

Review of the Markets in Financial Instruments Directive (MiFID) and Proposals for a Regulation on Market Abuse and for a Directive on Criminal Sanctions for Market Abuse: Frequently Asked Questions on Emission Allowances

General

1. Why is the Commission taking action to enhance oversight of the carbon market?

The lion's share of transactions in emission allowances are in the form of derivatives (futures, forwards, options), which are already subject to EU financial markets regulation. However, transactions for immediate delivery of allowances (also called "spot" transactions) are currently not subject to equivalent rules at the EU level and are not supervised. In the past, some carbon exchanges even "packaged" emission allowances as financial instruments (futures with a few days delivery period) which showed that many market participants expected protections and benefits of trading in financial instruments and had a clear preference for allowances offered in such form over instantly available allowances (spot) traded on other venues. To address this gap, the Commission has decided to come forward with proposals for a suitable regulation of this segment of the carbon market.

2. What does the Commission expect to achieve by applying financial markets rules to all segments of the carbon market?

The carbon market has experienced significant growth in size and sophistication. The European carbon market is the EU's flagship policy to reduce greenhouse gas emissions and has a crucial role to play over the coming decades in the transition to a low-carbon economy. As the Commission's low-carbon roadmap has indicated, this transition requires significant investments in the coming decades. The carbon market therefore needs a robust level of oversight in order to facilitate investments in this low-carbon transition.

The Commission's proposals also aim to provide a safe and efficient trading environment to enhance confidence in the carbon market in the wake of a series of unfortunate fraudulent activities which the market has experienced in recent years.

The Commission wants to enhance this market's overall transparency both in terms of data publicly available to all participants and the information submitted to supervisors. We also want to ensure the ability of supervisors to act swiftly and decidedly on cases of misconduct, unfair treatment of clients and threats to orderly functioning of the market. All this will be to the benefit of other market participants and clients of professional traders and intermediaries (often EU Emissions Trading Scheme (ETS) compliance buyers relying on professional help to buy and sell emission allowances). The rules of the Markets in Financial Instruments Directive (MiFID) and Regulation (MiFIR) will deal with all those matters.

It is furthermore necessary to minimise the risk of market abuse – comprising both insider dealing and market manipulation - in the carbon market. The proposed rules on market abuse – more specifically the proposals for a Market Abuse Regulation (MAR) and a Criminal Sanctions for Market Abuse Directive (CSMAD) – will deliver that.

Last but not least, professional intermediaries in the carbon market would be required to apply customer due diligence measures as provided by the Anti-Money Laundering Directive¹. Such verification would complement the measures foreseen already at the level of the EU ETS registries and would contribute to overall enhanced protection of the market from money laundering risks.

3. Has the Commission consulted stakeholders?

The Commission has been able to benefit from a useful and informative dialogue with industry, carbon traders, Member States, academics and other stakeholders on this issue in the context of the consultation reviewing MiFID² launched in December 2010, the Commission Communication³ of 21 December 2010 "Towards an enhanced market oversight framework for the EU Emissions Trading Scheme", a dedicated stakeholder meeting organised by the Commission services⁴ on 4 May 2011, the open invitation to stakeholders to submit comments and position papers between May and October 2011 and numerous discussions with individual stakeholders through to September 2011. We have taken into due account all stakeholders' arguments for and against classifying emission allowances as financial instruments.

4. Has the Commission prepared an impact assessment?

The Commission has duly considered the impacts of classifying emission allowances as financial instruments and submitting them to financial markets rules. Those impacts are presented in the impact assessment report accompanying the MiFID/MIFIR review proposals.

5. Why has the Commission opted for coverage of all segments of the carbon market by financial market rules instead of proposing a separate, tailor-made regime or the coverage of the carbon market by energy market rules?

