



— Nederlandse Emis­sie­au­to­ri­teit  
— Dutch Emis­sions Au­thority

## **Study report**

# **Risks of fraud in the emissions trading system**

**Original Dutch Report: 30 September 2010**

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## **Preface**

The emissions trading scheme is a complex system that applies market mechanisms to achieve environmental goals. It comprises of compliance buyers (i.e. mandatory participants, mostly companies) on the one hand and market traders (i.e. voluntary participants) on the other. In order to provide a context for this report, an introduction to the emissions trading scheme is given in chapter 2.

This introductory chapter is followed by an analysis of relevant forms of fraud (chapter 3), an analysis of the relevant powers of supervision and criminal investigation (chapter 4) and an analysis of the present instruments to combat fraud in emission allowances (chapter 5).

Chapter 6 contains a summary as well as conclusions and recommendations. In addition, a summary of the important findings in chapters 3, 4 and 5 are placed within a special frame.

## 1. Introduction emissions trading scheme

In 2005 the greenhouse gas emissions trading scheme was introduced in Europe.

The scheme is an environmental instrument designed to reduce the emission of greenhouse gas in a cost effective manner. After the European scheme was connected to its UN equivalent of the Kyoto Protocol in 2008, it was even possible for installations (mandatory participants of the scheme) as well as trading companies and individuals (voluntary participants) to transfer emission allowances all over the world.

After this trade had taken place in relative tranquility, it appears that organised crime began to show interest in the scheme around 2009. It also became clear that the environmental instrument of emissions trading in its original design was ill equipped against the threat of fraud. Within Europe, large-scale fraud was discovered in 2009, representing a financial damage of hundreds of millions of Euros. It concerned VAT fraud, identity fraud, suspicion of money laundering and security attacks on accounts in the emissions trading registries. In 2010 the media still frequently visits the topic of fraud within the scheme of allowance trading.

On a joint advice from the Netherlands Emission Authority (NEa) and the criminal investigation department of the Ministry of Environment (VROM-IOD), the Minister of Environment decided to charge the NEa, working together with relevant governmental agencies and departments, with the task of advising on an approach to best combat fraud.

Subsequently, the members of the "taskforce on fraud with emission allowances" came together a total of three times. The task force consisted of experts from the tax investigation department (FIOD-ECD), the VROM-IOD, the Financial Market Authority (AFM), the Royal border and military police (KMar), the Ministry of Finance, the Ministry of Environment and the NEa.

The draft advice of the task force was submitted to the legal department of the Ministry of Environment (BJZ), several financial experts of the Ministry of Finance and to traders in emission allowances for comment. Their comments have been incorporated in this report.

The taskforce has listed the forms of fraud that have affected the trading scheme thus far, and has compared the current powers and instruments of supervision to the risk that fraud poses to the scheme. The taskforce took into account that regulatory and procedural measures had already been taken by the Minister of Finance and the NEa. This report gives recommendations for further fraud reducing measures in order to address the remainder of the risk.

As the circumstances of the trade are constantly changing, the list of the forms of fraud is never complete. The taskforce has limited its scope to the forms of fraud that have already appeared and those forms of which experts have strong indications that they are occurring. For this reason, market manipulation and market abuse are not part of the scope of this report.

Nevertheless, the EU Commission has initiated a study of the risk of market manipulation, to start in 2011. The research will also involve looking into possible ways to safeguard the trading scheme against market manipulation in order to guarantee a sufficient level of market integrity and market efficiency. A comprehensive analysis of the market, its different products, trading volumes and participants will be part of this study. This may lead to new European legislation.

During the time the taskforce was working on this report, a taskforce headed by the former director of the French inspector general of finances Michel Prada published its report<sup>1</sup>.

Although the scope of the research also included market manipulation and market abuse, the analysis and recommendations of the French taskforce and the "taskforce fraud with emission allowances" are similar.

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<sup>1</sup> <http://www.minefe.gouv.fr/services/rap10/100419rap-prada.pdf>

## 2. Introduction to emissions trading

This chapter outlines the context of the emissions trading system. A brief introduction to use of emissions trading as an environmental instrument is followed by an explanation of the financial world that has been created around it.

### 2.1. Introduction to emissions trading as an environmental instrument

#### Kyoto Protocol

The Netherlands agreed to reduce greenhouse gas emissions (especially CO<sub>2</sub>) under the Kyoto Protocol of 1997. Between 2008 and the end of 2012 the Netherlands must cut its emissions by 6% compared with 1990. The Dutch government can achieve this target by curbing emissions or by obtaining extra emission allowances through projects in other countries. The government has set goals for reducing emissions by traffic, consumers and industry in the Netherlands, for example. The trading of CO<sub>2</sub> emission allowances has been introduced as a way of lowering CO<sub>2</sub> emissions in a large part of European industry.

#### European CO<sub>2</sub> emissions trading

The European CO<sub>2</sub> emissions trading system for tackling emissions by companies was launched in January 2005 before emissions trading began at country level in 2008 under the Kyoto Protocol. This system compulsorily covers companies within the European Union that meet certain conditions. They receive or purchase emission allowances and must surrender each year the number of allowances that corresponds with their emitted amount of CO<sub>2</sub>. The system allows companies that reduce their CO<sub>2</sub> emissions to retain allowances that they may sell to companies that do not have enough.

This incentivises companies to invest in reduction of CO<sub>2</sub> emissions. No company has an absolute emission limit. The CO<sub>2</sub> emissions can be reduced at the companies able to do so at the lowest possible cost.

#### Netherlands Emissions Authority (NEa)

The Ministry of Infrastructure and Environment is responsible for developing policy in liaison with the Ministry of Economic Affairs, Rural Affairs and Innovation. The Netherlands Emissions Authority (NEa) supervises companies that are part of the emissions trading scheme. The authority makes sure that companies monitor and report their emissions correctly and that they surrender sufficient emission allowances. The law gives NEa the power to enforce compliance with the system. However, NEa does not have regulatory powers for the trading of emission allowances.

