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CFTC'S PROPOSED GUIDANCE FOR VOLUNTARY CARBON CREDIT LISTINGS AND BROADER CARBON MARKET DEVELOPMENTS

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On December 4, 2023, the Commodity Futures Trading Commission ("CFTC") issued for public comment proposed guidance regarding the listing by designated contract markets ("DCMs") of voluntary carbon credit ("VCC") derivative contracts (the "Proposed Guidance"). The Proposed Guidance acknowledges challenges that market participants have faced in VCC markets, such as a lack of standardization, transparency, and integrity, as the sector has expanded. The CFTC's Proposed Guidance aims to address these concerns specifically in relation to VCC futures listed on DCMs. This article provides a summary and analysis of the Proposed Guidance and how it may affect voluntary carbon markets and the current patchwork of standardization efforts.

The Proposed Guidance identifies factors that DCMs should address in the design of a VCC derivatives contract to avoid the possibility of manipulation, including:

- **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

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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.

Comments on the proposal were due February 16, 2024.

BACKGROUND

Voluntary carbon markets allow carbon emitters to purchase credits that are awarded to projects that remove or reduce atmospheric carbon. These credits offset the carbon emitters' emissions in furtherance of a voluntary commitment to reduce "net" emissions. The voluntary carbon markets can be distinguished from "compliance" carbon markets, where a government or regulator issues a carbon allowance that participants must not exceed unless they can purchase additional compliance allowances from another participant under a cap-and-trade program. In both types of carbon markets, each credit typically corresponds to one metric ton of reduced, avoided, or removed carbon dioxide or equivalent greenhouse gas.

The importance of voluntary carbon markets in mitigating climate change and its effect on the U.S. economy is growing,[1] and with it, the CFTC's increasing attention to this market. In 2020, the CFTC's *Climate-Related Market Risk Subcommittee* issued a report concluding that climate change poses a major risk to the stability of the U.S. financial system and, in turn, the American economy, and presented fifty-three recommendations to mitigate the risks that climate change poses to the financial markets.[2] In March 2021, then CFTC Acting Chairperson Rostin Behnam established the Climate Risk Unit to "[focus] on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy."[3] One month later in June 2021, the CFTC issued a Request for Information on climate-related financial risk last year, including inquiries about the VCC market. The CFTC has also organized two Voluntary Carbon Markets Convenings in the past two years-in June 2022 and July 2023-to discuss issues concerning the market for VCC derivatives contracts.[4] And in June of this year, the CFTC issued a Whistleblower Alert, urging individuals to report misconduct in carbon markets, and announced the establishment of the Environmental Fraud Task Force to combat environmental fraud and misconduct in relevant derivatives and spot markets. To date, the CFTC has not brought any enforcement matters related to fraud in connection with VCCs.

Increased interest in the VCC markets is not limited to the CFTC, however. The day before the Proposed Guidance was released, the International Organization of Securities Commissions ("IOSCO") published a consultation report (the "IOSCO Consultation") outlining "Good Practices" for VCC markets.[5] And last year, International Swaps and Derivatives Association ("ISDA") published industry documentation for trading VCCs, including definitions and related template confirmations for spot, forward, and options contracts.[6] Also, the Office of the Comptroller of Currency, Board of Governors of the Federal Reserve, and the Federal Deposit Insurance Corporation proposed amendments to U.S. bank regulatory capital rules applicable to large banks that would include a prescribed risk weight for "carbon trading."[7]

The CFTC does not have full authority to directly regulate VCC markets, however, they do have anti-fraud and anti-manipulation authority over spot and exempt, physically settled forward transactions in commodities, including VCC markets, as well as substantive regulatory oversight and rulemaking authority with regard to commodity derivative markets. DCMs, the financial exchanges where standardized derivatives contracts are traded, are self-regulatory organizations operated under the oversight of the CFTC and must adhere to specific core principles (the "DCM Core Principles") to ensure fair and transparent trading practices, including regarding the trading and listing of futures contracts (such as VCC contracts). Understanding that the VCC market is still novel and evolving, the Proposed Guidance describes the CFTC's expectations of how DCMs can comply with the DCM Core Principles with respect to VCC contracts.