Any emerging regime for the spot carbon market would need to be fully coherent with the regulation of financial markets, in particular as the lion's share of the carbon market today consists of derivatives trading and is hence covered by financial market rules. Furthermore, the regulatory framework for the auctioning of emission allowances as of 2013 is closely aligned in key respects with the rules applicable for the secondary market in financial instruments. Any regime would also need to embrace adequate measures against market abuse, based on the MAR/CSMAD.

¹ Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:309:0015:0036:EN:PDF>

² http://ec.europa.eu/internal_market/consultations/2010/mifid_en.htm

³ http://ec.europa.eu/clima/events/0034/com_2010_yyy_en.pdf

⁴ http://ec.europa.eu/clima/events/0034/index_en.htm

Coverage by the financial market rules further stabilises the carbon market and ensures its robustness. It also gives a clearer regulatory status to emission allowances. In only five years, the European carbon market has grown from around €6 billion annual turnover to €90 billion. According to analysts, it is expected to continue to grow tenfold by the turn of the decade. As the market grows, the coverage by financial market rules will provide a comprehensive regulatory framework that will still be adaptable to carbon market specificities.

The Commission has examined the merits of a tailor-made regime. However, as all stakeholders acknowledge, even a tailor-made regime would have to reproduce the overall approach and most of the technical solutions already found in the MiFID/MAD. It is also questionable whether the coverage of the spot segment (currently a very small part of the overall carbon market activity) would actually justify development of a fully separate regime, which would also bear the risk of inconsistencies with the rules that already govern the largest part of the market.

Lastly, placing the spot carbon trade under a potentially less stringent set of rules than is the case for carbon derivatives trade may eventually be detrimental to the spot segment's prospects.

The proposed rules are coherent with the Regulation on Energy Markets Integrity and Transparency REMIT, where appropriate, for example as regards the duties to disclose inside information. The REMIT established a suitable framework for transparency and integrity in the electricity and gas markets. However, there are many quite specific elements in the REMIT which build on past legislation developed exclusively for the energy sector. At the same time, there are many other sectors covered by the EU ETS – the application of energy markets specific rules would not be appropriate in their case.

Supervision of market participants is another area where the approach of REMIT would not be optimal for the carbon market: wholesale energy markets activity would be subject to supervision of energy regulators while carbon derivatives markets are within the competence of financial regulators. Coverage of the spot carbon market by financial markets legislation rather than by the REMIT makes it possible to attribute market oversight competences for both spot and derivatives trading to just one category of public authorities – financial supervisors, under the coordination of the European Securities Markets Authority (ESMA).

6. How has the MiFID/MAD regime been tailored to EU ETS specificities?

The new market abuse regime will include several carbon-specific elements for example, a specific definition of inside information, a tailored inside information disclosure duty, and a complete coverage of the primary market (auctioning).

Individual ETS compliance buyers buying and/or selling emission allowances on own account as well as entities like trade associations which will provide investment services in emission allowances will be exempted from authorisation and compliance duties under the new MiFID as long as (i) this activity will be ancillary and (ii) they are not part of a financial group. If those two conditions are fulfilled, this exemption will also be available to companies other than financial intermediaries providing investment services to the group they are part of.

Trading venues will not be required to set position limits with regard to emission allowances.

Specific pre- and post-trade transparency requirements will be developed in due consideration of the specificities of emission allowance as an instrument of trade and the genuine carbon market features.

7. What carbon market instruments are effectively included in the scope of MiFID and MAD?

In addition to derivatives, the new MiFID/MiFIR and MAR/CSMAD rules will apply to emission allowances and other units recognised for compliance under the EU ETS (i.e. also including secondary market transactions in Certified Emission Reductions (CERs) and Emission Reduction Units (ERUs) which have been issued pursuant to the relevant process and are held on registry accounts in the EU).

In the same way as public authorities are exempt for monetary and public debt management activities, the Member States, the Commission and other authorities in charge of climate policy will be exempt from the application of MAR/CSMAD.

8. Who will be required to disclose inside information regarding emission allowances?

The duty to disclose inside information will be placed not on the issuer (as is the case of traditional financial instruments such as shares and bonds), but on the emission allowance market participant. The information to be disclosed – satisfying all essential criteria of inside information listed in MAR – will normally concern the physical activity of the disclosing party (e.g. on capacity and utilisation of installations).

