rules) to strengthen the presumption of proof of title over emission allowances.

## Germany

The German translation of Article 3(1)(a) ETS Directive 2003/87/EC defines an emission allowance ('Zertifikat') as '*das Zertifikat, das zur Emission von einer Tonne Kohlendioxidäquivalent in einem bestimmten Zeitraum berechtigt; es gilt nur für die Erfüllung der Anforderungen dieser Richtlinie und kann nach Maßgabe dieser Richtlinie übertragen werden'*. The word '*berechtigt*' could be translated as 'authorised', where its use could stem from the component of the word 'allowance' that 'allows' the addressee to emit GHG emissions.

The German law implementing the ETS Directive 2003/87/EC (*Treibhausemissionshandelsgesetz*, TEHG), however, distinguishes between the administrative approval of emitting ('*Emissionsgenehmigung*', § 4 TEHG) and the allowances that are submitted for deletion from the emitting entity's annual emissions ('*Berechtigung*', § 7 TEHG). Thus, the notion of a 'right to emit' is part of the administrative approval (*Genehmigung*) of an installation and not necessarily part of the allowance (*Berechtigung*).

In line with the direct applicability of the Registry Regulation 389/2013 (see also below), emission allowances could be interpreted here as a right '*in rem'*. German implementation of the use of the Union Registry provides a direct link to Article 19(3) of the ETS Directive 2003/87/EC (§ 17 TEHG). The transferability of allowances requires agreement by parties and an entry in the Union Registry (§ 7(3) TEHG).

With regard to the transfer of title when implementing Article 40(2) of the Registry Regulation 389/2013, the entrance in the Union Registry is deemed *prima facie* correct (§ 7 (4) TEHG), unless the holder of an emission allowance is aware of the incorrect nature of the record when receiving it in its account (from an authority, § 14 TEHG).

Before MiFID II, Germany's now-obsolete § 7 Para. 5 classified emission allowances as 'not to be viewed as financial instruments'. An earlier version of the TEHG distinguished between allowances and allowance derivatives (§§ 6 and 15 TEHG 2004), expressly declaring the latter to be within the scope of the Banking Act (§ 1 Para. 11 *Kreditwesengesetz*, KWG) and its enhanced safeguards and licensing requirements for security traders. These provisions were nullified by the act implementing MiFID II, without a replacement or any further specification. Germany aimed for a literal transposition of MiFID II in this regard and did not further specify the nature of allowances in the national legislation implementing the ETS Directive 2003/87/EC (TEHG).

In examining whether or not emission allowances can be considered 'transferable securities' under German law in accordance with Article 4(44) c) of MiFID II, it should be noted that the Act on securities (*Wertpapierhandelsgesetz*, WpHG) does not include emission allowances in its definition of 'securities' (§ 2 (1) WpHG). A discussion in the literature about whether allowances could be treated as a debt security or bond (§ 1 Para. 11 No. 1 KWG) or as a comparable instrument (§ 1 Para. 11 No. 2 KWG) was regarded as outdated once the (now obsolete) §7 Para. 5 TEHG (stating that emission allowances were not to be viewed as financial instruments) was introduced[455].

Following MiFID II implementation, emission allowances are now included as 'financial instruments' (§ 2(4) No. 5 WpHG), together with securities, money market instruments and others. This can be interpreted to mean that emission allowances are now regarded as 'other financial instruments' by the national measures transposing MiFID II. They are also covered as such by the Banking Act (§ 1(11) No. 9 *Kreditwesengesetz*, KWG).

The classification of emission allowances as (other) 'financial instruments' does not create a different regime in German law, nor does it affect their legal nature, transfer or proof of title. As the relevant provisions of the TEHG have remained unchanged, the transfer of title – or rem transaction ('*Verfügungsgeschäft'*), as opposed to an underlying contractual or *in personam* transaction ('*Verpflichtungsgeschäft'*) – continues to be conditional on both the material transfer agreement between the parties to the transaction, and the registration of the allowances in the registry account of the acquirer, a formal step effected by the transferor vis-à-vis the registry operator (§ 7 Para. 3 TEHG)[456]. Again, a presumption of accuracy applies to the registry unless the acquirer is aware of

[455] Frenz, W., Emissionshandelsrecht: Kommentar zu TEHG und ZuV 2020 (3rd ed., Heidelberg *et al*., Springer, 2012), §7 Annot. 85-87.

[456] § 7 Para. 3 TEHG reads: '*Berechtigungen sind übertragbar. Die Übertragung von Berechtigungen erfolgt durch Einigung und Eintragung auf dem Konto des Erwerbers im Emissionshandelsregister nach § 17. Die Eintragung erfolgt auf Anweisung des Veräußerers an die kontoführende Stelle, Berechtigungen von seinem Konto auf das Konto des Erwerbers zu übertragen*.' This has been unofficially translated by the German

irregularities, i.e. acts in *mala fide* when obtaining issued allowances at auction or through allocation (§ 7 Para. 4 TEHG)[457].

The sparse regime for acquisition and transfer of allowances established by the legislation implementing the ETS Directive 2003/87/EC continues to provide the only relevant stipulations in German law for the transfer of allowances. Although allowances and their derivatives are now included in the scope of banking and securities legislation (KWG and WpHG), extending additional safeguards and regulatory requirements to covered entities – such as the need for an authorisation by the Federal Financial Supervisory Authority (BaFin) under § 32 KWG[458] – the rules governing the allowances and their transfer remain unchanged by the adoption and implementation of MiFID II.

### 7.1.2 Scope *rationae personae* of MiFID II with respect to the trading of emission allowances classified as financial instruments: who is covered by MiFID II?

As explained above, the main consequence of classifying emission allowances as financial instruments is that the spot segment of the secondary market of the EU ETS is regulated by MiFID II requirements. The provisions of MiFID II thus apply to market players involved in transactions on any type of financial instruments relating to emission allowances, obliging them to comply with relevant MiFID II requirements unless a particular exemption applies to certain buyers and sellers. For instance, MiFID II provides for some specific exemptions for (a) EU ETS participants and/or (b) some market makers under certain conditions.

**a.** Article 2(1)(e) of MiFID II provides that the Directive shall not apply to:

> '*operators with compliance obligations under Directive 2003/87/EC who, when dealing in emission allowances, do not execute client orders and who do not provide any investment services or perform any investment activities other than dealing on own account, provided that those persons do not apply a high-frequency algorithmic trading technique*'.

This provision exempts those operators who need to engage in transactions to buy emission allowances on the spot market for compliance purposes.

**b.** Article 2(1)(j) also exempts those persons who deal on 'own account', including market makers, in commodity derivatives, emission allowances or derivatives, as follows:

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Emissions Trading Authority (DEHSt) as: 'Allowances shall be transferable. The transfer of allowances shall be effected by agreement and entry in the account of the purchaser designated in the emissions trading register in accordance with Section 17. The entry shall be effected on order of the seller to the account-servicing authority to transfer allowances from its account to the account of the purchaser.'

[457] § 7 Para. 4 TEHG reads: '*Soweit für jemanden eine Berechtigung in das Emissionshandelsregister eingetragen ist, gilt der Inhalt des Registers als richtig. Dies gilt nicht für den Empfänger ausgegebener Berechtigungen, wenn ihm die Unrichtigkeit bei Ausgabe bekannt ist*.' This has been unofficially translated by the German Emissions Trading Authority (DEHSt) as: 'Insofar as an allowance has been entered for a party in the emissions trading register, the content of the register shall be deemed to be correct. This shall not apply to the recipient of allowances which have been issued if they are aware that they are incorrect when they are issued.'

[458] Section 32 Para 1. KWG in unofficial translation reads: 'Anyone wishing to conduct banking business or to provide financial services in Germany commercially or on a scale which requires commercially organised business operations needs written authorisation from BaFin.'

*Article 2(1)(j)* This Directive shall not apply to*:*

*'persons:*

*(i) dealing on own account, including market makers, in commodity derivatives or emission allowances or derivatives thereof, excluding persons who deal on own account when executing client orders; or*

*(ii) providing investment services, other than dealing on own account, in commodity derivatives or emission allowances or derivatives thereof to the customers or suppliers of their main business; provided that:*

*- for each of those cases individually and on an aggregate basis this is an ancillary activity to their main business, when considered on a group basis, and that main business is not the provision of investment services within the meaning of this Directive or banking activities under Directive 2013/36/EU, or acting as a market maker in relation to commodity derivatives,*

*- those persons do not apply a high-frequency algorithmic trading technique; and*

*- those persons notify annually the relevant competent authority that they make use of this exemption and upon request report to the competent authority the basis on which they consider that their activity under points (i) and (ii) is ancillary to their main business;'*

In order to be exempted, those persons shall notify the relevant competent authority each year that they make use of this exemption and must furnish, on request, the basis on which their activity is considered ancillary to their main business. It is important to note that this exemption based on the ancillary nature of the activity would apply to both trading spot and derivatives contracts.

On the basis of Article 2(4) MiFID II, ESMA has developed standards to define the thresholds at which market makers can determine if they can benefit from such an exemption, based on the ancillary nature of their activity[459]. These standards should help to identify the SMEs or utilities that may benefit from this exemption.

In addition, Article 3(1)(d) MiFID II gives Member States the possibility to grant an exemption to those firms and companies providing investment services: '*exclusively in commodities, emission allowances and/or derivatives thereof for the sole purpose of hedging the commercial risks of their clients, where those clients are exclusively local electricity undertakings*[460] *and/or natural gas undertakings*[461]*, and provided that those clients jointly hold 100% of the capital or of the voting rights of those persons, exercise joint control and are exempt under point (j) of Article 2(1) of this Directive if they carry out those investment services themselves'*.

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[459] Commission Delegation Regulation (EU) supplementing Directive 2014/65/EU with regard to regulatory technical standards for the criteria to establish when an activity is considered to be ancillary to the main business, C(2016) 7643 final, Brussels, 1 December 2016.

[460] As defined in Article 2(35) of Directive 2009/72/EC.

[461] As defined in Article 2(1) of Directive 2009/73/EC.

However, any company exempted at national level should be subject to similar ('analogous') requirements in terms of authorisation procedures, conduct of business, and organisational requirements[462]. Member States shall communicate the provisions of national law that are analogous to the requirements of this Directive to ESMA. Some Member States (e.g. France) decided not to include this optional exemption in their transposition of MiFID II.
Consequently, if the spot market is aligned to the derivatives market in general terms for the purposes of transparency, investor protection and integrity, there are still some market players who may not be subject to MiFID II requirements for some operations, even if they are members of a trading venue. This would be the case for operators in the energy sector and their subsidiaries specialising in trading emission allowances to hedge commercial risk.

This creates a two-tiered approach to market oversight, with different legal obligations and associated transaction costs. As long as such exemptions are used solely for compliance purposes by operators (including in the energy sector to hedge commercial risk), with no risk of market speculation or manipulation, this difference of treatment can be legitimately justified by the EU legislator to avoid imposing cumbersome MiFID II requirements on EU ETS operators who are not actively engaged in financial markets on a routine basis.

### 7.1.3 Formal requirements due to the consideration of allowances as financial instruments

The consequences of considering EU ETS allowances as financial instruments means that carbon market players, including investment firms, market makers and trading venues, are required to comply with MiFID II/MiFIR and other financial market rules when trading emission allowances and derivatives on the secondary market, unless they are exempt. Considering the allowances as financial instruments implies the need to comply with certain requirements of the applicable legislation, which might provide more legal certainty for the trade in allowances, as well as for the development of the carbon market itself.

These requirements can be briefly presented as follows:

- **Obligation for authorisation and compliance with the MiFID II framework**

One of MiFID II's purposes is to cover the spot segment of the secondary carbon market (transactions in emission allowances for immediate delivery in the secondary market) and put it on an equal footing with the derivatives market in terms of transparency, investor protection and integrity. Respect for these principles is guaranteed by the authorisation procedure laid down by the MiFID II framework.

i) Investment firms

Any investment firm whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis, shall be subject to prior authorisation in accordance with Chapter I of Title II of MiFID II.

[462] See Article 3(2) a) to c) of MiFID II.

Article 4(1)(2) MiFID II defines 'investment services and activities' as any of the services and activities listed in Annex I Section A that relate to any of the instruments listed in Annex I Section C, including C.11 and C.4 (emission allowances and their derivatives, respectively).

Firms that cannot benefit from one of the exemptions granted under Article 2 or, where applicable, Article 3 of MiFID II, shall be subject to this authorisation requirement and any other requirements covered by the MiFID II framework for trading spot contracts on emission allowances and their derivatives. In particular, they shall comply with stricter rules on pre and post-trade transparency requirements and bear the associated implementation and transaction costs.

ii) Trading venues

Member States shall authorise a market operator to operate a regulated market, MTF or OTF where emission allowances would be traded according to Article 5(2) of MiFID II.

As far as regulated markets are concerned, the authorisation shall be granted only where the competent authority is satisfied that both the market operator and the systems of the regulated market comply at least with the requirements laid down in Title II of MIFID II[463]. In the case of an regulated market that is a legal person managed or operated by a market operator other than the regulated market itself, Member States shall establish how the different obligations imposed on the market operator under this Directive are to be allocated between the regulated market and the market operator.

Authorisations of trading venues shall be granted by the 'home' Member State's designated competent authority, which must register all investment firms. The register shall be publicly accessible and contain information on the services or activities for which the investment firm is authorised. It must also be regularly updated. Every authorisation is to be notified to ESMA, which is tasked with establishing a list of all investment firms registered in the EU.

The authorisation requirement strengthens the level of trust in investment firms with services relating to emission allowances, as well as providing certainty to investors. It thus provides a legal regime which can better regulate and control those involved in transactions on the spot segment of the secondary market. This improves the efficiency of trading while simultaneously providing greater surety against market abuse and increased legal certainty.

### ▪ Requirements for the operation of trading venues

All trading venues should lay down transparent and non-discriminatory rules governing access to their facility. From that perspective, the market makers operating multilateral platforms should not be affected by the extension of MiFID II to emission allowances, in that they should already be authorised and subject to all transparency, investor protection and integrity requirements laid down by the MiFID II/MiFIR framework.

Nevertheless, MiFID II has introduced requirements for a new category of trading venue, OTFs, which may be relevant for trading both spot and derivative contracts on emission allowances. OTF represents a new type of trading platform, operated by investment firms seeking discretion in determining and restricting access based, *inter alia*, on their role and obligations in respect of their clients. In view of

[463] See Article 44 (1) MiFID II.

that discretionary nature, an OTF cannot be a regulated market or a MTF. It is, however, subject to authorisation (see point 10 Section A Annex I to MiFID II) and it is expected that the relevant competent authority will pay particular attention to operator discretion before issuing the required authorisation. In addition, it is worth noting that Systemic Internalisers[464] and OTFs cannot be operated by the same legal person, as a Systemic Internaliser executes orders with its own funds, while an OTF must not trade against its own capital on its own platform.

MiFID II imposes similar obligations on OTFs as on MTFs, including trade transparency obligations and access requirements. Unlike MTFs, the main investor protection rules apply to OTFs, according to Article 20(8) of MiFID II, because of the active role that the OTF should play. This includes the requirements provided under Article 24 (general principles and clients' information), Article 25 (assessment of suitability of information provided to clients), Article 27 (best execution orders) and Article 28 (client order handling rules). OTFs differ from MTFs in that their operators are permitted to engage in matched principal trading in bonds, structured finance products, emission allowances and derivatives, where MTF operators are not. OTFs wishing to carry out matched principal trading will need to ensure that their client has given consent.

Whether or not OTFs will play a role in spot trading of emission allowances remains to be seen, in view of the compliance costs associated with conduct and investor protection rules.

Even if MiFID II requirements for operating trading venues do not affect the legal nature of emission allowances, they increase the level of transparency and integrity of emission trading on the secondary market.

- **Investor protection**

The objective of MiFID II is to ensure that investment firms act honestly, fairly and professionally, and in accordance with the best interests of their clients. Article 24 of MiFID II thus provides for investor protection rules.

As far as emission allowances and derivatives on the secondary market of the EU ETS are concerned, investors are better protected through requirements in respect of product design, information and reporting to clients, market governance and best execution of orders.

Crucially for emission allowances now classified as financial instruments, investment firms which deal in financial instruments for sale to clients must ensure that they are designed to meet the needs of an identified target market of end clients, that the strategy for distribution of the financial instruments is compatible with the identified target market, and that the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the target market identified.

This will undoubtedly require investment firms to provide their clients with specific and up-to-date information on the features and functioning of the carbon market, as well as on the particular nature of the instruments traded. It is therefore expected that investment firms will investigate the legal nature of emission allowances and anticipate any consequences for the transfer of title.

- **Reporting requirements**

[464] Systemic Internalisers, traditionally called market makers, are investment firms which could match 'buy' and 'sell' orders from clients in-house, provided that they conform to certain criteria. Instead of sending orders to a central exchange, such as the London Stock Exchange, banks can match them with other orders on their own books.

Article 58 of MiFID II requires detailed position reporting by trading venues. An investment firm or a market operator operating a trading venue trading commodity derivatives, or emission allowances or derivatives, is required to:

- Publish a weekly report with the aggregate positions held by the different categories of persons for the different commodity derivatives, emission allowances or derivatives thereof traded on their trading venue, specifying:
  - the number of long and short positions held in each category,
  - changes since the previous report,
  - the percentage of the total open interest represented by each category, and the number of persons holding a position in each category,
  - communicate that report to the competent authority and to ESMA, which is tasked with the centralisation of published information;
- Provide the competent authority with a complete breakdown of the positions held by all persons, including the members and clients of that trading venue, at least daily.

