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Practical Information for Emission Trading

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MIFID II – A true challenge after 2018 for distributors and operators or “scaremongering” in the market!?

After years of back and forth, system operators and distributors are now preparing the beginning of MIFID II execution on the CO2 market for the 03.01.2018.

Surely by now the group of distributors and one or another system operator are more or less faced by the question: Who anyway still is entitled to sell or purchase emissions certificates to what conditions to whom for what purpose?

As on the whole exclusively the spot trade and not the futures trade may be of interest for medium-sized and small system operators, Emissionshändler.com® explain the most important rules for this circle of operators.

The reason why this clarification is of special importance is the activity of one or another trader in the EU. According to Emissionshändler.com®s' observations, these traders use to deceive or partially confuse smaller and medium-sized operators, intentionally or unintentionally, by means of statements.

For this reason these present Emission News 09-2017 include the view of Emissionshändler.com® to some statements of “competitors” which have been submitted to operators in Germany in the form of brochures and pdf files. For their comments Emissionshändler.com® profited from the advice of the well-known law office Becker Büttner Held in Berlin.

All emission certificates will become financial instruments with the beginning of the year 2018

The revision of the Financial Instruments Directive (MiFiD) basing on the pre-mentioned Banking Act (KWG) until 03.01.2018. It will be implemented in Germany and will have become

An essential result of this process will be the modification that emission certificates will also be treated as a financial instrument in the future. This means that emission certificates being negotiated on the spot market and all emission certificates being negotiated in forward transactions (no matter if they will be fulfilled physically or financially or not) will be part of the financial market from this day on. Consequently the certificates will be subject to the Financial Market Authority.

European system operators who usually buy additional emission certificates on the market in order to meet their legal return obligation (compliance), are faced with the question if and what kind of changes will come towards them with the beginning of 03.01.2018.

At the same time traders are faced with the question what consequences will have to be drawn and what parts of their today's business models will have to

or continue to remain without supervision, as far as one of the exceptions provided by law finds application for them.



Revolution and drastic changes?

MIFID II is the English abbreviation for “Markets in Financial Instruments Directive” and rules, as the English term indicates, the “financial instruments”. This means for the CO2 trade that now also its futures trading and spot trading will be regulated. For some time past, market participants transmit the impression to many small and medium-sized operators that a

- *“revolution of the CO2 market“ after 01.01.2018*

would be starting for them.

Emissionshändler.com@s' comments:

that such a statement may irritate one or another operator: who is keen on entering into a revolution?

According to the statement of a trader the revolution announced by MIFID II and MIFIR (Markets in Financial Instruments Regulation, the “affiliated regulation” to the MIFID II) needs of course a “preparation” because

- *“commodity trading in Europe will undergo a drastic change after 3. January 2018”.*

Emissionshändler.com@s' comments: Principally such a statement deserves in fact a large approval but the real trade is concerned by it and less the simple procurement processes.

In so far a comparison can be drawn in this context as if a new directive for the trade with petrol and fuels has been entered into force which is going to “revolutionize” the oil market. But in fact the refuelling process at the service station will experience no or only a little change as the ordinary customer will fill up his fuel tank here which means fulfils his own needs in a procurement process. Nothing else happens with the system operator who buys himself CO2 certificates from the trader for his compliance.

From the view of a system operator who has to procure himself with CO2 certificates for his own compliance, no changes and no revolution at all will consequently take place due to MIFID II and due to MIFIR. Therefore an All Clear signal can be proclaimed in this respect.

CO2 Emissions certificate like EUA, EUAA, and CER turn to Finance Instruments

For some time it is also known to operators of an emission trade obliged facility in the EU that CO2 certificates will turn to financial instruments after 03.01.2018. These will then bear the same status as shares and credit loans.

Also for this reason certain traders might be tempted to assume to a statement in their brochures and e-mails with the content that the operators are requested to

- *“adapt to extensive regulations and new processes being typical for financial markets”*

Emissionshändler.com@s' comments: This is simply a scaremongering which serves the uncertainty of potential advisory clients who, in the course of a confidential conversation, could then be confronted with more exaggerations or half-truths.

