

# CONFLICT OF LAWS IN EMISSIONS TRADING

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- I. Background and Purpose of this Article
- II. Proprietary Issues Which May Give Rise to Conflict-of-Laws Problems
- III. Approaches for Determining the Law Applicable to the Proprietary Issues
  - A. Application of the Overriding Mandatory Rules of the Law of the Forum (*lex fori*)
  - B. Application of the Law of the Issuing State
  - C. Application of the Law of the Place of Registration
- IV. Clarification and Unification of Substantive-Law Rules on the Proprietary Issues
- V. Other Conflict-of-Laws Problems

## I. Background and Purpose of this Article

Emissions trading has been the subject of many debates since the Kyoto Protocol to the United Nations Framework Convention on Climate Change allowed industrialised nations to use it as a supplementary measure to achieve their target to reduce greenhouse gas emissions. Much has been written about its political and economic implications. Yet, its legal aspects have been largely unexplored. There has been surprisingly little analysis on the private international law aspects of it. This lack of analysis does not mean that there are no significant conflict-of-laws problems that arise.

The Kyoto Protocol's first commitment period will expire at the end of 2012. During the second commitment period, starting in 2013,<sup>1</sup> emissions trading will continue in various forms. The EU Emissions Trading Scheme,<sup>2</sup> for example,

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<sup>1</sup> The Parties to the United Nations Framework Convention on Climate Change (UNFCCC) decided in the COP (Conference of the Parties) 17 to launch a second commitment period of the Kyoto Protocol starting in 2013 for an unspecified duration.

<sup>2</sup> Established by the Directive 2003/87 of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community (*OJ L 275*, 25/10/2003, p. 32). This Directive has subsequently been amended by the Directive (2004/101), Directive (2008/101), Regulation (219/2009), and Directive (2009/29).

sets specific reduction targets for 2013 onwards.<sup>3</sup> In due course, the Kyoto Protocol will be replaced by a new legal regime.<sup>4</sup> It is expected that emissions trading will also be given an important role in that new regime. Moreover, emissions trading can be used to curb emissions of substances other than greenhouse gasses. In fact, the world's first emissions trading scheme was created to reduce the emission of substance harmful for the health.<sup>5</sup> Because emissions allowances are legal constructs, there can be as many emissions trading schemes as the legal regimes, which create them.<sup>6</sup>

The present analysis is not predicated on the particularities of any specific emissions trading scheme existing today. Its scope is broader, covering any emissions trading schemes of the past, present, and future with the following characteristics:<sup>7</sup>

– The States participating in the scheme (hereafter “constituent States”) make commitments to limit emissions of certain substance in their territories during a specified period of time.

– To honour their commitments, the constituent States impose obligations on the entities active within their territories to limit emissions arising from their activities.

– At the start of the commitment period, emissions allowances are allocated to the constituent States in quantities corresponding to their respective commitments.

– In the course of the commitment period, emissions allowances may also be generated from emissions abatement projects.

– The emissions allowances are capable of being owned by the States and non-State entities, which have, accounts in the registries maintained by the constituent States, with such ownership being transferable both domestically and internationally.

– The issuance, holding, transfer and other dispositions of emissions allowances are registered in the registries<sup>8</sup> maintained by the constituent States.<sup>9</sup>

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<sup>3</sup> Article 9 of the Directive 2003/87 (note 2), as amended by, *inter alia*, the Directive 2009/29. The amendment by the Directive 2009/29 applies to the trading period commencing in 2013.

<sup>4</sup> The Parties to the UNFCCC decided in the COP 17 to launch a process to develop by 2015 a new regime which is to take effect in 2020.

<sup>5</sup> Under Title IV added by the 1990 Amendments to the United States Clean Air Act, the aim of which is to reduce sulphur dioxide (SO<sub>2</sub>) emissions.

<sup>6</sup> Besides the Kyoto Protocol scheme and the EU scheme, other examples of currently existing emissions trading schemes include the Regional Greenhouse Gas Initiative of the north-eastern States of the United States and the national emissions trading schemes of Norway, Switzerland and New Zealand.

<sup>7</sup> In fact, the analysis of this article could be also applicable to the trading of quotas other than emissions allowances, such as fishing quotas, if it is equipped with all the listed characteristics.

<sup>8</sup> Instead of registries, certificates may be created to record emissions allowances (*e.g.* s. 18(1A) of the Personal Property Securities Act 1999 of New Zealand contemplates

### *Conflict of Laws in Emissions Trading*

– The constituent States and their entities are authorised to use emissions allowances to help meet their commitments and obligations.

The aim of this article is to suggest solutions to the conflict-of-laws problems which may arise in an emissions trading scheme meeting the above criteria. Reference will be made to the rules of currently existing emissions trading schemes for the sake of illustration. The analysis will focus primarily on proprietary issues such as the transfer of ownership of emissions allowances and the creation and effect of security interests in allowances. Those issues will be outlined in the following chapter.

## **II. Proprietary Issues Which May Give Rise to Conflict-of-Laws Problems**

The laws of constituent States of the same trading scheme may differ regarding the requirements for the transfer of ownership of allowances; the additional steps, if any, needed to make the transfer effective against third parties; the method for determining priority when multiple transfers are involved; the impact, if any, of the rescission or termination of an underlying contract on the validity of a transfer; and the possibility of and conditions for a good faith acquisition.

The possibility of a good faith acquisition is of particular importance for a transferee of an emissions allowance since ordinarily, a transferee cannot be sure whether the transferor's title to the allowance is free from any defects. In an

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the possibility of such certificates – “emissions unit certificates” – being issued). The present article will not extend its analysis to allowances embodied in certificates because the conflict-of-laws problems arising from such allowances could be dealt with in the same way as securities (shares and bonds) and because the trend of dematerialisation is expected to continue.