### 2.2. Introduction to emissions trading

#### Participants in trading

Although the European Emissions trading system primarily pertains to companies that emit CO<sub>2</sub> ('ETS companies'), the trading system is open to banks and other financial institutions, trading platforms and brokers, as well as other organisations and private individuals that wish to trade in or speculate with emission allowances.

The Netherlands Emission Allowance Trading Registry, managed by NEa, holds accounts for more than 400 ETS companies and some 250 trading organisations. Only 65 of the 250 trading accounts belong to Dutch account holders. A majority of the foreign account holders is located within the EEA and OECD countries, while another 15 account holders come from outside the EEA and OECD. Some Dutch organisations are known to hold accounts in other registries of other EU member states.

#### Role of the Registry in emissions trading

Each of the 27 EU member states has an emissions trading registry. The registry enables registered account holders to conduct transactions with emission allowances. The country registries are interconnected through a central electronic logbook of the European Commission so as to allow cross-border transactions. The registry works in much the same way as online banking, except that emission allowances are transferred, not money. The delivery contracts and financial settlements are matters that

fall outside the emissions trading registry. The registry is in effect the instrument used to transfer legal ownership of an emission allowance.

### Futures contracts versus spot trades

Spot transactions are the simplest way of trading emission allowances. Delivery occurs quickly (within two days). But the proportion of future contracts in overall trading is many times greater. The July 2010 monthly report of ECX (the largest trading platform for emission allowances) included a table of the total spot and future volumes traded through emission allowances exchanges in that month. More than 475 million emission allowances were traded during the month (amounting to more than €6 billion at a conversion rate of €14 per emission allowance). The 25 million spot allowances traded through known emissions trading exchanges in the same month came to about 5% of the volume of futures (even so the spot trades were still good for approximately €350 million). Besides futures some other derivatives have been created. Options are now possible on emission allowances, but the proportion is still very small.

Worldwide, the total trading volume in 2009 is estimated at €103 billion<sup>2</sup>.

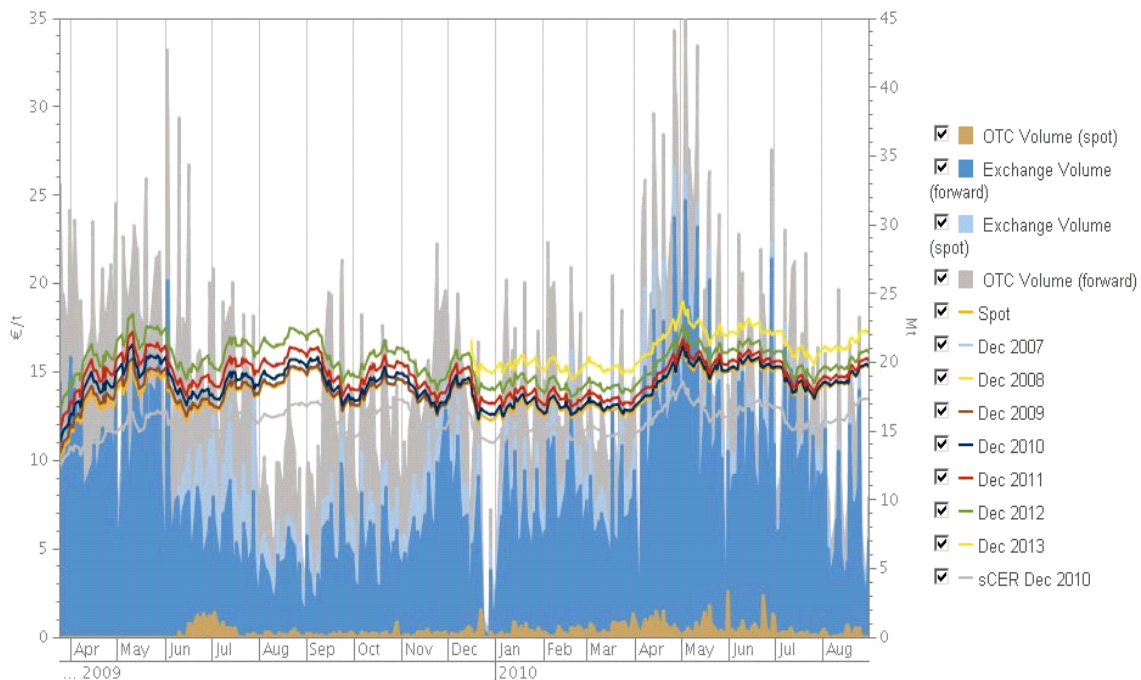


Figure 1: Transaction volumes according to type of contract (spot volumes in yellow / light blue)

### Trading through trading platforms

More than half of all emission allowances are traded by means of trading platforms. There are now six major trading platforms. They are Climex (NL), Bluenext, ECX, EEX, Nordpool and Greenmarkets, sometimes offering clearing and settlement facilities (such as APX for Climex). A number of them, including Bluenext in France and Climex, the only platform in the Netherlands, concentrate solely on spot trading (at least for the time being). The other four platforms focus principally on the trading of derivatives. Registered clients can offer or purchase allowances through a trading platform. They must first deposit money and allowances with a central counterparty. After a deal has been struck a settlement occurs by transferring money and allowances to the seller and buyer, respectively. This procedure, called clearing & settlement, is often handled by an organisation called a clearing house that is associated with the exchange. In principle the clients registered with an exchange hold their own accounts at an emissions trading registry for the purpose of depositing and receiving allowances. This working method ensures that the buyer and seller of the allowances remain anonymous to each other and that the price is established

<sup>2</sup> [http://siteresources.worldbank.org/INTCARBONFINANCE/Resources/State\\_and\\_Trends\\_of\\_the\\_Carbon\\_Market\\_2010\\_low\\_res.pdf](http://siteresources.worldbank.org/INTCARBONFINANCE/Resources/State_and_Trends_of_the_Carbon_Market_2010_low_res.pdf)

on the trading platform. Clients of trading platforms often pay registration fees and sometimes also a fee to the platform for each transaction.

