

IETA Position on Market Disruptive Impacts of Stolen Allowances in the EU ETS

Framework for discussion points with the Commission and National Regulators

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A. Overview of Market Concern

The publicised alleged theft of Allowances¹ creates substantive issues for market participants. The legal issues are complex and differ between Member States. However, there is enough analysis from previous incidents to conclude that unwitting recipients of allegedly stolen Allowances run the risk of **suffering loss or, at worst, criminal liability** arising from merely participating in the EU ETS.

This is not due solely to genuine concerns regarding whether the recipient has received good title to such Allowances or whether such Allowances were transferred free of competing claims but is also driven by the possible application of jurisdiction specific criminal laws (such as those relating to money laundering², handling stolen goods and fraud).

The effect of this is to create a significant real concern for market participants that, if they were to receive a volume of allegedly stolen Allowances, they may suffer a total loss on that purchase and may risk committing a criminal offence when passing these allowances on.

If the uncertainty as to the status of these Allowances is perceived to continue then there is a **real possibility of market failure**. In particular, this is because the success of the EU ETS is grounded on an assumption of a safe and liquid market existing. A failure to adequately resolve this issue could impact the liquidity of the market as participants determine that the risks of participation outweigh any benefits.

Market participants understand the Commission's plan to address this issue as involving:

- the suspension of, except for allocation and surrender of allowances, all processes in all EU ETS registries at least until 26 January 2011, 19:00 CET with a phased lifting of suspension after this date ; and

¹ This note discusses Allowances as they are the subject of the recent incidents. However, the comments apply equally to other types of carbon credits such as CERs and ERUs.

² It is very difficult for firms to be sure whether or not certificates delivered to them and possibly sold on by them are stolen. Firms though will be increasingly in the position that they may be suspicious that this is the case. This suspicion will cause firms to ask whether they should file 'Suspicious Activity Reports' with the relevant criminal agencies in response to Money Laundering disclosure duties. This will place a significant reporting burden on firms and is very likely to result in a flood of precautionary SAR reports. It would help if the Commission could provide guidance on this issue.

IETA - Climate Challenges, Market Solutions

24, Rue Merle d'Aubigné
Geneva, 1207, Switzerland
Tel: +41 (22) 737 0500

Boite 27
Rue de la Loi 235
Brussels, 1040, Belgium
Tel: +32 (0)22 30 11 60
Reg. 0889.072.702

1730 Rhode Island Ave., NW,
Suite 802, Washington, DC
20036 USA
Tel: +1 (202) 629-5980

100 King Street West, Suite
5700, Toronto, Ontario
M5X 1C7, Canada
Tel. +1 (416) 913 0135



- determination, together with national authorities, of the minimum security measures needed to be put in place before the suspension of a registry can be lifted.

The discussion points below summarise both immediate and longer term concerns of market participants on how this issue is being addressed and what more should be done.

B. Dialogue of immediate mitigations

Critical immediate clarifications needed through dialogue with the Commission and other relevant (including national) authorities are as follows:

What are the causes of the security breaches and how are they being addressed?

There is very limited information available on which security risks are being addressed or why they arose in the first place. Commission statements include that *“registries are known to be vulnerable to similar attacks”* and that the *“minimum requirements that each national registry has to fulfill in order to resume normal operations”* will address this. If the market is to take comfort in the work being done following the suspension, it will need more information regarding:

- the causes of the various occurrences of the alleged thefts (e.g. trojan attacks that have been reported);
- the measures that the Commission had repeatedly asked national registries to take before their suspension by the Commission;
- whether the introduction of those measures by the registries would have prevented the causes of the various occurrences of the alleged thefts previously, and will they now be prevented ?

IETA endorses for consideration by the Commission and national registries the recommendations coming from the report of an IETA member company attached to this letter, which has been sent to the Commission earlier this week. These measures are considered to be necessary to give back to market participants the necessary level of comfort to go back to business as normal. Of particular importance here is the need for a double approach:

1. Reinforce the security of the electronic transactions
2. Set up a more structured workflow/procedure in order to finalize the transaction.