<sup>9</sup>In the EU Emissions Trading System, an EU-wide centralised registry (“Union Registry”) became operational at the beginning of 2012 (See Article 19(1) of the Directive 2003/87 (note 2) as amended by the Directive 2009/29/EC). But an entity's account in the Union Registry is administered on behalf of the Member State where the entity is located (See Table I-I of Annex I of the Commission Regulation No. 920/2010 of 7 October 2010 establishing a Union Registry for the periods ending 31 December 2012 of the Union emissions trading scheme (*OJ L* 270, 14.10.2010, p. 1) (For the trading period commencing in 2013, the position is the same under Table I-I of Annex I of the Commission Regulation No. 1193/2011 of 18 November 2011 establishing a Union Registry for the trading period commencing on 1 January 2013, and subsequent trading periods, of the Union emissions trading scheme (*OJ L* 315, 29.11.2011, p. 1)). For the purpose of the present article, “an account on the registry of State A” should be understood in the EU context to mean “an account administered on behalf of State A in the Union Registry.”

international context, the question of good faith acquisition may arise in situations like the following hypothetical:<sup>10</sup>

*Case 1:* An emissions allowance held in X's account in the registry of State A is stolen by Y through a phishing attack. After registration has been transferred to Y's account in the registry of State B, Y concludes a sale contract with Z, who is acting in good faith. Registration is then transferred from Y's account in the registry of State B to Z's account in the registry of State C. The laws of States A and B allow good faith acquisition of an emissions allowance upon the transfer of registration. Under the law of State C, however, a good faith acquisition is not allowed. What law is applicable to determine whether and under what conditions Z acquires good title to the allowance?<sup>11</sup>

The significance of this question is amply demonstrated by a spate of thefts of allowances, which actually occurred in recent years within the EU Emissions Trading Scheme.<sup>12</sup> Trading was brought to a halt as Europe's registries were closed to improve security measures.<sup>13</sup> Even after the registries reopened, the liquidity of the market suffered from lingering uncertainty over the title of stolen allowances.

Transfer of ownership is not the only form of trading of emissions allowances. Allowances may also be used as collateral to secure indebtedness or other obligations.<sup>14</sup> Demands for such use will grow with improvement in the liquidity

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<sup>10</sup> The resolution of this hypothetical case will be discussed in section C. of Chapter III below.

<sup>11</sup> If Z fails to acquire good title, it does not necessarily follow that the allowance which Y has stolen will be returned from Z to X. If the trading scheme treats allowances as fungible property and enshrines the finality of registered transactions, Z may have to execute a new transaction to return allowances in the quantity equal to the amount it failed to acquire. This seems to be the case under Article 32b(3) and (4) of the Commission Regulation No. 920/2010 (note 9), which is applicable for the trading period ending 31 December 2012 (For the trading period commencing in 2013, the position is the same under Article 37(3) and (4) of the Commission Regulation No. 1193/2011 (note 9)).

<sup>12</sup> In January 2010, 250,000 units of allowances were stolen from various accounts in the German registry in a phishing attack; in November 2010, 1.6 million units were stolen from an account in the Romanian registry as a result of infiltration by a trojan virus; in January 2011, 7.5 million units were stolen from an account in the Austrian registry through a hacking attack; and in the same month, 7 million units were stolen from an account in the Czech registry.

<sup>13</sup> The national registries of Germany, the Netherlands and Belgium were closed in November 2010. In January 2011, the national registries of all constituent States of the EU trading scheme were closed. It took about three months before all registries could resume operation.

<sup>14</sup> Emissions allowances have been used as collateral within clearing and settlement systems. For example, ICE Clear Europe has been accepting such security since September 2009 (BOURSE CONSULT LLP, *The Post-Trade Infrastructure for Carbon Emissions Trading* (2010) para. 3.3.1.3).

and integrity of the market.<sup>15</sup> Yet, the law of the constituent States may differ regarding the types of security interests, if any, which may be created in emissions allowances, the effect of such security interests, and their survival upon transfer of the allowance. The uncertainty over the law applicable to those issues will have a negative impact on borrowing costs.

### **III. Approaches for Determining the Law Applicable to the Proprietary Issues**

To promote legal certainty, it is necessary to clarify the law applicable to the proprietary issues outlined in the preceding chapter. However, it is not sufficient for each constituent State to clarify individually the way in which it determines the applicable law, because if different constituent States of the same trading scheme determine the applicable law in different ways, the same allowance may be considered to be owned by different entities under the different laws which are applicable in different constituent States. To ensure the cohesive operation of a trading scheme, it is important to go one step further by unifying the determination of the applicable law among constituent States. The following analysis will evaluate several approaches with the aim of coming up with the appropriate uniform method of determining the applicable law.

The normal method for determining the applicable law is to apply choice-of-law rules. The normal way to determine the applicable choice-of-law rules is to characterise the issue. Since emissions allowances are a novel type of asset, various characterizations have been suggested, such as an administrative license, a commodity, a negotiable instrument, and a financial instrument.<sup>16</sup> Even in the same legal system, the characterization of an emissions allowance may differ depending on the field of law<sup>17</sup> since different questions need to be asked to determine characterization for different fields.<sup>18</sup> Therefore, the characterization of emissions

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<sup>15</sup> D. THRING, Carbon credits as collateral, in LANG MICHENER LLP ENVIRONMENT, *Energy and Emissions Trading Brief Summer 2010 and In Brief Fall 2010* (20 September 2010).

<sup>16</sup> J.-J. BARBÉRIS/ A. TIGNOL, *La régulation des marchés du CO<sup>2</sup> Rapport de la mission confiée à Michel Prada, Inspecteur général des Finances honoraire* (2010), Annexe VII lists the legal characterisations of emissions allowances in more than 30 countries around the world. In a majority of the countries, no clear legal characterisation exists.

<sup>17</sup> In New Zealand law, emissions allowances are an “investment security” for the purpose of the Personal Property Securities Act 1999, a “commodity” for the purpose of the Securities Markets Act 1988, and “chattel” for the purpose of the Securities Act 1978.

<sup>18</sup> Such questions include whether the government should be able to revoke the initial allocation of allowances with or without compensation, whether the use and trade of allowances should attract value added tax (VAT), whether emissions trading should be subject to the same regulation and supervision as financial instruments, whether the sale of

allowances for the purpose of conflict of laws is not necessarily affected by characterization in other fields of law. Generally, the conflict-of-laws characterization is determined by choosing the most suitable connecting factor for the issue in question. The following analysis will, before considering the appropriate connecting factor, first evaluate an approach that sidesteps the normal choice-of-law process.