### **OTC trading**

A transaction that does not come about through a trading platform is called an Over-the-Counter (OTC) trade. OTC trading falls into three categories:

- a. Transactions established through an intermediary (a broker), although closed deals are still registered with a trading platform, with clearing & settlement handled by a special clearing house. OTC transactions account for around 40% of all known transactions.
- b. Transactions established through a broker, without closed deals being registered with a trading platform and without clearance through a clearing house. The size of these trading volumes is unknown.
- c. bilateral transactions between two parties who came together without the assistance of a third party. The size of these trading volumes is also unknown.

A broker is merely a trader who trades *on the instructions of somebody else* (unlike a dealer, who trades for his own account and risk). A broker's revenue consists entirely of the transaction fees paid by clients. The advantages for the client compared with membership of a trading platform are the low registration fees charged by brokers (usually only transaction costs) and the lenient admittance requirements. Many small parties that trade infrequently, find it cheaper and simpler to trade through a broker because it obviates the need for registration (usually expensive) and screening at an exchange. Emissions trading brokers include large banks like Barclays, JP Morgan and Deutsche Bank. Amsterdam Capital Trading and STX Services are well-known Dutch brokers.

### **3. Analysis of fraud in emissions trading**

This section examines fraud detected in emissions trading in the past year and also fraud that is thought to be occurring. There is a description of each type of fraud, plus the measures taken and the residual risk for the Netherlands and Europe. Some potential additional measures are mentioned where applicable, based on the scale of the residual risk.

#### **3.1. VAT carousel fraud**

##### **Description of VAT carousel fraud**

FIOD-ECD launched an investigation into VAT fraud with emission allowances in the Netherlands following signals in June 2009 that there was major VAT fraud with emission allowances at Bluenext, a trading platform in France. This type of fraud causes a loss of State revenue on every transaction, because the buyer deducts the VAT but the fraudulent seller does not remit it. The seller will generally have registered under a false name. France incurred hundreds of millions of Euros in lost revenue. Fast action by the Dutch authorities probably kept the damage in the Netherlands very small compared to that in France and other countries.

##### **Active measures against VAT fraud**

In consultation with FIOD-ECD and NEa, the Ministry of Finance took action within a week of news of the fraud in France by reversing VAT liability for all types of emission allowances and making it payable by the buyer of the emission allowances. Dutch law was amended on 14 July 2009 to make this possible. A European directive was drawn up along the lines of the Dutch model to enable member states to introduce the VAT reversal nationally. The directive was adopted in December 2009. Implementation procedures for VAT reversal are in progress in various European countries. NEa allowed FIOD-ECD to inspect transactions and files.

##### **Residual risk for the Netherlands**

The Netherlands swiftly amended the law so as quickly to stop perpetration of this type of fraud at the expense of the Dutch State. Emission allowances now fall under an amended VAT regime, but there may still be a heightened risk of VAT fraud with other tradable environmental certificates (such as green certificates or biofuels). Although these matters fall outside the scope of this report, they are relevant to the Minister of Infrastructure and Environment.

##### **Residual risk within Europe**

Not all European countries have implemented VAT reversal nationally. This keeps the door open to carousel fraud in some European countries.

#### **3.2. Misleading of account holders (phishing/spoofing)**

##### **Description of phishing/spoofing**

A major attack occurred in spring 2010 with the aim of gaining unauthorised access to the registry for CO<sub>2</sub> emissions trading. This phishing attack included the sending of bogus e-mails to a large number of users of the Netherlands CO<sub>2</sub> Emissions Trading Registry. The object was to obtain user names and passwords fraudulently. Most if not all registries in the EU fell victim to this phishing attack.

The registries contain all emission allowances under the Kyoto Protocol and the EU Emissions trading system. The allowances in the Dutch registry are worth approximately €15 billion. In Germany, the allowances were deducted from 7 registry accounts, with a value of €3.2 million. Damage on an unknown scale was incurred in Spain. Prompt action by NEa prevented damage for Dutch account holders.

Immediately after the initial signals of a security attack, NEa closed down the registry and did not put it back online until the following week after implementing security measures in the system.



### Active measures against security attacks

In addition to the instant ad-hoc action by NEa, this incident prompted the agreement of additional measures by European Union (ETS trading) and the United Nations (Kyoto Protocol trading). The measures included those described below. The details of account holders will be kept confidential (i.e. they will not be published) to prevent them falling into the wrong hands. The UN prescribed a minimum level of access control that was higher than the username/password combination. In January 2011, NEa implemented the additional security by means of an SMS code. Also an uniform procedure to limit the impact of any future attack to the fullest extent possible was adopted. The uniform procedure is largely in line with the one NEa used for the first incident in this field.

### Residual risk in the Netherlands/Europe

After introduction of the intended measures, a risk of security attacks will remain, for example by means of spoofing (i.e. simulation of the secure NEa environment), as sometimes perpetrated successfully in Internet banking. Experts estimate that by taking the proposed measures the security of the emissions trading system will raise its security threshold to a level similar to that of banks, thereby making emissions trading less attractive for criminal activities.

## 3.3. Identity fraud

### Description of identity fraud

Applications submitted by new account holders have been accompanied by falsified or bogus identification papers in certain cases. FIOD-ECD says the intention of the applicants is to perpetrate VAT fraud later on, or to launder money in a way that makes it difficult to trace the perpetrator. The emissions trading system allows organisations or private individuals to request a personal account in an emission allowance trading registry of one of the EU member states. So far approximately 250 accounts have been opened in the Netherlands for (mostly foreign) organisations and private individuals.