While the Proposed Guidance focuses on physically-settled VCC contracts, the CFTC has indicated that these considerations are also relevant for cash-settled transactions and swap execution facilities ("SEFs") offering such products. Market participants in bilateral, over-the-counter markets should also consider how the Proposed Guidance may affect their regulatory obligations and liabilities across spot, forward, and swap transactions involving VCCs.

KEY ELEMENTS OF THE PROPOSED GUIDANCE

The Proposed Guidance lays out factors that DCMs should consider in order to comply with the Commodity Exchange Act ("CEA") and CFTC regulations on VCC derivative contracts. The Proposed Guidance would not modify existing law, regulation, or guidance by the agency, but rather would provide an outline of "particular matters" for DCMs to consider to comply with the existing laws and regulation.[8] The focus of the Proposed Guidance is primarily limited to DCMs that list VCC derivative contracts that are physically settled, given that every currently-listed VCC derivative contract is physically settled rather than cash settled.

The Proposed Guidance would direct DCMs to consider the following particular matters when listing VCC derivative contracts for trading:

- Listing for trading VCC derivative contracts that are not readily susceptible to manipulation;
- Monitoring the terms and conditions of listed VCC derivative contracts as they relate to the underlying commodity market; and
- Meeting the product submission requirements under part 40 of the CFTC's regulations and CEA section 5c(c).

I. A DCM SHOULD ONLY LIST DERIVATIVE CONTRACTS THAT ARE NOT READILY SUSCEPTIBLE TO MANIPULATION

Under the DCM Core Principle 3, DCMs must make sure that derivative contracts listed for trading must not be readily susceptible to manipulation. The CFTC adopted Appendix C to 17 CFR Part 38 (the "Appendix C Guideline") to outline considerations for DCMs when they draft terms and conditions of contracts and submit such contracts with supporting documents to the CFTC.

For physically settled contracts, the Appendix

C Guidance requires the terms and conditions of the contracts to address relevant criteria to show that they are not readily susceptible to manipulation. Under the quality standards criterion, for example, the commodity contract must include a description or definition of specific economically significant characteristics of the underlying commodity "depend[ing] upon the individual characteristics of the underlying commodity." The CFTC's Proposed Guidance would expand upon the "individual characteristics" in Appendix C Guidance by defining the characteristics that "help[] to inform the integrity of carbon credits" as "VCC commodity characteristics" in the Proposed Guidance. Furthermore, the Proposed Guidance would require DCMs to consider such characteristics for at least three criteria listed in the Appendix C Guideline when developing terms and conditions of VCC derivative contracts: 1) quality standards, 2) delivery points and facilities, and 3) inspection provisions.

A. QUALITY STANDARDS

For quality standards, the CFTC proposes that DCMs consider four VCC commodity characteristics for ensuring quality standards in drafting a VCC derivative contract's terms and conditions:

- transparency;
- additionality;
- permanence and accounting for the risk of reversal; and
- robust quantification.

(a) Transparency

To ensure transparency of the underlying VCCs, the Proposed Guidance would require DCMs to provide adequate and accessible information about the VCCs under the contract. These measures would help market participants match the quality and pricing of VCCs under the contract, thereby reducing the chance of manipulation or price distortion. Transparency would be achieved in several ways.

- *First*, the terms and conditions of the contract must specify the crediting programs and types of projects or activities that may issue VCCs eligible for delivery.
- *Second*, DCMs should also check that information regarding the carbon-removing or -reducing projects or activities and policies and procedures of the crediting program for the underlying VCCs are publicly available.

Under the Appendix C Guidance, such information may need to be described or defined in the contract terms and conditions as an economically significant characteristic of the underlying VCC.

(b) Additionality

For the additionality characteristic, the Proposed Guidance would require the DCMs to ensure that the GHG emission reductions or removals are "additional," meaning that they would not have occurred without "the added monetary incentive created by the revenue from the sale of carbon credits."[9] Ensuring additionality is a necessary component in addressing quality standards, as VCCs without such additionality would not serve the purpose of mitigating emissions.

To test for additionality, the Proposed Guidance would require DCMs to check whether the crediting program has rigorous and reliable procedures. Similar to the transparency characteristic, such procedures may need to be included in the terms and conditions of VCC contracts as economically significant characteristic of the underlying VCC.

