CEO

CARBON TRADE WATCH

October 2011

Letting the market play: corporate lobbying and the financial regulation of EU carbon trading

"Our role is to keep the regulatory structure as simple as possible and let the market play"

- Jos Delbeke, European Commission 2009

"[T]hese controversies provide evidence that the emissions market is maturing and becoming mainstreamed within the European economy. Entities don't seek out loopholes in insignificant markets, fraudsters do not focus on small businesses"

- World Bank, State and Trends of the Carbon Market 2010

This report outlines a series of reforms to the regulation of carbon trading in response to fraud and the financial crisis, and financial sector efforts to disrupt them. It shows that:

→ The European Commission adopted a deliberately light touch approach to regulating its Emissions Trading System since its launch in 2005. A series of fraud cases made this position untenable.

→ The Commission has proposed measures to tighten security, which was previously so lax that it was easier to become a carbon trader than to open a bank account. However, the new rules would also cover-up evidence of fraud and gaming by hiding carbon permit serial numbers. The Commission's intention is to re-issue stolen permits, opening an additional hole in the scheme's accounting for emissions.

→ The Commission has belatedly identified carbon as a commodity that is susceptible to excessive speculation. Leaked drafts of the Market in Financial Instruments Directive (MiFID), a set of rules governing European financial markets, are set to be extended to include carbon trading.

→ New regulations on carbon trading have been consistently opposed by financial services lobbyists. For example, in January 2011, the European Commission halted trading on a key part of the carbon market after the latest in a series of large fraud cases was uncovered. Less than a month later and with the suspension still partly in place, the International Emissions Trading Association (IETA, the main carbon trade lobby group) were privately insisting to Brussels officials that "there might be no need to regulate this market." This report documents how financial sector lobbying has been driven by a desire to find new opportunities for carbon market speculation by whatever means are necessary.

→ Although the lobbyists look to be losing some of these battles, plenty of loopholes remain in the financial regulation of the carbon market. More fundamentally, emissions trading introduces speculation by design and has failed to meet its stated objectives. There is a need to de-financialise climate policy.

I. Carbon fraud

Since the start of the Emissions Trading System (ETS), the EU has taken a laissez-faire approach and avoided any specific financial regulations for how carbon is traded.[1] "Our role is to keep the regulatory structure as simple as possible and let the market play," said Jos Delbeke, as Deputy Director-General for the Environment at the European Commission.[2] He is now Director of DG Climate Action, which oversees the scheme.

The rationale behind this light touch was to encourage the growth of the market at all costs. With the ETS failing to achieve emissions reductions, the EU fell back on claims that it had "successfully established the free trading of emission allowances across the EU, set up the necessary infrastructure… [and developed] the world's largest single carbon market."[3] The market in European Union Allowances (EUAs, the tradeable permits issued by the ETS) is now worth almost $120 billion. In conjunction with purchases of offset credits for use with the ETS, it drives 97 per cent of all trades in the $142 billion global carbon market.[4]

A series of fraud cases and instances of gaming the market has made this light touch position increasingly untenable, however. In December 2009, Europol revealed that "carousel" (or "missing trader") fraud resulted in a loss of around €5 billion in tax revenues.[5] The permits were bought in countries that did not impose value added tax (VAT) and sold in other countries where VAT was included in the price. The traders who engaged in this practice would then go missing without ever declaring the tax income to national treasuries.

A second, common carbon fraud is known as a "phishing" scam, which is no different in form to the email spam that encourages credit card holders to enter their online account details, with the stolen data then used to make unauthorized purchases. In January 2011, the theft of €34 million worth of permits forced the closure of "spot trading" markets after thieves gained unlawful access to an account in the Czech Republic using fake internet sites and emails.[6] Similar attacks had already been reported in Austria, Germany, Greece and Romania.[7]

While there is nothing specific to carbon in the form that these attacks took, they were enabled by lax rules on opening new accounts within carbon registries (the official databases recording who owns allowances and how they are allocated), as well as the fact that carbon emissions allowances are virtual: "there is no need to deliver goods, no inventories in warehouses, no shipping documents to issue, or releases to draft. There is no insurance, airfreight, road freight, or multiple bank accounts needed in this market. Both legitimate and illegitimate transactions can be conducted from a lap top."[8] The scale of this fraud can be shown by the fact that market volumes on the "spot market" (see box) dropped by 90 per cent once tax rules were changed on emissions allowances.[9]