The European Registry Regulation makes it mandatory to submit to an identity check when applying for a personal account. The NEa helpdesk makes these checks in the Netherlands. The Royal military and border police (KMar) has been called in to make expert analyses since mid-2009. These analyses by the KMar have already identified dozens of passports as false, stolen or otherwise unreliable.

### Active measures against identity fraud

NEa was confronted in April 2010 by an increasing number of requests for accounts whereby KMar uncovered fraudulent identity papers. Immediately afterwards NEa put on hold all current requests in order to introduce a far tighter screening regime. This included implementing the screening requirements of the new European Registry Regulation ahead of its entry into force. NEa reopened the process for applying for accounts in June. Besides the tighter criteria for admitting new account holders, the new Registry Regulation provides numerous extra instruments for assuring the integrity of account holders. It was within Europe to introduce the following intensified controls, and NEa accelerated their implementation in spring 2010:

- All applications for accounts must be accompanied by at least the following documents:
  - a. an authenticated copy of the applicant's passport (by means of an embassy stamp or note);
  - b. a copy of a statement of an active bank account within the European Economic Area (EEA);
  - c. an authenticated copy of Chamber of Commerce documents (legal persons);
  - d. a notarised document, authenticated by an embassy, showing the applicant's address of permanent residence.
- NEa will make some specific checks on the submitted documents in cooperation with KMar and the Immigration and Naturalisation Office (IND).
- The new rules enable NEa to refuse an account (or access to an account) following the widening of the legal grounds for such action.
- The registry administrators will keep a shared list of refused account holders in EU member states.
- Existing account holders will be re-checked against the more stringent criteria. Those who fail to satisfy the criteria will be denied access to the registry. NEa started this procedure immediately after the Registry Regulation entered into force in October 2010.

### Residual risks in the Netherlands

The extra measures that NEa has introduced pending amendment of the Registry Regulation have greatly curtailed the risk of persons registering as an account holder under a false name. But it is still possible to trade emission allowances without holding an active account in an emissions trading registry. This applies in any event to the clients of brokers, and possibly also to exchanges that do not offer derivatives. Traders instruct brokers to execute transactions. Where these are spot transactions and not derivative transactions, the broker offices are not subject to any rules concerning client admittance requirements. Consequently, there is still a risk of traders with being active (in the Netherlands) on behalf of clients that have given a false identity or of criminals having or opening an account in an EU member state that does not yet make stringent identity checks. The French Prada investigation explicitly recognises this matter.

### Residual risks in Europe

Like the Netherlands, most European countries lack admittance rules for traders who participate in trading through broker offices. So constructions remain possible where traders are able to take part in emissions trading under a false identity, which constitutes an extra risk for subsequent crimes like money laundering. Furthermore, not all registries have started holding present account holders to the new admittance criteria.

## 3.4. Money laundering

### Description of money laundering

Money laundering is the act of performing transactions to disguise the origin of illegally obtained money. The purpose of money laundering is to spend and invest illegally acquired funds without it being possible to prove that the funds came from criminal activities in order to prevent law enforcement agencies from seizing the funds. Well-known methods include concealment or circulation. These practices involve a succession of sometimes complex financial transactions with the aim of hiding the origin of the funds. Further concealment is possible by converting the funds (or emission allowances) from one currency to another. No concrete cases of money laundering have been detected in the Netherlands so far, but numerous signals point towards the existence of money laundering by means of emission trading, originating from the experts of the taskforce as well as expert organisations.

1. Experts on the taskforce describe emissions trading as a system with a high risk of money-laundering for the following reasons:
  - a. the lenient requirements for admittance to the market;
  - b. the value the market represents (many billions of Euros);
  - c. the complexity of the market (complex international transactions);
  - d. the proof that applications for accounts are being made under false identities, one of the basic crimes associated with money laundering;
  - e. the fact that the KMar has established that certain parties who apply for accounts are known to the police because they are suspected of or are sought in connection with money laundering or the financing of terrorism;
  - f. the registration of small shady foreign organisations as account holders (for example a trader whose address is a restaurant, a trader who has only a correspondence address, company addresses of employees of Gmail or Hotmail).
2. The following expert organisations have reported in published articles in the past year the existence of money laundering using the emissions trading system:
  - Europol<sup>3</sup>, a European law enforcement agency dedicated to improving the effectiveness and cooperation of competent authorities in member states in preventing and combating terrorism, illegal narcotics trading and other serious forms of organised crime;
  - Deloitte Forensic<sup>4</sup>, part of the Deloitte management consultancy, which investigates fraud, corruption and integrity issues nationally and internationally;
  - Asia/Pacific Money-Laundering Group (APG)<sup>5</sup>, a regional collaborative organisation that combats money laundering and the financing of terrorism. The organisation has 40 members from the Asia-Pacific region plus a number of observers including the United Nations, the

<sup>3</sup> <http://www.europol.europa.eu/index.asp?page=news&news=pr091209.htm>

<sup>4</sup> [http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Services/Forensic/Carbon\\_credit\\_fraud.pdf](http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Services/Forensic/Carbon_credit_fraud.pdf)

<sup>5</sup> <http://www.carbonoffsetsdaily.com/news-channels/global/carbon-trading-used-as-money-laundering-front-experts-40574.htm>

International Monetary Fund and the World Bank. APG is a sister organisation of the Financial Action Task Force (FATF). FATF sets standards for suppressing money laundering and the financing of terrorism.

### Active measures against money laundering

Indirect measures taken against money laundering include the more stringent admittance requirements introduced by NEa and the checking of identity papers by KMar. However, there are not yet any admittance requirements for trading by traders of spot emission allowances who do not have an account at an emissions trading registry.

