Client alert

A new registry regulation – are you ready for Phase IV of the EU ETS?

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ReedSmith

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Introduction

The European Commission published a new registry regulation for Phase IV of the EU ETS this summer (New Registry Regulation)[i]. The publication of the New Registry Regulation appears to have hardly been noticed.

The New Registry Regulation came into force on 22 July 2019. It partially amends Commission Regulation (EU) No. 389/2013 (the current Registry Regulation) (effective immediately) and, from 1 January 2021, will entirely replace the current Registry Regulation in respect of EU ETS transactions.

We summarise below some of the key points to note from this development.

Drivers for change

The history of the current Registry Regulation is worth recalling. In the context of the EU ETS, the registry regulation is the legislation that essentially supports its physical settlement, accounting and delivery infrastructure. As such, after Directive 2003/87/EC (the EU ETS Directive), it is the most significant legislative instrument for the EU ETS. The current Registry Regulation came into force in 2013 and was the third in a series of successive registry regulations published in 2010[ii] and 2011[iii]. The period leading into the current Registry Regulation was a turbulent one for the EU ETS. The EU Commission was grappling with the aftermath of stolen allowances, registry hacking and the transition from Phase II to Phase III of the EU ETS. The rushed nature of the three successive registry regulations tells the story of an attempt to 'bolt the stable doors after the horses had bolted'. Nonetheless, the current Registry Regulation, by the fact that it survived Phase III of the EU ETS without fundamental changes, provided a sense that security and operational certainty were restored during Phase III of the EU ETS. So why change the registry regulations now?

The main drivers for the introduction of the New Registry Regulation are as follows:

a. Facilitating the linkage between the EU ETS and the Swiss Emissions Trading Scheme (the Swiss ETS) under Article 25 of the EU ETS Directive

b. Hardwiring provisions to deal with EU member states that trigger Article 50 of the Treaty on European Union to withdraw from the EU (an Art. 50 Notice)

c. Recognising the consequences of EU allowances as 'financial instruments' under MiFID II[iv] and making necessary consequential changes to address that

d. With the hindsight of experience, it was appropriate to simplify certain rules governing the Union Registry to reduce the administrative burden of national administrators

e. Updating the requirement associated with handling of data and information by national administrators in light of the General Data Protection Regulation (GDPR)[v], and

f. Since Phase IV of the EU ETS does not allow Kyoto units for compliance within the EU ETS, the removal of references to the Kyoto Protocol and its relevant units in the registry regulation

We will use these drivers to briefly discuss some of the changes introduced by the New Registry Regulation. This is not an exhaustive summary of all the changes.

Linkage to the Swiss ETS

The long-awaited linkage of the Swiss ETS to the EU ETS looks set to happen from 1 January 2020. The linking agreement between the Swiss ETS and the EU ETS was signed on 23 November 2017. The EU approved the agreement at the beginning of 2018, and the Swiss parliament approved it on 22 March 2019. Once ratified by Switzerland and the EU, it is expected to enter into force on 1 January 2020[vi].

Signed pursuant to Article 25 of the EU ETS, this is the first formal linkage between the EU ETS and any other non-EU member state country. The EU ETS' inclusion, from the start of Phase II of the EU ETS, of Norway, Iceland and Liechtenstein was not concluded under Article 25 of the EU ETS but under its European Economic Area (EEA) arrangements with those countries. Therefore, this is the first proper experience of a third country linking with the EU ETS.

From a registry infrastructure perspective, this triggers two key changes. First, a formal link between the Union Registry and the Swiss National Registry will be established via the connection of the EU Transaction Log (EUTL) with the Swiss Supplementary Transaction Log. Second, the linking agreement obliges the EU and Switzerland to provide mutual recognition for each other's allowances (EUAs) and aviation allowances (AEUAs). The current Registry Regulation has also been amended to enable such mutual recognition. This will have a significant impact on the definition of an EU allowance, as previously used in the industry standard form trading documentation or exchange rules, in respect of Phase III and IV transactions[vii].

The Swiss–EU ETS linkage will bring the number of countries participating in the EU ETS to 32. However, with the expected eventual departure of the UK as a result of its delivery of an Art. 50 Notice, that number is likely to revert back to 31. The Swiss–EU ETS linkage is a possible model for future UK connectivity to the EU ETS, post Brexit.