It is a fact that this above-mentioned statement is not true, **as nothing will practically change for nearly all operators** of emissions trade obliged facilities as long as those only intend to procure themselves for reasons of legal compliance with certificates for their own need.

Original sound bite tone of a specialised attorney to the statements about MIFID II which are partially spook around on the market:

“It is indeed very lurid and tendentious with the goal of utmost uncertainty what is spread on the market.”

Which trader is allowed to offer what kind of CO2 trade to what market participant?

If now from the view of a system operator the question arises whether the well-known and familiar trader of his choice is allowed and him certificates, certain statements will be made on the market.

Due to the way how they are formulated, they may have the goal to divide the totality of traders in good ones (with a license) and bad ones (without a license) in the future.



A retailer booklet for example makes the following statement under the headline **“Practical consequences for trade obliged facilities”**:

- **“CO2 certificates are allowed to be dealt with in the future only by providers being controlled by the financial authority of the relevant country.”**

Emissionshändler.com@s' comments: The kind of this statement is not only wrong but seems to be a transparent attempt to present traders without a “finance license” in a way as if these lose their right to sell certificates of the EU emissions trade to operators after 2018 – or as if operators risk to get a problem if they make business with such a “bad” trader.

It is a fact and correct that activities which fulfil the requirements of a bank business or a financial service

may usually be executed by financial institutes only. These are enterprises that possess permission as a bank or as a financial service provider. They obtained their permission from the Financial Supervising Authority (the general term “financial authorities” belongs to the finance and tax administration sector), and are controlled by this institution.

This is not the case, however, if the enterprise can refer to one of the numerous existing exceptions. Most of the players being active in the CO2 trade sector will make use of these.

Trade in Parent Companies and Trade for Third Parties

Not only small and medium-sized system operators are made insecure by doubtful statements about MIFID II in the emissions trade but also parent companies and groups. It is not the question in this article whether these statements are made for the acquisition of advisory projects or simply for the creation of uncertainty. One statement made

- **“CO2 trade will (be) restrict(ed) to group internal activity by the parent company or a holding-company”**

Emissionshändler.com@s' comments: This statement is not only misunderstanding but wrong in its general meaning.

The MIFID restricts trade neither inside nor outside groups but establishes rules if the offering of certain kinds of business is subject to permission. Consequently the above-mentioned statement only refers to art. 2 paragraph 1 lit. (b) MIFID II which, as an exception to the rule, generally excludes group internal businesses from the MIFID permission duty.

Emissionshändler.com@ explains:

Provided that a system operator intends to consider the emission certificates trade with a retailer closer on a juridical base, he will not be able to avoid a closer view to the so-called “trading

on the execution of customer orders”.

In fact the result of an individual assessment

From the view of a system operator, however, it is easy if the deal **between him and a trader happens directly**: he only procures himself for his own purposes, thus avoiding the execution of customer orders.

Giving advice to system operators about CO2 transactions

Since the beginning of 2017 statements are made on the market about the advice for potential buyers and sellers of certificates. The contents of such statements are not less than doubtful, if not even diminishing and finally just wrong.

For example a scenery is presented which offers advice to potential customers where and what should be negotiated on the CO2 market. In order to decide from the “bad” traders

- **“traders/advisers are held to apply for a special “Investment Advisor Licence”**

Emissionshändler.com@s' comments:

This statement is a very generalizing one any validity. In fact the correct words for this statement should be: Advices for CO2 certificates request a preliminary verification from part of traders/advisers if they observe the fact of



financial services of an investment advice according to MiFID II. This is not guaranteed for every information but only for advice on the basis of a concrete single case.

But even then a check has to be made if not one of the MiFID II exceptions finds application, especially the already mentioned article 2 paragraph 1 lit (j) which enables an advice in half-time work leading to another main business.