> Carbon frauds were enabled by lax security and the fact that emissions allowances are virtual: "there is no need to deliver goods, no inventories in warehouses, no shipping documents to issue, or releases to draft. There is no insurance, airfreight, road freight, or multiple bank accounts needed in this market. Both legitimate and illegitimate transactions can be conducted from a lap top."
>
> Richard Ainsworth, Boston University

A third type of carbon market gaming – illegitimate, but not actually illegal – involved the "recycling" of carbon credits issued under the UN's main offset scheme, the Clean Development Mechanism (CDM), which can be handed in by companies to comply with their targets under the EU ETS[10]. Two million of these offset credits surrendered in Hungary were then re-sold by the country's government, exploiting a loophole in the scheme (which has since been closed). This re-use of the same credits made a mockery of the claim that they represent reductions in greenhouse gas emissions.[11]

How is carbon traded?

There is no legally agreed definition as to what "carbon" is or how it should be accounted for. The International Accounting Standards Board has yet to voice a clear opinion, despite starting to work on this issue in 2005; whilst EU member states have, to date, classified European Union Allowances (EUAs) in different ways.[12] The lack of definition is not simply a legal or accounting quirk, however, since it has significant effects on what regulations apply to the trading of carbon.

At present, the levels of regulation vary according to how the carbon is traded – although none are tight. The majority of EUAs are traded as "derivatives", which means contracts are exchanged corresponding to the future value of allowances. The trade in contracts deriving from these allowances is covered by MiFID (the European regulatory framework for financial services markets), so long as it involves banks and specialist trading firms.[13]

There is also a considerable "spot" market, so called because permits or credits are traded "on the spot" in return for cash payments. Almost 85 per cent of spot trading passes through the BlueNext exchange in Paris.[14] This trade is largely unregulated, and has been at the centre of both the VAT-carousel fraud and permit theft cases. The latter forced the closure of EU carbon spot markets in January 2011. Trading volumes remained low for several months. In evidence submitted to the UK Parliament in August 2011, Barclays Capital reported that the frauds had "paralysed the effective operation" of the spot market, while the City of London Corporation reported that "a number of large players are now withdrawing from trading and closing their desks" in response to "the hazards in this market."[15]

There are two basic forms of derivatives trading: exchanged-based and over the counter (OTC). While an exchange "functions much like a club", with membership rules on the solvency of the traders and minimum standards of transparency, OTC trading is less rule-governed.[16] OTC trades are structured in a complex fashion, encompassing a series of speculative bets on future outcomes, as well as mixing and matching a variety of permits and credits. They account for over 70 per cent of the trade in CDM offset credits.[17] Over 50 per cent of EUAs were also traded over the counter. These are also largely unregulated at present.

In common with other derivatives markets, there has been a gradual shift towards exchanges in recent years. The largest of these is the European Climate Exchange (ECX) in London, which accounts for or clears over 80 per cent of all exchange trades (and 90 per cent of derivatives), while there are also major exchanges in France, Norway and Germany.[18] One aim of MiFID, following a course agreed by the G20 at Pittsburgh in 2009, is to drive a greater proportion of trading through exchanges, although it is also likely to introduce a new "in-between" category of Organised Trading Facilities (OTF), whose status remains unclear.[19]

The carbon traders' lobby

There are several processes under way that could affect how the trade in carbon is regulated. Some of these revisions form part of a broader shake-up of financial regulation in the wake of the failings that led to the financial crisis, most notably the Market in Financial Instruments Directive (MiFID), which regulates the trading of derivatives within the EU.[20] The carbon market-specific fraud problems, meanwhile, are covered by a Communication (a non-legislative discussion document) on the potential for "an enhanced market oversight framework for the EU Emissions Trading Scheme," which was released in December 2010.[21] New legislation specific to carbon markets is expected to follow from this Communication.

Significant financial services sector lobbying has accompanied these proposed changes, led by the International Emissions Trading Association (IETA). At the core of its positioning is a stated desire to bolster carbon market "liquidity" – in other words, to keep trading volumes as high as possible, irrespective of the broader destabilising effects that this can have.

