

Market Integrity

Learning the Lessons of Other ETS Designs

CEEM Annual Conference, UNSW
16 December 2011

Ilona Millar, Senior Associate

Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

Experience with EU ETS

Development of EU ETS

Phase 1	2005-07: Loosely capped learning phase – price volatility
Phase 2	2008-12: Tighter caps & better functioning registries – experiences with fraud and theft
Phase 3	2013-20: Significant modifications under new EU Directive

3

EU ETS: Success or Failure?

- Created carbon price for Europe and, to some extent, globally despite high volatility
- Market infrastructure in place:
 - electronic registry system
 - exchanges, contracts, financial regulation, origination and distribution platforms
- Catalyst for significant capital flows to developing nations via CDM
- Model which other countries have looked to

4

Stolen EUAs and Risk Mitigation Strategies

Registry Problems

- VAT Fraud – over €500m
- Phishing scam (Feb 2010)
- Money Laundering
- Online theft of EUAs worth over €45m from registry accounts - examples include:
 - 475,000 EUAs (€ 7m) from Czech registry
 - 1.6mill EUAs (€ 20m) from Romanian registry (owned by Holcim, a Swiss cement co.)
 - From trading accounts in Poland, Greece & Estonia, & Austrian Govt holding account
- National registries have varying levels of security

Registry Suspension

- 19 Jan 2011 - Suspension of trading in all national registries (except allocation and surrender of allowances)
- EU Executive announced on 28 Jan that national registries would be closed until authorities gave "*reasonable assurances that the minimum security requirements are in place*"
 - 30 national registries required to satisfy security checks
 - France, Germany, the Netherlands, Slovakia & the UK submitted satisfactory reports & re-opened national registries on 4 Feb 2011
 - Portugal re-opened its national registry on 11 Feb 2011
 - Registries that fail to implement minimum measures - trading suspended indefinitely

7

Key Issues with Stolen EUAs

- Good title?
 - Different treatment in different registries
 - For holders of EUAs
 - review of contractual documentation
 - need to freeze and quarantine any suspect EUAs where possible
 - discharge anti-money laundering disclosure obligations
 - not sell or otherwise deal with any suspect EUAs or arrange to do so until the risk of criminal or civil liability has been appropriately assessed
- Compensation?
- Insurance?

8

Steps Undertaken by EU

- Amendments to EU ETS Directive in 2009 to improve market integrity
 - Requirements for EC to monitor the market and report to the Parliament and Council on functioning of the market (auctions, traded volumes, liquidity)
- New Regulations on market integrity passed October 2011 (address energy markets and EU ETS)
 - Data collection, sharing and market monitoring, rules for data protection and operational reliability of systems, penalties
- New Registries Regulation adopted November 2011
 - Preventative measures to avoid fraud, respond quickly and avoid market disruption
- Phase 3 will have a centralised registry, so varying security levels will not be an issue.

Integrity in the CPM

Design elements of CPM to protect integrity

- Carbon Units will be personal property
 - Represented by an electronic entry in the Registry with a unique identification number
 - Capable of being cancelled, surrendered or transferred
 - Equitable interests and security interests in units permitted
- Intention to provide registered holder of a carbon unit indefeasible title. This protects a bona fide purchaser for value without notice of any defects in registered title holder's title

11

Registry Security

- CE Act and ANREU Act contain measures to protect the integrity of the registry against fraudulent or dishonest conduct and theft
- Extensive disclosure requirements for opening registry accounts (fit and proper person test)
- Offences include:
 - Making false entries
 - Submitting falsified documents
 - Theft (punishable under the Criminal Code – Crimes extends to internet banking fraud etc.)
- Transparency of Registry through information disclosure provisions (account holder details and significant holdings in the registry)

12

Regulators Powers

- The Regulator may:
 - Refuse to make an entry in a registry account if reasonable grounds to suspect the instruction is fraudulent
 - Alter the registry to correct an entry wrongly existing or wrongly removed from the registry
 - Temporarily suspend the operation of the Registry
 - Suspend specific accounts in the registry
 - Remedy computer errors
- Rights of affected persons to review or appeal decisions

13

Market oversight

- Carbon units financial products under the Corporations Act and ASIC Act
- Persons dealing in, aggregating and providing advice in relation to units may be required to hold an AFSL and produce product disclosure statements and financial guides
- Secondary and derivative market for carbon units may be considered a financial market (not separately defined or licensed at present)
 - Licensed markets are subject to ASIC Market Integrity Rules – these may apply if carbon units (as financial products) are traded on these platforms (e.g. ASX)
 - Those rules place obligations on the market (e.g. ASX) to ensure it is 'fair, orderly and transparent' and to avoid manipulative trading
- OTC transactions – no centralised exchange yet. OTC likely to involve standardised documentation (e.g. AFMA ISDA)

14

How do we compare?

BAKER & MCKENZIE

Thank you

Ilona Millar, Senior Associate

Ilona.millar@bakermckenzie.com +61 (2) 8922 5710

Global Environmental Markets Practice
Baker & McKenzie

Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.