Simply put: **traders who are concerned by the various exceptions because their advisory activity falls under part time work need no licence of any kind**.

No system operator ever has to worry to find a trader

At least since the scandals with the turnover tax carousel a system operator should be aware that a trade with CO2 certificates with badly known business partners may cause severe problems and quickly lead to an involvement with black money business. For this reason it is advisable to know his trading partner.

But if a system operator is on his way to look for a new trader who would sell him certificates for the compliance, it is clear that this trader is inclined to get first of all acquainted with his new customer.

However, a statement having been taken from a trader's brochure is the subject of a big exaggeration. It is cited as follows:

- ***“Before obliging facilities have the opportunity to deal with CO2 certificates, they are obliged to go through a complex customer admission procedure.”***

Emissionshändler.com@s' comments:

It is correct that enterprises

need to have installed a careful “Know-your-customer-process (KYC process). This is necessary for the required prevention for the prevention of money-laundering.

However, this does not apply to the area of pure "goods traders", which legally also fall under the CO2 trade, as far as the spot trade is concerned!

It is clear, however, that a non-obliged CO2 trader certainly requested a few relevant data from a new customer so far – and should do so, in his own interest. In any case no system operator needs to worry that he has to undergo a “*complex customer admission procedure*”. **Otherwise he simply must have met the wrong trader.**

Or he met a trader with a bank licence, acquisition of which is to be justified retroactively by means of artificially increased effort.

Another item to be criticised is the fact that a statement like this is suitable to create the impression for system operators that those may probably fail to pass successfully through such a “*customer admission procedure*” and would consequently only achieve to obtain urgently needed certificates with the help of “competent advisers”. Every participant in the market may be free to form his own judgement on such kind of business practices.

Reporting and registration of emission business in accordance with EMIR

EMIR is the designation for European Market Infrastructure Regulation and stands for the EU regulation n° 648/2012 dated 04.07.2012 about OTC derivatives, central counter parties and a transaction register. The regulation rules the trade with derivatives which takes place outside the stock exchange. Core of the regulation is

as well as the communication of these OTC businesses to a transaction register.

Now an inexperienced system operator may assume that all his transactions in the CO2 trade are subject to this procedure and regulation. Some market participants originating from commercial enterprises and consulting business are profiting from this inexperience while obviously practising a politic of misinformation. An internationally operating trading and consulting company writes for example:

- ***“According to EMIR (European Market Infrastructure Regulation) spot as well as***



- *derivative transactions need to be reported to the competent authority”*

Emissionshändler.com@s' comments: this statement is, in these words, clearly wrong!

A reporting obligation for derivatives businesses has been established after EMIR came into force. Consequently CO2 derivatives are reported to a competent authority (most the time by the banks involved) already today. While nowadays CO2 derivatives are essentially financial transaction businesses respectively forward transactions via stock exchange, all forward transactions “physically” to be fulfilled outside the stock exchange will be considered as *derivative* after 03.01.2018. These will consequently be subject to registration in the future. But:

The **spot transactions** are **not concerned** by EMIR – as less as share purchases are, for example.

As now smaller and medium-sized system operators use to make their certificate purchases on the spot market in order to cover their submission obligation prescribed by law, they will never get into touch with a reporting obligation and need not to worry either that they might probably get obliged to work with banks or brokerage houses in order to fulfil better any fictitious reporting obligations.

Should/must system operators address themselves to authorities for a special permit?

Our consideration described in this **Emission News 09-2017** is just limited to the role of a system operator and the one of a trader. If the trader's deals with CO2 are a main activity or a secondary employment may be reserved to the next chapter.

But if the question arises that a system operator who wants to buy emission certificates at the spot market only for his compliance will need an authorized special permit for the period after January 2018, a short glance on the legal rules is worth to be thrown.