> "Given the hazards in this market, a number of large players are now withdrawing from trading and closing their desks."
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> City of London Corporation

To this end, IETA has supported limited security measures to pre-empt "another downturn in market confidence" while at the same time opposing vigorously any proposals that might have a structural impact upon how the market functions.[22] In January 2011, IETA urged the rapid re-opening of the major registries after the suspension of "spot trading".[23] When the resumption failed to bring traders back to the market, IETA issued further security suggestions, hoping that this would restore confidence and stem the tide of traders turning their backs on carbon.[24] Its general orientation is clearly anti-regulation, though. In their notes of a meeting with DG Market on 18 February 2011, for example, EU officials expressed incredulity that the President and European director of IETA "still argued that there might be no need to regulate this market!"[25]

The lobbying has not all been one way traffic, however, with Cembureau (the cement industry lobby) reporting "a sharp division between the world of finance and industry."[26] These "compliance buyers", who must purchase permits from the scheme to meet their emissions reduction targets but are not directly involved in speculation, have tended to argue for stricter rules on the grounds that a volatile, liquid market can wreak havoc with longer-term investment decisions.[27]

Registry reforms

Most cases of fraud to date have happened in the "spot trading" market, leading to calls for its greater regulation. However, the measures that have been put forward are at best patches to cover the existing holes, and do little to alter the structural susceptibility of the EU carbon market to fraud (see box, "Regulating the Unregulatable").

The immediate focus is on changes to the "registry infrastructure", which has been particularly lax until now, as Simone Ruiz, European policy director for IETA, explains: "The idea was to get the market going without spending a lot of time on security systems. It's easy prey to get into these markets. Your grandmother could open one of these accounts. There is no certification."[28]

The European Climate Change Programme, whose "stakeholder" grouping largely consists of EU-wide lobby associations, carbon traders and companies covered by the scheme, held consultations on this issue in March and May 2011. The resulting proposals include plans to create a single EU carbon registry; stricter rules on the identity of account holders; requirements that electronic trades be confirmed by email or phone, and the creation of separate accounts for holding and trading carbon. These steps will make certain frauds more difficult to conduct, as would a planned 24-hour delay on permit transfers between registry accounts, in response to the fact that both the VAT "carousel" fraud and the 2011 permit thefts were facilitated by the rapid circulation of permits. Although IETA broadly welcomed the package of measures, it criticised this delay – as did Barclays Capital, whose director of carbon markets Trevor Sikorski described it as "a bit heavy-handed."[29] They argue that slowing up transfers will affect "liquidity", reducing the number of trades on the market.

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>
> Simone Ruiz, European policy director for IETA

Most controversially, the Commission also plans to hide the "serial numbers" of permits, censoring the data that makes it possible to see how installations are meeting their targets under the scheme. The result would reduce transparency in an already opaque system, and make it more difficult for civil society groups to draw attention to cases of fraud and gaming.

This measure was initially opposed by many traders and financial lobbyists – including IETA and the BlueNext exchange, which were concerned about their members' liabilities if they receive stolen permits.[30] But it has been successfully promoted by Andrei Marcu, head of policy at Swiss energy trading firm Mercuria Energy Group Ltd, who proposed it at the 15 March stakeholder meeting of the European Climate Change Programme.[31] Marcu, who was formerly CEO of BlueNext and, prior to that, of IETA, is currently Vice-Chair of the International Chamber of Commerce Environment and Energy Commission – and is arguably one of the most influential EU carbon lobbyists. IETA subsequently weakened its criticism of the proposal, on the condition that it was accompanied by "the removal of liability for an innocent holder of an allegedly stolen permit."[32]

DG Clima's answer to this liability dilemma shows a flagrant disregard for the integrity of the market that it has created. It has consistently suggested that stolen allowances "represent legally valid compliance instruments."[33] Companies have already handed in an estimated 400,000 "blacklisted" permits as part of their compliance with ETS targets.[34] Replacements will *also* been issued to the victims of theft, however, as DG Clima explains:

> allowances will be fully fungible for compensation claims, which means that an allowance can be substituted by any other allowance, if there were a legal claim. In addition, the serial numbers of allowances will be visible only to relevant law enforcement authorities.[35]

DG Clima's proposal was agreed by Member States at the Climate Change Committee on 17 June, and is set to be adopted formally in October 2011.[36]

The combined effect of compensating theft victims with new permits and allowing the stolen permits to be handed in too is that the "cap" on emissions is inflated, opening a new hole in the credibility of the scheme's accounting for reductions. In this context, hiding carbon allowance serial numbers looks very much like a cover-up.