(c) Permanence and Accounting for the Risk of Reversal

For the permanence and risk of reversal characteristic, the Proposed Guidance would require DCMs to address the risk of reversal, which is the risk of an event that reverses the reduction or removal of carbon and thereby cancels or recalls an issued VCC. The CFTC noted in the Proposed Guidance that the risk of reversal is related to the quality of the underlying VCCs as market participants rely on the VCC contracts to meet their carbon mitigation agenda.

To ensure the quality of the underlying VCCs, therefore, the Proposed Guidance would require DCMs to evaluate whether the crediting program for a VCC addresses the risk of reversal with "reasonable assurance" of replacing the recalled or canceled VCC with another of a comparable quality.[10]

As most crediting programs make use of "buffer reserves" to replace VCCs, DCMs must evaluate whether such buffer reserves exist and whether they are regularly reviewed by the crediting program to address outside events (e.g., climate change) that may impact the risk of reversal.[11]

(d) Robust Quantification

For the robust quantification characteristic, the Proposed Guidance would require DCMs to consider whether the crediting program's quantification methodology to calculate GHG emission reduction or removals is "robust, conservative, and transparent."[12] Similar to the transparency and additionality characteristics, the methodology may need to be included in the terms and conditions of VCC contracts as an economically significant characteristic of the underlying VCC. A robust, conservative, and transparent quantification methodology would allow DCMs to form a reliable deliverable supply estimate, and DCMs would be able to use that estimate to set effective exchange-set speculative position limits as required for each listed VCC derivative contract and reduce the possibility of manipulation.

These quality standards are targeting the same issues underlying potential instances of fraudulent statements that the CFTC identified in its Whistleblower Alert, such as "quality, quantity, additionality, project type, methodology substantiating the emissions claim, environmental benefits, the permanence or duration, or the buffer pool."

B. DELIVERY POINTS AND FACILITIES

Under the Appendix C Guideline, contracts settled by physical delivery must have delivery procedures that "seek to minimize or eliminate any impediments to" delivery.[13] For delivery procedures of VCC derivative contracts that are physically settled, the CFTC's Proposed Guidance would require DCMs to evaluate the credit program for the underlying VCCs for its governance framework, tracking mechanisms, and measures taken to prevent double-counting.

(a) Governance Framework

The Proposed Guidance would require the

DCMs to show that there is a proper governance framework for "the crediting program's independence, transparency and accountability."[14] To ensure that the crediting program has an effective governance framework, DCMs should consider several key processes and policies as follows: the process of decision-making, the procedures to report and disclose information, policies to manage risks, and engagement processes for the public and stakeholders.

Information on the governance framework may need to be included in the terms and conditions of VCC derivative contracts that are physically settled, given the impact of the governance framework on the quality of the VCCs.

(b) Tracking Mechanisms of the Crediting Program

Under the Proposed Guidance, the DCMs should ensure that crediting programs have effective tracking mechanisms regarding "the issuance, transfer, and retirement of VCCs."[15] Notably, the tracking mechanism was one of the principles in the Core Carbon Principles and Assessment Framework drafted by the Integrity Council for the Voluntary Carbon Market ("ICVCM"), which advocated for the use of a registry to track carbon credits.[16]

(c) Prevention of Double-Counting

DCMs must also ensure that the crediting program does not count the same emission reduction or removals twice as credits. The Proposed Guidance would look for "a reasonable assurance" that there is a match between a VCC underlying a derivatives contract and "a single emission reduction," but it does not specify a set of measures that DCMs should take to obtain such "reasonable assurance."[17] Instead, the Proposed Guidance implies there are different effective measures to prevent double counting, including "procedures for conducting cross-checks across multiple carbon credit registries."[18]

Notably, double-counting was also a focus of the CFTC's Whistleblower Alert.

C. INSPECTION PROVISIONS: THIRD-PARTY VALIDATION AND VERIFICATION

The Proposed Guidance interprets the Appendix C Guidance to require VCC derivative contracts to specify "any inspection or certification procedures for verifying compliance with quality requirements or any other related delivery requirements."[19] In addition, the Proposed Guidance would require DCMs to evaluate the validation and verification procedures for claims about the carbon reduction or removal projects or activities by the crediting program for the underlying VCCs.