Given that theft of access codes can also happen within a registry, we also must secure the internal or outsourced site administration and certify/audit the security policies. It would be actually useless to build sophisticated authentication process if who has the rights of administration could access / manage the information without robust internal security policy.

How to monitor enhanced account opening KYC

The amended Registries Regulation enabled national registry administrators to enhance account opening procedures so as to limit the potential for fraudulent or criminal entities to access the EU ETS. Progress on this across Member States goes hand in hand with enhanced platform security of the registries themselves. What is the Commission doing to track compliance by



Member States of this and ensure speedy and consistent implementation across the EU? What measures is the Commission taking in relation to Member State registries that are not in a position to comply in the near future?

How to enhance speed of response to thefts?

Part of the issue that has emerged from previous incidents is the delayed and informal information flows regarding potentially affected Allowances. Market participants would be happy to work with the Commission and national administrators to develop a consistent set of emergency notification protocols. These would enable: (a) victims of an alleged incident of theft to immediately alert relevant EU ETS authorities; and (b) those authorities to in turn notify market participants and the national registry administrators. It is recognised that this would not address the issue where an incident is only discovered by a victim some time after its occurrence. However, this should not prevent work on such protocols being carried out and could lead to greater awareness by market participants of the risk and will raise levels of alertness.

How to reinforce monitoring and intervention capacity?

Market participants consider that there should be the capacity for the Commission (either itself or in conjunction with national administrators) to intervene to prevent the transfer of Allowances where a proper emergency notification has been made. The position of the Commission is noted that EU ETS legislation only allows the Commission to suspend access to national registries if there is a security breach that threatens the integrity of the overall registries system. Regarding individual transactions the Commission has stated that it “*has no powers to block any such allowances in a registry account*”. However, this should be re-visited to determine whether (a) this is a correct interpretation; and (b) if so, what changes to the Registries Regulation could be brought forward to enable such interventions to occur. These powers would need to be combined with the additional protocols or remedies discussed below. The robust view taken by the Commission as to its powers to intervene in respect of recycled CERs is noted as a positive precedent here.

How to support smooth transition to a safer registry system?

If it is correct to assume that resource limitations of some European registry administrators will cause an extended period of partial suspension then this needs to be tackled and dealt with.

Market impact of closed registries goes beyond the spot market, for instance, when a future or forward contract is due for delivery. For instance, the 28 March is a standard delivery date for a large number of derivative contracts. But, in the power market it is common for power stations to be tolled, that is a company other than the operator delivers physical fuel and carbon to the power station. The delivery of carbon occurs after the power has been generated and two common structures are for the carbon to be delivered on a monthly basis (for credit reasons) or annually and as we are in a period of month end and year end, if the registries do not come on line soon then power companies will not be able to fulfil their tolling obligations.



Market participants consider that appropriate resources need to be made available urgently for these jurisdictions and the Commission should give serious consideration to the acceleration of the transition to a single Union registry to as early as possible in 2012 (on the assumption that that the security for accounts in the EUTL will be superior).

C. Dialogue on near term mitigations

Even where security is enhanced many market participants consider that the residual risk of Allowance thefts occurring will remain. As such, the following proposal should be discussed in conjunction with Commission and other relevant EU ETS authority legal advisers.

Determining the legal nature of a carbon credit

One of the biggest concerns facing market participants is what rights and liabilities (including criminal liabilities) attach to their inadvertent receipt or purchase of an allegedly stolen carbon credit. It is currently not possible to give such market participants clear advice on this as the legal nature of a carbon credit is not a matter explicitly dealt with by the laws of most Member States. This results in assumptions being made about the presumed legal nature of carbon credits for the purpose of advising market participants. However, given that the assumptions made cannot be confirmed without judicial determination by a national court or EU court, such advice is, in many cases, subject to significant caveats and therefore, by definition, inconclusive. This situation is exacerbated when different assumptions are made in different Member States due to the individual characteristics of the Member State's legal system.