**A. Application of the Overriding Mandatory Rules of the Law of the Forum (*lex fori*)**

It is imaginable that States could enact rules for the proprietary issues of emissions trading as overriding mandatory rules to ensure their applicability in all cases within their scope, without the need to follow the normal choice-of-law process. For example, Japan's Act to Promote Measures to Counter Global Warming provides that the ownership of a Kyoto Protocol allowance is transferred upon its registration in the transferee's account (Article 35(1)). This means that, unlike the transfer of ownership of tangible movables for which it is sufficient that there be a valid contract to transfer (Article 176 of the Japanese Civil Code), it is necessary to effect registration to transfer the ownership of allowances. The Act also provides that in the case of transfer of registration to the registry of another Contracting State, registration in the transferee's account shall be deemed to be effected at the time notification from that other Contracting State that the registration has been completed is received by the administrator of the Japanese registry (Article 35(2)). Although those rules are not expressly characterised as overriding mandatory rules, some Japanese commentators interpret them as such to ensure legal certainty.

If there is no real prospect for unifying the determination of the applicable law among constituent States within the same trading scheme, there is something to be said for this approach, as at least it would clarify the legal position from the perspective of the enacting State. But this solution seems undesirable if there is a real possibility of unifying the determination of the applicable law. In such circumstances, if one of the constituent States enacts substantive-law rules as overriding mandatory rules, it risks disturbing the uniform application of law among the constituent States since even the States willing to secure the application of their own overriding mandatory rules<sup>19</sup> may not be open to the mandatory application of

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allowances should be subject to the same rules (*e.g.* rules on good faith acquisition) as the sale of tangible movables, whether the security interests available for tangible movables should be capable of being created in allowances, and what should be the proper treatment of allowances in the cases of insolvency and bankruptcy.

<sup>19</sup> See *e.g.* Article 9(2) of the Regulation No 593/2008 on the Law Applicable to Contractual Obligations (Rome I) (*OJ L 177, 4/7/2008 p. 6*); Article 16 of the Regulation No 864/2007 on the Law Applicable to Non-contractual Obligations (Rome II) (*OJ L 199, 31/7/2007 p. 40*). In Japan, the application of the forum's overriding mandatory rules has no statutory basis but scholarly support for it is unanimous and there are a few court decisions endorsing it (the decision of Tokyo District Court on 28 August 2007 (1991 *Hanrei Jihô* 89) on Article 24 of the Anti-Monopoly Act concerning the remedy of injunctions, the judgment

rules belonging to third States (*i.e.* States which are neither the forum State nor the State whose law is applicable under the normal choice-of-law process).<sup>20</sup> Thus, suppose that another Contracting State to the Kyoto Protocol has a rule identical to Article 35(1) of the Japanese Act. Where registration of an allowance is transferred from the registry of Japan to the registry of that Contracting State, the latter would consider ownership to be transferred upon registration in the transferee's account, whereas Japan would consider, in accordance with Article 35(2), ownership to be transferred upon receipt of notification from that Contracting State. This time gap, which could be substantial if a system error or human error is involved,<sup>21</sup> can become significant if the transferor or the transferee becomes insolvent in the intervening period.<sup>22</sup>

## **B. Application of the Law of the Issuing State**

It is imaginable that some might argue that the law of the issuing State, as the *lex creationis*, should be the law applicable to the proprietary issues outlined in Chapter II.

Obviously, this approach is workable only if each allowance is assigned an identifier showing the place of issuance and that information is disclosed to traders. In this regard, each Kyoto Protocol allowance is accompanied by a unique serial number indicating, *inter alia*, the national registry at which it was issued. However, the national identifiers of EU allowances are not disclosed to traders.<sup>23</sup>

Even with respect to the allowances which display unique identifiers, it would be inappropriate to apply the law of the issuing State for two reasons.

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of the Tokyo District Court on 24 February 2004 (1853 *Hanrei Jihô* 38) on Article 35 of the Patent Act concerning in-house inventor's rights).

<sup>20</sup> See *e.g.* Article 9(3) of the Rome I Regulation, which provides for the application of overriding mandatory rules of a limited category of third States in limited circumstances. The Rome II Regulation contains no provision sanctioning the application of overriding mandatory rules of third States. In Japan, there is no judicial or scholarly support for the application of such rules.

<sup>21</sup> Emissions trading schemes are certainly not immune from system errors. For example, on 28 and 29 June 2010, the International Transaction Log of the Kyoto Protocol closed down for a system failure. BOURSE CONSULT LLP (note 14), at paras 2.5.3, 3.3.2 also alerts to such risks.

<sup>22</sup> BOURSE CONSULT LLP (note 14) notes that a dispute as to the exact timing of the taking effect of a transfer may be triggered by the transferor's insolvency (para. 3.3.1.1), recalling that when administrators were appointed to Lehman Brothers, Lehman's counterparties experienced considerable uncertainty as to which transactions had passed the point of irrevocability (para. 3.3.1.4).

<sup>23</sup> See Article 75(1) of the Commission Regulation No. 920/2010 (note 9), which is applicable for the trading period ending 31 December 2012 (For the trading period commencing in 2013, the position is the same under Article 83 of the Commission Regulation No. 1193/2011 (note 9)).

Firstly, emissions allowances are usually traded as fungible commodities without specifying the issuing State because they are homogenous assets when the time comes for them to be surrendered to help meet the targets of emissions reduction. Secondly, it would be difficult, costly and time-consuming to apply the law of the issuing State in the cases of the transfer of ownership of, or granting of security interest in, a pool of emissions allowances. A bulk assignment is widely practiced with securities (shares and bonds)<sup>24</sup> and it is conceivable that the same practice will develop with emissions allowances.<sup>25</sup> Imagine the hypothetical case below.

*Case 2:* X purports to create a security interest in favour of Y in emissions allowances originally issued respectively in the States A, B and C, all of which are currently held in X's account in the registry of State A. No security interest may be created in allowances under the law of State B. The type of security interest, which may be created in allowances under the law of State A, is not available under the law of State C. What law is applicable to determine what security interest, if any, X may create in those allowances and under what conditions?