There are not yet any direct measures against fraud perpetrated through money laundering by trading emission allowances. Generally speaking, the obligation to report unusual transactions is an important means for detecting suspicious transactions. The Financial Intelligence Unit, based in Zoetermeer, receives these reports (more than 15,000 each year) and whittles them down to a list of suspicious transactions. Transactions involving emission allowances are not subject to the reporting obligation<sup>6</sup> in many cases (also see section 4.1). Therefore, there is no obligation to monitor or report unusual transactions (by NEa or for example a spot trading platform or an emission allowances broker) and from a legal point of view there is no desk to which such transactions can be reported for further analysis or investigation.

### Residual money laundering risk.

The residual risk of money laundering with emission allowances is considerable, according to fraud experts at FIOD-ECD and Europol. The emissions trading system is ideally suited for money laundering because of its features and, in particular, the disguising of transactions. Large amounts are concerned and foreign organisations are able to carry out anonymous transactions simply and quickly in the absence of a regime of controls. Moreover, there are confirmable signals from everyday practice that point towards money laundering: identity fraud, applications for accounts made by people with a criminal record in this field and VAT fraud. As yet there are no systematic instruments for curtailing money laundering perpetrated by means of emission allowances. The intensified identity checks on applications for accounts in the emissions trading registry are the only way of helping to reduce this risk, but traders may also be active (through a broker) without needing an account at an emissions trading registry.

## 3.5. Summary of residual risks

The Netherlands very quickly took adequate measures against most of the observed forms of fraud. Fast action by various authorities avoided major damage in the Netherlands. The main residual risk still requiring additional measures is in the field of money laundering, according to the taskforce.

Clear signs and sources indicate the existence of money laundering as a way of financing terrorism through the emissions trading system. So far no targeted measures have been taken against this risk and as yet there are no appropriate rules. There is no regime for reporting unusual transactions and there are no requirements for admitting traders to the spot market. They are subjected to serious identity/integrity checks only if they register as an account holder with an emissions trading registry.

<sup>6</sup> The applicability of the Prevention of Money Laundering and Financing of Terrorism Act is not determined by the type of transaction, but by the institutions involved. If an institution within the meaning of the Act is involved in the transaction and suspects (on the basis of the subjective indicator) that a transaction in emission allowances was conducted for money laundering purposes, then said institution must report the transaction. Emission allowance brokers and companies covered by the emission trading system (e.g. energy companies, blast furnace operators) do **not** qualify as institutions within the meaning of the Act; banks, on the other hand, **do** qualify.

## 4. Analysis of regulators and investigative services

This chapter describes investigative services and regulators that have their own distinct powers in fields where fraud is committed by means of trading emission allowances.

### 4.1. NEa's role in emissions trading

NEa was established as an operational and supervisory body. The authority keeps a watch on the correct reporting of emissions (polluting emissions) of companies by inspecting their premises. The main goal is to verify compliance with the monitoring method laid down in the licence issued by NEa. NEa can take legal action against licensed companies that commit violations. The authority further manages emissions trading registries where online transactions occur with emission allowances in a way similar to Internet banking. NEa has a front office for account holders in the form of a telephone helpdesk. In the CO<sub>2</sub> emissions trading registry NEa has approximately 400 accounts of companies licensed to engage in CO<sub>2</sub> emissions trading and 250 accounts of other organisations. Two persons in each account are registered as being authorised to conduct transactions. NEa occupies a central position in transferring allowances and may impose requirements for the reliability of traders or the level of security of the transaction registry. However, NEa does not hold any regulatory powers for the trading of emission allowances. But NEa did file an official report on a security attack and on request provides information to FIOD-ECD for investigation purposes. NEa possesses extensive knowledge and expertise of the complex world of trading of emission allowances, but does not have any specific knowledge of crime in trading markets.

#### View of Department of Legal Affairs (BJZ) of NEa's powers

The Department of Legal Affairs (BJZ) of the Ministry of Infrastructure and Environment recognises that NEa has no regulatory powers over the trading of emission allowances. BJZ points out that the European Registry Regulation gives NEa a number of statutory powers. "NEa is responsible for ensuring that transactions can be conducted in a 'safe environment'. This role also gives NEa responsibility for ensuring the existence of a fair system and for reporting suspected criminal offences to the public prosecutor's office." Additionally, "the authority to lay down additional security requirements can be considered as a power held by NEa (or more precisely the registry administrator working at NEa) to limit fraud. This concerns preventive measures."

### 4.2. FIOD-ECD's role in emissions trading

FIOD-ECD has no specific role in emissions trading. It is the generic investigative service for preventing fiscal, financial and economic fraud. The large-scale VAT fraud in Europe perpetrated with emission allowances followed by suspected money laundering has brought the trade in emission allowances under the attention of FIOD-ECD. FIOD-ECD took very decisive action against VAT fraud in 2009 and launched investigations with the help of information provided by NEa.

### 4.3. AFM's role in emissions trading

The Netherlands Financial Market Authority (AFM) is the regulator for the trading of financial instruments. In emissions trading, only futures and options qualify as financial instruments. By consequence AFM may maintain supervision only over these particular instruments and, if necessary, may take legal action. A second relevant role of AFM consists of the advice that it gives the Minister of Finance on the granting of licences to trade financial instruments on regulated markets. Exchanges established for emissions trading that allow the trading of financial instruments need to hold a licence issued by the Minister of Finance. AFM does not maintain supervision over the spot market for emission allowances. Consequently, the authority does not maintain supervision over exchanges that facilitate only spot trading. The explanatory memorandum accompanying the Act implementing the EC Directive on greenhouse gas emissions trading (Lower House of Parliament, 29 565, No. 3, p 75) explained that an emission allowance itself does not qualify as a financial instrument. Therefore, there is no legal basis for AFM to maintain supervision over trading in emission allowances. Trading in financial derivatives like futures and options with emission allowances as the underlying security currently occurs principally in other countries (especially the UK). For that reason AFM does not keep a watch on this trading of derivatives.