At the same time, an exemption is foreseen for those emission allowance market participants the activity of which (expressed in terms of annual emissions or thermal input or a combination thereof) would be below a certain minimum threshold. That threshold would be determined by the Commission by means of a delegated act.

As a result, the disclosure duty would apply to only those entities, the activity of which on an individual basis can have material impact on the price formation of emission allowances or the (consequential) risks of insider dealing. In practice, only information concerning the activity of the largest emitters in the EU ETS (typically belonging to the EU power sector) can be expected to have a significant impact on the carbon price formation.

Impact of the proposal

9. If financial market rules are extended to all segments of the carbon market, are we not exposing the carbon market to the risk of increasing speculation, and as a result, price volatility and disorderly pricing of carbon?

The European carbon market has grown substantially from around €6 billion turnover in 2005 to €90 billion in 2010. However, empirical evidence shows that historically high levels of volatility in carbon prices in 2005 to 2007 are due to some very specific reasons and since 2008 prices are fairly stable and less volatile than, for example, most energy commodities. There is no evidence of any pattern between the influx of investors and volatility in carbon prices.

Furthermore, financial intermediation is a necessary part of a market. Market intermediaries typically fill supply or demand voids by standing ready to buy or sell from market end-users (EU ETS compliance buyers) on a continuous basis. Such participants also may enhance the price discovery process by collecting and bringing information to the market. The lion's share of the carbon market today already consists of futures and other derivatives trading and is hence covered by financial market rules. That dominance of the financial segment has not led to any particular disturbances neither in the carbon market nor for the compliance by the EU ETS compliance buyers. It is the unregulated spot segment that has attracted illicit behaviour over the past years.

10. Can we be confident that new demanding rules will not curb liquidity and thus hurt the carbon market?

Yes. Otherwise futures and forwards would not have become the dominant segment of the European carbon market. Stricter regulatory standards will provide for a safer and more reliable trading environment. Carbon market participants already now display a clear preference for concluding transactions in emission allowance derivatives on MiFID-licensed exchanges and mostly have their transactions cleared by a clearing house.

How will the new framework apply to...

11. ...ETS compliance buyers?

The application of MiFID and MAD will not limit the possibilities of ETS compliance buyers to buy or sell allowances on the market, be it on exchange or over-the-counter. In most cases, where their emission allowances trading activity would be ancillary to their main business, they will be dispensed from the duty to have a MiFID-licence normally required from investment firms (e.g. professional commodity derivatives traders). Even without such a licence, exempted ETS compliance buyers would still be able to hold membership of or direct participation in exchanges offering carbon trading (as long as they satisfy the conditions for membership or direct access set by that venue).

Pursuant to the new market abuse regime, all ETS compliance buyers will need to respect the prohibitions of insider dealing and market manipulation, and where applicable, follow the related obligations like disclosure of inside information and holding an insiders' list.

12. ... professional traders in emission allowances?

As a rule, entities providing investment services specialising in emission allowances (e.g. reception and transmission of orders and their execution, safe-keeping and administration of clients' assets) would be required to hold a MiFID licence and comply with all MiFID organisational and operational requirements (including know-your customer checks, transactions reporting, record keeping and investor protection rules). It is only normal for companies with this kind of activity to be covered by financial market organisational and conduct of business rules and be subject to the supervision of financial regulators.

Traders in emission allowances may try to obtain an exemption from MiFID authorisation (e.g. on the basis of restricted and ancillary character of a firm's investment services activity relating to emission allowances). However, in a large majority of cases, these traders also provide services involving derivatives of emission allowances or of commodities, and are hence already required to hold a MiFID licence, independent of the new framework for the spot carbon market.

13. ...carbon exchanges?

