

## EU Suspends Carbon Trading After Almost \$38 Million Stolen

February 1, 2011

The most recent theft of almost US\$38 million in EU Emission Trading System carbon credits may shift political support in favor of centralization and abolition of national registries.

On January 20, 2011, the European Commission, the executive arm of the European Union (EU) in charge of overseeing the Emission Trading System (ETS), suspended all spot-trading activity on that carbon emissions market after determining US\$37.7 million worth of credits may have been stolen. The EU suspects the fraud occurred because of insufficient network security on the national carbon registries for Austria, the Czech Republic, Estonia, Greece and Poland. Maria Kokkonen, spokeswoman for the EU's Climate Action Commissioner, announced that spot-trading will be suspended until all countries participating in the ETS provide the commission with independent reports confirming network security system upgrades.

The ETS is the oldest and largest of the greenhouse gas trading markets established to reduce carbon emissions from stationary sources through market-based incentives. The trading system places a "cap" on annual carbon dioxide emissions and allows entities whose carbon emissions are below their allowable cap to sell surplus emission credits to other entities that require additional credits to cover their carbon emissions. The total value of ETS credits traded in 2010 was almost US\$120 billion, with spot trading accounting for 10 to 20 percent of those trades. The ETS derivatives and futures markets that comprise the rest of the trading are not affected by the suspension.

The recent theft is the latest in a string of trading issues involving ETS and the national registries. In November 2010, hackers stole almost US\$33 million worth of allowances from Holcim Ltd., a Swiss cement company, which held credits with the Romanian National Registry for Greenhouse Gases. There have been similar reports of fraudulent transfers in the Dutch and German registries.

Currently, each of the countries participating in the ETS operates an independent national carbon registry to track carbon credit ownership within that country. Unlike a bond or stock trade that is settled through a clearinghouse, the national registries cannot verify ownership before moving the credits into an account. The credits are traded through independent emissions exchanges; however, since the credits only exist online, they can then be sold in multiple transactions before the owners are aware that they have been stolen.

While catching the thieves is a primary concern, the speed of emission credit trading also raises complex legal questions over ownership and what entity suffers the loss in the event of theft. Depending on which country's law

applies, the “owner” can be the original owner, one of the entities that bought the credits, the exchanges where the credits were traded or the defrauded national registries.

ETS has suffered the setbacks characteristic of an immature financial market, namely, volatility, booms, busts, and fraud and abuse. When it was established in 2005, centralization of the trading market and abolition of national registries were discussed but never implemented, due to lack of political support from individual countries. While a 2013 deadline for centralizing ETS trading into one clearinghouse in Brussels is fast approaching, earlier political opposition to such centralization appears to be waning as a result of pressure from the trading community.

Based upon the lessons learned in EU ETS design, it can be expected that the new clearinghouse will incorporate centralized registry and exchange mechanisms like those adopted in China and California. This in turn will increase the security of the credits, thereby increasing investor confidence and bolstering public opinion in the efficacy of a cap-and-trade program.

The material in this publication may not be reproduced, in whole or part without acknowledgement of its source and copyright. On the Subject is intended to provide information of general interest in a summary manner and should not be construed as individual legal advice. Readers should consult with their McDermott Will & Emery lawyer or other professional counsel before acting on the information contained in this publication.

© 2010 McDermott Will & Emery. The following legal entities are collectively referred to as “McDermott Will & Emery,” “McDermott” or “the Firm”: McDermott Will & Emery LLP, McDermott Will & Emery/Stambridge LLP, McDermott Will & Emery Rechtsanwälte Steuerberater LLP, MWE Steuerberatungsgesellschaft mbH, McDermott Will & Emery Studio Legale Associato and McDermott Will & Emery UK LLP. McDermott Will & Emery has a strategic alliance with MWE China Law Offices, a separate law firm. These entities coordinate their activities through service agreements. This communication may be considered attorney advertising. Previous results are not a guarantee of future outcome.