#### **View of financial experts on AFM's powers**

Financial experts outside the expert group emphatically stress that AFM exists to watch over speculative trading and that the instruments for doing this seek to protect participants in trading by keeping a watch on insider dealing, an accurate description of financial products and similar. Together with parties including the Netherlands Central Bank (*De Nederlandsche Bank*), AFM is charged with overseeing compliance with obligations laid down in the Prevention of Money Laundering and Financing of Terrorism Act. Financial institutions subject to AFM supervision are investment companies, investment institutions and financial service providers insofar as they act as intermediaries in establishing life insurance agreements. AFM's supervision under the Act focuses on assuring confidence in the market by monitoring and promoting the fair conduct of business and preventing institutions consciously or unconsciously becoming embroiled in money laundering.

#### **View of BJJ on AFM's powers**

The Department of Administrative and Legal affairs of the Ministry of Infrastructure and Environment points out that the fraud currently known to exist "must be regarded as criminal offences, which means that investigators and subsequently the public prosecutor must take action against violations. AFM cannot have any supervisory role in this respect. After all, violations like fraud and similar have nothing to do with non-compliance with rules concerning the emissions trading system as such."

#### **4.4. VROM-IOD's role in emissions trading**

VROM-IOD is the special investigative unit of the former Ministry of Housing, Spatial Planning and Environment. The unit conducts large and complex investigations in the housing and environmental fields. The unit carried out a broadly-based investigation into the risks that may occur in emissions trading. Besides the potential opportunities for fraud in the actual trading of emissions, the unit identified opportunities in other parts of the emissions trading system. This has resulted in cases where charges have been brought against parties. The unit plays no role in the approach adopted to market trading of emission allowances. The specific knowledge needed for this is embedded at other enforcement organisations.

#### **View of the BJJ of the powers of VROM-IOD/VROM Inspectorate**

The Legal Affairs department of the Ministry of Infrastructure and Environment noted in its report on VROM-IOD that the unit holds broadly-based investigative powers. "These investigations in the field of emissions trading (under Chapter 16 of the Environmental Management Act) do not need to be confined to the Act's monitoring and compliance requirements, but may also relate to fraud with emission allowances (money laundering and similar)". The department additionally points out that the VROM Inspectorate has no second-line supervisory powers over the trading in emission allowances, because NEa has no first-line supervisory powers over the trading.

#### **4.5. KMar's role in emissions trading**

The Royal military and border police (KMar) has a special centre of expertise for identity fraud. A person who applies for an account in the NEa registry is required to enclose a copy of his passport with the application. In the past it was not always clear to NEa whether a passport (particularly a foreign passport) was reliable. Therefore, arrangements were agreed with KMar in mid-2009 under which the police conduct an expert analysis of identity papers. Besides these reliability checks, KMar advises on reliable procedures for checking identity.

#### 4.6. Summary

The figure below outlines the current prevention, supervision and investigation powers of the various supervisory bodies and investigative services with regard to fraud involving emission allowances.

