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ALERT MEMORANDUM

CFTC Proposes Voluntary Carbon Credit Derivatives Guidance

December 6, 2023

On December 4, the Commodity Futures Trading Commission (the "CFTC") proposed guidance for designated contract markets ("DCMs") listing voluntary carbon credit ("VCC") derivative contracts. The proposed guidance, published to coincide with COP 28, and the opportunity to provide comment will be welcomed by the VCC market which has seen several years of significant expansion of VCC markets as well as increased attention from professional and regulatory organizations globally, including the CFTC. This alert provides a summary and preliminary analysis of the key aspects of the proposed guidance. We plan to publish additional analysis in the coming days.

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In particular, the proposal follows the CFTC Whisleblower Alert encouraging individuals to alert the CFTC of misconduct in the carbon markets, which market participants have been very focused on as they expand their activity in the primary and secondary VCC markets. Principally, the proposal would provide guidance on the factors that DCMs should consider when addressing certain provisions of the Commodity Exchange Act ("CEA"), and CFTC regulations thereunder, that are relevant to the listing for trading of VCC derivative contracts, with a particular focus on physically-settled contracts. However, the CFTC anticipates that the guidance would also be relevant to cash-settled transactions and SEFs offering such products. We also expect participants in the bilateral, over-the counter markets to consider how the proposal affects their regulatory obligations and liabilities under spot, forward and swap transactions in VCCs.

DCMs are self-regulatory organizations required by the CFTC to comply with statutory "Core Principles" set forth in CEA, including requirements regarding the listing of futures contracts. Futures contract where the underlying commodity is a VCC are currently listed on DCMs for participants to purchase carbon credits whose retirement represents the reduction or removal of greenhouse gas emissions.

The preamble to the proposal notes that market participants have encountered challenges related to a lack of standardization, transparency, and integrity as VCC markets have grown, and the CFTC's proposed guidance is an attempt to address those concerns with respect to VCC futures listed on DCMs.

Over the past two years, the CFTC has held two Voluntary Carbon Markets Convenings to discuss issues related to the supply of and demand for VCC derivatives contracts and last year the CFTC issued a Request for Information on climate-related financial risk, which included questions regarding the VCC market. The proposed guidance leverages the work the CFTC has done through these public initiatives to establish standards for VCC derivatives contract listings on DCMs, and also references work done by the International Swaps and Derivatives Association ("ISDA"), the Board of the International Organization of Securities Commissions ("IOSCO"), and the Futures Industry Association ("FIA"). The proposed guidance states:

- A DCM should take into account certain characteristics of VCCs, which the CFTC refers to as VCC commodity characteristics, when designing a VCC derivatives contract to avoid the possibility of manipulation. These VCC commodity characteristics include:
  - **Quality Standards** such as (i) transparency, (ii) additionality, (iii) permanence and risk of reversal, and (iv) robust quantification;
  - **Delivery Points and Facilities**, taking into account the governance framework and tracking mechanisms of the crediting program underlying the VCCs, as well as the crediting program's measures to prevent double-counting; and
  - **Inspection Provisions** or certification procedures for verifying compliance with the latest procedures in the voluntary carbon markets.
- A DCM should also consider these characteristics when selecting one or more crediting programs from which eligible VCCs, meeting the derivative contract's specifications, may be delivered at the contract's expiration. The CFTC believes that any inspection or certification procedures for verifying compliance with quality requirements or any other delivery requirements for physically-settled VCC derivatives contracts should be specified in the contract's terms and conditions. The CFTC believes that these inspection or certification procedures should be consistent with the latest procedures in the voluntary carbon markets. To that end, the Commission preliminarily believes that the DCM should consider, among other things, how the crediting program for the underlying VCCs requires validation and verification that credited mitigation projects or activities meet the crediting program's rules and standards.
- A DCM should continually monitor, the contract's terms and conditions as they relate to the underlying commodity market, to the convergence between the contract price and the price of the underlying commodity, and to monitor the supply of the underlying commodity in light of the contract's delivery requirements. The guidance also reminds DCMs of their obligation to require their market participants to keep records of their trading which include records of their activity in the underlying commodity and related derivatives market, as well as CFTC recordkeeping rules.
- A DCM must provide supporting documentation, evidence, and data to describe how a listed VCC derivative contract complies with the CEA and CFTC rules and regulations to comply with the product submission requirements. The CFTC anticipates that in connection with the submission for a VCC derivative contract, a DCM may provide

qualitative explanations and analysis to assist in addressing the three above described requirements.

Comments on the proposal are due by February 16, 2024.

For background see:

- Deborah North, et al., Decarbonization in the Wake of COP 27: The Role of Private Capital, PLI Current: The Journal of PLI Press, Vol. 7 (2023)
- Cleary Alert on the Secondary Voluntary Carbon Markets Convening

For additional information, please see:

- CFTC Press Release
- CFTC Proposed Guidance
- Statement of CFTC Chairman Rostin Behman
- Statement of CFTC Commissioner Kristin Johnson
- Statement of CFTC Commissioner Christy Goldsmith Romero
- CFTC Whistleblower Alert

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