When trading takes place outside of a trading venue, investment firms shall provide their national competent authorities with a complete breakdown of their positions taken in emission allowances, or derivatives traded on a trading venue and economically equivalent OTC contracts, as well as those of their clients and their clients' clients, until the end client is reached. Members or participants in regulated markets, MTFs and clients of OTFs are also required to report to the investment firm or market operator operating on one of these trading venues, the details of their own positions held through contracts traded on that trading venue at least daily, as well as those of their clients, and their clients' clients, until the end client is reached.

Most importantly, in the case of emission allowances or derivatives, the reporting obligations should be respected without prejudice to the compliance obligations under the ETS Directive 2003/87/EC, including reporting requirements laid down by the Auctioning Regulation 1031/2010. Even though this does not affect the legal nature of emission allowances, these new and additional reporting requirements will help both national competent authorities and the European Commission to scrutinise all carbon trading segments so as to ensure the smooth functioning of the EU ETS.

### Pre and post-trade transparency

Under MiFID I, pre-trade transparency applied only to equity instruments (shares) admitted to trading on a regulated market.

MiFIR[465] extended pre and post-trade transparency requirements to bonds, structured finance products, emission allowances and derivatives, subject to certain conditions and waivers, which apply to all investment firms (including Systemic Internalisers) as well as trading venues, i.e. regulated markets, MTFs and OTFs. Transparency requirements are calibrated for different types of instruments and different types of trading, such as central order book, quote-driven, hybrid and periodic auction trading systems.

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[465] Markets in Financial Instruments, Regulation (EU) No 600/2014 (MiFIR).

Pre-trade transparency obligations (i.e. making public bids and offering prices and depth of trading) are now extended to apply to a new category of trading venue – OTFs - as well as to regulated markets and MTFs. They also apply to actionable indications of interest.

Post-trade transparency obligations to make the price, volume and time of transactions available are now extended to all trading venues and to the same range of financial instruments, subject to deferral of disclosure for transactions that are large in scale compared to normal market size, where authorised by the competent authority.

Pre-trade quoted prices (bid and offer) and indications of interest, as well as post-trade transaction data, must be available on a reasonable commercial basis as close to real time as is technically possible. Regulated markets, MTFs and OTFs will have to offer pre and post-trade transparency data separately and will have to publish it, free-of-charge, within 15 minutes of a transaction's publication.

Emission allowances are treated as a separate category under the secondary market pre and post-trade transparency obligations of the MiFID II/MiFIR framework in order to ensure that specific implementing rules can be developed. MiFIR empowers the Commission to adopt a delegated regulation, which was proposed in July 2016 (following submission of a draft regulatory technical standard by ESMA in September 2015)[466]. In its Final Report on RST[467], ESMA proposed thresholds for waivers from pre-trade transparency and deferrals from post-trade transparency for the liquidity assessment of non-equity instruments. ESMA's final draft sets out the methodology proposed for calculating size-specific-to-the-instrument (SSTI) and Large-In-Scale (LIS) thresholds for non-equity instruments, including emission allowances and derivatives.

These pre and post-trade transparency requirements will impact on investment firms, with Systemic Internalisers having pre-trade transparency obligations. For non-equity financial instruments, such as emission allowances and derivatives, they will be required to provide firm quotes when prompted by a client, make these quotes available to other clients in an objective, non-discriminatory way, and enter into transactions at or below a size specific to the instrument, which in turn is subject to any limits they may set on the number of transactions at any price.

- **Competent Authorities, ESMA coordination, market surveillance and applicable sanctions**

All carbon market players active on the secondary market are now placed under scrutiny and, where applicable, under the investigation of the national Competent Authorities (designated by the Member States in accordance with Article 67) in exercising their duties under the MiFID II/MiFIR framework. ESMA plays the role of both market regulator and coordinator, working closely with national Competent Authorities, which are required to cooperate among themselves to ensure compliance. In addition, sanctions for infringements of Article 70 MiFID II shall apply to carbon market players in cases where they do not comply with MiFID II requirements. (See Section 7.2 below for a discussion of the interaction of these MiFID II market oversight rules with those laid down by the Auctioning Regulation 1031/2010.).

[466] Commission Proposal for Regulation C(2016) 4301 of 14 July 2016.

[467] Final Report ESMA Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR, 8 September 2015, ESMA/2015/1464.

### 7.1.4 Conclusions on the application of MiFID II to emission allowances

The transposition of MiFID II has not changed the definition of emission allowances in those Member States which have already provided a statutory definition of their legal nature, nor has it prompted review or definition among other Member States. Where the legal nature is not precisely defined, the classification of emission allowances as a financial instrument can help to clarify the applicable legal framework for transactions taking place on the secondary market through financial markets. In Germany, for instance, the civil law regime applicable to transactions has not changed – § 7 Paras. 3 and 4 TEHG still stipulate the required material transfer agreement and registration for *in rem* transactions (in addition to any underlying *in personae* contract), which is consistent with general civil law (BGB). MiFID II has, however, changed the compliance obligations imposed on those trading venues (in keeping with financial market regulations), if not the rules governing the transfer of allowances themselves.

It is clear that such treatment will require carbon market players, including investment firms, market makers and trading venues, to comply with MiFID II/MiFIR and other financial market rules when trading emission allowances and derivatives on the secondary market, unless they are exempt. The key consequence of applying MiFID II to the EU carbon market, therefore, is the creation of two categories of market player: those who are extensively covered by financial market rules, and those who are not. This is, in some respects, sensible, as it requires more from investment firms and market makers who speculate for their clients for the sake of increasing their profits, and less from operators who buy and sell solely for compliance purposes.

The extension of MiFID II coverage to the spot segment of emission trading concerns two broad categories of market player: investment firms and market makers who manage or will manage a trading venue, whether a regulated market, an MTF or, possibly, an OTF. Whether or not OTFs will play a role in spot trading emission allowances remains to be seen, given the compliance costs associated with conduct and investor protection rules. However, in general terms, market makers should not be significantly affected by the extension of MiFID II to emission allowances, in that they are already authorised and subject to all transparency, investor protection and integrity requirements laid down by the MiFID II/MiFIR framework for trading financial instruments.

## *7.2 Analysis of interactions between the new MiFID II framework (including MiFIR and market abuse rules) and the Auctioning Regulation*

The main objective in classifying emission allowances as financial instruments under MiFID II is to reinforce the integrity of the secondary spot market of the EU ETS (Recitals 11 of MiFID II and 45 of MiFIR) and to safeguard its efficient functioning. It is necessary, therefore, to examine how the new MiFID II framework and the regime under the Auctioning Regulation 1031/2010 interact (Section 3.1 of this study). The Auctioning Regulation 2013/2010 was clear that the MiFID I framework would apply to trading rather than auctioning, and only to financial instruments, not spot products (Recital 11 of the Auctioning Regulation 1031/2010). In addition, the new MiFID II framework, in particular

MiFIR, complements the measures established for the EU ETS by bringing emission allowances fully into the scope of the Market Abuse Regulation 596/2014 and the Market Abuse Directive 2014/57/EU, thereby ensuring comprehensive supervision of trading activity on the secondary market (Section B of the study).

### 7.2.1 Regime under the Auctioning Regulation

A number of provisions of the Auctioning Regulation 1031/2010 were already shaped by some provisions of MiFID I, with a view to providing the primary market with an equivalent level of protection to that afforded to financial markets, even though only derivatives in emission allowances were considered financial instruments at that time.

One key question is how the changes brought by the provisions of MiFID II interact with those of the Auctioning Regulation 1031/2010 and whether such changes will require amendment of the latter.

- **Submission and withdrawal of bids**

Article 6(5) of the Auctioning Regulation 1031/2010 provides that '*the reception, transmission and submission of a bid by an investment firm or credit institution on any auction platform shall be deemed to constitute an investment service where the auctioned product is a financial instrument'*.

Now that all contracts on emission allowances are considered financial instruments according to MiFID II, any bid submitted by an investment firm or credit institution on any auction platform shall be *a fortiori* regarded as an investment service, thus subject to the relevant MiFID II provisions applicable to these operations (unless exempt, see Section 7.1 above), in particular with regard to investor protection rules, and transparency and reporting requirements.

- **Persons eligible to apply for admission to bid**

According to Article 18(1)(b) and (c) and Article 18(2) of the Auctioning Regulation 1031/2010, investment firms authorised under MiFID II are eligible to apply for an admission to bid on their own account or on behalf of their clients, as are credit institutions authorised under Directive 2006/48/EC[468] (Banking Consolidation Directive). Commission Regulation (EU) No 1210/2011 amending (for the first time) the Auctioning Regulation 1031/2010 had already removed the authorisation requirement for an investment firm or credit institution when bidding directly for auctioned products that are not financial instruments, on the condition that the Member State in which they are established has enacted legislation enabling such clients to do so. Now that emission allowances, whether spot or derivatives contracts, are classified as financial instruments, any investment firm or credit institution that wishes to apply for an admission to bid must demonstrate that it is authorised in accordance with MiFID II requirements.

- **Appointment requirements applicable to any auction platform**

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[468] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ L 177, 30.6.2006, p.1. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1537175315603&uri=CELEX:02006L0048-20140101

According to Article 35(1) of the Auctioning Regulation 1031/2010, auctions shall only be conducted on an auction platform authorised as a regulated market under MiFID, whose operator organises a market in allowances or allowances derivatives. The requirement for the auction platform to be a regulated market is founded on the desire to use the organisational infrastructure available on the secondary market for the administration of auctions in order to safeguard auctioning operations and prevent market abuse (Recital 29).

Insofar as the Auctioning Regulation 1031/2010 provides for the appointment of the auction platform(s), the fact that emission allowances are now classified as financial instruments neither affects the appointment requirements nor raises problems for the existing auction platforms already authorised in accordance with MiFID II requirements. In the Member States where they are located, a regulated market and its market operator must demonstrate that they meet all requirements laid down by Title III of MiFID II concerning regulated markets[469].

### Transparency and client information

Both MiFID II and the Auctioning Regulation 1031/2010 establish transparency and client information requirements.

Transparency is a key feature of the auctioning process (see Articles 60 to 63 of the Auctioning Regulation 1031/2010), where all relevant information (beyond the list of clients and their contact details) is published on a dedicated, up-to-date auctioning website maintained by the auction platform. This information includes legislation, guidance, instructions, forms, documents, announcements including the auction calendar, any other non-confidential information pertinent to the auctions on a given platform, any decision to impose a maximum bid size, and any other measures necessary to mitigate an actual or potential discernible risk of money-laundering, terrorist financing, criminal activity or market abuse (see Article 57). Results of auctions should be announced no more than 15 minutes after the bidding window closes, with information sent to successful bidders simultaneously. A key task of the auction monitor is to scrutinise the degree of transparency in the primary market (Article 25(1)c)).

These transparency and client information requirements echo those laid down by MiFID II, in particular for regulated markets (see Article 47), which are relevant for the appointed auction platforms, given that they are to be authorised under MiFID by the competent authority of their 'home' Member State.

Now that emission allowances are classified as financial instruments, one of the key questions is the compatibility of the new pre and post-trade transparency provisions laid down by MiFID II with the provisions of the Auctioning Regulation 1031/2010. As MiFIR extended the application of such transparency requirements to emission allowances and derivatives (subject to certain conditions and waivers), they now apply to all investment firms (including Systemic Internalisers), as well as trading venues, i.e. regulated markets, MTFs and OTFs.

Pre-trade transparency obligations (i.e. making public indications of interest, bids and quoted prices (bid and offer) and depth of trading) and post-trade transparency obligations (i.e. to make the price,

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[469] The national CAs designated for the implementation of the Auctioning Regulation 1031/2010 shall take the necessary measures to ensure that the appointment requirements are met, in accordance with Article 35(6) Auctioning Regulation 1031/2010.

volume and time of transactions available (subject to deferral of disclosure for transactions depending on market size)) must be available on a reasonable commercial basis as close to real time as is technically possible. For instance, regulated markets, MTFs and OTFs will have to offer pre- and post-trade transparency data separately and will have to publish it, free-of-charge, within 15 minutes of a transaction's publication.

These transparency obligations shall apply to investment firms and trading venues dealing in emission allowances on the secondary market, while the Auctioning Regulation 1031/2010 provisions shall apply to the auction platforms dealing with the primary market. The timings for the announcement of transactions and the publication of transaction data are compatible, including information on the clearing and settlement systems to be used.

### 7.2.2 How does the market abuse framework complement market control and oversight of the EU ETS?

The Market Abuse Regulation 596/2014 replaced the Market Abuse Directive 2003/6/EC[470] after the 2008 financial crisis, in order to close the gaps identified, particularly the lack of effective provisions to combat the misuse of inside information and to prohibit market manipulation.

The Market Abuse Regulation 596/2014 has expanded and developed the existing EU market abuse regime to which both MiFID II (Articles 31, 54, 57) and the Auctioning Regulation 1031/2010 (Article 56) refer. As the allowances were subject to criminal market abuse, their status as financial instruments provides the legal framework necessary to deter this type of behaviour on the secondary market.

Compared to the Market Abuse Directive (I and II) framework, which covered only financial instruments admitted to trading on a regulated market, the scope of the Market Abuse Regulation 596/2014 has been significantly extended to include the following instruments and practices:

- Financial instruments admitted to trading on an regulated market;
- Financial instruments admitted to trading on an MTF;
- Financial instruments admitted to trading on an OTF;
- Financial instruments, the price of which depends on the price of the instruments;
- Behaviour in relation to benchmarks;
- Spot commodity contracts, excluding wholesale energy products;
- Financial instruments relating to the transfer of credit risk.

Crucially for the EU ETS, the Market Abuse Regulation 596/2014 also applies to '*behaviour or transactions, including bids, relating to the auctioning on an auction platform authorised as a regulated market of emission allowances or other auctioned products based thereon, including when auctioned products are not financial instruments, pursuant to Regulation (EU) No 1031/2010'* (the Auctioning Regulation 1031/2010)[471].

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[470] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation

[471]; Article 2(1), last indent, of the Market Abuse Regulation 596/2014.

Both the primary and secondary markets are covered by the Market Abuse Regulation 596/2014 framework, which applies to auctions even when the products auctioned are not financial instruments. The links between MiFID II and the Market Abuse Regulation 596/2014 on the one hand, and between the Market Abuse Regulation 596/2014 and the Auctioning Regulation 1031/2010 on the other hand, are intended to ensure efficient market oversight and compliance.

Thus, any requirements and prohibitions of the Market Abuse Regulation 596/2014 referring to orders to trade shall apply to bids on the auction platforms, although without prejudice to any specific provisions referring to such bids submitted in the context of an auction.

Article 3 of the Auctioning Regulation 1031/2010 makes a direct reference to the market abuse framework in defining the following terms: 'insider dealing', 'inside information' and 'market manipulation'. As the Market Abuse Regulation 596/2014 replaces the Market Abuse Directive 2003/6/EC, its definitions apply when determining cases of market abuse and related offences in respect of the auction of emission allowances.

The nature and scope of offences covered by the Market Abuse Regulation 596/2014 and relevant for emission trading are briefly summarised below:

- **Inside information and insider dealing**: the offence has been extended to include information relating to spot commodity contracts and the cancellation or amendment of orders based on inside information.
- **Market manipulation:** the offence has been extended to include attempted manipulation and behaviour in relation to benchmarks, notably the transmission of false or misleading information or inputs in relation to a benchmark, or on the basis of opening and closing prices, or placing or amending orders on a trading venue to (i) disrupt or delay the functioning of the trading system; (ii) make it more difficult for other persons to identify genuine orders; or to (iii) create false or misleading signals by entering orders to initiate or exacerbate a trend.
- **Investment recommendations**: the Market Abuse Regulation 596/2014 strengthens the regime that requires those providing investment recommendations to ensure that information is objectively presented and to disclose potential conflicts. This could cover information relating to the legal nature - or the consequences of the lack of a clearly defined legal nature - of allowances.
- **Managers' transactions**: persons discharging managerial responsibilities within issuers must notify the issuer and regulator of any relevant personal transactions they undertake.
- **Insider lists and market soundings**: there are more detailed rules on insider lists and a new framework on market soundings to gauge investors' interest in possible transactions.
- **Suspicious transaction and order reporting**: the Market Abuse Regulation 596/2014 extends the existing obligation to report suspicious transactions to cover suspicious orders.

However, because the Auctioning Regulation 1031/2010 makes a distinction between emission allowances regarded as financial instruments under MiFID and those that are not so considered, it is necessary to examine whether or not the application of the Market Abuse Regulation 596/2014 requires changes to be made to the Auctioning Regulation 1031/2010 in order to align the two.

Article 36(1) of the Auctioning Regulation 1031/2010 clearly provides that MiFID I (and the Market Abuse Directive) provisions should apply to the auctioning of two-day spot or five-day futures contracts <u>which are financial instruments</u> within the meaning of Article 1(3) of MiFID I. But it specifies that this is '*without prejudice to the application of Articles 38 to 40 of the Regulation (EU) No 1031/2010 to the use of inside information to withdraw a bid'*. <u>Where two-day spot or five-day</u>

futures are not financial instruments within the meaning of MiFID, then Article 36(2) stipulates that the provisions of Articles 37 to 43 of the Auctioning Regulation 1031/2010 should apply.

Now that spot and derivatives on emission allowances are listed as financial instruments in Annex I, Section C MiFID II, Article 36(2) of the Auctioning Regulation 1031/2010 is no longer relevant, in that it specifically targeted emission allowances not considered financial instruments under MiFID I. Articles 38 to 40 (prohibition of insider dealing, and other prohibited uses of inside information) nonetheless continue to apply, as emission allowances are classified as financial instruments with regard to the use of inside information to withdraw a bid. Those provisions are compatible with the Market Abuse Regulation 596/2014, whose Article 7 extends the offences of 'insider dealing' and 'use of inside information' to include information relating to spot commodity contracts and the cancellation or amendment of orders based on inside information.