To evaluate these procedures, DCMs must look for "up-to-date, robust and transparent" procedures of validation and verification by a third-party and "best practices with respect to third-party validation and verification" within the crediting program.[20] Also, DCMs should consider whether the third-party is "a reputable, disinterested party or body."[21]

II. A DCM SHOULD MONITOR A DERIVATIVE CONTRACT'S TERMS AND CONDITIONS AS THEY RELATE TO THE UNDERLYING COMMODITY MARKET

Under the DCM Core Principle 4, DCMs are required to deploy "market surveillance, compliance, and enforcement practices and procedures" in an effort "to prevent manipulation, price distortion, and disruptions of the physical delivery or cash-settlement process."[22] Compliance with the DCM Core Principle 4 for derivative contracts that are physically settled, in the CFTC's opinion, requires DCMs to monitor the following: VCC "contract's terms and conditions as they relate [to] the underlying commodity market[] and to the convergence between the contract price and the price of the underlying commodity" and "the supply of the underlying commodity" as required to be delivered under the contract.[23]

The requirement also includes continuous monitoring and updating of the terms and conditions of VCC derivative contracts to reflect any changes that relate to the standard or certification of the underlying VCC. Lastly, DCMs have to comply with the record-keeping requirements by "requiring their market participants to keep records of their trading" in VCC cash markets.[24]

1. A DCM SHOULD SATISFY THE PRODUCT SUBMISSION REQUIREMENTS UNDER PART 40 OF THE CFTC'S REGULATIONS AND CEA SECTION 5c(c)

DCMs have two ways to list derivative contracts for trading. DCMs may either self-certify the listed contract's compliance with the CEA and the relevant CFTC regulation at least one business day before the listing or volunteer to receive an approval from the CFTC before the listing. As both processes involve submission of various information including the terms and conditions of the contracts to the CFTC, the Proposed Guidance emphasizes three submission requirements. *First*, there should be "explanation and analysis of the contract and its compliance with applicable provisions of the [CEA], including core principles and the Commission's regulations thereunder."[25] *Second*, such explanation and analysis must "either be accompanied by the documentation relied upon to establish the basis for compliance with applicable law, or incorporate information contained in such documentation, with appropriate citations to data sources[.]"[26] *Third*, DCMs should respond to the CFTC's request with " 'additional evidence, information or data that demonstrates that the contract meets, initially or on a continuing basis, the requirements' of the CEA or the Commission's regulations or policies thereunder."[27]

2. STATEMENTS OF THE CHAIRMAN AND COMMISSIONERS

Chairman Rostin Behnam, Commissioner Kristin Johnson, and Commissioner Christy Goldsmith Romero issued statements in connection with the Proposed Guidance.

- Chairman Behnam issued a statement supporting the Proposed Guidance, highlighting the "whole-of-government approach" and the private-public partnerships the CFTC leveraged in developing the proposal. Chairman Behnam also recognized that the derivatives markets are "global markets" and invited stakeholders to comment on IOSCO's recently proposed set of Good Practices, as discussed later herein.[28]

- Commissioner Johnson said that the Proposed Guidance was "necessary, but insufficient." Johnson identified several issues that the Proposed Guidance does not address but that Commissioner Johnson believes the CFTC needs to implement for all environmental derivatives products including VCCs: material risk disclosures, good faith and fair dealing, and clearing.[29]

- Commissioner Goldsmith Romero supported the Proposed Guidance, stating that it was a step in promoting market integrity, along with the CFTC's other initiatives such as the Environmental Fraud Task Force. Commissioner Goldsmith Romero also called for comments regarding the CFTC's adaption of ICVCM's Core Carbon Principles, as discussed later in this article.

OTHER DEVELOPMENTS IN VOLUNTARY CARBON MARKETS

As described above, similar efforts to increase transparency, integrity, and standardization have been underway by self-regulatory organizations ("SROs") and voluntary bodies, and the CFTC drew upon the work of many of these organizations in preparing its Proposed Guidance.

I. IOSCO CONSULTATION

Following its November 2022 Discussion Paper,[30] IOSCO, on December 3, 2023, published the IOSCO Consultation[31] Amongst other things, the Consultation sets out IOSCO's understanding of the carbon credit ecosystem and market structure, potential vulnerabilities of carbon markets, and key considerations relating to carbon markets, and it outlines 21 proposed Good Practices to promote the integrity and orderly functioning of voluntary carbon markets. These Good Practices are grouped under four headings: (i) *Regulatory frameworks*, including domestic and international consistency and cooperation; (ii) *Primary market issuance*, including standardization, transparency, disclosure, soundness and accuracy of registries, and due diligence; (iii) *Secondary market trading*, including market functioning and transparency, governance and risk management, and market abuse; and (iv) *Use and disclosure of VCCs*.