Regulating the Unregulatable

This report focuses on financial regulations on EU carbon trading, and financial sector lobbying surrounding it. But there are several important senses in which the carbon market is unregulatable.

First, carbon markets are particularly prone to fraud and gaming because they create a large trade in intangible and hard-to-measure assets.[37] Carbon allowances are paper or on-screen permission slips that can quickly change hands. In this sense, emissions trading "streamlines the fraudster's profession" - a matted that went unconsidered when the market was set up.[38]

Second, the problems are more intractable when the issue is one of tackling excess speculation. The carbon market will continue to be prone to *arbitrary volatility* because the underlying asset is fundamentally unstable: there is no clearly identifiable commodity being traded, but merely an assemblage of incommensurable activities re-packaged to form a tradeable commodity.[39]

Moreover, the supply of carbon is "uniquely at the mercy of the political pen – where it was conceived", since the act of allocating permits (or determining quantities available for auctioning) is the result of a political decision, rather than something that is indexed to a real-world product. The combination of this factor with the difficulty of identifying clear price drivers makes for arbitrary volatility.[40]

A third, related point is that the political determinants on supply make the EU carbon market particularly prone to *lobbying influence* – either through direct lobbying by Brussels-based associations, or by lobbying national governments to act on behalf of certain industries in EU processes. Such lobbying effects not simply the rules governing how the market operates, but the supply of permits and credits. In the case of international offsets, governments are both supplies and users of credits, contributing to significant conflicts of interest (these also play out within the CDM Executive Board, which is intended to regulate that scheme).[41]

Fourth, the creation of a speculative market contradicts the stated purpose of setting a price on carbon. This can be seen clearly in the case of "position limits" (as discussed below). A position limit sets an upper limit on the proportion of the market that any one trader can hold. The proposal to include such limits in MiFID could in theory contribute to preventing large banks and financial speculators from having too great an influence on market prices. The real problems tend not to be single large traders, however, but rather certain categories of speculative trading, so to be more effective as a means of regulating markets such a proposal should involve "aggregate position limits [to] cap the amount of any market that can be held by any category or group of traders in total" (eg. investment banks or index funds).[42] In the case of carbon markets, however, the real issue is not so much one of limiting certain types of trader as excluding them entirely: "actors not covered by emissions targets prefer price volatility over price predictability because their profit is dependent on volatility" which, as the NGO FERN points out, is contradictory to the stated aim of setting a stable carbon price to affect energy and industrial investment decisions.[43] However, this is still an inadequate check insofar as it fails to capture speculation by energy providers and industry. The former, in particular, treat commodity speculation as an important part of their business portfolio – so the creation of a rigid distinction between "compliance buyers" and financial speculators does not capture the extent to which companies with ETS caps are *also* speculators. It is not clear that such a distinction could be legislatively drawn, and this begs the question as to why a carbon market has been created in the first place. The point of carbon markets is to offer a form of "flexibility" that leads to speculative excess by design - a clear sign that a return to the drawing board is needed.

Ultimately, carbon markets contribute to a financialisation of climate change that inhibits the search for genuine solutions. Carbon trading has evolved a complex technocratic architecture, but it is based upon a reduction of complex ecological and social process to a simplified "carbon" commodity, which renders vastly different processes (from methane reductions in coal mines to tree planting) equivalent.[44] This has become more of an end in itself, with rapid trades conducted to achieve marginal speculative gains rather than the environmental goods that the market is purported to aim at. In this sense, the carbon market reflects a broader wave of financialisation, where profits are generated via capital markets rather than through "real economy" investments. The present financial crisis invites us to consider turning back this tide, and to start de-financialising climate policy.

II. Carbon speculation

The risk of fraud in carbon markets is not the only issue behind the current regulatory drive. The European Commission has belatedly identified carbon as a commodity that is susceptible to excessive speculation and, for this reason, is seeking to classify it as a "financial instrument."