It can be concluded that the Market Abuse Regulation 596/2014 reinforces the legal framework against market abuse by expanding its scope to transactions on the primary market of the EU ETS, as well as derivatives markets (OTC transactions in derivatives), new trading venues (notably OTFs), new technologies (high-frequency algorithmic trading) and to new market abuse offences (such as *inter alia* attempted insider dealing, unlawful disclosure, manipulation of benchmarks and commodities).

In accordance with Article 30 of the Market Abuse Regulation 596/2014, '*Member States shall, in accordance with national law, provide for competent authorities to have the power to take appropriate administrative sanctions and other administrative measures in relation to (...) infringements'*.

The Market Abuse Regulation 596/2014 is also complemented by the Market Abuse Directive 2014/57/EU, which specifies that '*Member States should extend liability for the offences provided for in this Directive to legal persons through the imposition of criminal or non-criminal sanctions or other measures which are effective, proportionate and dissuasive (...)'* (Recital 18 of the Market Abuse Directive 2014/57/EU).

The Market Abuse Directive 2014/57/EU thus introduces minimum rules on criminal offences and criminal sanctions for market abuse. To ensure compliance with MiFID II and Market Abuse Regulation 596/2014 provisions, the Market Abuse Directive 2014/57/EU requires Member States to establish appropriate sanctions, whether administrative or criminal, to discourage, deter and punish any behaviour harmful to the proper functioning of financial markets (Article 30(1) of the Market Abuse Regulation 596/2014). Consequently, market players can be subject to substantial monetary and punitive sanctions if they do not abide by MiFID II and Market Abuse Regulation 596/2014 requirements.

This framework on financial markets is complemented by the new Anti-Money Laundering Directive 2015/849 implemented on 26 June 2017. Chapter II of this Directive implements customer due diligence and, as the Commission reports[472], it shall '*trigger a mandatory application of customer due diligence checks by MiFID-licensed carbon traders to their clients in the secondary spot market in emission allowances'*. Its scope was extended, as due diligence checks were already mandatory in both

[472] Report from the Commission to the European Parliament and the Council, 'Climate action progress report, including the report on the functioning of the European carbon market and the report on the review of Directive 2009/31/EC on the geological storage of carbon dioxide', Brussels, 18 November 2015, COM(2015) 576 final.

the primary market and in the secondary market in emission allowance derivatives, under the previous Anti-Money Laundering Directive (2015/849).

### 7.2.3 Conclusions on interactions between the new MiFID II framework and the Auctioning Regulation

It is clear that the Auctioning Regulation 1031/2010 makes a number of direct and deliberate references to the MiFID framework. Its transparency provisions are compatible with the new requirements laid down by MiFID II, in particular post-trade transparency requirements. Even though it does not affect the legal nature of emission allowances, the interaction of the two regimes ensures consistency between the primary market for auctioned two-day spot and five-day futures contracts, as well as the application of financial market rules to all segments of the secondary market.

Beyond the requirement for appointed auction platforms to be authorised as regulated markets under MiFID II, and the fact that investment firms authorised under MiFID II are eligible for admission to bid, the link between MiFIR and the Market Abuse Regulation 596/2014, which is explicitly required for auctions) is particularly relevant. It was not only appropriate but necessary to prevent market abuse when trading spot contracts, taking account of the information made available through the transparency frameworks of both MiFID II (pre and post-trade) and the Auctioning Regulation 1031/2010 (Articles 60 and 63) (see Section 3 for further discussion).

Although oversight of the primary market of the EU ETS is still primarily regulated by the Auctioning Regulation 1031/2010, the Market Abuse Regulation 596/2014 provisions apply to market abuse cases in both the primary and secondary markets for emission trading.

The national competent authorities for the implementation of the Market Abuse Regulation 596/2014 framework shall maintain effective market oversight and take the necessary measures to ensure that the auction platforms which authorise regulated markets on their territory are fully compliant with the Market Abuse Regulation 596/2014 provisions.

The reporting obligations set out under MiFID II aim to monitor the activities of investment firms trading financial instruments on regulated trading venues (regulated markets, MTFs, OTFs, Systemic Internalisers). These not only ensure compliance with MiFID II provisions but also monitor for those abuses sanctioned under the Market Abuse Regulation 596/2014. As such, the requirements under MiFID II mirror the scope of the Market Abuse Regulation 596/2014. Reporting under both MiFID II and the Auctioning Regulation 1031/2010 will provide national competent authorities with the necessary information to scrutinise potential cases of market abuse and to coordinate and cooperate in cases of cross-border market abuse.

Undoubtedly, one of the core merits of the extension of MiFID II to emission allowances is to subject all segments of the carbon market to the market abuse framework, thus preventing market manipulation and excessive speculation. Even where the legal nature of emission allowances is not clearly defined at national level, their consideration as financial instruments under MiFID II provides an adequate framework to address cases of market abuse on both the primary and secondary markets in an equivalent and consistent manner.

## 7.3 Emission allowances classified as financial instruments: interactions between MiFID II, the Settlement Finality Directive and the Financial Collateral Directive

Now that emission allowances are classified as financial instruments by MiFID II, they can be regarded as an asset and thus a source for collateral operations on EU financial markets.

It is important to examine the extent to which such classification affects the possibility of taking and giving collateral under the regime established by Settlement Finality Directive 98/26/EC), where a designated system is used to transfer financial instruments and payments, or under the regime of the Financial Collateral Directive 2002/47/EC, which complements the former and facilitates the use of (cross-border) collateral in either cash or financial instruments outside a designated system. It is important to understand how the consequences of the classification of emission allowances as financial instruments can resolve some of the issues resulting from their unclear legal nature in the Member States concerned.

### 7.3.1 Settlement Finality Directive

The Settlement Finality Directive 98/26/EC regulates the designated systems[473] used by participants (e.g. financial institutions, banks' systems operators, such as CSDs or central counterparties (CCPs)) to transfer financial instruments and payments.

The Settlement Finality Directive 98/26/EC guarantees the settlement and finality of transfer orders[474] entered into such a system (including their irrevocability) in the event of the insolvency of a participant, based on predefined moments which must be contained in the rules of the system. As of 3 January 2018, the Settlement Finality Directive 98/26/EC became fully applicable to transfer orders, where previously it applied only to collateral security. These guarantees apply to collateral security, defined in Article 2(m) of the Settlement Finality Directive 98/26/EC as:

> '*all realisable assets, including, without limitations, financial collateral referred to in Article 1(4)(a) of Directive 2002/47/EC on financial collateral arrangements*[475]*, (...) provided under a pledge (including money provided under a pledge), a repurchase or similar agreement, or otherwise, for the purpose of securing rights and obligations potentially arising in connection with a system*'.

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[473] Article 2(a) of the Settlement Finality Directive 98/26/EC defines a 'system' as '*a formal arrangement:*
*- between three or more participants, (...), with common rules and standardised arrangements for the execution of transfer orders between the participants,*
*- governed by the law of a Member State chosen by the participants; the participants may, however, only choose the law of a Member State in which at least one of them has its head office, and*
*- designated, without prejudice to other more stringent conditions of general application laid down by national law, as a system and notified to the Commission by the Member State whose law is applicable, after that Member State is satisfied as to the adequacy of the rules of the system'.*

[474] Article 2(i) SFD defines 'transfer order' as:
"*- any instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a credit institution, a central bank, a central counterparty or a settlement agent, or any instruction which results in the assumption or discharge of a payment obligation as defined by the rules of the system, or*
*- an instruction by a participant to transfer the title to, or interest in, a security or securities by means of a book entry on a register, or otherwise'.*

[475] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02002L0047-20140702&from=EN

'Realisable assets' should be understood to mean 'bankable/money-making' and could include emission allowances.

Article 9(1) of the Settlement Finality Directive 98/26/EC provides that:

'*the rights of a system operator or of a participant to collateral security provided to them in connection with a system or any interoperable system, (...), shall not be affected by insolvency proceedings against:*
*(a) the participant (in the system concerned or in an interoperable system);*
*(b) the system operator of an interoperable system which is not a participant;*
*(c) a counterparty to central banks of the Member States or the European Central Bank; or*
*(d) any third party which provided the collateral security.*
*Such collateral security may be realised for the satisfaction of those rights.'*

The Settlement Finality Directive 98/26/EC applies to the 'financial instruments' listed in MiFID II, thus now includes emission allowances. In effect, Article 2(h) of the Settlement Finality Directive 98/26/EC defines 'securities' as '*all instruments referred to in section C of Annex I to Directive 2004/39/EC'* (i.e. MiFID I, now amended by MiFID II). Emission allowances may also be regarded as a 'realisable asset' in accordance with Article 2(m) of the SFD, including financial collateral covered by the Financial Collateral Directive 2002/47/EC (see Section 7.4.2.) below).

The legal nature of emission allowances and their classification as financial instruments through the national measures transposing MiFID II may affect the way that Settlement Finality Directive 98/26/EC conditions can be applied to taking and giving of 'collateral security' with emission allowances, with a view to benefitting from the protection provided by Article 9 of the that Directive. For instance, if emission allowances can be regarded as a 'realisable asset' under national law (or a collateral security under the Financial Collateral Directive 2002/47/EC, see Section 7.4.2 below), Article 9(1) would apply in cases of insolvency proceedings, even if the legal nature of emission allowances is not clearly defined by the national law in question.

It would clearly reassure investors to have this right of protection when trading emission allowances or as collateral takers, in order to obtain payment without any obstacle resulting from the absence of a clearly defined legal nature.

The national measures implementing the Settlement Finality Directive 98/26/EC must be examined in order to determine if the classification of emission allowances as financial instruments by MiFID II offers the possibility of their being given and taken as collateral in a designated system, and benefitting from the protection regime laid down by Article 9 of the Settlement Finality Directive 98/26/EC.

The national legislation of three selected Member States is analysed below: France, Belgium and Germany.

- **France**

The Settlement Finality Directive 98/26/EC, as amended by Directive No 2009/44/EC was transposed by Law No 2001-420 and Ordinance 2011-398, which are codified in the Monetary and Financial Code.

Article L.330-1,I of this Code defines the concept of a designated system in accordance with Article 2(a) of the Settlement Finality Directive 98/26/EC, while its paragraphs III and IV transpose the protection regime established by Article 9(1) of that Directive. Article L.330-2,I allows such designated systems to require the participating institutions to provide securities, as follows:

> *'The operating rules, framework agreement or model agreement governing any system referred to in Article L.330-1 may, where they organise the relations between more than two parties, require that institutions participating directly or indirectly in such systems furnish guarantees which are established and enforceable as provided for in Article L.211-38 or make a special allocation of securities, certificates, bills, receivables or sums of money to meet the payment obligations deriving from participation in such a system'.*

The same provision stipulates that no creditor of an institution participating directly or indirectly in such a system or, where applicable, of the system itself, may avail itself of any right whatsoever over said guarantees. In other words, no creditor may benefit from unlimited rights or limit the rights over the guarantees offered.

Article L.211-38, I of the Monetary and Financial Code actually transposes most of the Financial Collateral Directive 2002/47/EC provisions, notably the definition of collateral security provided in its Article 2(m), so as to ensure that 'realisable assets' under the Settlement Finality Directive 98/26/EC effectively include the 'collateral security' covered by the Financial Collateral Directive 2002/47/EC (see Section 7.4.2 below).

It reads as follows:

> *'In order to secure the present or future financial obligations referred to in Article L.211-36, the parties may provide for the transfer with full title, enforceable against third parties without formalities, of financial instruments, bills, receivables, contracts or sums of money, or securities on such property or rights, enforceable even when one of the parties is the subject of proceedings referred to in Book VI of the Commercial Code, or equivalent court-ordered or amicable proceedings founded on foreign legal systems, or civil enforcement proceedings or exercise of a right to object'.*

France's transposition of the Settlement Finality Directive 98/26/EC in conjunction with the Financial Collateral Directive 2002/47/EC shows that the term 'realisable assets' is primarily used by the French legislator to indicate the possibility of using assets as collateral securities, whose attached rights are enforceable by the designated system in order to secure the settlement of payment.

In any case, emission allowances are legally defined as personal property by the French Environmental Code and they are not listed among the financial instruments. As such, and since they are regarded as movable property (intangible asset), they can be used as, or can be subject to, securities under the Financial Collateral Directive 2002/47/EC (see Section 7.4.2 below), in particular as a collateral security in the meaning of Article 1(4)a) of the Financial Collateral Directive 2002/47/EC, to which Article 2(m) of the Settlement Finality Directive 98/26/EC expressly refers. They can thus also be regarded as 'realisable assets' under the Settlement Finality Directive 98/26/EC.

The classification of emission allowances as financial instruments by MiFID II does not, therefore, affect the legal regime applicable to the taking and giving of collateral security under Article 9(1) of the Settlement Finality Directive 98/26/EC in France because such allowances are personal property which can be used as, or be subject to, collateral security for the purposes of implementing the Settlement Finality Directive 98/26/EC for the transfer and payments of financial instruments.

## ▪ Belgium

The Settlement Finality Directive 98/26/EC was transposed by the amended Law of 28 April 1999 on settlement finality in payment and securities settlement systems, which applies to 'securities' covering all 'financial instruments' (Article 1,8°, of the Law of 28 April 1999) as defined by Article 2 (1°) of the amended Law of 2 August 2002 (transposing MiFID I and II). Article 1(9°) of this Law correctly transposes the definition of 'transfer order' provided for in Article 2(i) of the Settlement Finality Directive 98/26/EC.

The protection system provided by Article 9(1) of the SFD (e.g. the guarantee of settlement and finality of transfer orders entered into a designated system in the event of insolvency of one of the participants in that system) is correctly transposed into Belgian law by the provisions of Article 8(1) of the amended Law of 28 April 1999.

The last indent of Article 8(1) stipulates that where a system operator has provided collateral security to another system operator in connection with an interoperable system, the rights of the providing system operator to that collateral security shall not be affected by insolvency proceedings against the receiving system operator. Article 8(2) is a literal transposition of Article 9(2) of the Settlement Finality Directive 98/26/EC. Interestingly, Article 8(3) specifies the nature and scope of possible questions that could be raised with regard to the determination of the rights of holders of collateral security, mentioning 'the legal nature and property consequences attached to the security'.

As a result, in Belgium, the determination of the rights associated with emission allowances provided as collateral security legally recorded on a register, account or centralised deposit system shall be governed by Belgian law.

Article 8(4) specifies the types of collateral security that can be used to ensure that the holder will benefit from the protection laid down by Article 9(1) of the Settlement Finality Directive 98/26/EC: '*Une garantie au sens du présent article est tout gage, toute opération de cession-rétrocession ou de transfert de propriété à titre de garantie, ou toute autre forme de garantie analogue ou tout privilège spécial portant sur des actifs réalisables (y compris des espèces et des créances), organisé par le droit belge ou par un droit étranger, dans le but de garantir des droits et obligations susceptibles de naître dans le cadre d'un système, ou fourni aux banques centrales des Etats membres de l'Union européenne ou à la Banque centrale européenne*'.

Although this definition is very close to the definition of 'collateral security' provided in Article 2(m) of the Settlement Finality Directive 98/26/EC, it primarily points to the 'pledge', which is the most common collateral taken on movable intangible assets and is regulated by the Law of 15 December 2004 transposing the Financial Collateral Directive 2002/47/EC into Belgian law (see Section 7.4.2 below).

Now that emission allowances are classified as financial instruments, they can be regarded as 'realisable assets' in the meaning of Article 2(m) of the Settlement Finality Directive 98/26/EC, and can be used as 'collateral securities' in implementing Article 9(1) of that Directive.

The issues deriving from the absence of a clearly defined legal nature of emission allowances are thus resolved by the classification of emission allowances as financial instruments, insofar as that classification allows their holders to take or give them as collateral securities under the Settlement Finality Directive 98/26/EC.

### Germany

The implementation of the Settlement Finality Directive 98/26/EC introduced changes to the Banking Act (*Kreditwesengesetz,* KWG), as well as to the Securities Deposit Act (*Depotgesetz*, DepotG) and the Insolvency Act (*Insolvenzordnung*, InsO).

The term 'realisable asset' is translated as '*verwertbarer Vermögensgegenstand'*. This term is frequently used in the German Commercial Code (*Handelsgesetzbuch*, HGB), e.g. in relation to the required contents of the annual financial statement (see § 246 and § 266 HGB). However, it is not defined in law. As an 'asset', it is understood to include both the abstract ability to be capitalised, as well as the concrete ability to be capitalised (in that there is no specific restriction).

The participants in a system within the meaning of Settlement Finality Directive 98/26/EC (see above: § 1(16) KWG) are subject to several specific regulations in the InsO that implement the requirements of Article 9(1) SFD:

- § 21(2) and § 96(2) InsO increase the potential for arrangements over financial collateral and securities in systems under § 1(16) KWG in the (preparation of an) insolvency procedure;
- § 104(1) sentence 3 No. 2 and sentence 4 link to the delivery of financial instruments (as listed in Annex I Section C MiFID II): creditors are limited to compensation for non-delivery;
- § 166(3) InsO limits the liquidator's competence in the realisation of assets (including movable objects and financial collateral) that are a collateral for system operators or participants in such systems;
- § 223(1) InsO limits the content of an insolvency plan: the right to satisfy claims from financial collateral and collateral that is part of a system according to § 1(16) KWG cannot be limited.

Given the implementation of Article 9(1) SFD in the InsO as outlined above, emission allowances could be covered if they are part of a system with a formal arrangement as defined in Article 2(a) SFD and implemented by § 1(16) and § 24b KWG.

