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THE LATEST ON STOLEN CARBON CREDITS

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In April 2011, we published a briefing (http://www.hfw.com/publications/client-briefings/are-you-a-victim-of-stolen-carbon-credits) about the European Union Emission Trading Scheme “EU ETS” market crisis following a spate of approximately 3.3 million carbon credit thefts in early 2011. The European Commission has sought to address the inadequacies in the current trading system by publishing a draft Regulation which includes new proposals such as a trusted account list, a 24 hour delay in effecting transfers, view only access to accounts, as well as strict rules on the finality of transactions. These proposals are due to be voted on by Member States on 17 June 2011 and, if approved, are expected to be implemented by the end of this year.

As we discussed in our April 2011 briefing, one of the most patent flaws in the current system is the difference in the levels of security applicable to, and the overall regulation of, the individual national registries. In order to address this issue, a single EU Registry will be established on 1 January 2013. However, most of the new modifications proposed by the Commission to regulate the carbon market will be available before this date.

The draft Regulation implements not only a new set of measures to further enhance the integrity and security of the trading system, but it also implements the third phase (Phase III) of the EU ETS, with the Commission introducing long held plans to make amendments to existing legislation. Phase II of the EU ETS is due to end in 2012, and Phase III calls for a more ambitious climate change and emission reduction policy, by imposing more challenging emission reduction targets on installations subject to the EU ETS. Additionally, there is a plan to phase out gradually the free allocation of allowances that took place in Phases I and II with a new auctioning system being introduced. The scheme will also be broadened to cover more industrial sectors and greenhouses gases.

Some of the proposals included in the draft Regulation are as follows:

- **Trading accounts and trusted account list**

  Transfers of allowances or Kyoto units from holding accounts will now only be possible if transferred to an account on the trusted account list of the account holder. However, this restriction will not apply to trading accounts which will permit transfers of allowances or Kyoto units to all holding or trading accounts in the Union Registry.

- **Authorised representatives**

  Each account will be required to have at least two authorised representatives (save for verifier accounts, which need at least one). The authorised representatives are required to initiate transactions and associated processes on behalf of the account holder. The mandatory requirement of two authorised representatives in order to initiate transactions is a departure from the previous Regulation, where the requirement for more than one authorised representative was optional. However, the approval of an additional authorised representative is not required for transfers to an account on the trusted account list of the account holder.

- **Transactions**

  Under the draft Regulation, confirmation will be required by the Union Registry before a transfer can be initiated, and this can only take place between 07:00 and 17:00 GMT, Monday - Friday and where all additional authorised representatives required to give their approval have done so. Once an initiation is invoked, a notification shall be sent to all account representatives indicating the proposed terms. Crucially, a 24 hour delay will apply between initiation and transfer being finalised, during which time an account representative may propose cancellation of the proposed transfer to the national administrator on the ground of a suspected fraudulent initiation.

- **View only access to accounts**

  The draft Regulation also seeks to amend the existing Regulation (No 920/2010) by providing that, in addition to the previously specified authorised representatives, some authorised representatives may be granted view only access to accounts. This provides scope for viewers to trace back the chain of title to their source before trading, which will provide greater credibility to exchanges where the credits are being traded.

- **Finality of transfers**

  All transactions under the draft Regulation shall become final and irrevocable upon finalisation of the transaction, save for a reversal for processes initiated in error or where a transaction is completed after a relevant judicial or administrative authority has handed down a decision opening insolvency proceedings in respect of the account holder initiating the transaction. Holding an allowance or Kyoto unit in the Union Registry is conclusive evidence of the account holder's ownership of said allowance or unit. Transfer of the same shall constitute conclusive evidence of a change in ownership of the allowance or Kyoto unit.

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Comment

Clearly, action had to be taken to restore some faith in carbon credit trading and the exchanges where trading takes place. Spot trading in EU allowances has slumped some 90 per cent since companies reported carbon credit thefts earlier this year. However, the Commission is tasked with the unenviable job of trying to strike a balance between improving security in the markets by taking drastic measures while simultaneously not restricting trade

in spot markets, which, by their nature, require immediate and 'on the spot' trading. Indeed, spot market participants are not simply accustomed to such efficiency, they demand it.

The Commission is to be commended on some of the changes that it is seeking to implement under the draft Regulation, as it aims to address the teething problems in the market that have seen a significant drop in the confidence levels of market participants and investors in carbon credit trading. For instance, the 24 hour delay before trades become finalised may well reap dividends where authorised representatives are able to address suspected fraud before the product becomes lost in the market place with no recourse for the innocent party. Additionally, the introduction of the 'trusted account' list provides market participants with an opportunity to retain a designated list of approved trading partners which enable spot trading to take place without much intervention from the Commission.

Although the legislation is still being hotly debated and negotiated, the Commission has shown encouraging signs of addressing the current flaws in the market system and we wait to see the final form of the Regulation and the impact that this will have on carbon credit trading.

For more information, please contact Andrew Williams (pictured below), Associate, on +44 (0)20 7264 8364 or andrew.williams@hfw.com, or Lindsey Greer (pictured below), Associate, on +44 (0)20 7264 8769 or lindsey.greer@hfw.com, or your usual contact at HFW.

For further information, please also contact:

Brian Gordon
London Partner
T: +44 (0)20 7264 8284
brian.gordon@hfw.com

Konstantinos Adamantopoulos
Brussels Partner
T: +32 2 535 7861
konstantinos.adamantopoulos@hfw.com

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Lawyers for international commerce

HOLMAN FENWICK WILLAN LLP
Friary Court, 65 Crutched Friars
London EC3N 2AE
T: +44 (0)20 7264 8000
F: +44 (0)20 7264 8888

hfw.com