The application of the law of the issuing State would compel X to satisfy, for each of the allowances, the requirements of the law of States A, B, and C respectively. It would be burdensome to ascertain and comply with each law.<sup>26</sup> It would even be impossible to create a security interest in a pool of allowances, which changes composition over time.

### C. Application of the Law of the Place of Registration

Transfer of ownership of, or granting of security interest in, a diversified or mutable portfolio of emissions allowances would be facilitated if the law of the place of registration is applicable because it would be sufficient to ascertain and comply with a single law only. If this approach is applied to Case 2, the law of State A would be applicable to determine what security interests X may create in the allowances issued in States A, B, and C and under what conditions they may be created.

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<sup>24</sup> R. GOODE/ H. KANDA/ K. KREUZER/ C. BERNASCONI, *Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary* (Permanent Bureau of the Hague Conference on Private International Law, 2005), para. Int-38.

<sup>25</sup> As noted earlier, the writings which allude to conflict-of-laws problems of emissions trading are rare. The few which exist particularly mention the issues which could arise from the creation of security interests in a pool of emissions allowances: e.g. FINANCIAL MARKETS LAW COMMITTEE, *Issue 116 – Emission Allowances: Creating Legal Certainty: Legal assessment of lacunae in the legal framework of the European Emissions Trading Scheme and the case for legislative reform* (2009), paras 3.1-3.8; BOURSE CONSULT LLP (note 14), at para. 3.3.1.3.

<sup>26</sup> To the same effect, see P. THIEFFRY, *La titrisation des quotas d'émission de gaz à effet de serre*, *Bulletin du Droit de l'Environnement Industriel* (Suppl. to No 10, 2007); FINANCIAL MARKETS LAW COMMITTEE (note 25), at para. 3.8.



*Conflict of Laws in Emissions Trading*

The application of the law of the place of registration will also enhance legal certainty because the place of registration is easily ascertainable by all parties concerned. This advantage is palpable where the registration necessary to carry out a transaction is completed within the same national registry, as the law of the State of that registration would become applicable regardless of whatever foreign elements involved in the transaction. Another element that will promote legal certainty is the fact that the types of security interests available under the law of the place of registration will be able to be registered in the registry in which the allowance is held, whereas other kinds of security interests, available under other legal systems, will not be able to be registered.

The application of a single law to the creation of security interests in a diversified portfolio could be ensured also by applying the law of the place in which the security grantor is located.<sup>27</sup> An advantage of this approach is that in the event of a grantor's insolvency, insolvency proceedings are likely to be administered in that State.<sup>28</sup> But determining the grantor's location may not be straightforward because the concept of location has various meanings, such as the place of central administration, the principal place of business, the place of business engaged in the particular transaction, habitual residence, domicile, and the like. Even if the concept of location was clearly defined,<sup>29</sup> it would be harder to identify than the place of registration. The law of the place of registration seems preferable also because the kinds of security interests available under the law of the grantor's location may not be able to be registered in the registry where the allowance is held except where the grantor's location coincides with the place of registration.

It is therefore submitted that the proprietary issues outlined in Chapter II should be governed by the law of the place of registration of the allowance. In the context of the EU trading scheme, where there is an EU-wide centralised registry,<sup>30</sup> the "place of registration" should be understood to refer to the law of the State on whose behalf the account in question is administered.<sup>31</sup> In the relevant Regulation, it is provided that an account shall be governed by the law of the Member State of

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<sup>27</sup> This approach is recommended by the UNCITRAL Legislative Guide on Secured Transactions (2010) with respect to the creation, third-party effectiveness and priority of security rights in intangible assets (Recommendation 208).

<sup>28</sup> UNCITRAL Legislative Guide on Secured Transactions (2010), paras 41, 42 at p. 393.

<sup>29</sup> Recommendation 219 of the UNCITRAL Legislative Guide on Secured Transactions (2010) defines the grantor's location as its place of business. If the grantor has a place of business in more than one State, it is defined as the place of business where central administration is exercised. If the grantor has no place of business, it is defined as habitual residence.

<sup>30</sup> See (note 9) above.

<sup>31</sup> If it were envisaged to create an emissions trading scheme with only one common registry which, unlike the EU scheme, is not operated on behalf of a particular constituent State for a particular transaction, it would be unwise to leave disharmonised the diverse substantive-law rules of the constituent States, unless they could agree to apply the law of a particular State to all proprietary issues.

its administrator and the units held in the account shall be considered to be situated in that Member State's territory.<sup>32</sup> Although it is not totally clear whether this provision is intended to specify the governing law for proprietary issues, it seems consistent with the above submission.

The view that the applicable law should be the law of the place of registration is espoused also by a report of the Financial Markets Law Committee.<sup>33</sup> That report reaches that conclusion by drawing an analogy between emissions allowances and registered intellectual property (such as patents and trademarks). It may be thought that the analogy is workable because it is generally undisputed that the issues regarding whether and under what conditions registered intellectual property may be transferred or furnished as collateral are determined by the law of the place of registration.<sup>34</sup> However, the analogy cannot be sustained where the registration of emissions allowances is transferred across borders. Consider the following scenario.

*Case 3:* X holds an emissions allowance in its account in the registry of State A. It concludes a contract with Y to sell the allowance to Y. The registration of the allowance is accordingly transferred into Y's account in the registry of State B. Under the law of both States A and B, the ownership of an allowance is transferred upon registration in the transferee's account in accordance with a valid sale contract. What law is applicable to determine whether and when the ownership of the allowance is transferred to Y?

As in this scenario, the registration of an emissions allowance may be transferred across borders. This gives rise to the question of which place of registration (State A or State B in Case 3) serves as the connecting factor. For intellectual property rights, no cross-border transfer of registration takes place: the registration of a patent issued by State A cannot be transferred to the registry of State B because only patents issued by State B can be registered in the registry of State B. The analogy with intellectual property cannot, therefore, provide an answer to the question presented by a cross-border transfer of the registration of an allowance.

