European Financial
Markets Lawyers Group

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European Commission

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Re: Fostering carbon markets through increasing legal certainty: emission allowances and carbon removals; regulated and voluntary markets.

Dear Sir, dear Madam,

pillars are a predictable and simplified regulatory environment and speeding up access to finance, we consider that it is essential that financial markets and their stakeholders can leverage the European Green Deal objectives. To that end, robust and reliable markets are required as an integral part of the decarbonization strategy. Furthermore, to increase transparency and reliability of carbon markets we believe that further improvement of the regulatory framework should be pursued, in order to provide more legal certainty and confidence amongst market operators as well as to increase liquidity and improve the price formation process. Only by increasing legal certainty and market confidence, financial markets will be able to channel investments towards projects contributing to the objectives of the net-zero commitment by 2050.

In particular, we have identified the points described below:

(A) Regulated markets

The European Emission Trading System ("**ETS**")[1] is a key tool of the EU policy against climate change. Although it has already been functioning for a long period of time, there is general agreement that it can still be improved. We note that legal uncertainty may stem from the legal framework applicable to emission allowances and derivatives thereof. Although the inclusion of emission allowances as a new financial instrument under MIFID II[2] has been a very positive step, we note that in some cases the legislative framework treats or appears to treat derivatives in emission allowances as commodity derivatives, creating legal uncertainty for market participants.

Furthermore, ESMA has already identified several areas for improvement in its Final Report on Emission allowances and associated derivatives published on 28/03/2022 (the "**Final Report**")[3]. We would like to focus on some of the points which have given rise to ESMA's policy recommendations:

(i) Clarification of position reporting in emission allowances. - While the literal wording of Art. 58 of MIFID II sets out that positions in emission allowances (and not only in derivatives in emission allowances) should be reported to the competent authority, this requirement has given rise to great uncertainty. We refer to Section 5.2 of ESMA's Final Report where some of the inconsistencies regarding this requirement have been described leading ESMA to conclude that the position reporting regime set out in MiFID II (Art. 58) does not serve its intended purpose when it comes to position reporting in emission allowances. The EFMLG shares this view and encourages the relevant authorities to remove the position reporting requirement in emission allowances from the Level 1 text.

(ii) Clarification on the EEOTC concept. – Art. 6 of Delegated Regulation 2022/1302[4] sets out criteria for determining whether a commodity derivative contract is an economically equivalent OTC ("**EEOTC**") contract to that traded on a trading venue for position limit purposes. No such definition is, however, provided for EEOTC derivatives on emission allowances for position

[1] Created by 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 (the "**ETS Directive**")

[2] 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.

[3]The Final Report can be found here: https://www.esma.europa.eu/sites/default/files/library/esma70-445-38_final_report_on_emission_allowances_and_associated_derivatives.pdf

[4] Commission Delegated Regulation (EU) 2022/1302 of 20 April 2022 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives and procedures for applying for exemption from position limits.

reporting purposes. While we understand the EEOTC concept foreseen in Art. 6 would apply by analogy to derivatives on emission allowances, a specific reference in Delegated Regulation 2022/1302 in this regard would be welcome to avoid legal uncertainty. Alternatively, the European Commission ("**EC**") or ESMA could provide clarity to the market through a specific Q&A.

(iii) Clarification on the frontier between spot and derivative on emission allowances- Delegated Regulation 565/2017 supplementing MIFID II sets forth the frontier between spot and derivatives with regards to contracts relating to currencies (Art. 10.2) and to certain contracts relating to commodities (Art. 7.2). However, there is no similar clarification for emission allowances. Although it seems that by analogy the frontier would be that of commodity derivatives under Art. 7.2 of Delegated Regulation 575/2017, this is another field where the regulation lacks clarity and has been included as a policy recommendation in ESMA's Final Report ("*Providing further clarity on the distinction between spot emission allowances and derivatives on emission allowances*"). Again, a specific reference in Delegated Regulation 565/2017 or further clarification from the EC or ESMA in level 3 documentation will increase legal certainty.

In addition to the policy recommendations issued by ESMA, the EFMLG has identified other areas where legal uncertainty may arise:

(a) Competent authority for position reporting purposes

In accordance with Art. 58.2 of MIFID II the position reports should be sent to the competent authority of the trading venue where the relevant derivatives are traded. In case that derivatives are traded in more than one trading venue, to the competent authority of the trading venue with higher volumes. The EFMLG believes that reporting by the relevant entities will be easier and more efficient if addressed to their relevant national competent authority, who usually supervises them. This is because the relevant entities already have reporting mechanisms in place which should not change because of the volume traded. In view of the foregoing, we propose amending Article 58 so that position reporting requirements are fulfilled before national authorities just like the rest of the reporting requirements foreseen in the Regulation.

(b) Transparency and reporting of transactions in emission allowances –

ESMA already identified several issues related to reporting of OTC transactions in emission allowances arising from inconsistencies found in the ISIN codes assigned to the relevant contracts/instruments (section 5.5 of the Final Report).

amendments on certain product specifications so that contracts on EUAs specify that both EUAs and EUAAs may be delivered. The ETS Directive maintains though a distinction between EUAs and EUAAs for the purposes of issuance, allocation and auctioning.