A. REGULATORY FRAMEWORKS

IOSCO recommends that regulators and other authorities:

- apply appropriate and effective regulation, supervision, and oversight to voluntary carbon markets, covering, among other things, the issuance, trading, and retirement of VCCs (GP 1).

IOSCO considers that this can be achieved using existing frameworks, or developing new or amended ones. Key objectives of such frameworks could relate to the integrity of VCCs and the adequateness and public disclosure of carbon crediting programs' standards.

Further, regulators could:

- consider ways to provide clarity regarding the regulatory treatment of VCCs (GP 2); and

- consider seeking both domestic and international consistency and alignment when developing their own regulatory approach to VCCs, including with regards to cross-border cooperation for enforcement (GP 3).

Regarding supervision and enforcement, IOSCO highlights the importance of information exchange and cross-border cooperation, which would also encourage consistent regulatory outcomes.

Further, regulators could:

- consider (i) promoting the need for firms and senior management to have adequate skills and competence; and (ii) developing investor education programs to improve the public's knowledge of VCCs (GP 4).

B. PRIMARY MARKET ISSUANCE

While the IOSCO Consultation focuses more heavily on secondary market trading, IOSCO nonetheless considers that regulators may play an important role in promoting good practices at the primary market issuance level. For example, regulators could aim to

- standardize a taxonomy of carbon credit attributes, strengthen verification methodologies, and streamline verification processes (GP 5);
- promote transparency around the creation of a carbon credit (GP 6); and
- promote complete, accurate, and understandable disclosure of information related to the primary issuance of VCCs as well as transparent disclosure of any associated risks (GP 7).

IOSCO's key concerns in this respect are the risk of investors' being misled as to the environmental or carbon emissions reductions benefits of VCCs and whether validation and verification of carbon reductions/removals is sufficiently robust.

These concerns could be addressed, for example, through comprehensive disclosures on the project development process, verification and auditing methodologies, and the entities responsible for measurement, reporting, and verification. Transparency of contracts and pricing in the primary market could also be encouraged.

Regulators could also aim to ensure that:

- registries are accurate, complete and current in order to serve as reliable sources of information regarding the price at issuance, tracking and/or retirement of VCCs (GP 8); and
- carbon crediting programs perform adequate levels of know-your-customer (KYC) and due diligence procedures to prevent the use of VCCs for money laundering (GP 9).

C. SECONDARY MARKET TRADING

(a) Market functioning and transparency

IOSCO notes that the majority of VCCs are traded over-the-counter ("OTC"), but that availability of more uniform VCCs on centralized trading platforms would make VCCs more accessible, deepen liquidity, enhance price transparency and market efficiency and promote competition.

With a view towards promoting the functioning and transparency of voluntary carbon markets in this way, IOSCO recommends that regulators:

- ensure open and fair access to secondary market trading on VCMs for interested market participants (GP 10), and
- ensure that VCM participants observe high standards of integrity and fair dealing with respect to business activities relating to VCCs (GP 11).

Potential measures in this respect might include applying quality- and integrity-related eligibility standards before VCCs can be traded on trading venues, and requiring trading venues to establish, maintain, and disclose their standards for listing VCCs and to implement records management policies and procedures.

IOSCO further notes that transparency can also be achieved through disclosure of transactions, and, accordingly, proposes that regulators:

- require that trading venues and registries, including for OTC trading, make public reports which disclose relevant data regarding trading, including pre- and post-trade price transparency, trading volume, bid-ask spreads, and deliveries of VCCs (GP 12).

IOSCO also recommends that, in a similar way as in respect of "traditional, regulated financial markets," regulators could

- consider encouraging an entity operating a VCM, derivatives exchanges, or an intermediary to provide pre- and post-trade disclosures (GP 13).

To enhance the standardization of carbon credit derivatives, regulators could also:

- ensure that contract specifications for carbon credit derivatives include sufficient details on the standards by which the underlying credits were certified, the applicable delivery requirements, and procedures for market participants (GP 14).