At present, emissions allowances themselves are not directly regulated under MiFID – it covers carbon derivatives, but not trading on the "spot market."[45] This is not the whole story, however, since "the commodity market exemptions in MiFID ensure that most non-financial institutions dealing in commodity derivatives can structure themselves to fall outside the scope of that regime."[46] Put simply, MiFID applies to carbon derivatives traded by banks and specialist trading firms, but not to most traders from energy companies or industry.

At the core of IETA's positioning is a desire to keep carbon trading volumes as high as possible, irrespective of the broader destabilising effects

The EU is now considering changes that would "extend the responsibilities of financial regulators to the supervision of secondary trading of spot emission allowances." [47] This would, in effect, create a unified financial regulatory regime for carbon, as well as requiring stricter checks on financial intermediaries – many of whom are currently small and poorly capitalised "boutique" traders.

This move has seen mixed responses from business, according to where different sectoral interests lie. Industrial sector lobbyists (such as CEFIC and CEMBUREAU, representing the chemicals and cement sectors) are mostly in favour of classifying carbon as a "financial instrument," since they consider the volatility of carbon markets to be a destabilising influence.[48] However, the financial and power sectors, which profit from speculative trading in carbon, have voiced considerable opposition to this measure. IETA, the International Swaps and Derivatives Association (ISDA) and EURELECTRIC have been backed in this stance by BusinessEurope, the European employers' confederation.[49]

BusinessEurope released a Position Paper covering "Market Oversight of the EU Emissions Trading Scheme" on 1 July 2011. It claims that the existing coverage of carbon derivatives by MiFID means that "no further regulation" is needed, while at the same time seeking to isolate as much of the trade in carbon as possible from MiFID's "burdensome rules."[50]

IETA argues that treating carbon as a financial instrument would increase the cost for "compliance" buyers.[51] It argues instead that more limited regulations be devised specifically for carbon.[52]

EURELECTRIC, the electricity industry lobby group, claims that classifying carbon as a financial instrument could extend financial checks that are inappropriate for compliance buyers, as well as potentially harming SMEs (small to medium sized enterprises).[53] The European Federation of Energy Traders - which includes the trading divisions of the major electricity and oil companies - expressed similar opposition, claiming that emissions allowances are not financial instruments, since their primary purpose is to meet emissions targets and "not to serve as an investment product. "[54]

This line of argument seeks to draw a clear line between "compliance" with emissions targets and other forms of speculative trading. Yet, as the World Bank has pointed out, "financial and technical trades now account for a greater portion of [carbon] market activity than do trades for compliance purposes."[55] The Prada Commission, an influential French government study on the financial regulation of carbon markets, also noted an increase in financialisation.[56]

Finally, the International Swaps and Derivatives Association (ISDA), one of the main lobby groups representing financial speculators, has also warned against blurring the boundary between physical commodities (a definition under which they include carbon) and other financial markets. Their concern is that re-classifying carbon could open the door to a broadening of MiFID to include other "non-financial assets".[57]

Proposals to introduce position limits or capital limits (which would require that those who are trading have sufficient funds to cover their "exposure" should their investments go sour) have also been opposed by the ISDA, as well as those representing energy companies, for whom speculation on commodity and carbon prices now represents an important part of their business.[58] Like IETA, they argue that these would diminish "liquidity" and so destabilise the market (on the grounds that a market with a high trading volume is one in which any individual trade would not significantly affect the price), although it is widely acknowledged that an excess of risk-taking on the basis of unsecured and often unidentified assets was a major factor in the leading to the financial crisis.

Limiting speculation

The latest draft of the new MiFID regulations, leaked to *Reuters* in September 2011, is a significant set-back for the financial sector lobbyists. It proposes to make "the entire EUA market subject to financial market regulation. Both spot and derivative markets would be under a single supervisor. MiFID and the Directive 2003/6/EC on market abuse would apply."[59] In defining carbon allowances as financial instruments, it specifies that this definition should include not just EUAs but also UN offsets.[60] The leaked draft also proposes that "position limits" be set on a variety of commodities, including "emission allowances or derivatives thereof."[61] These measures are welcome signs that the EU is coming to grips with aspects of the financial regulation of carbon trading. A leaked draft may represent a high-water mark in negotiations, however, and the risk remains that intensive lobbying could see these proposals watered down in the published version.