Trading venues offering contracts for spot trade in emission allowances and not currently subject to the MiFID, would be expected to obtain a MiFID authorisation in accordance with their specific profile (as a regulated market, a multilateral trading facility (MTF), or the new category of organised trading facility (OTF)).

The application of the revised MiFID in their case would mean that in order to continue spot trading activity they would need to make necessary adaptations to be in a position to seek a MiFID authorisation.

Relation with other measures

14. Will financial services legislation cross-referring to MiFID also apply to the spot trade in emission allowances?

A number of other EU financial-market measures cross-referring to the MiFID would also be applicable to transactions and other market activity involving emission allowances. Those impacts would include, for example:

- Market Abuse Regulation and Criminal Sanctions for Market Abuse Directive ;
- Anti-Money Laundering Directive;
- Settlement Finality Directive⁵:

At the same time emission allowances trade would fall outside the scope of the following EU financial market measures:

- Prospectus Directive,⁶
- Transparency Directive,⁷
- Undertakings for Collective Investment in Transferable Securities (UCITS) Directive⁸;
- Financial Collateral Directive⁹.

15. Will the classification have a knock-on effect on the grounds of capital requirements legislation?

Legislation on capital requirements¹⁰ only applies to credit institutions and investment firms. Most ETS compliance buyers which have limited trading activity, ancillary to their main business will be exempt from the MiFID and thus also exempt from such capital requirements.

⁵ Directive 98/26/EC on settlement finality in payment and securities settlement systems:
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1998:166:0045:0050:EN:PDF>

⁶ Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:345:0064:0089:EN:PDF>

⁷ Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0057:EN:PDF>

⁸ Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to UCITS:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF>

⁹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>

¹⁰ Capital Requirements Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF>

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0049:20091207:EN:PDF>

Professional traders with investment services or activities involving emission allowances are typically also active in the trading of derivatives of emission allowances or of commodity derivatives. As a result, and without prejudice to currently applying transitional exemptions¹¹, they are therefore anyhow covered by capital requirements stemming from the MiFID and the Capital Requirements Directive. This means that any future coverage of emission allowances by the MiFID would not impact their treatment under the Capital Requirements Directive. Such impacts could materialise in the unlikely case that a professional trader specialises solely in the spot trade of emissions allowances and is covered by the MiFID registration duties only on those grounds.

16. Will the clearing and settlement systems replace the system of EU ETS registries?

No, the system of EU ETS registries will not be redundant as a result of coverage of emission allowances by financial markets rules. Clearing houses and settlement systems will continue to provide support services to the trading pursued on- or off-exchange and will be complementary to the functions performed by the single Union registry. The registry does not record market transactions, but does record any resulting physical delivery of allowances. Furthermore, it also performs other (supporting) functions, such as recording the creation of allowances, surrendering for compliance with the EU ETS and their deletion, as well as free allocation and auctioning.

17. Will classification of emission allowances as financial instruments mean that they are to be treated as financial assets?

The proposals on carbon market oversight will not alter the fundamental purpose of the emission allowances. Their classification as financial instruments is made for the purposes of application of the EU financial markets regulation and is not aimed to deal with the legal nature of emission allowances (on the grounds of private law) or their accounting treatment.

18. Will the classification have an impact on the accounting treatment of emission allowances?

No, the classification of allowances as a financial instrument would have no direct impact on the accounting treatment of emission allowances under the Union law. Classification of emission allowances for accounting purposes depends on the criteria set by accounting standards only. There are currently no harmonised accounting standards for emission allowances at international level. National approaches in a few Member States may already require companies to recognise them as regular (financial) assets. In absence of a harmonised accounting treatment of emission allowances at international level, which is under the authority of the International Accounting Standards Board, the Member States take individual responsibility in this regard.

¹¹ *The application of capital requirements does not automatically flow from being caught under MiFID. There is an exemption for commodity dealers in the Capital Requirements Directive (CRD) due to be reviewed before end of 2014. As a result the capital requirements these firms should be subject to will be dealt in a separate review of the CRD exemptions. See Article 48 of Directive 2006/49/EC)*