Addressing Brexit and any future Art. 50 Notices

One of the few changes to the current Registry Regulation that was required during Phase III was as a result of the UK serving its Art. 50 Notice and its potential departure midway through an EU ETS compliance phase. The previous registry regulations did not have a mechanism to protect the remaining EU ETS participating countries from the disruption caused by a departing country. Dealing with all the uncertainties of Brexit forced an urgent amendment to the current Registry Regulation at the start of 2018[viii]. The mechanism envisaged that the country serving an Art. 50 Notice would have its issued EUAs and AEUAs tagged with a country code after a certain point. Any EUAs or AEUAs so tagged may not be surrendered for compliance within the EU ETS.

In the context of Brexit, the UK's 2018 allowances were not tagged because these could be surrendered before the compliance deadline for the 2018 calendar year, ahead of any Brexit deadline. However, the UK's 2019 allowances would be tagged under the mechanism, unless a withdrawal agreement requiring compliance with the EU ETS Directive is put in place and ratified prior to the annual compliance deadline of the 2019 calendar year[ix]. Since this has not yet occurred, currently, the UK has not issued or auctioned any of its 2019 EUAs or AEUAs.

The New Registry Regulation hardwires the equivalent mechanism in anticipation of any new Art. 50 Notices. Therefore, in Phase IV, any EUAs or AEUAs created pursuant to a national allocation table of an EU member state that serves an Art. 50 Notice will be identified by a country code and shall specify its year of issuance (that is, vintage). There are, therefore, technical provisions in the New Registry Regulation to facilitate the showing of such country codes and vintages in respect of EUAs and AEUAs.

"Following from the Swiss-EU ETS linkage, mutual recognition of each other's allowances will change the definition of allowances capable of being used for compliance in the EU ETS in Phase IV."

EUAs and AEUAs, as financial instruments under MiFID II

MiFID II and MiFIR[x] came into force on 3 January 2018 and, with that, spot EUAs and AEUAs became financial instruments subject to financial services licensing requirements, unless otherwise benefiting from an exemption. Although entities participating in the EU ETS that are traditional compliance operators or are participating for pure hedging needs need not worry too much about the impact of the licensing requirement, it does not change the fact that those entities are now dealing in a financial instrument that carries with it certain practical consequences. The New Registry Regulation seeks to address these consequences. The following is not an exhaustive list:

Change	Description of the change	Impact of change
ISIN codes for EUAs and AEUAs will exist.	International Securities Identification Numbers (defined in ISO 6166) for EUAs and AEUAs shall be displayed in the Union Registry.	In order to facilitate trade and transaction reporting, ISIN codes are used as a means of identifying financial instruments. It is a mandatory data field under MiFIR reporting requirements. The absence of an ISIN code would have led to difficulties in transaction reporting of EUAs/AUEAs. This change will make it easier for such reporting to occur.
Registry account holders will need a Legal Entity Identifier (LEI) code[xi].	Trading Account applicants will need to provide the relevant national administrators with an LEI code where one has been assigned to the applicant.	MiFIR obliges that certain details of transactions in financial instruments should be reported to competent authorities to enable them to detect and investigate potential cases of market abuse as well as to monitor the activities of investment firms. MiFIR require investment firms to obtain an LEI from their clients prior to providing a service that would result in a transaction reporting obligation. Market participants will not be able to trade with in-scope investment firms if they do not have an LEI.
Express power to share confidential data (e.g., transaction data stored in the EUTL) with financial regulators.	The list of regulators to whom data stored in the EUTL can be shared has been expanded to include: (a) ESMA[xii], ACER[xiii], competent national supervisory authorities (e.g., BaFin[xiv] in Germany) and the European Data Protection Supervisor.	Consistent with the idea that EUAs and AEUAs are financial instruments requiring the oversight of financial regulators (including, specifically, market abuse), this list of entities to whom confidential data may be shared has been expanded.

Simplifying the Union rules on account management

Recognising the impact of some of the rushed changes to the registry infrastructure between 2010 and 2013, a number of account related rules, which were in the current Registry Regulation, have been simplified. Based on feedback from national administrators, these simplifications had been identified with a view to reducing the national administrator's burdens. The following is a non-exhaustive list:

Change	Description of the change	Impact of change
No more 'Person Holding Accounts'.	All 'Person Holding Accounts' will be converted into Trading Accounts from 1 Jan 2021.	Current documentation may need to be updated to change the obligations on parties in respect of account opening. Clients using 'Person Holding Accounts' will need to convert their accounts to Trading Accounts before 31 December 2020.
The 'visible' information about EUAs and AEUAs will change.	The trading period in which the EUAs and AEUAs were created will now be visible on the EUAs and AEUAs.	This change is necessary to distinguish between Phase III EUAs/AEUAs and Phase IV EUAs/AEUAs. After all, Phase III EUAs/AEUAs are valid in Phase IV but not vice versa.
Transfers of EUAs/AEUAs from Trading Accounts to accounts not indicated on a Trusted List are subject to a 24-hour rule.	This replaces the 26-hour rule with a 24-hour rule but only if the proposal for transfer is made before 12pm CET. Anything proposed after 12pm CET (on T) will be executed, in effect, at T+2 days.	This will encourage greater use of Trading Accounts with specified Trusted Account Lists as it allows for immediate transfers of EUAs and AEUAs proposed between 10am and 4pm CET.