As one might expect, the market disposes of presentations which are suitable to make system operators insecure and urge them to a probably unnecessary consultation. One statement for example says:

- *“Enterprises are expected to inform the relevant authority and present information in order to be 'excluded' from these directives.”*

Such a statement may refer to the exception already mentioned in accordance with

Enterprises which meet this requirement are obliged to announce this in the future once within a year to the relevant authorities and prove their legislation on request of the authority.

Until now it is not known how this legislation will look.

But the *exception* will have to consider this question. It is expected that the question for sideline activities will base essentially on the part of the total European CO2 trade. As long as this trade will not become too severe, even enterprises which are speculating very actively on the CO2 trade may profit from the sideline activities' exception.

It therefore seems likely that the notification to the supervisory authority is limited to a representation of the own trading volume during the reference period.

The above-mentioned statement *in so far* but has in fact the potential to awe utmost respect to an incompletely informed system operator for a possibly incomplete or wrong application which may lead to the fact that he all of a sudden finds himself in front of a financial market authority with all disagreeable consequences. This is **not the case at all!**

Which CO2 trader may be allowed to deal under what conditions after 2018?

At the beginning of the discussions in the year 2014 previous to MIFID II it seemed to be the case that only financial market actors will shape the emission trade of the future. Traders having been active on the spot market previously had to reconsider if they will found a “bank” or a



“brokerage house” for the continuation of their business – or if they should stop their business with commencement of MIFID II. An adjustment would have had taken place on the whole as the trader would have had faced enormous expenditures in time and finance. Moreover permanent and expensive reporting obligations to authorities and institutions would have afflicted him.

In the course of the final work on the MIFID II it became clear that such a development could not be in the sense of ~~the system operator~~ system operators. Moreover the financial institutes and big brokerage houses would have achieved a market-dominating position through the elimination of small dealers. So the page has turned.

Not only many exceptions entered into the MIFID II who will fall among those and who will not, but it became more detailed how a main activity and a sideline activity can be defined.

The term “sideline activity exception” may assume the thought that the decision that will fall under the financial market authority will be made under the aspect how an enterprise defines a main activity and a sideline activity. **But this is not the case at all!**

~~the~~ the commission finally decided to follow primarily another way. The definition what a sideline activity is and what not is **based essentially on the meaning of an enterprise for the European derivative market.**

This is an extraordinary comfortable rule because hardly any enterprise will achieve the specified thresholds in the particular derivative classes for all over Europe.

If the appropriate regulations are supposed to be presented in the form of a calculative example this would mean that a trader who has up to 50% of his position open for speculating will be subject to a financial supervision only if he rules more than 10% of the European CO2 market. Such a ruling position is achieved only by the biggest German electricity companies in Europe, if even.

And through this it becomes clear that almost all previous medium-sized and small traders could fall

under the MIFID II article 2 exemption permit – of course always in dependence on the concrete definition of their kind of services.

Nor will the financial institutes and brokerage houses automatically rule the market alone.

Conclusion on the introduction of MIFID II in January 2018

The MIFID II is no serious threat for traders and operators being active in the CO2 spot trade and not a revolution at all, as some brokerage and trading houses may make believe.

A system operator who ~~is not~~ and buys CO2 certificates on the spot market will hardly experience any change. Even if he buys and sells to 100% on his own account and for speculative reasons – which, in fact, almost nobody might do – he can be sure that no financial market authority will knock on his door. Unless he moves annually more than 4% of the EU emission trade market. By way of calculation this would be several hundred millions EUA certificates. An amount that even medium-sized trader will not have as turnover.

This is also the reason why almost all traders can get organized in a way that they are concerned by the exception rule.

But if some traders intend to position themselves on the market as “dealer with finance market licence” or if they mutate to a bank, they may go the appropriate way and also try then to survive in the competition on the market with considerably higher cost.

As it can be recognised by now, some of these semi-truths and scaremongering are suitable to make believe to system operators that the revolution comes closer. Others gave up already as it can be seen at the well-known East European business group CONSUS who changed already last year from the CO2 market to the real estate market.

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Kind emission regards



Michael Kroehnert

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