Following MiFID II implementation, emission allowances are expressly defined as 'financial instruments' ('*Finanzinstrumente*') in § 1 Para. 11 Subpara. 1 No. 9. This term is not identical to the term 'financial collateral' ('*Finanzsicherheiten*') used in the provisions of the InsO to implement the Financial Collateral Directive 2002/47/EC and in § 1(17) KWG (Section 3 part b) below. Thus, the implementation of MiFID II in German law has not changed the legal consequences of insolvency for allowances.

## 7.3.2 Financial Collateral Directive

Collateral is covered by the Financial Collateral Directive No 2002/47/EC as amended in 2009 and is also subject to Directive No 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms[476].

[476] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and

The Financial Collateral Directive No 2002/47/EC complements the Settlement Finality Directive 98/26/EC in facilitating the use of (cross-border) collateral in the form of cash or financial instruments outside a designated system. It applies to supervised financial institutions (credit institutions, investment firms, insurance undertakings, etc.), central counterparties, settlement agents, and clearing houses, as well as any persons other than natural persons, unincorporated firms and partnerships, provided that the other party is one of the aforementioned entities.

The Financial Collateral Directive No 2002/47/EC sets out minimum formal requirements for the Member States concerning collateral arrangements, including, for example, that such arrangements must be evidenced in writing or in a legally equivalent manner. Enforcement of collateral arrangements by the collateral taker is possible, for example, by sale or appropriation of the financial instruments. In effect, the collateral taker has a contractually agreed **right to use** the financial collateral as if he were the full owner. If he chooses to exercise this right, he is obliged to transfer back the equivalent amount of collateral. According to the Financial Collateral Directive No 2002/47/EC provisions, Member States must recognise the so called 'close-out netting' arrangements, even if the collateral taker or provider is subject to insolvency proceedings or reorganisation, and they are not allowed to apply their national insolvency rules to financial collateral arrangements in certain cases.

Under the Auctioning Regulation 1031/2010, bidders or any intermediaries shall be required to give collateral prior to the opening of the bidding window for the auctioning of two-day spot or five-day futures (Article 49), whereas the auctioneer shall only be required to give allowances as collateral to be held in escrow by the clearing system or settlement system acting as custodian, pending their delivery (Article 50). It is important to keep in mind that '*allowances auctioned by any auction platform shall be transferred by the Union Registry prior to the opening of a bidding window, into a nominated holding account, to be held in escrow by the clearing system or settlement system acting as custodian, until delivery of the allowances to successful bidders or their successors in title, pursuant to the results of the auction*', as provided for in Article 46 of the Registry Regulation 389/2013.

The classification of emission allowances as financial instruments by MiFID II thus raises the question of whether or not they can be used as collateral by some market players. Even if it is primarily a security/insolvency issue (see Section 6.5), it is important to know if, and how, Financial Collateral Directive No 2002/47/EC provisions can apply to the transfer of emission allowances used as collateral now that they are classified as financial instruments.

There are no specific provisions stating that Financial Collateral Directive No 2002/47/EC and its safeguards apply specifically to emission allowances as financial instruments[477], but some clearing houses accept emission allowances as collateral under certain conditions and on the basis of private law contracts. As suggested in Section 6.5 of this report, one option could be to extend the protections

Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173 12.6.2014, p. 190, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1537178110170&uri=CELEX:02014L0059-20171228

[477] 'Financial instruments' are defined by the FCD as 'shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing' (Article 2(1)(e)).

afforded to takers of collateral under the Financial Collateral Directive No 2002/47/EC to expressly include emission allowances.

In order to assess this proposal to improve the EU legal framework and create consistency between the EU financial market legislation and the EU ETS, the current national implementation of the Financial Collateral Directive No 2002/47/EC must be examined, including whether or not national measures may apply to the giving and taking of emission allowances as collateral. This is particularly relevant in those Member States where emission allowances can be regarded as 'transferable securities' under Article 4(44)c) of MiFID II, in a way that could give an equivalent level of protection to the taker of emission allowances as collateral outside a system designated under the Settlement Finality Directive 98/26/EC (see Section 7.4.1 above).

This analysis considers the national legislation of France, Belgium and Germany.

- **France**

As explained in Section 1 above, emission allowances are legally defined as personal property by the French Environmental Code, and they cannot be simultaneously regarded as 'transferable securities'. They have not been listed among the financial instruments by the measures transposing MiFID II in the French legal system.

However, as personal property, emission allowances can be used as collateral in the form of a pledge, in accordance with the provisions of Articles 2333 and 2337 of the French Civil Code, '*A pledge is an agreement by which the pledgor gives to a creditor the right to be paid in preference to his other creditors out of a corporeal movable or a set of corporeal movables* [e.g. intangible asset]*, present or future. The claims which are secured may be present or future; in the latter case, they must be determinable'* (Article 2333 French Civil Code).

A pledge may be given by the debtor or by a third party but, in the latter case, the creditor has an action only against the asset given as a security. It is effected by a written agreement that contains the description of the debt secured, the quantity of assets pledged, and their kind or nature, but it is effective against third parties only when it has been published in a dedicated registry (Article 2338 French Civil Code).

Most importantly, the taking of a pledge can be with or without dispossession of the intangible asset, depending on the need to guarantee the creditor transfer of the title:

- Article 2341 of the French Civil Code provides that, for a pledge with dispossession for fungible goods, the creditor must keep the goods in question separate from his goods of the same nature. If the agreement exempts the creditor from that obligation, he acquires ownership of the pledged items with the obligation to give back the same quantity of equivalent items.

- Article 2342 of the French Civil Code states that when a pledge without dispossession relates to fungible goods, the pledgor may separate them only if the agreement so provides, with an associated obligation to replace them with the same quantity of equivalent goods.

Clearly, the consequences depend on whether the pledge is with or without dispossession.

A pledge with dispossession involves a transfer of property for the benefit of the creditor, to be materialised by an inscription of the emission allowances in an account opened in the Union Registry. In the event the debt can be paid, the allowances must be returned. If the creditor has sold the emission allowances before the term of the debt payment, he should return other, similar allowances purchased on the market. Since the reform by Law No 2008-776 of 4 August 2008, another important feature of a pledge with dispossession is the creditor's 'right of retention' to pledged goods (e.g. property right

over the goods) until the complete payment of the debt, even if he is not in physical possession of the goods in question (Article 2286).

If there is no dispossession attached to the pledge, then the debtor retains ownership over the emission allowances. These are not transferred from his account in the Union Registry and he can use them for compliance purposes or even sell them on the market if so provided in the agreement concluded with the creditor, which can foresee the possibility to apply the pledge to emission allowances available the following year.

These options do not affect the legal nature of emission allowances as personal property, nor do they contradict the provisions of the Registry Regulation 389/2013 with respect to the proof of the title transfer, e.g. that the record of the Union Registry constitutes *prima facie* and sufficient evidence of title over emission allowances for the holder's account.

- **Belgium**

The Financial Collateral Directive No 2002/47/EC is transposed by the Law of 15 December 2004, whose Article 4(1) clearly indicates that it applies to financial collateral arrangements covering 'financial instruments' (Article 3,1°) as defined by Article 2,(1°) of the amended Law of 2 August 2002 (transposing MiFID I and II). The scope of the national measures on financial collateral arrangement is therefore more up-to-date than that of the Financial Collateral Directive No 2002/47/EC itself, whose Article 2(1)e) defines 'financial instruments' without making any direct cross-reference to Annex I, Section C, MiFID (I or II).

In the absence of a statutory definition of the legal nature of emission allowances, their classification as financial instruments by the amended Law of 2 August 2002 gives the possibility to take or give them as collateral for the implementation of the Financial Collateral Directive No 2002/47/EC in Belgium.

As noted in Section 5, Belgium considers emission allowances classified as financial instruments to be intangible movable property, notwithstanding the question of whether or not they confer property *in rem* or *in personae*. From that legal perspective, the most relevant security to take or give over movable assets is the 'pledge', which is governed by the Civil Code (Articles 2073 to 2084). There are many similarities between the Belgian and the French Civil Code provisions relating to the taking of a 'pledge', with the exception being that the Belgian system was, until recently, based on the dispossession of pledged assets only.

A reform of the legal framework of security interests was adopted through the Law of 11 July 2013 (*Loi modifiant le Code Civil en ce qui concerne les sûretés réelles mobilières et abrogeant diverses dispositions en cette matière*). This reform entered into force only on 1 January 2018 and applies without prejudice to the specific provisions of other legislation, such as the Law of 15 December 2004 on financial collateral arrangements transposing the Financial Collateral Directive No 2002/47/EC (see discussion above), which remain relevant for the taking and giving of emission allowances as collateral outside a so-called SFD-designated system.

The Law of 11 July 2013 applies to security interests over movable assets, including 'financial instruments'.

Key to this reform is that a pledge is no longer conditional upon the dispossession of the pledged assets when they are intangible assets (dematerialised securities). Without dispossession, the pledgor can retain the pledged assets and continue to exploit or commercialise them. The pledge is effected through its registration in a National Pledge Registry, held at the Mortgage Registry (maintained by the Ministry of Finance), from which time it is enforceable against third parties. The registration of the

pledge, which is the responsibility of the pledgee, permits any third party to rapidly identify (through a quick search in the registry) whether or not the debtor's assets are already pledged. Pledge registration (and renewal) fees range from EUR 5 to EUR 500, depending on the amount secured by the pledge.

If they so wish, the parties may opt for a dispossession pledge, in which case they do not have to register the pledge in the new National Pledge Registry. Both regimes will co-exist. It remains to be seen if this dual system will cause problems in the event of a conflict of security interests.

Now that emission allowances are classified as financial instruments, they can be used as, or made subject to, a 'pledge', which can be regarded either as collateral security for settlement finality payment purposes in SFD-designated systems, or as collateral security for guaranteeing OTC transactions under the Financial Collateral Directive No 2002/47/EC. This new pledge regime for business assets is not reserved for financial institutions or companies providing investment services, but can be used by any sort of creditor, including - eventually - EU ETS operators.

Similar to the French legal system, pledges without dispossession should allow the pledgor to use pledged emission allowances freely, for compliance purposes or otherwise, or even to sell them on the secondary market. These rights will be offset by the right of the pledgee to inspect the pledged assets at any time and by the obligation on the pledgor to look after the pledged assets as a 'prudent trustee'. Finally, in the event of fraud committed by the debtor, the pledgee will have a 'right of pursuit' over the pledged asset that would have been sold or assigned to a third party in breach of a legal or contractual provision.

The pledge regime therefore applies to emission allowances now that they are classified as financial instruments in a way that grants the creditor the level of protection required by the Financial Collateral Directive No 2002/47/EC. It can be concluded that the issues deriving from the absence of a clearly defined legal nature of emission allowances are resolved by the classification of allowances as financial instruments, insofar as that classification allows their holders to take or give such allowances as collateral security under the Financial Collateral Directive No 2002/47/EC.

- **Germany**

Similar to the Settlement Finality Directive 98/26/EC implementation (see analysis of German legislation in section 7.4.1. above), the German implementation of the Financial Collateral Directive No 2002/47/EC provisions with regard to the protection of financial collateral are contained *inter alia* in the KWG, the DepotG and the InsO. A provision on the realisation of liens was also added to the Civil Code (see § 1259 *Bürgerliches Gesetzbuch*, BGB).

§ 1(17) KWG introduces the principal part of the definition of financial collateral under the Financial Collateral Directive No 2002/47/EC (with the exception of shares). While it does not include financial instruments in its definition in sentence 1, its second sentence links to the term. If the collateral provider is a person other than a natural person (Article 1(2) lit.e) of the Financial Collateral Directive No 2002/47/EC) 'financial collateral' requires that the collateral secures contractual obligations relating to financial instruments[478]. Financial collateral could thus secure contracts relating to allowances but the allowances themselves are not considered financial collateral *per se*.

[478] § 1(17) sentence 2 KWG links to contracts on i) the acquisition or disposal of financial instruments, ii) repurchase transactions, loans or similar transactions of financial instruments, or iii) loans to finance the acquisition of financial instruments.

The InsO aims to provide similar protection to financial collateral compared to securities under a formal arrangement (see Section 7.4.1 above). Relevant provisions include the following (although their applicability to allowances is doubtful given the narrow definition of financial collateral in § 1 Para. 17 KWG):

- § 21(2) and § 96(2) InsO increase the potential for arrangements over financial collateral and securities in systems under § 1(16) KWG in the (preparation of a) insolvency procedure;
- § 166(3) InsO limits the liquidator's competence in the realisation of assets (including movable objects and financial collateral) that are collateral for system operators or participants in such systems;
  § 223(1) InsO limits the content of an insolvency plan: the right to satisfy claims from financial collateral and collateral that is part of a system according to § 1(16) KWG cannot be limited.

Given that § 1(17) KWG provides a narrow definition of financial collateral that includes only specific types of financial instruments[479] rather than using the broader definition of 'financial instrument' provided earlier in the same Act and expressly including allowances (§ 1 Para. 11 No. 9 KWG), it follows that allowances are not covered by the provisions transposing the Financial Collateral Directive No 2002/47/EC. Thus, the classification of allowances as financial instruments under MiFID II has not resulted in the extension of the additional safeguards under the Financial Collateral Directive No 2002/47/EC to collateral takers obtaining allowances as security under German law.

### 7.3.3 Conclusions on the interactions between MiFID II, the Settlement Finality Directive and the Financial Collateral Directive

The current legal framework applicable to emission allowances has been affected by their inclusion in the list of financial instruments under MiFID II, with the Settlement Finality Directive 98/26/EC thus applying to them. As emission allowances may also be regarded as a realisable asset in accordance with Article 2(m) of the Settlement Finality Directive 98/26/EC, emission allowances can be used as financial collateral covered by the Financial Collateral Directive No 2002/47/EC. The national measures implementing the Settlement Finality Directive 98/26/EC were examined to determine if the classification of emission allowances as financial instruments by MiFID II offers the possibility of their being given and taken as collateral by a designated system, and benefitting from the protection regime laid down by Article 9 of the Settlement Finality Directive 98/26/EC.

In some Member States, the classification of emission allowances as financial instruments may affect the possibility to take and give 'collateral security' and allow the taker to benefit from the protection regime laid down by Article 9 of the Settlement Finality Directive 98/26/EC.

- In France: being legally defined as personal property (intangible asset), emission allowances can

[479] § 1 Para. 17 KWG defines financial collateral as: 'cash balances, monetary amounts, securities/shares, money market instruments as well as credit exposures' *('Finanzsicherheiten im Sinne dieses Gesetzes sind Barguthaben, Geldbeträge, Wertpapiere, Geldmarktinstrumente sowie Kreditforderungen')*, provided as collateral under security interest, transfer or title transfer structures on the basis of an arrangement between a collateral taker and a collateral provider.

be used as or be subject to securities in the meaning of the Financial Collateral Directive No 2002/47/EC, in particular as a collateral security taking the form of a pledge, governed by the French Civil Code, whether within or outside an SFD- designated system for the transfer and payment of financial instruments. Therefore, their classification as financial instruments does not affect the legal regime applicable to the taking and giving of collateral security.

- In Belgium: now that emission allowances are classified as financial instruments, they can be regarded as realisable assets, which confer rights *in rem*. This supports the view of allowances as a movable property (intangible asset). As such, they can be used to take or give collateral security within or outside an SFD-designated system for the transfer and payment of financial instruments, even though there is no clear definition of their legal nature in Belgian law. Outside of a designated system, the most relevant security to take or give over a movable property would be a pledge, governed by the Law of 11 July 2013, which applies without prejudice to the national measures transposing the Financial Collateral Directive No 2002/47/EC.
- In Germany, the situation remains unclear. Beyond the lack of a definition of the legal nature of emission allowances, § 1 Para. 11 Subpara. 1 No. 9 defines them as 'financial instruments' since the MiFID II implementation in Germany. However, this term is not identical with the term 'financial collateral' used in the provisions of the Insolvency Act to implement the Financial Collateral Directive No 2002/47/EC. Given that § 1(17) KWG provides a narrow definition of financial collateral that includes only specific types of financial instruments rather than using the broader definition of 'financial instrument' provided earlier in the same Act and expressly including allowances (§ 1 Para. 11 No. 9 KWG), it follows that allowances are not covered by the provisions transposing the Financial Collateral Directive No 2002/47/EC into German law. Thus, the implementation of MiFID II in German law has not changed the legal consequences of insolvency for allowances.

# 8 Options for measures to address the issues identified

## 8.1 Horizontal issues

### 8.1.1 Legal certainty

#### 8.1.1.1 Would harmonisation of the legal nature of EU ETS allowances provide legal certainty?

The European Court of Auditors report pointed out that a clear and harmonised definition of the legal nature of the allowances at EU level could improve legal certainty and the liquidity of the market[480].

Any measures to increase the legal certainty regarding allowances must be designed with Member State consideration of the legal nature of allowances in mind, as well as the effectiveness of the legal framework regulating different aspects of the ETS at EU level.

Of the five Member States examined in this report, only **France** has legislation explicitly referring to the legal nature of EU ETS allowances. However, most of the national experts and the stakeholders interviewed found no evidence to suggest that a harmonised definition of the legal nature of the allowances would produce the legal certainty required for an effective system and market liquidity.

Indeed, even while the French law defines the legal nature of the allowances and assigns clear property rights for the holders once the allowances are issued, there is some legal uncertainty as to the interpretation of the relevant provisions. The national judge has already ruled that the identification of entitlements to free allocation of allowances through NAPs does not create rights for operators, unlike the annual decisions made by the Minister for Environment for the issuance of allowances, which were considered a source of rights for holders - not to the allowances themselves but to a given volume of allowances. The 2010 Smurfit Kappa case (case no 383771) led the legislator to improve the legal framework, with Article L.229-11-1 of the Environmental Code now regulating those exceptional cases where the operator was delivered undue free-of-charge allowances. This allows the national administrator to instruct the operator to return excess allowances delivered in error and, if such an instruction is denied, the national administrator can automatically take over the excess allowances and impose a fine on the operator. The legal uncertainty is thus removed.