Dealing with the impact of GDPR

National administrators, in the discharge of their duties in respect of accounts under their jurisdiction within the Union Registry, are handling personal data of account holders and authorised account administrators. The New Registry Regulation now regards both national administrators as well as the EU Commission as controllers, as opposed to processors, under the GDPR and Regulation 2018/1725 (which applies to Union institutions, bodies, offices and agencies) respectively.

This subjects them to data protection obligations in respect of personal data processed within the Union Registry and the EUTL. Such obligations include implementing appropriate technical and organisational measures to protect and process personal data, and to be able to demonstrate compliance with data protection principles. A data protection officer must also be designated, and the contact details of the data protection officer published. National administrators are further tasked to ensure that other information (including personal data) required by the New Registry Regulation, but not captured in the Union Registry or EUTL, are processed in accordance with EU and national laws.

No CERs or ERUs in Phase IV

Although not a big change in terms of market impact, the removal of certified emission reductions (CERs) and emission reduction units (ERUs) as valid compliance units in Phase IV, does have a sizable impact on the legislative framework that previously existed for supporting their use in Phase II and Phase III of the EU ETS. The true-up period for the second commitment period of the Kyoto Protocol runs until 2023. As such, the current Registry Regulation is not repealed in its entirety by the New Registry Regulation and it continues to apply until 1 January 2026 in respect of CERs, ERUs and other Kyoto units during Phase III and the second commitment period of the Kyoto Protocol.

Conclusion

Besides the changes to the registry infrastructure resulting from the abovementioned drivers, there are many other subtle changes that have been made which are mostly operational in nature. However, these operational changes will have consequences that will impact the day-to-day approach currently taken by market participants both in terms of their operations and, due to the start of the Swiss-EU ETS linkage from 1 January 2020, the trading documentation that they use in Phase III and Phase IV, whether that be the EFET[xv], ISDA[xvi] or IETA[xvii] forms.

We anticipate that current operations will have to be reviewed in advance of 1 January 2021, and trading documents for Phase III and Phase IV be updated prior to 1 January 2020, to recognise the impact of the changes introduced by the New Registry Regulation.

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[i] Commission Delegated Regulation (EU) 2019/1122.
[ii] Commission Regulation (EU) No. 920/2010 of 7 October 2010.
[iii] Commission Regulation (EU) No. 1193/2011 of 18 November 2011.
[iv] The Markets in Financial Instruments Directive II.
[v] Regulation (EU) 2016/679 of 27 April 2016.
[vi] The linking agreement provides that it shall enter into force on 1 January of the year following the exchange of the instruments of ratification or approval by the parties.
[vii] Article 1 of the linkage agreement provides that an "'Emission allowance' means an allowance to emit one tonne of carbon dioxide equivalent during a specified period, which has been issued under the EU ETS or the ETS of Switzerland valid for the purposes of meeting the requirements under the EU ETS or the ETS of Switzerland".
[viii] Commission Regulation (EU) 2018/208 of 12 February 2018.
[ix] Commission Delegated Regulation (EU) 2019/401 of 19 December 2018.
[x] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014, the Markets in Financial Instruments Regulation.
[xi] An LEI, is a 20-character, alpha-numeric code, to uniquely identify legally distinct entities that engage in financial transactions.
[xii] The European Securities Markets Authority.
[xiii] The Agency for Cooperation of Energy Regulators.
[xiv] The German Federal Financial Supervisory Authority.
[xv] The European Federation of Energy Traders.
[xvi] The International Swaps and Derivatives Association.
[xvii] The International Emissions Trading Association.

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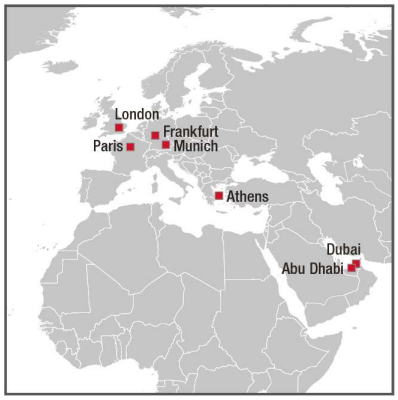

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