Although, from 2021, fungibility for both types of allowances applies, EUAs and EUAAs have different ISINs[7]. This could give rise to potential doubts with regard to post-trade and transaction reporting requirements. In particular, the fact that both types of allowances are fungible may imply that an entity does not know the type of allowance it will deliver/receive until the relevant transaction is settled (i.e. not necessarily on the trade date); i.e. once any post-trade or transaction reporting (if applicable) should have already been met.

(b.2) Distinction between emission allowances issued under Phase 3 and Phase 4

Similar doubts may arise regarding allowances issued under phase 3 and phase 4. According to Art. 13 of the ETS Directive, installations can surrender phase 3 and phase 4 allowances to fulfill their ETS obligations during phase 4 as allowances issued from 1 January 2013 onwards are allowances under the definition of financial instruments in the Financial Collateral Directive within the consultation process it undertook in May 2021, no legislative initiative has been adopted in this regard. We believe that it would be convenient to include emission allowances under the scope of the Financial Collateral Directive.

(B) Voluntary markets

Voluntary carbon markets are growing rapidly and will expectedly play an increasingly important role in supporting the European Union transition to net zero. However, to the present date these markets are complex, fragmented and face issues regarding credibility and integrity; so that they have thus far not yet scaled to their full potential in helping to mitigate climate change, as also acknowledged by IOSCO in its Discussion Paper "Voluntary Carbon Markets" published in November 2022.

Both the public and private sectors need a voluntary carbon market that is transparent, liquid and environmentally robust, providing confidence and legal certainty to market operators. In the opinion of the EFMLG, there are two main problems that are preventing the voluntary carbon markets to provide all the benefits they could be granting to society:

> **i) Lack of trust/reliability** resulting from the different methodologies used by certifiers, the lack of oversight over certifiers and registries, the potential conflicts of interest arising between project developers, verifiers, certification standard bodies, traders and investors, the lack of transparency and, ultimately, the risk of fraud and greenwashing.
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> **ii) Legal uncertainty** around the legal nature of voluntary carbon credits and thus, doubts about their ownership and security transfer, conflict of laws, potential restrictions to trade with certain counterparties, treatment in case of insolvency etc.

a) Addressing lack of trust/reliability

The EFMLG welcomes the proposal for a regulation establishing a Union certification framework for carbon removals adopted by the EC on 30/11/2022 which lays down requirements for independent verification of carbon removals, as well as rules to recognize certification schemes and on the functioning of registries. This initiative may strengthen the oversight of voluntary carbon markets and mitigate the risk of greenwashing that is a cause of concern.

This initiative is, without any doubt, a very positive first step to build up a strong and reliable voluntary carbon market which will once again showcase the European Union's leadership in the fight against climate change.

Notwithstanding the foregoing, our main concern in this regard is that the EC's proposal may differ from those adopted outside the EU, especially considering that the main registries and project developers are located in third countries, and this could result in market fragmentation.

In this regard, we trust that the EC will closely monitor in the coming months the current requirements to become mandatory. Market participants should be subject to the same rules of the game to avoid market fragmentation and the creation of an uneven level playing field.

b) The need to reduce legal uncertainty

This need is as important as addressing lack of trust / reliability. The legal nature of voluntary carbon credits (VCCs) has not so far been determined by any specific legislation or authoritative statement of law (in statute or court precedent) in most jurisdictions. This situation gives rise to uncertainty on a number of relevant legal issues (i.e. ownership and security transfer, conflict of laws, netting, security arrangements, potential restrictions to trade with certain counterparties, treatment in case of insolvency etc.) which are negatively affecting the ability of stakeholders to acquire these rights and trade them in the market.

In order to provide further confidence and legal certainty when trading in voluntary carbon markets we believe that carbon credits should be subject to a clear legal framework and our preliminary view is that MIFID would qualify as such[9].

We understand the complexity around this measure and, as mentioned above, the need to align any regulatory measures/initiatives with international standards. At the same time, it is also our understanding that voluntary carbon markets will not really contribute to net zero policies with all their potential until there is legal certainty about their legal nature. An analysis and impact assessment with the pros and cons of the VCCs becoming financial instruments under MIFID and other related financial markets regulation would be a good start to take the steps in the direction required by the EU Green Deal commitment.

To that end, the EFMLG stands ready to assist the EC or ESMA with such an exercise including if a working group with market expertise is set up. The EFMLG remains indeed at your disposal for any support you may need on these matters. Please kindly keep the EFMLG informed on the evolution of the legal thinking and practice of the EC and ESMA on the issues above.

Yours faithfully,

Fernando Conlledo

Vice Chairman of the EFMLG

[9] VCCs i) are not covered by the EU ETS Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowance trading or the revised Markets in Financial Instruments Directive (MIFID II) and ii) are not recorded in the European registry created by Regulation (EU) 389/2013. In this respect, it is worth recalling that – as indicated in page 1 of this document – emission allowances consisting of any units recognised for compliance with the requirements of Directive 2003/87/EC are included in the list of “financial instruments” provided for by Section C of Annex I of Markets in Financial Instruments Directive (MIFID II).
Without prejudice to the above, it is also worth noticing that in a Motion for a European Parliament Resolution on sustainable carbon cycles (2022/2053(INI)) adopted, on 15 June 2022, by the Committee on the Environment, Public Health and Food Safety of the European Parliament, "the creation of a dedicated financial instrument for carbon cycling investments" was proposed (para. 19).