The French legislator decided not to explicitly classify allowances as financial instruments but, rather, to introduce references to the EU ETS allowances in all relevant provisions of the Financial and Monetary Code. While this introduced a certain degree of uncertainty, the latter has been removed recently as Ordinance no 2016-827 of 23 June 2016 clarified how the Financial and Monetary Code should apply to allowances in light of the transposition of MiFID II[481].

The French expert highlighted that a harmonised definition would ensure legal certainty only if it provided for consistent consequences across the EU for theft, fraud or insolvency, claims for compensation and option to use collateral. This raises a second factor: the legal framework regulating

[480] European Court of Auditors, Special Report No 6, 'The integrity and implementation of the EU ETS', Publications Office of the European Union, 2015. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

[481] See Section 5.1.4.

the EU ETS allowances. National reports highlight that the characteristics of EU ETS allowances 'trigger' the applicability of other pieces of national legislation but it is not always easy to determine the legislation applicable to allowances. In **Poland**, various regulations in Polish civil, financial, administrative and criminal law are applicable to allowances, even if they are not specifically and explicitly prescribed. In this context, doubts may arise as to the applicability of certain provisions to allowances, since they do not explicitly refer to them and depend on their interpretation. Similarly, in **Germany,** the national law applicable to the regulation of allowances includes the TEHG provisions, the German Basic Law/Constitution (*Grundgesetz*, GG) providing guidance on what constitutes 'property' (Article 14 GG) and the German Civil Code (*Bürgerliches Gesetzbuch*, BGB) providing the general framework applied to any property, which may include EU ETS allowances although the legislation does not refer to them. Finally, the applicability of the financial legislation has been modified to include the Securities Trading Act (*Wertpapierhandelsgesetz*, WpHG) and the Banking Act (*Kreditwesengesetz*, KWG). Likewise in **Belgium,** the legal framework regulating EU ETS allowances includes the provisions of the Civil Code (*Burgerlijk Wetboek*), Article 16 of the Belgian Constitution, and the Belgian Companies Code (*Wetboek van Vennootschappen*). Here, again, none of these pieces of legislation explicitly refer to EU ETS allowances.

At the level of EU law, determining the nature of EU ETS allowances has practical implications whenever they are subject to claim for return, reversal of a transaction or cancellation by public authorities[482]. EU law, and the Registry Regulation 389/2013 in particular, regulates cases of erroneous allocation of EU ETS allowances by envisaging return procedures for excess allocation (Article 53(4)) and reversal of an allocation (Article 70(4)).

The legal analysis concludes that the legal certainty depends more on the coherence of the national legal framework than on the explicit recognition of the legal nature of the allowances by a specific EU-level provision. There is a fundamental difference between the French system - where there is clear definition of the legal nature of allowances - and the other national legal systems examined here. However, all five national legislations seem to suffer (or have suffered in the past) some degree of uncertainty regarding the applicable provisions to the allowances.

In addition, the legal uncertainty relating to the rights granted by allowances when considering whether or not possession and ownership may be separated has not been solved. A clearer framework for situations where transfer of positions should not mean transfer of title might be needed (see Section 3.5 and Section 4 of this study).

Ultimately, the establishment of a legal framework regulating the consequences of the allowances being considered as property or rights would better address the issues raised during the implementation of the ETS Directive 2003/87/EC. For example, the recognition of allowances as irrevocable and freely transferable might be more effective than an express declaration that they constitute property. Thus, a clear legal framework applicable to the allowances might be more effective than the definition of their legal nature, as the legal certainty depends more on the coherence of the EU legislation internally and with the relevant national framework than on explicit recognition of the legal nature of the allowances by a specific EU-level provision. While the definition at EU level might trigger more harmonisation and consistency, it might not clarify all the legal consequences.

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[482] For further aspects of the importance of this distinction, see Mace, M.J., 'The Legal Nature of Emission Reductions and EU Allowances: Issues Addressed in an International Workshop', in *Journal for European Environmental & Planning Law*, Vol. 2(2), 2005, p. 125.

#### 8.1.1.2 Options for harmonisation

**Defining the legal nature of EU ETS allowances at the level of EU law** would require changes to Article 3 of the ETS Directive 2003/87/EC, by amending it through the ordinary legislative procedure, as well as an amendment to the Registry Regulation 389/2013 (e.g. Article 40) via a delegated act (Article 290 TFEU) being adopted by the Commission.

The feasibility of these legislative measures is linked to the involvement of other actors in the procedure and also depends on the effectiveness of such measures.

The adoption of the measures would involve the European Parliament and the Council as co-legislators for the ETS Directive 2003/87/EC. They also have the right to object to the Commission's delegated acts, in accordance with Article 290(2)(b) of the TFEU. This is particularly relevant for the Council, as the EU ETS allowances are defined differently in the Member States, which might therefore take an opinion in line with their legal system.

In addition, there is legal uncertainty in relation to the interpretation of Article 345 TFEU and the EU's competence to adopt legislation defining the legal nature of EU ETS allowances. In its response to the 2015 European Court of Auditors report, the Commission considered that under Union law, property law is the prerogative of the Member States. Certain authors do not consider that Article 345 TFEU means that property law cannot be regulated through European law. They argue that this provision merely limits the impact of potential new EU legislation so that it does not undermine Member States' systems of property ownership[483]. This provision has been interpreted by the CJEU as an expression of the principle of neutrality of the Treaties in respect of questions of private or state ownership of companies[484] and which does not confer any exclusive powers to deal with property law to the EU or the Member States[485]. The CJEU held this provision to be an expression of the principle of neutrality of the Treaties in respect of questions of Member States' rules on private or state ownership of companies[486]. Similarly, according to some authors, this provision does not confer any exclusive powers to deal with property law to the EU or the Member States, but, rather, confirms the neutrality of the Treaty in respect of questions of private or state ownership of companies[487]. The same authors conclude that Article 345 TFEU '…does not concern the content of the right of ownership, nor the objects of a right of ownership. It does not therefore form an obstacle to the development of a European property law'[488].

In relation to the **effectiveness** of the measures, the foregoing analysis concludes that the definition of the legal nature of EU ETS allowances will not necessarily provide more legal clarity. In this sense, the AG to the Arcelor Mittal case (C321/15) stated that there is no need to define the legal nature of allowances as it is sufficient for the Court to determine whether the allocation and subsequent administrative decision or order to return the allowances to the public authorities which erroneously allocated them, complies with the ETS Directive 2003/87/EC [489]. The Court ruling on the case did not define the nature of EU ETS allowances but stated that the allowances issued after an operator has

[483] Akkermans, B. and Ramaekers, E., p. 292.
[484] Joint cases C-105/12 to 107/12 request for preliminary ruling from Hoge Raad der Nederlanden para 29.
[485] Akkermans, B. and Ramaekers, E., p. 308.
[486] Joined cases C-105/12 to 107/12 request for preliminary ruling from Hoge Raad der Nederlanden para 29.
[487] Akkermans, B. and Ramaekers, E., p. 308.
[488] Akkermans, B. and Ramaekers, E., p. 292
[489] Opinion of Advocate General Campos Sánchez-Bordona, delivered on 5 July 2016 (1) Case C 321/15 b ArcelorMittal Rodange et Schifflange SA v Grand Duchy of Luxembourg.

ceased the activities performed in the installation to which those allowances relate, without first informing the competent authority, cannot be classified as emission 'allowances' within the meaning of Article 3(1)(a) of the ETS Directive 2003/87/EC [490].

A further consideration in favour of a common legal definition of EU ETS allowances is the fact that increased legal certainty could remove potential risk to **market liquidity**. However, the lack of a harmonised definition does not appear to have had a noticeable impact on the liquidity of the market in the 12 years of the EU ETS' existence (see Section 6.2.3), although some argue that it could become relevant in the future.

On the question of whether a legal definition of EU ETS allowances would have the indirect benefit of further reducing the potential for **fraudulent activity** (in addition to the measures in place since 2011), the analysis suggests that market security would not be noticeably affected by any such legal definition.

The introduction of a definition of allowances via the Registry Regulation 389/2013 or the ETS Directive 2003/87/EC would not take a lot of time as the procedure for adoption of delegated acts takes about one year and the legislative procedure often takes about two years.

An alternative to amending existing secondary legislation would be for the Commission to issue a **guidance document** which could take the form of a Commission Communication or Recommendation stating the legal nature of the allowances. Such alternative measure would clarify the situation, thereby harmonising the practice in all Member States without regulating the issue. This would accommodate the Commission's assertion that Article 345 TFEU precludes regulating any aspects of property law through European law.

This option is more feasible as it simply requires the Commission to draft a document describing its opinion on the legal nature of the EU ETS allowances, and Member States and other stakeholders to consider it. The document needs to be adopted by the College of the Commission, which means that all relevant Commission services need to agree the interpretation.

As this alternative does not require a legislative procedure, it also represents a quicker and more flexible solution.

**Table 6:**

| **Option: The harmonisation of the legal nature of EU ETS allowances in relation to legal certainty** | | | | |
|---|---|---|---|---|
| Type of measure required | Scope: national / EU | Feasibility: low/medium/ high | Effort: low/medium/ high | Long/medium/ short-term |
| Amendment to Article 3 of the ETS Directive 2003/87/ EC | EU | Low | Medium (Directive currently under review but proposal does not include it) | Long-term |
| Amendment to Article 40 of the Registry Regulation 389/2013 | EU | Medium | Amendment to the Regulation | Medium-term |
| Guidance to Member States, Non-binding Commission Communication/ Recommendation | EU | Medium | Drafting of the guidance and interpretation | Medium-term |

[490] Case C-321/15 Arcelor v Luxembourg, can be found at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=188666&pageIndex=0&doclang=FR&mode=req&dir=&occ=first&part=1&cid=157476

### 8.1.2 Liquidity of the market

#### 8.1.2.1 Measures already taken: re-establish scarcity of allowances

The 2015 European Court of Auditors report raised the issue of clarity and legal certainty with respect to the definition of the legal nature of the allowances in order to support the liquidity of the emission market, echoing concerns voice by others[491] since as early as 2009[492, 493]. Yet, despite the lingering legal uncertainty and associated risks, the liquidity of the European carbon market has not proved a problem.

Until recently, the surplus of emission allowances was one of the main issues for the European carbon market which could potentially affect its liquidity. The economic crisis of 2008, lower than expected economic growth for the last decade, better than expected performance of some complementary climate and energy policies, and a substantial inflow of international offset credits in 2012 all contributed to the accumulation of a surplus of more than two billion allowances in the EU ETS in 2013 and 2014, with more recent estimates at 1.8 billion allowances[494]. This created an apparently paradoxical situation whereby the trades were not very active, despite an overall available surplus of allowances. This is because many emitters covered by the EU ETS found themselves sufficiently endowed with free allocations to cover their compliance needs for current and future years, and therefore did not need to become active on the carbon market. In addition, the surplus led to a prolonged slump in the price of EU ETS allowances. Low prices, a limited dynamic and modest future price expectations further limited the opportunities for intermediaries to realise gains from trade.

In order to restore scarcity, two main channels were used to limit the number of allowances in circulation, either by withholding them from auction for a certain period of time (back-loading), or by placing them in a reserve in accordance with strict pre-defined rules (Market Stability Reserve, MSR). The back-loading was initially implemented in the EU in a makeshift fashion and with a limited volume for the years 2013-2014. As of 2019, the MSR operates as a permanent rule-based mechanism to temporarily withhold allowances from the market[495]. Even before the MSR entered into operation, the revision of the ETS Directive 2003/87/EC (agreed on 14 March 2018) included several elements to strengthen the functioning of the MSR, including a temporary doubling of its intake rate from 2019 to 2023, and a provision that, from 2023, allowances held in the MSR above the total number of allowances auctioned during the previous year will become invalid. Taken together, these measures represent significant steps towards re-establishing scarcity in the European carbon market. This is evidenced by the fact that, following the agreement in March 2018, the price of allowances rose above EUR 10 for the first time since 2012, effectively doubling between September 2017 and the end of

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[491] Mace, J.M., The legal nature of Emission Reductions and EU Allowances: Issues addressed in an International Workshop, 2005.

[492] Manea, S., 'Instrumentalising Property An Analysis of Rights in the EU Emissions Trading System', London School of Economics and Political Science, 2013, p. 93.

[493] Financial Markets Law Committee, 'Emissions Allowances: Creating Legal Certainty', London: Bank of England, October 2009, p. 15.

[494] European Commission, 'Report on the Functioning of the European Carbon Market', Brussels: European Commission, 2 January 2017.

[495] Decision (EU) 2015/1814 of the European Parliament and of the Council of 6 October 2015 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and amending Directive 2003/87/EC.

March 2018. As a result of the changes agreed, analysts expect that more than two billion allowances could lose their validity in 2023, and that the price of allowances could rise to more than EUR 30 by the mid-2020s[496]. However, it should be noted that the rules governing MSRs do not recognise any discretion either for the Member States or for the Commission to influence the activation of the MSR mechanism.

The main benefits of eliminating the surplus – and also the main motivation – are increased environmental effectiveness and restored economic efficiency of the EU ETS. By eliminating the surplus, it is hoped that the EU ETS will provide a long-term price signal that is more capable of directing investments and innovation, as well as operational decisions, towards the deployment of low-carbon technologies.

#### 8.1.2.2 Clarification, communication and capacity-building around EU ETS and MiFID II

To ensure a safe and efficient trading environment and to enhance confidence in the market, the scope of revised rules governing financial markets applicable to the carbon market now include all segments of the carbon market[497] by classifying the spot emission allowances as financial instruments under MiFID II. The provisions of MiFID II thus apply to market players involved in transactions on any type of financial instruments relating to emission allowances (spot or derivatives contracts), which must comply with relevant MiFID II requirements unless a particular exemption applies to certain buyers and sellers. However, this is without prejudice to the property rights that may be conferred upon their holders under national law. Nevertheless, the legal nature of EU ETS allowances is affected by their classification as financial instruments in the implementation of MiFID II.

The Polish example showed that there is a positive link between MiFID II and the legal nature of allowances. In Poland, alongside the transposition of MiFID II, the regulator stipulated that allowances will be expressly treated as financial instruments, thereby removing doubts as to the applicable legislation (see Section 5.1.1.2). An interviewed representative of the FMLC contested this view, however, arguing that the definition of allowances as a financial instrument merely amounted to a regulatory change and would not change the legal identity of the allowances. As it does not clarify whether allowances can be used as securities, legal uncertainty persists.

This is an important measure for ensuring future liquidity of the EU carbon market. MiFID II brings about a number of changes for many market participants and creates new compliance requirements (see Section 7 for a detailed analysis). Increased transparency with respect to the potential effects of MiFID II on players active on the European carbon market would bring some welcome clarity. This could happen in a number of ways:

- Member States could offer **information and advice** through different communication and engagement channels, e.g. explanatory publications in appropriate formats and language, interactive activities and platforms that help to build capacity and confidence among market actors unfamiliar with the new MiFID II regime. Where possible, this could also extend beyond pure information provision, to issuing analysis and possibly recommendations about the new

[496] Ferdinand, M., Feuchtlinger, S. and Rothenberg, F., ‘EU ETS Post-2020 Reform: Status Quo or Seismic Shift?’, EU ETS White Paper, Karlsruhe: ICIS, 11 December 2017.
[497] https://ec.europa.eu/clima/policies/ets/oversight_en

compliance requirements imposed by MiFID II. For instance, national governments could offer targeted, free or low-cost on-demand advice through a helpdesk or hotline. Coordination at EU level using appropriate forums would ensure consistency of national efforts.

- In a broader sense, **training sessions, working groups and other capacity-building activities** and processes have already helped to overcome resistance and lack of knowledge ahead of the introduction of the EU ETS, by engaging stakeholders and fostering an understanding of the EU ETS. Such formats could be used again, albeit on a smaller scale, with the goal of providing greater clarity about MiFID II and its consequences for both the EU carbon market and its participants. Such an approach could extend beyond information provision and work towards joint development of solutions for the implementation of MiFID II. Public agencies, such as the CAs for EU ETS implementation at national level and national financial oversight bodies, could serve an important function as impartial, non-commercial mediators in this process. Coordination at EU level would ensure consistency of national efforts.
- Finally, a far-reaching option would be to establish **aggregators or similar services** geared at **improving cooperation** between administrative bodies, bundling any new administrative burdens and reducing transaction costs for those entities covered by the new financial services regime. In particular, it would be useful the competent authorities responsible for the EU ETS, MiFID II and the Market Abuse Regulation 596/2014 to establish structural mechanisms to ensure systematic cooperation. This process could be initiated or aided by public agencies, with the service itself offered on a commercial basis.

The main benefit of such activities would be close the knowledge gaps in respect of MiFID II and its implications for the carbon market.

The above measures are all in the realm of capacity-building, outreach, training, information and dissemination, with no legislative changes needed to implement them. Such measures would typically be offered through the respective authorities and public agencies in the Member States, which are already engaged in disseminating EU ETS-related information and outreach. One practical challenge is that knowledge of MiFID II and its implications for the carbon market is also limited among these agencies. It can be assumed that few individuals in the EU ETS authorities of the larger Member States will have such information. As a capacity-building and dissemination measure, this would have a short-term effect and would need to be repeated at regular intervals. At the same time, since entry into application of MiFID II is very recent, there is a greater need for information.

The effort required to do this is likely to be modest, as the dissemination of information and training could be conducted based on existing structures. Some effort would be required in order to produce suitable training materials, especially since the prior knowledge about MiFID II in the national EU ETS authorities is likely to be limited.