In his article,<sup>35</sup> Professor Louis D'AVOUT also comes to the conclusion that the law of the place of registration should be the applicable law but on a different reasoning. He sees the transfer of an emissions allowance as the transfer of personal right, based on the observation that what is transferred is the right to demand

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<sup>32</sup> Article 10(4) of the Commission Regulation No. 920/2010 (note 9), which is applicable for the trading period ending 31 December 2012 (For the trading period commencing in 2013, the position is the same under Article 10(5) of the Commission Regulation No. 1193/2011 (note 9)).

<sup>33</sup> FINANCIAL MARKETS LAW COMMITTEE (note 25), at para. 3.6. The Committee is an independent committee of legal experts established by the Bank of England.

<sup>34</sup> See UNCITRAL Legislative Guide on Secured Transactions, Supplement on Security Rights in Intellectual Property (2011), paras 297-299.

<sup>35</sup> L. D'AVOUT, Les quotas face au conflit international des lois, 56 *Revue Lamy Droit des Affaires* 93 (2011).

### *Conflict of Laws in Emissions Trading*

the registry administrator to modify the registration. He draws inspiration from the choice-of-law rule for the assignment of receivables consisting of two prongs: a transfer is governed by the law of the transferred right and the third-party effectiveness of the transfer is governed by the law of the debtor's domicile. He concludes that both prongs of the rule, in the context of the transfer of emissions allowances, would point to the law of the place where the administrator of the national registry is established. However, it would seem that the right to demand the registry administrator to modify a registration is a relatively insignificant aspect of the right emanating from emissions allowances.<sup>36</sup> Furthermore, the analogy with the transfer of a personal right is unable to provide an answer to the question presented by a cross-border transfer of the registration of an emissions allowance. Professor D'AVOUT suggests that in such cases, the law of the initiating registry should primarily be the applicable law, on the condition that registration in the receiving registry is effected. Whether this is tantamount to a cumulative application of the law of the initiating registry and the law of the receiving registry is unclear. Whatever is meant, that suggestion is not a conclusion flowing directly from the analogy with the transfer of a personal right.

It seems that a better analogy can be drawn with tangible movables. It is well established that proprietary issues of tangible movables are governed by the law of the place of their location (*lex loci rei sitae*).<sup>37</sup> Since emissions allowances are intangible, they have no physical *situs* (location). But fictional *situs* could be attributed to allowances by treating their places of registration as their *situs*. It would then be possible to draw a parallel with tangible movables and apply the choice-of-law rules for the latter by analogy to emissions allowances. Because the location of movables can be changed, the choice-of-law rules for tangible movables of all countries should have a built-in mechanism for dealing with a change of location across borders (*conflict mobile*). It should therefore be possible, by applying choice-of-law rules for tangible movables by analogy, to deal with a cross-border transfer of registration in emissions trading. In what will follow, this approach will be illustrated by using the Japanese choice-of-law rules for tangible movables as a model. The rules of many other countries are by and large the same.<sup>38</sup> To the extent there are differences, such other rules might serve as an equally good model.

Let us first consider a simple case of transfer by reference to Case 3. Under the Japanese choice-of-law rule for tangible movables, the acquisition and/or loss of proprietary rights are determined by the law of the place where the movable is situated at the time the causal facts are completed.<sup>39</sup> A mechanism for dealing with

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<sup>36</sup> J.-J. BARBÉRIS/ A. TIGNOL (note 16), at para. 3.1.4, is also against the characterization of emissions allowances as personal right.

<sup>37</sup> G.C. VENTURINI, Property, in K. LIPSTEIN (*et al*, eds) *International Encyclopedia of Comparative Law: Private International Law*, 1976, p. 7.

<sup>38</sup> See notes 39, 41, 43, 44 below. For a broader comparative survey, see G.C. VENTURINI (note 37), at 13-14.

<sup>39</sup> Article 13(2) of *Hô no Tekiyô ni Kansuru Tsûsoku Hô* (literally "Act to Provide for the General Rules on the Application of Laws"). It seems that the rules are the same

*conflict mobile* is built in. Thus, suppose that X, the owner of chattel, concludes with Y a contract to sell the chattel to the latter when the chattel is situated in State A and then transfers its possession to Y in State B. Whether and when ownership is transferred from X to Y is determined by following the timeline. First is the moment when the sale contract is concluded. At that moment, the chattel is situated in State A and, accordingly, the law of State A governs the requirements for the transfer of ownership. If under that law, the taking of possession by the transferee is needed in addition to a valid contract, ownership is not transferred to Y at that moment. Second is the moment when Y takes possession of the chattel. At that moment, the chattel is situated in State B and, accordingly, the law of State B is applicable. If the requirements for the transfer under the law of State B are met, ownership is transferred to Y. This is how the change of location of chattel is handled. This built-in mechanism for *conflict mobile* comes into operation if the choice-of-law rules for tangible movables are applied by analogy to Case 3. Then, the law of State A and the law of State B would successively govern the requirements for the transfer of ownership, with the result that the ownership of the allowance is transferred to Y upon the registration in Y's account in accordance with the law of State B.

The same approach may be applied to deal with the question of good faith acquisition arising in the context of a cross-border transfer. The relevant choice-of-law rules for tangible movables and the built-in mechanism for dealing with *conflict mobile* are the same as outlined above. Thus, suppose that Y steals chattel from X in State A and removes it to State B. While the chattel is in State B, Y concludes a sale contract with Z, acting in good faith. Z then takes possession of the chattel in State C. Whether and when Z acquires good title is determined by following the timeline. First is the moment when the sale contract is concluded. At that moment, the chattel is situated in State B and, accordingly, the law of State B governs the requirements for good faith acquisition. If the law of State B requires the transferee to take possession of the chattel, good faith acquisition does not occur at that moment. Second is the moment when Z takes possession of the chattel. At that moment, the chattel is situated in State C and, accordingly, the law of State C is applicable. If the requirements for good faith acquisition under that law are met, Z acquires good title. This built-in mechanism for *conflict mobile* comes into operation if the choice-of-law rules for tangible movables are applied by analogy to Case 1. Then, the law of State B and the law of State C would successively govern the requirements for good faith acquisition. Since the requirements are not met under either law in Case 1, Z would not acquire good title.