(b) Governance and risk management

IOSCO considers that appropriate governance standards have an important role to play in improving efficiency in decision-making, increasing fair access, facilitating transparency, and balancing opposing views-all of which decrease risk and increase market integrity. In light of this, IOSCO recommends that regulators:

- requiring that voluntary carbon market participants[32] have in place a comprehensive governance framework with clear lines of responsibility and accountability for the functions and activities they are conducting (GP 15).

Another key recommendation by IOSCO relates to risk management. Specifically, regulators could require that:

- carbon credit intermediaries, marketplaces, and exchanges have effective enterprise risk management frameworks in place to address any potential operational or technological risks associated with the trading of or provision of services relating to VCCs;

- each of the key market participants, including registries, deploy appropriate enterprise management, information technology, and security protocols to effectively guard against fraud, hacking, and other, criminal activities related to VCCs;

- an enterprise risk officer, with sufficient staffing and support resources, be employed; and

- business continuity disaster recovery plans and operational resilience programs be implemented, with system safeguards that are developed and routinely reviewed for consistency with industry best practices (GP 16).

IOSCO is further concerned about the risk of conflicts of interest, as they may arise in the context of issuance, verification, certification, transfer, and retirement of VCCs. To address these risks, regulators could:

- establish policies and procedures to address and mitigate conflicts of interest pertaining to VCCs, with prohibitions of the most obviously problematic conflicts, including adequate disclosures regarding legal or beneficial relationships between project developers, validation and/or verification bodies, carbon crediting programs, registries, marketplaces and exchanges, intermediaries, etc; and

- require or encourage trading venues to establish clear processes to identify and monitor conflicts of interest and to take appropriate actions if there are risks to orderly trading or market integrity (GP 17).

(c) Market abuse

Highlighting that the growth of voluntary carbon markets has been hindered by concerns about carbon credit integrity and fraud, IOSCO considers that regulators can play an important role in preventing fraud and protecting market participants from misleading claims. In line with this, regulators could:

- ensure the avoidance of fraud with respect to any systems used to issue, track, record, and/or register ownership of a carbon credit;

- implement rule enforcement programs with disciplinary mechanisms to discourage trade practice violations, including monetary sanctions to deter recidivism;

- bring enforcement actions if there are fraudulent or abusive practices in VCMs, such as false and misleading statements regarding the attributes of VCCs (GP 18);

- conduct market surveillance and trade monitoring to identify fraud, manipulation, price distortion, and/or other market disruptions (GP 19); and

- ensure that trading venues maintain adequate resources to detect and investigate fraudulent or manipulative practices, including a Chief Compliance Officer and Chief Regulatory Officer (GP 20).

D. USE AND DISCLOSURE OF USE OF VCCs

Lastly, IOSCO notes the increase in firms' public commitments to achieving net-zero emissions, and that the use of carbon offsets may give rise to doubts whether firms actually reduce their emissions (especially to the extent that carbon offsets continue to be subject to integrity concerns). In light of that, regulators could:

- encourage or require disclosures regarding an entity's use of VCCs to achieve any net GHG emission targets (GP 21).

IOSCO notes in this respect that certain sustainability-related disclosure standards, such as the ISSB's IFRS S1 and S2 standards or the European Sustainability Reporting Standards,[33] may,[34] assist in promoting this Good Practice.

E. NEXT STEPS

The Consultation is open for comments until March 3, 2024.

Chairman Behnam's statement on the Proposed Guidance recognized the work that IOSCO did in focusing on how regulators can encourage transparent and orderly voluntary carbon markets and noted that the Proposed Guidance was drafted to be complementary to IOSCO's work.[35] Chairman Behnam also serves as a co-chair to IOSCO's Sustainable Finance Task Force's Carbon Market Workstream.

Chairman Behnam has encouraged CFTC stakeholders to submit comments on IOSCO's December 2023 Consultation Report. Comments are due on or before March 3, 2024.