**Table 7:**

| **Options: Re-establish scarcity of allowances and other measures to safeguard liquidity of the market for emission allowances** | | | | |
|---|---|---|---|---|
| **Type of measure required** | **Scope: national/EU** | **Feasibility: yes/no** | **Effort: high/medium/low** | **Long/medium/ short-term** |
| Provide information and advice on MiFID II impact on EU ETS allowances through communication tools, i.e. helpdesk / hotline | National/EU | Yes | Low | Short-term |
| Engage stakeholders through training/workshops on MiFID II and consequences for EU carbon market and | National/EU | Yes | Low | Short-term |

| its participants | | | | |
|---|---|---|---|---|

## 8.2 Thematic issues

### 8.2.1 Options for remedial measures in the context of criminal activity

#### 8.2.1.1 Remedial measures for VAT fraud

In response to VAT fraud schemes in the EU ETS, the Council adopted Directive 2010/23/EU[498] amending the VAT Directive 2006/112/EC which allows Member States to apply, on a temporary basis, a domestic VAT reverse-charge mechanism whereby the obligation to pay VAT shifts onto the taxable person to whom allowances are transferred[499]. Originally, Member States could apply this reverse-charge mechanism until 30 June 2015, but Directive 2013/43/EU[500] has prolonged this possibility until 31 December 2018. Based on the positive results, the Commission adopted a proposal to amend the VAT Directive 2006/112/EC with respect to the period of application of the optional reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud and of the Quick Reaction Mechanism against VAT fraud[501]. This proposal extends the reverse-charge for trade in services up to 30 June 2022 and was adopted on 12 November 2018 by the legislator[502]. This revision follows the publication in February 2018 of a Commission report to the Council and the European Parliament on the effects of Articles 199a and 199b of Council Directive 2006/112/EC on combating fraud (COM/2018/0118 final), which assessed the effectiveness of the sectoral reverse-charge mechanism in fighting carousel fraud, stating the Commission's intention to prolong the application of the derogation based on this assessment[503].

This solution has had no impact on the definition of the legal nature of allowances but has addressed the problem of VAT fraud. Although practically eliminating the possibility of VAT fraud, some observers have questioned the effectiveness of the VAT reverse-charge mechanism[504]. The Commission proposal to amend the VAT Directive 2006/112/EC responds to initial concerns about the temporary nature of this measure and the consequences of Member States no longer being allowed to apply the reverse-charge mechanism (had the measure not been extended). While the VAT reverse-charge mechanism has been implemented by Member States on a voluntary basis, the latest statistics from 2016 show that 22 of the 28 Member States have now applied it. This high rate of Member States

[498] Council Directive 2010/23/EU of 16 March 2010 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse-charge mechanism in relation to supplies of certain services susceptible to fraud.
[499] Article 1 VAT Directive.
[500] Council Directive 2013/43/EU of 22 July 2013 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud.
[501] COM(2018) 298 final at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018PC0298&from=EN
[502] Council Directive (EU) 2018/1695 of 6 November 2018 amending Directive 2006/112/EC on the common system of value added tax as regards the period of application of the optional reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud and of the Quick Reaction Mechanism against VAT fraud. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2018.282.01.0005.01.ENG&toc=OJ:L:2018:282:TOC
[503] COM/2018/0118 final, at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=COM:2018:0118:FIN
[504] Efstratios, 2012, p. 47.

applying it significantly diminishes the risk of VAT fraud, although some threats remain due to the lack of implementation in some Member States.

In theory, the classification of allowances as **financial instruments could potentially address VAT fraud** as '[it] will provide a more harmonised VAT treatment for the domestic trade of emission allowances, as in general the domestic supply of financial instruments is VAT exempt under EU law'[505]. However, in July 2016, the VAT Committee unanimously agreed that **the definition of allowances as financial instruments under MiFID II shall have no impact on the VAT treatment of such allowances** as already agreed in 2004 and 2010. More specifically, the VAT Committee held the unanimous view that such classification for the purposes of MiFID II shall not render applicable the provisions laid down in Article 135(1) of the VAT Directive 2006/112/EC, by which certain financial transactions are exempt from VAT[506]**.** As a result, VAT continues to apply to allowances transactions, whether transfers or auctioning of allowances, which are classified as financial instruments under MiFID II[507]. The VAT reverse-charge mechanism has proven to be an effective solution to prevent VAT fraud in the EU ETS, thus no further measures are required other than to ensure its longer term application.

The continuation of the reverse-charge mechanism is highly practical, as it is already in place and applied. The proposal for Council Directive amending the VAT Directive 2006/112/EC should be adopted quickly without major problems by the Council to ensure the extension of the reverse-charge mechanism in relation to supplies of certain services susceptible to fraud until June 2022.

It is further recommended to establish a permanent VAT regime for trade in services, similar to the current proposal for trade in goods[508]. However, the recently adopted Directive 2018/1695 establishing the continuation of the reverse-charge mechanism until 2022 and the permanent VAT regime for trade in services provide a medium-term solution.

#### 8.2.1.2 Remedial measures taken against theft of EU ETS allowances

Following the theft of allowances, the EU created a centralised Union Registry and adopted stricter rules governing the means by which accounts could be opened and managed[509]. The inclusion of these stricter rules on the opening of accounts and the authorisation of transactions, similar to those applied in banks, together with standardised procedures, aimed to ensure the integrity of the registries and public access to information, and to strengthen the system.

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505 Nield, K. and Pereira, R., 'Financial Crimes in the European Carbon Markets', in *Research Handbook on Emissions Trading*, Research Handbooks in Climate Law, Edward Elgar Publishing, 2016, p. 201.

506 Guidelines resulting from the 107th Meeting of 8 July 2016, Document A – taxud.c.1(2016)656943-910.

507 Readers must bear in mind that the guidelines issued by the VAT Committee are not compulsory. The European Commission and the Member States are not obliged to follow them.

508 See proposal for Council Directive COM(2018)298 final, 25.5.2018.

509 The EU adopted its first regulation on the Union Registry in 2011. See 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. This Regulation was repealed in 2013. See Commission Regulation (EU) No 389/2013 of 2 May 2013 establishing a Union Registry pursuant to Directive 2003/87/EC of the European Parliament and of the Council, Decisions No 280/2004/EC and No 406/2009/EC of the European Parliament and of the Council and repealing Commission Regulations (EU) No 920/2010 and No 1193/2011 (the Registry Regulation 389/2013).

For instance, Article 22(2) of the Registry Regulation 389/2013 provides that a national administrator may refuse to open an account if the prospective account holder is under investigation or has been convicted for fraud involving allowances or Kyoto units, money laundering, terrorist financing or other serious crimes for which the account may be an instrument, or if the national administrator has reasonable grounds to believe that the accounts may be used for fraud involving allowances or Kyoto units, money laundering, terrorist financing or other serious crimes. Pursuant to Article 34(1) of the Registry Regulation 389/2013, an administrator may suspend access to any account in the Union Registry if he/she has reasonable grounds to believe that the authorised representative has attempted to access accounts or processes to which he is not authorised or attempted to compromise the security, availability, integrity or confidentiality of the Union Registry or the EUTL, or of the data handled or stored therein.

Article 40 of the Registry Regulation 389/2013 on the nature of allowances, is important in the context of fraud, such as allowances theft. According to Article 40(1) of the Registry Regulation 389/2013, an allowance 'shall be a fungible, dematerialised instrument that is tradable on the market'. Article 40(2) specifies that the dematerialised nature of an allowance shall imply that the record of the Union Registry shall constitute *prima facie* and sufficient evidence of title over an allowance. Article 40(3) provides that the fungibility of an allowance shall imply that any recovery or restitution obligations that may arise under national law in respect of an allowance shall only apply to the allowance in kind. In the context of allowances theft, this provision means that victims can only request recovery or restitution in kind. They cannot request the recovery or the restitution of the exact allowances that were stolen from them. Article 104 provides that a transaction shall become final and irrevocable upon its completion. Without prejudice to any provision of remedy under national law that may result in a requirement or order to execute a new transaction in the Union Registry, no law, regulation, rule or practice on the setting aside of contracts or transactions shall lead to the unwinding in the registry of a transaction that has become final and irrevocable under the Registry Regulation 389/2013.

Importantly, 'an account holder or a third party shall not be prevented from exercising any right or claim resulting from the underlying transaction that they may have in law, including to recovery, restitution or damages, in respect of a transaction that has become final in the Union Registry, for instance in case of fraud or technical error, as long as this does not lead to the reversal, revocation or unwinding of the transaction in the Union Registry.'[510] As a result, in the context of allowances theft, victims (who can be either the account holder or a third party) have the right to claim recovery, restitution or damages for the damage suffered by them, but they cannot claim the reversal, revocation or unwinding of the transaction in the Union Registry. Finally, Article 40(4) provides that a purchaser and holder of allowances acting in good faith shall acquire title to an allowance free of any defects in the title of the transferor. This provision seeks to protect potential recipients of stolen allowances who have acquired these allowances in good faith. However, the interpretation of the concept of 'good faith' is left to national law, with the risk of divergent interpretations among Member States affecting both victims of allowances theft and purchasers of stolen allowances who were unaware of the fraudulent nature of the allowances they purchased.

It should be pointed out that some trading platforms and exchanges and service companies have adopted short-term solutions to protect market participants from the legal risks involved in buying stolen allowances on the EU ETS. In 2011, the BlueNext exchange opened a '**safe trading zone**', in

[510] Recital 8 and Article 40(3) third para of the Registry Regulation 389/2013.

which only allowances that have their chain of title traced back to the source of issuance and have been verified as not stolen could be traded. However, these solutions 'came at a cost and by no means represented long-term comprehensive solutions to protect the market from the confidence-disabling impacts of allowance thefts'[511].

**Block-chain technology** may also offer some opportunities to improve the traceability of allowances in the longer term. For instance, some energy commentators have suggested that applying block-chain technology to emission trading systems in general may improve transparency and traceability in data collection and governance structures, thereby improving trust in these schemes[512]. It has been observed that block-chain characteristics, such as transparency and immutability, could be satisfactory in terms of accuracy of data, which is an essential element in the credibility of emission trading systems in general[513]. However, before the use of block-chain technology is proposed, it should be noted that no governance rules exist as yet in this respect.

#### 8.2.1.3 Remedial measures taken against money laundering and market abuse

The EU introduced several provisions in the Registry Regulation 389/2013 and Auctioning Regulation 1031/2010 to address the threat of money laundering in the EU ETS and to detect and prevent occurrences of money laundering. More specifically, Article 98 of the Registry Regulation 389/2013 and Article 55 of the Auctioning Regulation 1031/2010 introduced new customer due diligence measures, which establish a tailored regime for the EU ETS registries system and auctioning (see Section 3.3.4).

Several provisions of the Registry Regulation 389/2013 seek to prevent the use of allowances transactions as a tool for money laundering or any other type of fraud. Under Article 97 of the Registry Regulation 389/2013, national administrators and the central administrator can suspend access to allowances when they suspect that the allowances have been the subject of fraud, money laundering, terrorist financing, corruption, or other serious crimes. Article 98 of the Registry Regulation 389/2013 requires the national administrator, its directors and employees to cooperate fully with the competent authorities to establish procedures to forestall and prevent operations related to money laundering or terrorist financing. This cooperation includes promptly informing the financial intelligence unit (FIU) of the Member States on their own initiative, where they know, suspect or have reasonable grounds to suspect that money laundering, terrorist financing or criminal activity is being or has been committed or attempted, as well as an obligation to provide all necessary information to the national FIU. This requirement is mirrored in Article 55 of the Auctioning Regulation 1031/2010.

Several other provisions of the Auctioning Regulation 1031/2010 are also concerned with primary criminal activities, such as money laundering, market abuse, insider dealing, inside information, or

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[511] Nield, K. and Pereira, R., 'Financial Crimes in the European Carbon Markets', in *Research Handbook on Emissions Trading*, Research Handbooks in Climate Law, Edward Elgar Publishing, 2016, p. 206.

[512] See, for instance, Burke, J., 'Don't write off Blockchain because of the Bitcoin hype', *businessGreen*, 8 February 2018. Available at https://www.businessgreen.com/bg/opinion/3026107/dont-write-off-blockchain-because-of-the-bitcoin-hype. Also, https://ac.els-cdn.com/S0306261917314915/1-s2.0-S0306261917314915-main.pdf?_tid=e019b254-17d5-11e8-bb1c-00000aacb35f&acdnat=1519306979_14c195ccf9ed65d1fb731fbfc5327730

[513] Khaqqia, N., Khamila, *et al.*, 'Incorporating seller/buyer reputation-based system in blockchain-enabled emission trading application', *Applied Energy* 209, 2018, pp. 8-19.

market manipulation, in the context of auctioning of allowances. For instance, under Article 21(2), an auction platform shall refuse to grant admission to bid in its auctions and revoke or suspend any admission to bids already granted, if it suspects money laundering, terrorist financing, criminal activity or market abuse in relation to an applicant. A due diligence check is carried out before granting admission to auctions. The auction platform shall notify the Member States of its suspicions of money laundering, terrorist financing, criminal activity or market abuse[514]. Additional provisions govern the notification of money laundering, terrorist financing or criminal activity[515], notification of market abuse[516], or contact rules for persons authorised to bid on behalf of others[517]. In line with Article 98 of the Registry Regulation (EU) No 389/2013 and Article 55 of the Auctioning Regulation 1031/2010 for an auction platform appointed pursuant to Article 26(1) or 30(1) of the Auctioning Regulation 1031/2010 can be held liable for infringements of the provisions against money laundering, terrorist financing or criminal activity. Article 55 of the Auctioning Regulation 1031/2010 includes requirements for the notification of money laundering, terrorist financing or criminal activity. Accordingly, the national competent authority must monitor and take the necessary measures to ensure that appointed auction platforms comply with the customer due diligence requirements set out in Article 19 and Article 20(6) of the Auctioning Regulation 1031/2010.

The classification of **allowances as financial instruments** will also have consequences for the risk of occurrence of money laundering in the EU ETS. From the moment allowances are considered financial instruments, entities trading them fall under the scope of the Anti-Money Laundering Directive 2015/849/EU[518]. This Directive imposes obligations on entities falling within its scope (such as financial institutions (including investment and brokerage firms)), such as the obligation to identify and verify the identity of their customers and that of the beneficial owners of their customers. In the context of the EU ETS, this means that MiFID II-licensed carbon traders will have to carry out mandatory customer due diligence checks on their clients in the secondary spot market in emission allowances[519].

While the tailored regime of the Registry Regulation 389/2013 will remain applicable for national administrators, it is worth noting that the customer due diligence measures ('know-your-customer'

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[514] Article 27(1)(g) and Article 28(1)(g) Auctioning Regulation 1031/2010.
[515] Article 55 Auctioning Regulation 1031/2010.
[516] Article 56 Auctioning Regulation 1031/2010.
[517] Article 59 Auctioning Regulation 1031/2010.
[518] Article 2(1) lists the entities to which the Anti-Money Laundering Directive applies:
(1) credit institutions;
(2) financial institutions;
(3) the following natural or legal persons acting in the exercise of their professional activities:
(a) auditors, external accountants and tax advisors;
(b) notaries and other independent legal professionals, where they participate, whether by acting on behalf of and for their client in any financial or real estate transaction, or by assisting in the planning or carrying out of transactions for their client concerning the: (i) buying and selling of real property or business entities; (ii) managing of client money, securities or other assets; (iii) opening or management of bank, savings or securities accounts; (iv) organisation of contributions necessary for the creation, operation or management of companies; (v) creation, operation or management of trusts, companies, foundations, or similar structures;
(c) trust or company service providers not already covered under point (a) or (b);
(d) estate agents;
(e) other persons trading in goods to the extent that payments are made or received in cash in an amount of EUR 10,000 or more, whether the transaction is carried out in a single operation or in several operations which appear to be linked;
(f) providers of gambling services.
[519] Report from the Commission to the European Parliament and to the Council, Report on the functioning of the European carbon market, 23 November 2017 (COM(2017) 693 final, p. 29.

obligations)[520] required under MiFID II will supplement the existing requirements of information for the carbon traders dealing with allowances. The latter will also have to report suspicions of money laundering or terrorist financing on the EU ETS to the public authorities[521].

#### 8.2.1.4 Remedial measures taken against market abuse

Once allowances are classified as financial instruments, they fall under the EU legal framework on market abuse. As a result, market manipulation, insider dealing, and unlawful disclosure of non-public information occurring in the context of allowances transactions is clearly prohibited under EU law.

As the EU ETS allowances were the subject of criminal market abuse, their status as financial instruments frames them within the financial legislation to deter this type of behaviour in the secondary market. The Market Abuse Regulation 596/2014 was adopted (replacing the Market Abuse Directive 2003/6/EC) following the 2008 financial crisis, with the aim of tackling some of the problems identified, particularly the lack of effective rules to fight the misuse of inside information and to prohibit market manipulation. The Market Abuse Regulation 596/2014 has reinforced the existing EU market abuse regime by expanding the rules established under MiFID II (Articles 31, 54, 57) and the Auctioning Regulation 1031/2010 (Article 56). The system is complemented by the Market Abuse Directive 2014/57/EU which requires Member States to establish appropriate sanctions whether administrative or criminal - to discourage, deter and punish any behaviour harmful to the functioning of the financial market.

The reporting obligations under MiFID II ensure compliance with other MiFID provisions as well as provisions on market abuse under the Market Abuse Regulation 596/2014. Reporting on the carbon market participants under MiFID II and the Auctioning Regulation 1031/2010 should provide CAs with the information necessary to scrutinise potential cases of market abuse and ensure cooperation in cases of cross-border market abuse.