Significant devil lurks in the details, however. MiFID currently excludes firms that are "trading for their own account" (traders who claim they are simply managing assets, rather than seeking speculative profit) or for whom it is "ancillary to their main business."[62] These exemptions encompass most energy firms which, between them, account for the bulk of trade (including for speculative purposes) on carbon markets would remain exempt from MiFID. Industrial installations would also be exempted for the same reason. The new legislation may, at most, result in some internal restructuring within the trading arms of energy firms – as well as covering specialist traders and banks.[63]

Further ambiguities remain in the leaked MiFID draft. Although it suggests thats regulators at national level must be given the power to set position limits, "It does not say that regulators must use these powers."[64] The regulators of the UK market, which accounts for the majority of carbon traded, are likely to keep these powers in reserve. No definition is given as to position limits, either. In the USA, where a similar proposal was passed as part of the Dodd-Frank Act in 2010, a backlash against the tougher financial rules saw the Commodity Futures Trading Commission (CFTC) propose limits of 25 per cent of market volume, far too low to deter excessive speculation.[65]

Conclusion

The European Commission initially took a light-touch approach to regulating carbon markets, putting increases in the volume of trade ahead of security concerns. In so doing, it failed to anticipate the specific opportunities for gaming and fraud posed by creating a large market in an intangible commodity. A series of carbon fraud cases, and the role played by "derivatives" in triggering the financial crisis, has made this position untenable and ushered in a new wave of regulation. This brings together measures designed to address fraud and gaming, with others designed to limit the destabilising effects of speculation. These may clean up the market's image, but they do not address the core problems with carbon trading.

Fraud risks, in the narrow sense of deliberate deception for unlawful gain, are potentially less significant than those posed by "gaming" - deliberate deception that is legally sanctioned.

The measures proposed to tackle fraud focus on tightening registry security – in essence, regulating more strictly who can trade in carbon so that it is no longer possible to simply register as a trader from a home computer, steal funds, then disappear without trace. This much is sensible, although the fact that it took a series of fraud cases to bring about these obvious protections casts Commission decision-makers, and the lobbyists who pressured them to avoid regulation, in a poor light.

More controversially, the Commission's package of security measures includes changes that hide serial numbers. The City of London Corporation, not known for its radical pro-regulatory stance, reports surprise at this decision, stating that "It is not understood how this will aid security as it prevents the market from identifying the provenance of the allowances."[66] Indeed, it is hard to find explanations that do not point towards a cover-up. In making it impossible to anyone except law enforcement agencies to trace individual allowances, the Commission has reduced transparency across the whole scheme, making it harder for civil society to reveal evidence of fraud and gaming, or the perverse effects of the system, and making it impossible to trace the volume of permits re-issued as a result of theft. These reissued permits would, in turn, further inflate the already generous emissions limits that the scheme establishes.

Significant fraud and gaming risks remain, despite these changes. Holes in registry security mean that there is still a risk that carbon trading could be used for money laundering.[67] This is a particular problem across different legal jurisdictions.[68] While the EU is trying to close the door to registry fraud within its borders, it is at the same time attempting to link it's carbon market to other emerging markets (eg. Australia), as well as allowing offsets to be traded within its scheme – increasing the potential for carbon fraud globally.

Fraud risks, in the narrow sense of deliberate deception for unlawful gain, are potentially less significant than those posed by "gaming" - deliberate deception that is legally sanctioned. As we have shown elsewhere, the lobby pressure to freely allocate large surpluses of emissions permits has resulted in windfall profits for industry and the power sector.[69] The offset markets are notorious for the same practice. CDM credits are issued in relation to "additionality" claims that are impossible to prove.[70] A recently leaked US cable gave dramatic evidence of the scale of this problem, reporting from a meeting in Delhi that "all interlocutors conceded that all Indian projects fail to meet the additionality in investment criteria and none should qualify for carbon credits."[71] These interlocutors included the Chair of the national CDM authority, as well as some of the country's largest project verifiers and developers. In a nutshell, carbon trading schemes are awash with paper "reductions" that do not correspond to actual reductions of greenhouse gas emissions in the real world, and this is a systematic problem. Gaming results in windfall profits and undermines efforts to address climate change.

Carbon trading schemes are awash with paper "reductions" that do not correspond to actual reductions of greenhouse gas emissions in the real world.