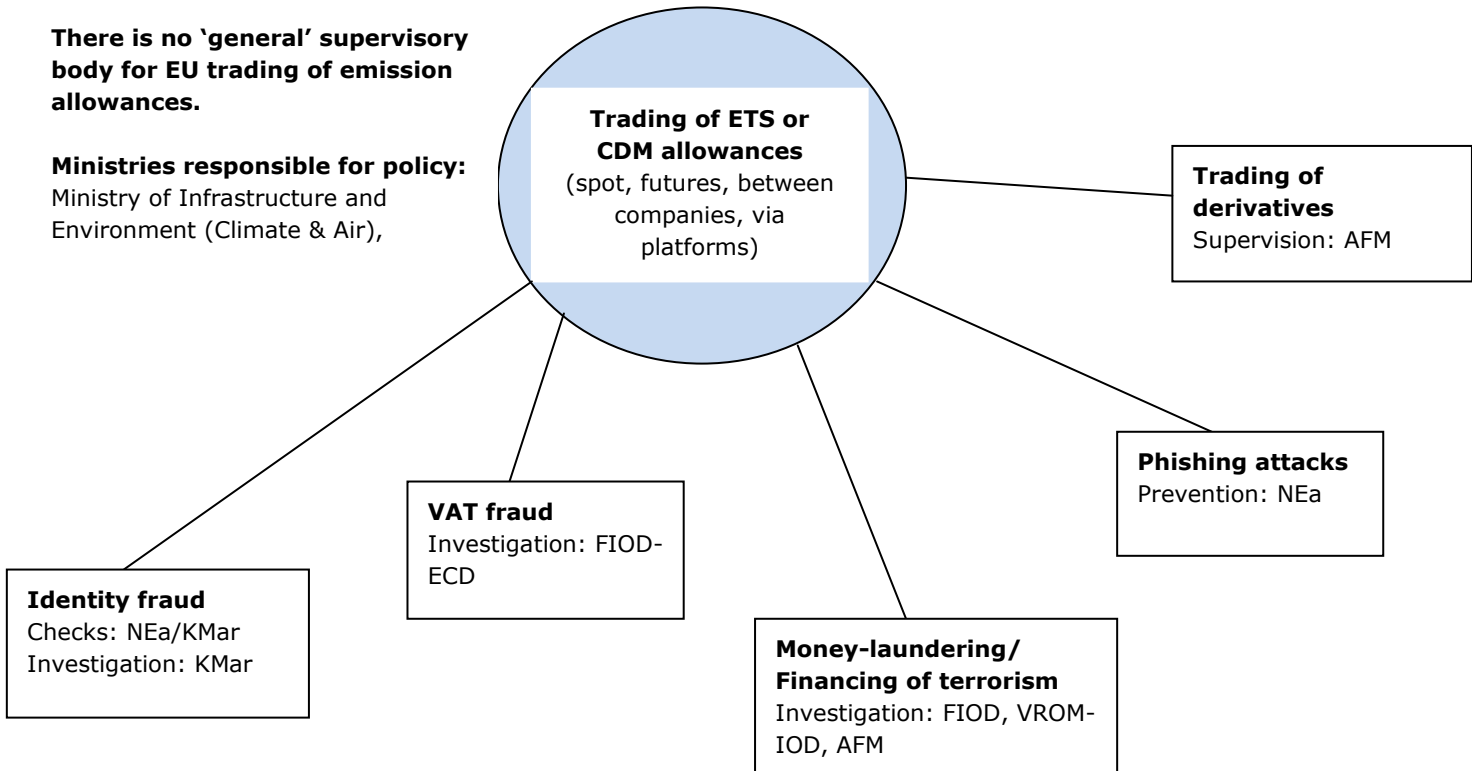


Figure: powers to maintain supervision and to conduct investigations

## 5. Analysis of instruments for reducing ETS fraud

This section explains the main instruments available to supervisory bodies and investigative services for tackling fraud with emission allowances. There is a brief explanation of each instrument, its added value in the tackling of fraud and the possible limitations of the instrument.

### 5.1. Prevention of Money Laundering and Financing of Terrorism Act

#### Description of the Act

The Prevention of Money Laundering and Financing of Terrorism Act came into force on 1 August 2008. The Act implemented in the Netherlands the EU's Third Money Laundering Directive, while the Financial Services Identification Act and the Disclosure of Unusual Transactions (Financial Services) Act were merged. All institutions listed in Section 1 of the Prevention of Money Laundering and Financing of Terrorism Act are under obligation to report unusual transactions. A list of indicators was added to help identify unusual transactions. They must be reported to the Financial Intelligence Unit (FIU) in the Netherlands. Each year FIU receives thousands of reports of unusual transactions from which it identifies suspect transactions and may launch targeted investigations.

#### Added value:

In many cases the Prevention of Money Laundering and Financing of Terrorism Act does not apply to the trading of emission allowances. Consequently, it has only theoretical added value at present. Transactions involving emission allowances do not currently seem qualifiable as unusual transactions. If this were to be the case, there would automatically be an obligation for NEa and also for trading platforms (and intermediate traders) to disclose any unusual transactions.

#### Limitations of the Act

By extension the Prevention of Money Laundering and Financing of Terrorism Act in its present form does not yet provide any pointers for reporting unusual transactions. Consequently, a potentially appropriate investigative instrument remains unusable for tackling fraud involving emission allowances.

### 5.2. European Registry Regulation

#### Description

The most recently adopted European Registry Regulation (October 2010) provides several possibilities for reducing fraud. The main rules concern tighter checks on an applicant's identity.

- possibility to require extra assurances at national level;
- sharing of information concerning rejected applications;
- possibility to deny access or to close an account;
- possibility to report unusual transactions to competent national authorities.

#### Added value of Registry Regulation

The added value of the Regulation is that it prescribes a tighter minimum level of identity checks by competent authorities around Europe and thus restricts the scope of account holders to divert to the member state with the lowest admittance controls. The Regulation also offers registry administrators greater possibilities for preventive and corrective measures.

#### Limitations of Registry Regulation

The Regulation contains no harmonised European arrangements for types of fraud other than identity fraud and IT security attacks. It is still unclear how the possibilities described in the Regulation for reporting unusual transactions shapes up in relation to the Prevention of Money Laundering and Financing of Terrorism Act in the Netherlands. One difference is that the European legislation does not prescribe a reporting obligation but merely a possibility (not mandatory) to make a disclosure.

Besides establishing the identity of the party opening an account, there should be a check from time to time on whether the client is still the same and whether the institution or person is the subject of a criminal investigation. This amounts to the monitoring of account holders.

### 5.3. Financial Supervision Act

**Description:**

The Financial Supervision Act regulates the supervision of financial institutions in the Netherlands. The Act entered into force on 1 January 2007. Among other things the Act defines the roles of AFM and the Netherlands Central Bank. With regard to the trading of emission allowances, the Act designates AFM as the supervisory body for financial instruments and provides a subdivision of the instruments.

**Added value:**

As derivatives of tradable emission allowances fall under the definition of financial instruments, AFM holds authority to maintain supervision over trading in these instruments.

**Limitations:**

Since an emission allowance as such does not fall under the definition of a financial product, the spot trading of emission allowances is not subject to supervision by AFM.

### 5.4. VAT reversal

**Description:**

A reverse charging scheme was introduced in spring 2009 following VAT fraud with emission allowances. The scheme means the buyer no longer pays VAT to the seller, thus making this kind of VAT fraud impossible in the Netherlands.

**Added value:**

The scheme has had great added value. Without the scheme there would have been a very real risk of the daily loss of VAT revenues.

**Limitations:**

No limitations are known to exist.

### 5.5. Summary of weaknesses in instruments

Introduction of the Registry Regulation will significantly improve some initial weaknesses in the instruments. This will give NEa (and specifically the registry administrator) a possibility to take preventive and corrective measures to tackle phishing attacks and false registrations effectively.

The more generic financial legislation does not yet appear to be tailored to fit the new market in emission allowances. The following two vulnerabilities are particularly significant:

1. New entrants to the trade in spot emission allowances are not subject to any requirements.
2. A basis does not exist for reporting unusual transactions involving emission allowances.



## 6. Summary, conclusions and recommendations

It became clear in 2009 that large-scale fraud had been perpetrated through the trading of emission allowances. VAT fraud, digital phishing, passport fraud and money-laundering had caused Europe-wide damage amounting to hundreds of millions of euro.