#### 8.2.1.5 Options to strengthen the integrity of the EU ETS against criminal activity

The analysis demonstrated that defining the legal nature of an allowance, while it may improve legal certainty, is not necessarily the best solution to prevent the risk of criminal activity within the EU ETS. Instead, a strong regulatory framework overseeing all aspects of the EU ETS would represent the strongest approach to deterring fraud. Scholars, policy-makers, and other relevant stakeholders have suggested a number of options to improve the legal framework governing the EU ETS.

##### a. Innovative IT solutions

The promotion of innovative IT solutions has been suggested as an efficient way to prevent criminal activity. In the case of VAT fraud schemes, IT solutions include the promotion of electronic invoicing,

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[520] According to Article 13 MiFID II Directive 2014/65/EU, customer due diligence measures shall comprise identifying and verifying the customer's identity based on reliable documents; identifying and verifying the identity of the beneficial owner (in the case of legal persons, to understand the ownership and control structure); assessing information on the purpose and nature of the business relationship; and monitoring the business relationship.

[521] See Article 14 MiFID II Directive 2014/65/EU and its Chapter IV on reporting obligations (e.g. Article 40).

the adoption of a VAT Locator Number, or the introduction of real-time VAT collection[522]. One advantage of using IT solutions is that they avoid expensive administrative and financial burdens.

### b. Regulatory and administrative cooperation

The European Court of Auditors has insisted on both vertical and horizontal regulatory collaboration following the classification of allowances as financial instruments. For vertical cooperation, the Commission should collaborate with relevant stakeholders at national level, including national financial regulators, in respect of the functioning of the EU ETS[523]. For horizontal cooperation, there should be a system of ongoing and effective cooperation within the Commission, principally between the services responsible for EU ETS and financial markets regulation (DG Climate Action & DG Financial Services)[524]. In relation to VAT fraud schemes, there should be an improvement in the coordination of national tax authorities to avoid time-consuming and ineffective procedures when administrative assistance is needed by Member States[525]. Similarly, there is a need for systematic cooperation between the EU ETS authorities and those responsible for dealing with money laundering at national and EU level.

### c. Capacity-building

Some of the options cited above require investment in technology and human resources (training). It has been suggested that, despite the possible objections posed by stakeholders, the potential benefits would outweigh the financial costs[526]. Capacity-building will be particularly necessary to train regulators and law enforcement staff to deal with the growing complexity of allowances as they develop as financial instruments. In addition, there is a need to raise awareness among financial authorities and actors of the consequences of the classification of the EU ETS allowances as financial instruments and how the carbon market works.

**Table 8:**

| **Option: Combating criminal activity in the context of the EU ETS** | | | | |
|---|---|---|---|---|
| Type of measure required | Scope: (national/ EU) | Feasibility: low/medium/ high | Effort: low/medium/ high | Long/ medium/ short-term |
| VAT fraud: continuation of the reverse-charge mechanism | EU | Yes, already applicable | Amendment to VAT Directive | Medium |
| VAT fraud: classification of allowances as financial instruments | EU | No, the VAT Committee stated that the definition of allowances as financial instruments has no impact on the VAT treatment | - | - |
| Theft of allowances | | Legislation already adopted under the Registry Regulation 389/2013.<br>Block-chain technology could increase transparency; however, the relevant governance rules should be established first. | | |

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[522] Ainsworth, R., 2014, 'Phishing & VAT fraud in $CO_2$ permits: Dice in the EU-ETS now; Dice in power tomorrow', *Boston University School of Law*, Research Paper No 14-74. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2537545; Efstratios, 2012, p. 48.
[523] European Court of Auditors, 2015, p. 23.
[524] *Ibid.*
[525] Efstratios, 2012, p. 48.
[526] *Ibid.*, p. 49.

| | | |
|---|---|---|
| Money laundering/market abuse | EU | Consideration should be given to the question of whether the existing legal framework based on the tailored system under the Registry Regulation 389/2013 and the Auctioning Regulation 1031/2010, together with MiFID II, is sufficient |
| Money laundering/market abuse | EU/ national | Increased cooperation and awareness-raising of the consequences of the classification of EU ETS allowances as financial instruments |

### 8.2.2 Options for measures on taxation and accounting (excluding criminal activity)

The challenges arising from the **heterogeneity of taxation and accounting rules** could be most directly addressed by **harmonisation** of regulatory frameworks at EU level. It bears noting, however, that the EU has **very limited** competence – with stringent voting requirements – to promote harmonisation of tax frameworks across the Union. Rather than adopt formal legislation, a previous study set out three alternative recommendations to achieve greater coordination across Member States[527]:

- Adopting a set of best practice rules for taxation, outlining key voluntary taxation and accounting principles, along with coordinated treatment of allowances in the context of bilateral double taxation agreements. While this would only afford 'soft' harmonisation at EU level and would rely on cooperation between Member States to coordinate and implement adjustments to their domestic laws, it could still serve to reduce heterogeneity of tax treatment of allowances across Europe to some extent.
- Inclusion of tax and accounting treatment of allowances in the development of a Common Consolidated Corporate Tax Base (CCCTB) for businesses operating within the EU, which, if adopted, would mandate (or allow entities to opt for) taxation according to common rules rather than divergent national rules. Implementation of a CCCTB is being proposed through a Directive, necessitating successful passage of the legislative procedure in Article 115 TFEU and therefore unanimity in the Council, as well as consultation of the European Parliament and the Economic and Social Committee. Although potentially a more powerful lever to harmonise tax treatment of allowances across the EU, the political barriers to implementation are also significantly higher.
- Specifying the inclusion of allowances within the scope of the Interest and Royalty Directive 2003/49/EC. This option could achieve considerable harmonisation of the taxation of allowances at the European level, albeit only for those companies and specific constellations covered by the Interest and Royalty Directive. Here, too, the required legislative procedure would necessitate a unanimous vote in the Council.

These recommendations are discussed at length in the referenced report, including their respective benefits and shortfalls, and are not further detailed here.

Requiring uniform application of **international accounting standards** across the EU could help to introduce greater homogeneity and reduce the risks described. According to Article 3 of **Regulation (EC) No. 1606/2002**[528], the European Commission can require the application of **international accounting standards** in the EU under **certain conditions** and using a specified Committee procedure[529]. 'International accounting standards' are defined as comprising International Accounting

[527] Copenhagen Economics, 'Tax Treatment of ETS Allowances: Options for Improving Transparency and Efficiency', Taxation Studies from Directorate General Taxation and Customs Union, European Commission. 2010, No. 35, pp. 14-15.
[528] Regulation (EC) No. 1606/2002 on the Application of International Accounting Standards, OJ L 243/1 (2002).
[529] Conditions set out in Article 3(2) of Regulation (EC) No. 1606/2002 include that applicability of such international accounting standards be conducive to the European public good and that they meet the criteria of comprehensibility, relevance, reliability and comparability required of the financial information needed to make economic decisions and assess the stewardship of management.

Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), as well as subsequent amendments, future standards and related interpretations adopted by the International Accounting Standards Board (IASB).

In the past, the IASB has sought to adopt an IFRS on the accounting of pollutant pricing mechanisms but these efforts have stalled. Earlier guidance issued in December 2004 by the International Financial Reporting Interpretations Committee (IFRIC 3 Emission Rights), which classified **allowances as intangible assets**, set out rules for the treatment of allowances allocated free-of-charge and the duty to surrender allowances[530] was withdrawn following a recommendation by the European Financial Reporting Advisory Group (EFRAG) that it not be endorsed for use in the EU[531]. Although specifically developed to become effective at the time of the launch of the EU ETS in 2005, the IFRIC guidance met with opposition based on concern about unsatisfactory measurement and reporting mismatches.

Given the differences among its members, IASB instead opted to conduct a broader assessment of the issue, including whether and how existing standards should be amended to reduce or eliminate some of the challenges in accounting for emission rights. A joint research project of the IASB and the US Financial Accounting Standards Board (FASB) to prepare potential future guidance on the accounting implications of emission trading systems was abandoned in 2010, and later reactivated as an IASB-only research project. Rather than create a new standard or an interpretation or amendment of existing standards, the project was initially expected to produce a **discussion paper** assessing potential reporting solutions in emission trading systems. The project was designed to address accounting for allowances awarded by a system administrator, as well as those liabilities associated with the emission of GHG.

The project was also to assess whether or not allowances should be subject to **international accounting standards for intangible assets** (IAS 38 – Intangible Assets) or for **financial instruments** (IAS 39 – Financial Instruments: Recognition and Measurement), a question that might be affected by their changed classification under MiFID II. Again, however, this research project appears to have stalled. Following a change in project name from 'Emission Trading Systems' to 'Pollutant Pricing Mechanisms' in February 2015, IASB staff updated the Work Plan in July 2016 to indicate that the project is on hold. In November 2016, IASB declared the project 'not currently active', but included it in a list of future research projects that are expected to start, or restart, before the next Agenda Consultation, scheduled to begin in 2021[532].

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[530] IFRIC 3 specified that allowances 'are intangible assets that should be recognised in the financial statements in accordance with IAS 38 - Intangible Assets'. Additionally, when allowances are issued to a participant by a government (or government agency) for less than their fair value, IFRIC 3 stipulated that 'the difference between the amount paid (if any) and their fair value is a government grant that is accounted for in accordance with IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance'. Finally, IFRIC 3 also recognised that as a participant produces emissions, provision for its obligation to deliver allowances should be made in accordance with IAS 37 - Provisions, Contingent Liabilities and Contingent Assets. This provision is normally measured at the market value of the allowances needed to settle it. See IASB, IFRIC 3 – Emission Rights (withdrawn), available online at: https://www.iasplus.com/en/standards/ifric/ifric3 (last accessed on 31 May 2017).

[531] EFRAG, Letter to the European Commission Directorate General for the Internal Market, 6 May 2005. Available online at: http://www.iasplus.com/en/binary/efrag/0505ifric3endorsementadvice.pdf (last accessed on 10 April 2016).

[532] IASB, Pollutant Pricing Mechanisms (formerly Emissions Trading Schemes), November 2016. Available online at: https://www.iasplus.com/en-ca/projects/ifrs/research-projects/pollutant-pricing-mechanisms-formerly-emissions-trading-schemes (last accessed on 31 May 2017).

For work to proceed on the **development of a new international accounting standard**, an amendment of one or more existing international accounting standards, or guidance and interpretation of one or more existing international accounting standards, the current impasse at **IASB** would have to be overcome. While the development of international guidance could prompt greater convergence of Member State practices and the Commission could even require its application by Member States subject to the conditions set out in **Regulation (EC) No. 1606/2002**, it remains unclear how the EU alone could significantly advance the agenda item within IASB. Nonetheless, strong **support from EFRAG** could conceivably provide the necessary impetus to arrive at a **uniform international accounting practice**.

The literature describes several options to address the heterogeneous treatment of allowances for accounting and taxation purposes (see above). Given the limited EU legislative powers here, some of these options are non-legislative in nature and aim to establish a common understanding or harmonised best practice in the treatment of allowances across Member States.

**Accounting practices are very much linked to taxation** and these also differ to some extent between Member States. While the development of **recommended practices** at EU level is likely to be the most viable solution in the short term, it will also by its very nature have limited ability to achieve full harmonisation.

Other proposals, such as the advancement of IASB guidance or amendments to the Interest and Royalty Directive 2003/49/EC to include allowances under its harmonised taxation rules, will have a significantly longer lead time but also offer greater reliability.

Each of these options has the potential to reduce the current heterogeneity of accounting and tax treatment of allowances in Europe. Even partial harmonisation has the potential to reduce transaction costs, increase legal certainty and avoid the incidence of double taxation or tax avoidance strategies.

**None of the proposals in isolation would achieve full harmonisation** of the treatment of allowances for taxation and accounting purposes, as each addresses only a subset of the many ways in which allowances are treated differently across Member States. Full harmonisation of all identified taxation and accounting issues, meanwhile, would require a considerable reform effort, exceeding the scope of EU legislative competence.

Some of the options described above (recommended best practices, IASB guidance or standards) would require a political effort to advance the **harmonisation of tax and accounting treatment of allowances**, which in turn would presuppose **greater awareness and acknowledgment of the challenges** posed by current heterogeneous practices. This could be supported by further research on the issue, followed by targeted communication and awareness-raising among relevant policy makers at national and EU level. At the European level, the process could be formally coordinated by DG Climate Action working with DG Taxation and Customs Union, or less formally by a private body such as EFRAG.

An **amendment to the Interest and Royalty Directive 2003/49/EC** or to the relevant secondary legislation proposed with a view to a **Common Consolidated Corporate Tax Base (CCCTB**) would necessitate passing the relevant legislative procedure set out in Article 115 TFEU (i.e. requiring a unanimous vote, as well as consultation of the European Parliament and the Economic and Social Committee). Given past objections by individual Member States to attempts to develop uniform international guidance on the accounting of allowances (IFRIC 3 - Emission Rights), it is unclear if unanimity is achievable in the Council, suggesting that further informal or working-level discussions on the urgency of the problem and the need for a legislative solution would have to precede any formal legislative proposal.

**Table 9:**

| **Option:** Taxation and accounting (excluding criminal activity/law) | | | | |
|---|---|---|---|---|
| Type of measure required | Scope: national/EU | Feasibility: yes/no | Effort: low/medium/high | Long/medium/ short-term |
| Recommended best practices for accounting and taxation of allowances | EU/European | Unclear | Process coordinated by DG Climate Action and/or Taxation and Customs Union, or less formally, e.g. by EFRAG | Achievable in the short to medium term, could offer long-term (but partial/imperfect) solution |
| International accounting guidance or standards | Joint, through EFRAG | Low<br>EFRAG has in the past shown influence in shaping outcomes of IFRIC guidance on the topic | Through its involvement in IASB processes, EFRAG could stimulate renewed effort to adopt IAS/IFRIC guidance or standard on allowances | Medium |
| Interest and Royalty Directive 2003/49/EC | EU | Low<br>Harmonised tax treatment already specified for interest and royalty payments | Legislative amendment using process under Article 115 TFEU, requiring unanimity | Long-term |
| Common Consolidated Corporate Tax Base | EU | Low<br>Legislative proposals of 2016 could be amended to add provision on allowances | Amended proposal would still have to pass legislative process under Article 115 TFEU, requiring unanimity | Long-term |

### 8.2.3 Options for measures relating to financial legislation

The classification of EU ETS allowances as financial instruments raises the question of whether or not the application of MiFID II can help to clarify the legal nature of emission allowances at national level, particularly where they confer rights *in rem* or *in personae* or give rise to both types of rights.

Financial legislation does not provide any clarification on the legal nature of EU ETS allowances, as financial instruments may take different legal forms and have different legal nature with different consequences. While the classification of emission allowances as financial instruments clarifies the regulatory framework applicable to those allowances, it does not provide full legal certainty about the rights conferred upon the holders of EU ETS allowances, as described below.

For the implementation of MiFID II, the national legislation of the five selected Member States simply states that emission allowances are classified as financial instruments, or that they should be regarded as such for the implementation of relevant provisions of MiFID II, but without providing further clarification on their legal nature.

The main consequence of classifying emission allowances as financial instruments is that the spot segment of the secondary market of the EU ETS is then regulated by MiFID II/MiFIR and other financial market rules requirements applied to market players when trading emission allowances and derivatives, unless they are exempt. This ensures consistency between the primary market for auctioned two-day spot and five-day futures contracts on the one hand, and financial markets' rules, now applying to all segments of the secondary market, on the other.

MiFID II has changed the compliance obligations regarding investor protection, requiring information to be provided to clients on the functioning of the carbon market and the nature of the traded instruments, as well as reporting to the public, clients and CAs on the positions taken in emission allowances (Articles 24 and 58 MiFID II). In addition, MiFID II establishes pre-trade transparency obligations (i.e. making public indications of interest, bids and quoted prices (bid and offer) and depth of trading) and post-trade transparency obligations (i.e. to make the price, volume and time of transactions available (subject to deferral of disclosure for transactions depending on market size)) which need to be published on a reasonable commercial basis as close to real time as is technically possible.

While the rules on transparency of the auctioning process (Articles 60 to 63 of the Auctioning Regulation 1031/2010) mirror those laid down by MiFID II, one of the key questions is the compatibility between the new pre and post-trade transparency provisions laid down by MiFID II and the older provisions of the Auctioning Regulation 1031/2010. These requirements have triggered two categories of market players: those who are extensively covered by financial market rules (investment firms, brokers) and those who are not (EU ETS operators or other stakeholders exempt from MiFID II under certain conditions). Even if MiFID II requirements do not affect the legal nature of emission allowances, they improve the efficiency of trading, provide more safety against market abuse, and increase the level of transparency and integrity of emission traded on the secondary market, providing more certainty for the development of the carbon market itself.

However, the classification of emission allowances as financial instruments raises issues in relation to the possibility of taking and giving collateral when transferring allowances (by way of pledge or security interest or by title transfer collateral arrangement) under the regime established by Settlement Finality Directive 98/26/EC for designated systems, or under the regime established by the Financial Collateral Directive 2002/47/EC, which facilitates the use of (cross-border) collateral in either cash or financial instruments outside a designated system. The Settlement Finality Directive 98/26/EC applies

to the 'financial instruments' listed in MiFID II, and can be considered both as 'securities' under Article 2(h) and as collateral securities or 'realisable asset' which confer rights in rem in accordance with Article 2(m) of the Settlement Finality Directive 98/26/EC. This implies that even if the legal nature of emission allowances is not clearly defined by EU or national law, they may nevertheless benefit from the protection regime laid down by Article 9 of the Settlement Finality Directive 98/26/EC.

