

# ADVISORY

**SULLIVAN & WORCESTER LLP CLIMATE-RELATED BUSINESS & TECHNOLOGY AND SECURITIES & CORPORATE FINANCE PRACTICE GROUPS – CLIENT ADVISORY**

## Does Carbon Trading Implicate U.S. Securities Laws?

The carbon market could become the largest trading market in the world, according to a recent report by the *Financial Times*. The World Bank estimated the value of carbon trading last year at \$64 billion. PointCarbon has estimated that the global carbon market could be worth more than \$3 trillion in 2020 if the United States were to participate by implementing a cap-and-trade system to limit greenhouse gas (“GHG”) emissions through an international agreement to succeed the Kyoto treaty. The market potential is very large for entities creating and marketing carbon credits, and many companies in the renewable energy, energy efficiency, and clean technology space are positioning themselves to take advantage of the developing carbon markets domestically and internationally. Few, however, are aware of the potential securities law implications.

While the U.S. Securities and Exchange Commission (“SEC”) has not yet sought to regulate carbon trading and the corresponding issuance, purchase and sale of emission reduction units (“ERUs”), it is important to note that certain activities conducted in connection with carbon trading regimes may trigger the application of U.S. securities laws. While it is unlikely that certificates evidencing ownership of ERUs alone would be deemed securities under U.S. law, certain arrangements that give rise to the creation and sale of ERUs may be deemed investment contracts, a type of security, thus providing a basis for SEC jurisdiction over persons offering investment opportunities. SEC rules governing offers and sales of securities are restrictive and complex, and, if applied, could limit the activities of players in carbon markets.

The definition of “security” includes traditional instruments such as notes, stocks, bonds and similar items, as well as documents traded for speculation or investment and any interest or “instrument commonly known as a security.” However, the definition of a security also includes so-called investment contracts.

“Investment contract” has been broadly defined to capture various novel investment-related instruments, contracts, transactions and schemes. Investment contracts may include instruments that are always securities, as well as interests and transactions that may constitute securities only under certain circumstances. For regulatory

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purposes, there is no difference between an investment contract arising from the circumstances of a transaction and an instrument commonly known as a security, such as a share of stock or a bond. Both are regulated as securities, and their issuance and trading implicates a number of securities laws.

Generally, an investment contract is defined as “a contract, transaction or scheme” whereby a person invests “money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” The “touchstone” of an investment contract is “the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” In *SEC v. Howey* and *United Housing Foundation, Inc. v. Forman*, the U.S. Supreme Court fashioned a test to determine when an investment contract exists (known as the Howey-Forman test). Under the Howey-Forman test, an arrangement is not an investment contract unless each of four distinct elements is present: (1) the investment of money; (2) in a common scheme or enterprise; (3) with the expectation of profits; (4) to come solely from the managerial or entrepreneurial efforts of others. Complex case law exists on each prong of the Howey-Forman test, which analyzes the types of arrangements that may be investment contracts.

For example, in the *Howey* case, the U.S. Supreme Court concluded that an investment contract existed where Company A offered investors the opportunity to purchase land in an orange grove and enter into a servicing agreement to permit Company B, an affiliate of Company A, to cultivate and develop the groves, as well as harvest and market the resulting produce. If interested, investors were presented with a land sale contract and a service contract. While investors were permitted to engage a service provider other than Company B to manage the groves, Company B was strongly recommended. Most, if not all, of the investors lacked the requisite knowledge and skill to manage the groves on their own.

Once investors purchased the land and entered into the servicing agreement, they relinquished control of the land to the service company. The service contract granted the servicing company a leasehold and full and complete possession of the

land. The servicing company had full discretion and authority over the cultivation of the groves, and the harvest and marketing of the crops. The investors shared in the revenues generated by the sale of the crops.

The U.S. Supreme Court determined that the transactions were clearly investment contracts because Company A offered an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by Company B. This was offered to persons in distant localities who lacked the equipment and expertise to cultivate, harvest and market the crops. The tracts sold gained utility as a citrus grove only when cultivated and developed as part of the grove as a whole.

Recently, in *United States v. Leonard*, the United States Court of Appeals for the 2<sup>nd</sup> Circuit found an investment contract to exist where two promoters sold interests in film companies to investors. The Court held that the promoters could be held criminally liable for securities fraud in connection with the marketing and sale of an arrangement deemed to be an investment contract.

The determination of whether ERUs are deemed securities is a very fact specific inquiry; however, ERUs may be deemed investment contracts where, for example, a company offers investors an opportunity to purchase an interest in one or more projects that will be managed by a person other than the purchaser to generate ERUs for sale, with a portion of the proceeds to go to the purchaser of the interest in the projects. Additionally, those engaging in activities such as establishing and operating funds that buy or sell ERUs or invest in projects designed to generate ERUs, as well as those engaged in facilitating investment in or providing consulting services to entities producing ERUs, should seek advice regarding the applicability of the U.S. securities laws.

Neither the SEC nor the courts have addressed whether investments in the production or sale of ERUs are investment contracts, although they may do so in the future as investments in ERUs and carbon trading arrangements become more accessible to retail investors. While there is, as yet, no decisional law on the question whether, and under what circumstances, an ERU constitutes an

investment contract, the existing cases can provide guidance by analogy. The specifics of each ERU transaction must be examined individually to determine if a given ERU is likely to be defined as an investment contract for purposes of the securities laws.

If you have questions regarding these issues or are involved in carbon trading activities, the firm's Climate-Related Business & Technology, and Securities & Corporate Finance practice groups are prepared to provide assistance.