On the side of financial speculation, the key regulatory proposal is to classify carbon as a "financial instrument." This would bring it under the scope of MiFID, a key component of EU market legislation that is currently under review. IETA and other financial sector lobbyists have vigorously opposed this change, fearing that it could limit some avenues for financial speculation on carbon. A leaked draft of the proposed Directive suggests that the Commission may not side with the lobbyists, although some key exemptions remain in place. Most notably, leaving it to national authorities to set "position limits" would be ineffective: the majority of trades on exchanges pass through the UK, which is opposed to this concept and would not implement it in any meaningful way. The restriction to trading on "own account" fails to capture speculation engaged in by energy companies, which are the largest players on the carbon market.

More fundamentally, though, restrictions on speculation shed critical light on the flawed purpose of the carbon market in the first place: it introduces speculation by design, undermining the stated objective of long-termer clean investment decisions. To really address these issues requires bolder steps to de-financinalise climate policy and move away from the carbon market model.

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Acknowledgements: *Thanks to Belén Balanyá, Helen Burley, Joanna Cabello, Michelle Chan, Kenneth Haar, Jutta Kill and Steve Suppan.*
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Glossary

Carousel fraud. Also known as "missing trader" fraud, this exploits differences in how states apply value added tax (VAT). A carousel fraud in carbon trading saw permits bought in countries that did not impose value added tax (VAT) and sold in other countries where VAT was included in the price. The traders who engaged in this practice would then go missing without ever declaring the tax income. This lost treasuries around €5 billion in lost revenue.

CDM. Clean Development Mechanism. A UN-administered scheme that allows industrialised countries and companies with greenhouse gas emissions reduction targets to invest in "emissions-saving projects" that supposedly compensate for their continued pollution.

CER. Certified Emissions Reduction. Carbon offset credits issued as part of the Clean Development Mechanism.

Derivative. A financial contract for the supply of an asset (eg. carbon permits) at a future date.

DG Clima. Directorate-General for Climate Action. Administrative department of the European Commission that takes a lead role in international climate negotiations, as well as developing and implementing EU-wide climate policies, such as the Emissions Trading System.

Exchange. A private company that provides a platform for trading contracts and goods. Exchanges function like a club, with members sharing the latest prices on standard contracts on the products they buy and sell to each other.

EU Communication. A non-legislative discussion document produced by the European Commission.

EU ETS. European Union Emissions Trading System. A scheme that sets an overall legal limit on greenhouse gas emissions ("a cap") and then grant industries a certain number of licenses to pollute (EUAs). Companies that do not meet their cap can buy permits from others that have a surplus ("a trade"). The EU ETS is the world's largest emissions trading scheme, but has been criticised for rewarded major polluters with windfall profits, while undermining efforts to reduce pollution.

EUA. European Union Allowance. A permit to pollute issued to a power station or factory covered by the EU Emissions Trading System.

IETA. International Emissions Trading Association. The largest carbon trade lobby group, with over 150 company members globally.

Liquidity. In a "liquid" market, an asset can be bought or sold without causing significant price movements. Carbon lobbyists argue that a larger market provides greater stability. However, liquidity can also result from an excess of risk-taking on the basis of unsecured and often unidentified assets – a key factor leading to the financial crisis.

OTC. Over the Counter. A financial trade that does not take place on a stock exchange. Most are structured in a complex fashion, encompassing a series of speculative bets on future outcomes, as well as mixing and matching a variety of permits and credits. Most CDM offset credits are traded this way.

MiFID. Market in Financial Instruments Directive. An EU regulation on financial markets, which is currently under review.

Phishing. A form of fraud that is no different in form to the email spam that encourages credit card holders to enter their online account details, with the stolen data then used to make unauthorized purchases. Lax security resulted in a series of successful phishing attacks on the ETS.

Position limit. An upper limit on the proportion of a market that any one trader can hold.

Registry. An official national database recording how carbon allowances are allocated, who owns them, and the use of allowances in relation to the emissions caps of installations covered by the ETS.

Spot Market. An immediate (or "on the spot") exchange of financial instruments or commodities in return for cash payments. In reality, it takes up to three days for carbon permits or credits to be transferred. This segment of the market is unregulated at present, and is where most carbon fraud cases have occurred.

Notes

1. Prada, M. (2010) *The Regulation of CO2 markets.* France: Ministry of Finance, p.15
2. Mimeo (2009). "Carbon Markets 1", World Business Summit on Climate Change, 25 May
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