The protection offered by Articles 4 and 5 of the Financial Collateral Directive 2002/47/EC setting out minimum formal requirements concerning collateral arrangements facilitates their enforcement through the recognition of a contractually agreed **right to use the financial collateral**. The legal protection of the system is reinforced by Article 8, on the order of payment in case of insolvency, and Article 9, on the conflicts of law. However, there are no specific provisions stating that Financial Collateral Directive 2002/47/EC and its safeguards apply specifically to emission allowances as financial instruments[533]. While some clearing houses accept emission allowances as collateral, their protection system is based on certain conditions established on the basis of private law contracts and not on the legal protection system of the Financial Collateral Directive 2002/47/EC. As suggested in Section 6.5 of this report, one option could be to extend the protections afforded to takers of collateral under the Financial Collateral Directive 2002/47/EC to expressly include emission allowances in the definition of financial instruments. However, this proposal might not be enough to ensure protection in cases of insolvency. The Commission could also consider amending the Registry Regulation 389/2013 and other EU legislation, as proposed by the FMLC in October 2009.

These proposals are analysed under Section 6.5, on the use of allowances as collateral and the options are described again below.

### 8.2.4 Options for measures regarding security interests on allowances

#### 8.2.4.1 Partial harmonisation of EU law

As outlined in earlier sections, a variety of factors currently increase uncertainty associated with **using allowances as collateral** or determining title in the **event of insolvency**[534]. While EU rules have established a harmonised recognition of the EU ETS allowances as financial instruments, the lack of a **harmonised approach** to their legal nature in other respects across Europe leads to their being treated differently in different jurisdictions, potentially affecting the validity and predictability of any security arrangements involving allowances. The associated challenges will become further magnified in circumstances of default or insolvency[535].

[533] 'Financial instruments' are defined by the FCD as 'shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing' (Article 2(1)(e)).

[534] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, Section 9.2.3.

[535] FMLC, Response to the EU ETS Stakeholder Consultation Survey, 15 October 2013, Letter of 18 February 2014, p. 2.

The European Court of Auditors has thus recommended adopting an 'express EU-level provision that emission allowances are capable of supporting the existence of security interests, and a registration mechanism for such interests' as a way to increase the commercial value of emission allowances for market participants[536]. Similarly, the FMLC has proposed full or partial harmonisation of substantive law at EU level, or at least 'minimal treatment of the question of whether allowances are capable of being the subject of security interests'[537].

More specifically, the FMLC has outlined three different options for legislative reform at EU level[538]:

- Harmonizing conflict of law rules in the Member States: requiring Member States to apply a uniform set of conflict of law rules for contractual and proprietary issues would reduce uncertainty about applicable law and jurisdiction and reduce the risk associated with allowances used as collateral or affected by insolvency.
- Partial harmonisation of substantive law: such partial harmonisation would include clarification at EU level of the possibility of creating security, or other limited proprietary interests, in allowances. This would include any necessary formal and substantive requirements, the option to register security interests in emission allowances, and priorities between competing claims to emission allowances.
- Complete harmonisation or adoption of a Community Code: legislation would seek to harmonise all legal issues relevant to EU ETS allowances.

While full harmonisation of the rules on security interests and insolvency would offer the greatest benefits in terms of addressing heterogeneous treatment of allowances across Member States, limitations in the legal competence of the EU and consistency with the principle of subsidiarity are likely to rule out this option.

**Partial harmonisation** to allow security or other limited proprietary interests in allowances may offer a more realistic prospect for legal certainty without unduly interfering with national legal systems. **Amendments to the Financial Collateral Directive 2002/47/EC or the Registry Regulation 389/2013**, or technical changes to the registry operation, would improve certainty and predictability of security interests (and, in the case of the Financial Collateral Directive 2002/47/EC, for certain institutional actors only), allowing constructions other than collateral through full transfer of title. In all cases, partial or full **harmonisation** is expected to increase the commercial value of emission allowances for market participants, and, possibly, increase trading activity and liquidity.

Allowing registration of security interests in allowances through the Union Registry has been proposed as a more direct and limited measure to encourage the use of allowances as collateral[539]. Without such a change, only collateral provided through a full transfer of title will be reliable and valid across all Member State jurisdictions. When the Registry Regulation 389/2013 was being

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[536] European Court of Auditors, 'The integrity and implementation of the EU ETS', Luxembourg: Publications Office of the European Union, 2015, p. 25, para. 28. Available at: http://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf

[537] FMLC, Commission Regulation establishing a Union Registry in connection with the Union emissions trading scheme, Letter of 5 January 2012, p. 2.

[538] FMLC, Emissions Allowances: Creating Legal Certainty. Legal assessment of lacunae in the legal framework of the European Emissions Trading Scheme and the case for legislative reform, 2009, pp. 18-20, paras. 6.2-6.7. Available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/116e.pdf

[539] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, p. 78.

negotiated, discussions about including such a provision collapsed very late in the process[540]. Instead, Recital 27 of the Registry Regulation 389/2013 merely states that 'taking of a security interest' in allowances 'should be examined in the context of a future review of this Regulation.' It is possible that Member State views on the legal nature of allowances, and thus the possibility to create inherent security interests, were too heterogeneous for consensus. Whether political appetite for such a change has grown since the enactment of the Registry Regulation 389/2013 is difficult to ascertain, but obstacles are likely to remain.

Additionally, or alternatively, the protections afforded to takers of collateral under **Financial Collateral Directive 2002/47/EC** could be **extended to allowances**. One study suggests that bringing allowances within the scope of the Financial Collateral Directive 2002/47/EC would 'bring commercial and legal advantages and would also be relatively straightforward to implement'[541]. Doing so would offer greater legal certainty to allowance holders and those parties who accept allowances as collateral (such as some clearing houses), potentially lowering opportunity costs for parties and increasing the market value of allowances. In particular, because the Registry Regulation 389/2013 does not allow limited interest to be registered in allowances, the applicability of Financial Collateral Directive 2002/47/EC to allowances (including its Article 3 disallowing the need for a formal act to establish a security interest) would not only promote uniformity across the EU but would also help to address the limitations of the Registry Regulation 389/2013. Such an extension could be effected by amending Financial Collateral Directive 2002/47/EC to refer directly to the financial instruments listed in Section C of Annex I to MiFID II. As political readiness to amend Financial Collateral Directive 2002/47/EC may be limited at present, a similar option would instead rely on the Member States to include all financial instruments covered by MiFID II – including allowances – in the scope of their implementing national legislation[542]. Barring a concerted and coordinated process, however, this approach would likely result in renewed heterogeneity between Member States, and therefore fail to fully dispel the legal uncertainty caused by divergent national approaches.

Each of the proposed options described above has its own legal and procedural requirements. Wholesale **harmonisation** of the regulatory **framework applicable to security interests and insolvency** would require legislation most likely adopted under Article 114 TFEU on the approximation of laws to ensure the functioning of the internal market (Article 26 TFEU), applying the ordinary legislative procedure described in Article 294 TFEU. **Amending Financial Collateral Directive 2002/47/EC** would also be based on Article 114 TFEU (as the legal basis of the current Directive) and would likewise occur through the ordinary legislative procedure.

Finally, amending the Registry Regulation 389/2013, would require merely technical or operational solutions that could be achieved by allowing the establishment of locked sub-accounts with access restrictions, for example, or other means of granting control of allowances in accounts by persons other than the legal owner. These would require changes in the registry by the authorities responsible for its operation, and could likely be introduced without legislative changes.[543]

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[540] FMLC, Commission Regulation establishing a Union Registry in connection with the Union emissions trading scheme, Letter of 5 January 2012, p. 2.
[541] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015.
[542] Section 7 of this study.
[543] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015, p. 78.

At this point it appears very unlikely that Member States would back a new legislative initiative to harmonise considerable parts of domestic private law (i.e. the legal frameworks relating to security interests and insolvency. Likewise, there is no indication of political support for an amendment of Financial Collateral Directive 2002/47/EC, which represents the extent to which Member States have agreed to delegate the regulation of security interests to European level.

As outlined above, Recital 27 of the Registry Regulation 389/2013, states that 'taking of a security interest' in allowances 'should be examined in the context of a future review of this Regulation.' At the time of writing, the work on amending the Registry Regulation 389/2013 was ongoing.

Any legal issues that are not currently harmonised, such as treatment of allowances in the event of insolvency, would remain within the purview of the Member States. However, even where legal obstacles to such reform efforts might be overcome, the political will for far-reaching harmonisation is likely to be elusive. Even increased efforts among Member States to coordinate conflict of law rules are not likely to be politically straightforward, with a risk that only a subset of Member States would be willing to amend their domestic legislation accordingly.

Harmonisation of the rules on security interests and insolvency, amendment of the Financial Collateral Directive 2002/47/EC, or amendment of the Registry Regulation 389/2013 would all have substantial lead time but offer a permanent (if not ever entirely comprehensive) solution. These can thus be considered long-term solutions. Mere technical or operational changes to the Union Registry could be a shorter term and more flexible solution, provided they are designed to be compatible with the current legal framework.

Adoption of harmonising legislation on security interests and insolvency, or amendment of existing secondary legislation on financial collateral, would require the ordinary legislative procedure of Article 294 TFEU. Changes to the Registry Regulation 389/2013 could occur through a non-legislative procedure for the adoption of a delegated act. Merely technical or operational changes to the Union Registry could be achieved by the authorities responsible for operating the Union Registry, requiring appropriate changes to the Union Registry software and technical or guidance documentation, all of which are developed exclusively under the provisions of the ETS Directive 2003/87/EC and the Registry Regulation 389/2013.

**Table 10:**

| **Option:** Security interests in allowances and treatment of insolvency | | | | |
|---|---|---|---|---|
| Type of measure required | Scope: | Feasibility: yes/no | Effort: | Long /short-term |
| Full harmonisation of rules relating to security interest/insolvency | National /EU | No; Conferring legislative power on security interests/insolvency through the adoption of a directive to harmonise rules EU-wide | Adoption of secondary legislation | Long-term |
| Allowing registration of security interests in allowances under the Registry Regulation 389/2013 | EU | Unclear; Amendment to the Registry Regulation 389/2013 | Amendment to the Registry Regulation 389/2013 | Long-term |
| Allowing sub-accounts with restricted access under the Registry Regulation 389/2013 | EU | Yes; Addition of security register function | Amendment to technical guidelines and registry software | Short-term |
| Inclusion of allowances in financial collateral Directive 2002/47/EC | EU | Unclear; Amendment to Financial Collateral Directive 2002/47/EC to refer directly to MiFID II, Annex I, Section C | Amendment to the FCD | Long-term |

# 9 Conclusions

The analysis carried out for this study suggests that greater clarity on the definition of the legal nature of emission allowances might not provide legal certainty on the rights deriving from allowances, nor would it necessarily have an impact on the liquidity of the emission market or the protection of security interests in allowances. The study shows that the approach in the Member States differs, generating certain legal uncertainty. However, the study did not identify major practical problems directly linked to the lack of definition of the legal nature of the allowances or, indeed, any issues that would be solved by a harmonised definition of the legal nature of the allowances.

Even if the legal nature of EU ETS allowances were defined by EU law, the meaning and scope of the rights attached to such classification is not automatic and would still need to be properly determined under the relevant legislation. In this sense, the AG of the ArcelorMittal case[544] argued that a definition of the legal nature of allowances is unnecessary as it is sufficient for the Court to determine whether the allocation and subsequent order to surrender the allowances complies with the ETS Directive 2003/87/ EC. The Court ruling on the case did not define the nature of the EU ETS allowances but considered that the allowances issued after an operator has ceased the activities performed in the installation to which those allowances relate, without informing the competent authority beforehand, cannot be classified as emission 'allowances' within the meaning of Article 3(1)(a) of the ETS Directive 2003/87/ EC [545].

The Commission could propose to clarify the legal nature of the EU ETS allowances by an act of EU law despite Article 345 TFEU. The CJEU considers Article 345 TFEU an expression of the principle of neutrality of the Treaties in respect of questions of private or state ownership of companies[546]. Some authors follow this interpretation and state that this provision does not confer any exclusive powers to deal with property law to the EU or the Member States[547] and therefore, it does not form an obstacle to the development of a European property law'[548]. However, there are no legal assurances that such a harmonisation measure would be feasible.

The characterisation of allowances seems to have evolved in response to the specific issues raised during its implementation, affecting the functioning of the EU ETS and triggering the modification of several areas of EU law. MiFID II entered into force on 3 January 2018 and defines allowances as **financial instruments**. This classification raises the question of whether or not the application of MiFID II can help to clarify the legal nature of emission allowances at national level, particularly where they confer rights *in rem* or *in personae* or give rise to both types of rights.

Liquidity of the market for emission allowances has not been a major concern for the EU ETS. Until recently, an issue potentially affecting the liquidity of the European carbon market has been (arguably) the surplus of emission allowances on the market. The scarcity of allowances has been dealt with by the implementation of the Market Stability Reserve (MSR). However, other measures might be

[544] Preliminary ruling from the Luxembourg Court http://publications.europa.eu/en/publication-detail/-/publication/3d9ac471-4287-11e6-af30-01aa75ed71a1/language-en/format-HTML/source-search
[545] Court of Justice of the EU on the Case C-321/15 Arcelor v Luxembourg, can be found at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=188666&pageIndex=0&doclang=FR&mode=req&dir=&occ=first&part=1&cid=157476
[546] Joined cases C-105/12 to 107/12 request for preliminary ruling from Hoge Raad der Nederlanden para 29
[547] Akkermans, B. and Ramaekers, E., at p.308.
[548] Akkermans, B. and Ramaekers, E. at p.292

necessary to provide information and advice, training and capacity-building for operators on the interaction of the EU ETS in relation to the implementation of MiFID II and Market Abuse Regulation 596/2014. Measures are also necessary to improve cooperation between administrative bodies (in particular, between those in charge of the EU ETS and those responsible for MiFID II and the market abuse regime) and establish structural mechanisms to ensure systematic cooperation.

Although measures have already been taken to tackle criminal activities affecting the EU ETS allowances, including market abuse and money laundering, there is a need to ensure consistency of the transparency and reporting obligations under MiFID II and the market abuse regime.

The VAT Directive 2006/112/EC considers the sale and transfer of EU ETS allowances as supply of services subject to VAT. As a response to the so-called 'carousel fraud' in the transfers of allowances from one Member State to another on the secondary spot market[549], the reverse-charging accounting rule was introduced in 2010. Based on the positive results, the legislator adopted the amendment to the VAT Directive 2006/112/EC prolonging the application of the reverse-charge mechanism derogation that was published in the Official Journal on 12 November 2018[550].

Financial legislation does not provide any clarification on the legal nature of EU ETS allowances, but it clarifies the regulatory framework applicable to emission allowances. Even if MiFID II requirements do not affect the legal nature of emission allowances, they improve efficiency of trading, provide more safety against market abuse, and increase the level of transparency and integrity of emission trading on the secondary market, providing more certainty for the development of the carbon market itself.

However, the classification of emission allowances as financial instruments raises issues with the possibility of taking and giving collateral when transferring allowances (by way of pledge or security interest or by title transfer collateral arrangement). The current legal framework governing the EU ETS, including both the Auctioning Regulation 1031/2010 and the Registry Regulation 389/2013 imposes limitations on the types of collateral arrangements available to allowance holders looking to use these as security. In its current form, the Financial Collateral Directive 2002/47/EC does not extend its legal protections to financial collateral arrangements involving allowances. The scope of the Financial Collateral Directive 2002/47/EC could be extended to include allowances in order to 'bring commercial and legal advantage. It would also be relatively straightforward to implement'[551]. Doing so would offer greater legal certainty to allowance holders and those parties who accept allowances as collateral (such as some clearing houses), potentially lowering opportunity costs for parties and increasing the market value of allowances.

[549] For instance, in the UK, see *R v Dosanjh and others* [2013] EWCA Crim 2366. In France, various individuals and companies have been found guilty of VAT fraud (Nathanael in 2012; Keslassy in 2013). See also Cour des Comptes, 2012, *Rapport public annuel 2012*, pp. 147-196; Robert, A., 'Deux Français et un Polonais suspects de fraude sur le $CO_2$ encourent de Lourdes peines', *EurActiv.fr*, 2016, available at : http://www.euractiv.fr/section/justice-affaires-interieures/news/deux-francais-et-un-polonais-suspects-de-fraude-sur-le-co2-encourent-de-lourdes-peines (viewed on 31 January 2017).

[550] Council Directive (EU) 2018/1695 of 6 November 2018 amending Directive 2006/112/EC on the common system of value added tax as regards the period of application of the optional reverse-charge mechanism in relation to supplies of certain goods and services susceptible to fraud and of the Quick Reaction Mechanism against VAT fraud.

[551] Europe Economics and Norton Rose Fulbright, Interplay between EU ETS Registry and Post Trade Infrastructure, Study commissioned by the European Commission, Publications Office of the European Union, 2015.

# Glossary

| | |
|---|---|
| CCCTB | Common Consolidated Corporate Tax Base |
| CJEU | Court of Justice of the European Union |
| EFRAG | European Financial Reporting Advisory Group |
| EUTL | European Union Transaction Log |
| ESMA | European Security and Markets Authority |
| EU ETS | European Union Emission Trading System |
| FASB | Financial Accounting Standards Board |
| FCD | Financial Collateral Directive 2002/47/EC |
| FCA | Financial Conduct Authority |
| FMLC | Financial Markets Law Committee |
| FSMA | Financial Security Markets |
| IASB | International Accounting Standards Board |
| MAR | Market Abuse Regulation |
| MiFID II | Markets in the Financial Instruments Directive 2014/65/EU |
| MiFIR | Markets in Financial Instruments |
| NAP | National Allocation Plan |
| PRA | Prudent Regulatory Authority |
| SFD | Settlement Finality Directive 98/26/EC |
| TFEU | Treaty on the Functioning of the European Union |
| VAT | Value Added Tax |

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