Another illustration may be drawn from a case involving security interests. Imagine the following scenario:

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under Dutch law (J. RUTGERS, *International Reservation of Title Clauses*, 1999, para. 2.3.3.3). It is broadly the same under English law under *Winkworth v. Christie, Manson and Woods Ltd* [1980] Ch. 496. See also L. COLLINS (*et al.* eds), *Dicey, Morris & Collins on the Conflict of Laws* (14<sup>th</sup> ed.), 2006, Rule 125.

*Case 4:* X concludes a contract with Y to create a security interest in favour of Y in the allowance which it holds in its account in the registry of State A. X records Y's interest in the allowance in its (X's) account. X then transfers the registration of the allowance to its own account in the registry of State B. Under the law of State A, a security interest may be created in emissions allowances by a valid contract with the security taker and by recording that interest in the security grantor's account.<sup>40</sup> Under the law of State B, a similar security interest may be created in emissions allowances but that interest cannot be exercised unless it is recorded in the account of the security taker. What law is applicable to determine what security interest, if any, is created and under what conditions? What law is applicable to determine what effects, if any, the security interest created has when the registration is transferred to the registry of State B?

The Japanese choice-of-law rules for tangible movables make a distinction between, on the one hand, the acquisition and/or loss of proprietary rights and, on the other, the effects of the rights created or acquired.<sup>41</sup> Again, a mechanism for dealing with *conflict mobile* is built in. Thus, whereas the acquisition and/or loss of proprietary rights are governed by the law of the place where the movable is situated at the time the causal facts are completed, the exercise and effects of the acquired proprietary rights are governed by the law of the place where the movable is situated presently, *i.e.* as and when questions arise.<sup>42</sup> It follows that if a security interest is created in chattel pursuant to the law of State A while the chattel is situated in State A and subsequently the chattel is removed to State B, that security interest will survive as the comparable security interest available under the law of State B,<sup>43</sup> provided that the requirements for its exercise are satisfied under that law. If no comparable security interest exists under the law of State B, the effect of the security interest created under the law of State A is suspended while the chattel remains situated in State B.<sup>44</sup> This built-in mechanism for dealing with *conflict*

<sup>40</sup> Various systems of recording a security interest in an emissions allowance are conceivable. Broadly, there will be two types. One is the system requiring the allowance to be left in the security grantor's account. The other is the system requiring the allowance to be transferred to the security taker's account. Each of these systems is sub-divided into two categories. The first is the system requiring no recording of security interests in the account. The second is the system requiring security interests to be recorded in the account. Which system is adopted will depend on the law of each constituent State as well as the overall design of the trading scheme.

<sup>41</sup> The same distinction is stipulated in Swiss law (Article 100 of the Federal Act on Private International Law (*Loi fédérale sur le droit international privé*)). It is also observable in French law (See *e.g.* S. CLAVEL, *Droit international privé* (2<sup>nd</sup> ed.), 2010, paras 881-896; P. MAYER/ V. HEUZÉ, *Droit international privé* (10e éd.), 2010, para. 656).

<sup>42</sup> Article 13(1) of *Hô no Tekiyô ni Kansuru Tsûsoku Hô* (note 39).

<sup>43</sup> It seems that the position is the same under Dutch law (J. RUTGERS (note 39), at para. 2.3.3.5).

<sup>44</sup> English law seems to come to a similar result albeit by a different route: the exclusion of the law of the former *situs* as being contrary to the *ordre public* of the present *situs* (L. COLLINS *et al.* (note 39), at para. 24-037).

*mobile* comes into operation if the choice-of-law rules for tangible movables are applied by analogy to Case 4. The result is that the security interest available under the law of State A is created when it is recorded in X's account in the registry of State A. When the registration of the allowance is transferred to the registry of State B, it would have effect as the comparable security interest under the law of State B if it were recorded in Y's account. Yet, because it is not so recorded, the security interest cannot be exercised while the allowance remains registered in the registry of State B.

From the foregoing analysis, it could be concluded that the law of the place of registration should be the law applicable to the proprietary issues outlined in Chapter II. It could also be concluded that the choice-of-law rules for tangible movables, along with their built-in mechanism for dealing with *conflict mobile*, should be applied by analogy to deal with the transfer of registration across borders. This approach should be adopted as a uniform solution by the constituent States of the same trading scheme to ensure the scheme's cohesive operation.

#### **IV. Clarification and Unification of Substantive-Law Rules on the Proprietary Issues**

Even if the constituent States of the same trading scheme adopt a uniform approach for determining the law applicable to proprietary issues, it is not enough to ensure legal certainty unless each constituent State clarifies its substantive-law rules. Since emissions allowances are a novel type of asset, substantive-law rules relating to allowances will be unclear unless either the pre-existing rules for other assets are extended to cover allowances or rules specific to allowances are created.

For instance, the possibility of good faith acquisition and its requirements with regard to emissions allowances may be unclear. To take Japanese law as an example, the Act to Promote Measures to Counter Global Warming provides that an entity holding a Kyoto Protocol allowance in its account is presumed to have good title (Article 38). On that basis, the Act further provides that a transferee of an allowance acquires good title by having the registration transferred to its account from the transferor's account, unless it knows, or fails to discover due to its gross negligence, that the transferor has no good title (Article 39). To this extent, the position is clear. But Article 39 excludes from its scope of application cases in which registration is transferred to the Japanese registry from the registry of another Contracting State. In such cases, it is not clear whether the provisions of good faith acquisition for tangible movables (Article 192 *et seq.* of the Civil Code) are to be applied by analogy.

The position may be unclear also regarding what, if any, security rights may be created in emissions allowances. Some States have express legislative provisions on this issue. Japan's Act to Promote Measures to Counter Global Warming provides that no possessory pledge (*shichiken*) may be created in Kyoto Protocol allowances (Article 36). The Dutch law likewise expressly prohibits the pledging

### *Conflict of Laws in Emissions Trading*

of emissions allowances.<sup>45</sup> On the other hand, New Zealand law makes it clear that security interests may be created in allowances.<sup>46</sup> However, a majority of States have no specific provisions detailing what, if any, security rights may be created in allowances.<sup>47</sup> Even under the legal systems, which have specific provisions, there may be points left open for interpretation. Thus, it has been suggested under Japanese law that nothing prevents a chattel mortgage (*jōtotanpoken*), a kind of security interest different from a possessory pledge (*shichiken*), from being created in allowances.