An interdepartmental Emissions trading Antifraud Working Party conducted an investigation in the first half of 2010 at the request of the Minister of Housing, Spatial Planning and the Environment. The working party consisted of experts of the Fiscal Information and Investigation Service/Economic Investigation Service (FIOD-ECD), the Intelligence and Investigation Service of the Ministry of Housing, Spatial Planning and the Environment (VROM-IOD), the Netherlands Authority for the Financial Markets (AFM), the police of the Royal Netherlands Marechaussee (KMar), the Ministry of Finance, the Ministry of Housing, Spatial Planning and the Environment and the Dutch Emissions Authority (NEa). The working party analysed how the instruments and powers of government departments measured up to the risk of this kind of fraud and identified the residual risk after implementation of a series of measures.

There is in general a great risk of fraud in emissions trading because of its very nature. It is a trading system that turns over billions of euro in transactions that represent monetary value, the transactions are rapidly executable worldwide and it is easy for participants all over the world to join the system. There are no admittance requirements for participants in spot market trading, which include trading platforms and broker offices and their clients, and by consequence they are not subject to supervision. The working party drew the following specific conclusions.

### Risks already covered

For a long time the major risks of fraud within the trading system were at odds with the limited measures and powers that existed. Adequate measures have since been taken or will shortly be introduced against most types of fraud, namely:

1. The European Registry Regulation was amended in 2010 to tackle ID fraud in applications made for accounts in the Emission Trading Registry. The Dutch Emissions Authority (NEa) introduced these measures in the Netherlands in June 2010 before the Regulation's entry into force. The monitoring of account-holders could as yet be added.
2. NEa has a plan of action to raise access security to the level of online banking before 1 January 2011, by means of a secure SMS code, in conformity with the new requirements of the UN Climate Agency, so as to prevent unauthorised access to accounts by means of phishing/spoofing.
3. The Netherlands quickly took an appropriate measure in 2009 to prevent VAT fraud by declaring the reverse charge mechanism applicable to emission allowances. The European Commission has now developed a directive in line with this method.

### Residual risks

At the same time it has to be recognised that risks still remain. The main risks are:

1. Money-laundering currently poses the biggest residual risk of fraud in emissions trading. There are clear signs and sources that point towards the emission trading system being used for money-laundering and the financing of terrorism. Billions of euro circulate within the system, it is a global market and a possibility exists to engage in spot trading (via broker offices) without any identity/integrity checks. It has been established that there have been large-scale registrations using falsified/stolen passports and KMar has discovered that persons suspected of or sought in connection with money-laundering and the financing of terrorism are also trading emission allowances. Respected bodies like Interpol have already pointed out that money-laundering occurs through the trading of emission allowances<sup>7</sup>. There do not yet seem to be any rules aimed systematically at preventing money-laundering and the financing of terrorism. The working party draws attention to the existence of two important limitations:
  - a) The first limitation in detecting and prosecuting notably money-laundering is the frequent absence of an obligation (in the Netherlands) to report unusual transactions involving emission allowances. It is extremely important to receive reports of unusual transactions in order to investigate money-laundering. Under the present legislation the NEa, banks and trading platforms can not and may not report these transactions in the Netherlands.
  - b) A second major limitation in tackling money-laundering is that participants in the spot trading of emission allowances are not subject to rules for identity/integrity checks. Tough checks will exist

<sup>7</sup> <http://www.europol.europa.eu/index.asp?page=news&news=pr091209.htm>

shortly but only for applications for an account in an emission trading registry. However, it is not necessary to hold a registry account in order to participate in trading. Trading is also possible via a broker office that executes transactions on the instructions of traders.

2. NEa occupies a central position in transactions involving emission allowances and holds legal powers to set requirements and frameworks for the reliability of account-holders and the security of the registry. For this purpose it is essential to possess knowledge of financial markets and to be able to assess fraud risks. No allowance was made for these factors when the NEa organisation was set up.

**Recommendations:**

The working party recommends tightening up the powers and instruments in the near future to a level commensurate with other trading systems. Over the past months a series of measures have been taken to reduce significantly most of the fraud risks. The greatest danger still lies in money-laundering and the financing of terrorism. The recommendations that the working party wants to submit to the Minister of Housing, Spatial Planning and the Environment are summarised below. The first two measures in particular will require interdepartmental liaison.

1. Work in 2011 towards an obligation to report unusual transactions involving emission allowances. Making this mandatory for trading platforms, brokers and NEa will enable the investigation of money-laundering committed via emissions trading. The Ministry of Housing, Spatial Planning and the Environment can enter into talks with the Ministry of Finance on this matter, if desired using the knowledge present at NEa.
2. Develop in 2011 a regime for subjecting all participants in emissions trading to stringent identification requirements. This has already been introduced for registration in the NEa Registry for the purpose of transactions. Other service providers like trading platforms and broker offices also need to give high priority to applying these identification requirements to their client bases. Checks should be made on participants from time to time. This matter again concerns an instrument of the Ministry of Finance and it is prudent for the Ministry of Housing, Spatial Planning and the Environment to enter into consultations with them on this subject.
3. Make sufficient resources available in 2010 to allow NEa to take technical and organisational measures (some of which are mandatory internationally) before the end of the year to help prevent fraud. The measures should include the extensive screening of registered account-holders and the tightening up of the security measures for the transactions registry. This will require a non-recurring investment (€50,000 to €100,000).
4. Ensure soon that NEa possesses in-house knowledge and expertise of financial fraud to allow the authority to act pre-emptively, pro-actively and methodically to reduce and prevent fraud involving emission allowances. This will require a widening (temporarily or otherwise) of NEa's terms of reference or the reprioritisation of its tasks in consultation with its principal (i.e. the Ministry of Housing, Spatial Planning and the Environment).