If, in tandem with unifying the determination of the applicable law among constituent States of the same trading scheme, each such State individually clarifies its substantive-law rules, a degree of legal certainty will be achieved. However, if a higher level of certainty is desired, constituent States would have to go one step further by unifying their substantive-law rules.<sup>48</sup>

To illustrate the merit of unifying substantive-law rules, it is convenient to re-visit Case 4. Under the analysis presented above, the security interest created under the law of State A will survive as the comparable security interest available under the law of State B provided that the requirements for the exercise of such security interest under that law are satisfied. However, due to the doctrine of *numerus clausus* (a limited number of proprietary rights), there is a diversity among legal systems as to the kinds of security interests available. Thus, it may happen that no similar security interest exists under the law of State B. Even where similar security interests exist, it may not be easy to determine which security interest is comparable. Even if a comparable security interest is identifiable, the requisites for its exercise under the law of State B may not be satisfied. All these conflict-of-laws barriers may inhibit the use of emissions allowances as collateral for borrowings. Those hurdles could be avoided if security interests capable of being created in emissions allowances were harmonised among the constituent

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<sup>45</sup> There is a specific prohibition under Article 16.42(3) of the Environmental Management Act which provides that as an exception to Article 228 of book 3 of the Dutch Civil Code, no right of pledge can be created in emissions allowances (P. ZAMAN, *Developing Carbon Structured Products*, *Butterworths Journal of International Banking and Financial Law* (16 January 2008), p. 16 (fn. 11); B. AKKERMANS, *The European Union Development of European Property Law* (October 19, 2010), Conference Proceedings, Oldenburg, May 27-28, 2010 (<<http://ssrn.com/abstract=1694404>>), p. 8).

<sup>46</sup> See Climate Change (Unit Register) Regulations 2008 (SR 2008/357), Regulation 18.

<sup>47</sup> It has been suggested that under French law, allowances may be subject to a pledge (*nantissement*) as intangible property (J.-J. BARBÉRIS/ A. TIGNOL (note 16), at para. 3.1.4.3) and that under Finnish law, allowances may be subject to mortgage under section 3 of the Business Mortgage Act (yrittäjäkiinnityslaki 634/1984) as intangible property similar to patents (K. ANTONEN/ K. UPSTON-HOOPER/ M. MEHLING, *Breathing Life into the Carbon Market: Legal Frameworks of Emissions Trading in Europe*, 16 *European Environmental Law Review* 96, 99 (2007)).

<sup>48</sup> To the same effect, see FINANCIAL MARKETS LAW COMMITTEE (note 25), at para. 6.3.

States of the same trading scheme.<sup>49</sup> One possible approach is to create new kinds of security interests uniquely tailored for emissions allowances and recognised by all constituent States of the same trading scheme. A useful model can be found in the 2001 Cape Town Convention on International Interests in Mobile Equipment.<sup>50</sup> It has created international security interests for mobile assets which can be registered in an international register to disclose their existence and to clarify priorities among competing interests. This Convention has demonstrated that by limiting the objects of security interests, it becomes easier to achieve harmonisation and cater for the particular needs of the objects. If international security interests were created for emissions allowances, the registries for recording the holdings and transfers of allowances could be conveniently used to disclose the existence of such security interests and clarify priorities among competing interests.

It would be beneficial if rules on other proprietary issues could also be harmonised. Thus, a uniform rule might provide that the ownership of an allowance is transferred only upon registration in the transferee's account pursuant to a valid agreement of transfer. Such a rule seems preferable to the rule providing that ownership is transferred by a valid agreement alone, since the latter might give rise to a priority question in the case of multiple transfers of the same allowance. The preferable rule has been actually implemented by at least two States.<sup>51</sup> The European Commission Regulation No. 1193/2011, too, seems to endorse that position by stating in Recital that title to an allowance should be established by its existence in the account in which it is held.<sup>52</sup>

With respect to the impact, if any, of rescission or termination of the underlying contract on the validity of the transfer, the Commission Regulations provide that the dissolution of the underlying contract shall not lead to the unwinding of the transaction in the registry, though they leave open the possibility that the execution of a new transaction may be ordered under national law.<sup>53</sup> This position has the merit of safeguarding legal certainty.<sup>54</sup>

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<sup>49</sup> The Commission Regulation No 1193/2011 (note 9), notes in Recital (13) that means to facilitate the taking of a security interest in allowances should be examined in the context of a future review of the Regulation.

<sup>50</sup> In force since March 2006 with 51 Contracting States as of January 2012.

<sup>51</sup> *E.g.* s. 22(1) of Climate Change Response Act 2002 New Zealand and Article L. 229-15-I, al. 2 of the French *Code de l'Environnement*.

<sup>52</sup> Recital (12) of the Commission Regulation No. 1193/2011 (note 9).

<sup>53</sup> Article 32b(3)(a) of the Commission Regulation No. 920/2010 (note 9), as amended by the Commission Regulation No. 1193/2011 (note 9), applicable for the trading period ending 31 December 2012. For the trading period commencing in 2013, the position is the same under Article 37(3)(a) of the Regulation No. 1193/2011.

<sup>54</sup> According to B. AKKERMANS (note 45) at 8, in the Netherlands, Article 16.42(1) of the Environmental Management Act provides that rescission or avoidance of an agreement of transfer has no consequence on the validity of the transfer. That provision was made in derogation from the general rule (causal transfer system) requiring the underlying agreement to remain valid, since the Dutch government had pointed out in its Memorandum accompanying the bill that an unwinding of a transaction between a Dutch buyer and an



With respect to good faith acquisition, it would be more difficult to come up with a uniform rule acceptable to all parties concerned because good faith acquisition is a zero-sum game, protecting the transferee at the sacrifice of the rightful owner. Opinions will be divided as to whether good faith acquisition should be permitted at all, whether the acquisition should be for value, whether an exception should be made if the allowance in question has been stolen, and such other points.<sup>55</sup> The European Commission, apparently taking lessons from previous thefts, has inserted a uniform rule in its Regulation No. 920/2010. It provides that the purchaser of an allowance acting in good faith shall acquire title free from any defects in the transferor's title.<sup>56</sup> It sets no requirement beyond the good faith of the transferee and, accordingly, is strongly favourable to the transferee.

Unlike the European Union, which has permanent legislative bodies, it may be unrealistic to expect individual States involved in negotiations for setting up an emissions trading scheme to also engage in discussions for prescribing detailed private-law issues. Yet, all efforts should be made to promote legal certainty by trying to clarify and unify not only the way in which the applicable law is determined, but also the contents of substantive-law rules.

## V. Other Conflict-of-Laws Problems

The present article has examined the trading of allowances registered in national registries,<sup>57</sup> a basic form of emissions trading engaged in by States and entities bound by emissions reduction targets. Another type of trading may develop with respect to emissions units held in the books of intermediaries which are derived from emissions allowances registered in national registries. Such trading may be engaged in by, *inter alia*, those who wish to offset carbon footprints but are not qualified to open an account in the national registries.<sup>58</sup> Transactions would be

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English seller would make it necessary to alter not only the Dutch registry but also the English registry and the log of the European Commission.

<sup>55</sup> *E.g.* Article 193 of the Japanese Civil Code, applicable only to tangible movables, allows the rightful owner to recover stolen movables for a period after theft.

<sup>56</sup> Article 32b(4) of the Commission Regulation No. 920/2010 (note 9), as amended by the Commission Regulation No. 1193/2011 (note 9). This Regulation is applicable for the trading period ending 31 December 2012. For the trading period commencing in 2013, the position is the same under Article 37(4) of the Regulation No. 1193/2011.

<sup>57</sup> Spot and forward contracts fall within this category. But transactions of financial derivatives associated with emissions allowances are outside the scope of the present analysis. The issues arising from such transactions are not specific to emissions trading but instead are suited to be regulated by securities law.

<sup>58</sup> Who is qualified to open an account on national registries will depend on the stipulation of the international agreement establishing the trading scheme or the law of each constituent State. Japan's Act to Promote Measures to Counter Global Warming, for

settled by entries in the books of intermediaries. Layers of intermediaries may be developed below the level of the national registries, creating a pyramid shaped structure of holding. Each intermediary would keep an omnibus account with its upper-tier intermediary in which it would hold its clients' positions. The uppermost *intermediary* would keep an omnibus account in the national registry.<sup>59</sup> Some intermediaries may offer the facility of delivery versus payment (DVP) settlement which enables cash to be transferred simultaneously with units, by holding both accounts for units and accounts for cash and linking them with each other.<sup>60</sup> Since an emissions unit is fungible, it would not be traceable to a particular emissions allowance. Consequently, it would be impossible to determine the law applicable to the transaction of indirectly-held units by reference to the national registries, if pyramid shaped structures of holding were formed across borders. To deal with essentially the same problem presented by securities held with intermediaries, the Hague Conference on Private International Law has created a convention<sup>61</sup> setting forth elaborate rules for determining the applicable law. But different choice-of-law rules have been implemented in the EU directives.<sup>62</sup> The EU Commission is currently re-visiting the problem as part of its deliberation on the draft Securities Law Directive. The thoughts and debates accumulated during those processes will provide useful guidance when it comes to considering the law applicable to the trading of indirectly-held emissions units.

The present article has focused on the proprietary aspects of emissions trading. Conflict-of-laws problems also arise in contractual matters, such as the formation and validity of a contract for the sale of allowances. Since party autonomy is universally respected in contractual matters,<sup>63</sup> parties can secure a high level of

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example, allows only Japanese corporations to open an account on the national registry (Article 32(2)), excluding individuals and foreign corporations.

<sup>59</sup> Such a structure is already emerging in the EU with the advent of settlement services offered by Clearstream, Euroclear and CDC (BOURSE CONSULT LLP (note 14), at para. 5.3). Clearstream, for example, offers a settlement service called GEMA (Global Emissions Market Access) which is linked to several national registries ("GEMA: Access to the Carbon Emissions Market via Clearstream" Clearstream Announcement A10170 (18 October 2010)).

<sup>60</sup> In the securities market, the DVP settlement is commonly offered by CSDs (central securities depositories) such as Euroclear and Clearstream. Clearstream has extended the DVP settlement to emissions allowances (Clearstream Announcement A10170 (note 59)).

<sup>61</sup> 2006 Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (not yet in force as of January 2012).

<sup>62</sup> Article 9(2) of the European Parliament and Council Directive 98/26/EC on settlement finality in payment and securities settlement systems; Article 9(1) of the European Parliament and Council Directive 2002/47/EC on financial collateral arrangements; Article 24 of the European Parliament and Council Directive 2001/24/EC on the reorganisation and winding-up of credit institutions.

<sup>63</sup> *E.g.* Article 3 of the Rome I Regulation; Article 7 of *Hô no Tekiyô ni Kansuru Tsûsoku Hô* (Japan) (note 39).

*Conflict of Laws in Emissions Trading*

legal certainty by expressly choosing the governing law for their contract. Although there are few issues peculiar to emissions trading, the questions which may be worth asking include whether the United Nations Convention on International Sale of Goods (CISG) has any chance of being applied to the sale of emissions allowances, how to determine the law applicable to a sale contract concluded between sovereign States, and what would be the legal relationships if the principles of public international law are chosen to govern a sale contract.

In the field of dispute resolution, the question may be raised as to whether a dispute concerning the ownership or registration of emissions allowances is arbitrable. Closely related to this question is the question of whether such disputes are subject to the exclusive jurisdiction of the courts for the State of registration. In the case of a cross-border transfer, an additional question may arise as to whether it is the courts for the State of the initiating registry or those for the State of the receiving registry, which have jurisdiction. Where a State is party to a dispute, the issue of sovereign immunity, including the width of the exception based on commercial transactions, may arise.

In the preceding chapters, this article has examined the problems which merit more attention than have hitherto attracted if a stable and cohesive operation of emissions trading schemes is to be ensured. Some other conflict-of-laws problems which may arise from emissions trading have been sketched out in the present chapter. A thorough analysis of those other problems is left for the future.