II. INTEGRITY COUNCIL ON VOLUNTARY CARBON MARKETS

On March 29, 2023, the ICVCM, an independent governance body, announced the launch of its Core Carbon Principles ("CCPs"), which have been in development since 2022, and the first part of its Program-Level Assessment Framework, which provides (i) the criteria for whether carbon-crediting programs are CCP-Eligible; (ii) the Assessment Procedures, which explain the process for implementing the CCP label to carbon-crediting programs; and (iii) the CCP Attributes, which programs can apply to CCP-labelled programs to highlight certain features of the programs.[36] As of September 14, 2023, ICVCM allows carbon-crediting programs to apply to become CCP-Eligible.[37]

In a statement issued with the Proposed Guidance, Commissioner Christy Goldsmith Romero noted that the Proposed Guidance adapts terminology, concepts, and standards from the ICVCM's CCPs and Assessment Framework.[38]

To develop the CCPs, ICVCM worked with carbon-crediting programs and other stakeholders, and drew from a variety of sources including the Taskforce on Scaling Voluntary Carbon Markets ("TSVCM"), the Intergovernmental Panel on Climate Change ("IPCC"), the United Nations Convention on Climate Change's Paris Agreement and Cancun Safeguards, Carbon Offsetting and Reduction Scheme for International Aviation ("CORSIA") of the International Civil Aviation Organization ("ICAO"), and the work of Calyx Global and the Carbon Credit Quality Initiative.

Prior to publication of the CCPs, ICVCM held a 60-day public consultation overseen by the British Standards Institute ("BSI") and received 350 submissions from stakeholders including programs and project developers, academics, and non-governmental organizations. In addition, ICVCM organized workshops for Indigenous Peoples and Local Communities ("IPs" and "LCs") to give feedback on the CCPs and reserves three of the 22 seats on its board for IPs and LC members.

The 10 CCPs are divided into three categories: governance, emissions impact, and sustainable development.[39]

- *Governance.* Carbon-crediting programs must have (1) effective governance, (2) tracking of each credit from issuance to retirement, (3) transparency to enable scrutiny of mitigation activities, and (4) robust, independent third-party validation and verification.
- *Emissions Impact.* The emissions impact of the voluntary carbon credit programs must involve (5) additionality in reducing or removing greenhouse gas emissions, (6) permanence, (7) robust quantification of

emission reductions and removals, and (8) no double counting.

- *Sustainable Development.* Procedures should be in place to ensure (9) sustainable development benefits and safeguards and (10) contribution toward the net zero transition.

The Program-Level Assessment Framework builds out the CCPs by establishing the requirements for carbon-crediting programs. For example, the Assessment aims to increase the transparency of CCP-labelled VCCs and the impact they have on emissions, society, and the environment. This transparency is achieved through:

- Comprehensive and accessible disclosure on how projects calculate and quantify emissions impact, additionality, and social and environmental impacts;

- Published documentation including the spreadsheets used to calculate, validated design documents, and projects' monitoring reports; and

- Requirements to ensure high-integrity credits come from "robust social and environmental safeguards that deliver positive sustainable development impacts."

CCP-Eligible programs measure impacts including those on IPs and LCs, biodiversity, pollution, human rights, labor rights, and gender equality. Programs must work with IPs and LCs to get free, prior informed consent ("FPIC") and to share the benefits of mitigation activity.

The report also lays out the procedures for how programs and credits can become CCP-Eligible, with a fast-track for CORSIA-Eligible programs.

Commissioner Goldsmith Romero requested comments on whether the Proposed Guidance adapts the "right parts" of the ICVCM standards to encourage integrity and transparency in the voluntary carbon markets and whether the CFTC's adaptation provides clear, workable expectations.

III. COP28 NEGOTIATIONS

At COP28 this month, negotiations failed to adopt Article 6 of the Paris Agreement. Article 6 establishes three approaches for voluntary cooperation with reducing carbon emissions, one of which addresses carbon crediting. Article 6.4 would establish a new UN Climate Change Conference ("UNFCCC") mechanism for the validation, verification, and issuance of high-quality carbon credits with the goal of increasing integrity and transparency of the carbon market globally.[40] If finalized, Article 6.4 would create a centralized crediting mechanism administered by the Supervisory Body. Companies and governments would be able to buy verified carbon offsets to achieve nationally determined contributions and net-zero targets.[41]

The Article 6 Supervisory Body worked for a year prior to COP28 to consult with carbon market participants and create a proposal regarding rules, modalities, and procedures of the centralized crediting mechanism. While the Supervisory Body's proposals detailed topics such as the challenge of reversal and reporting requirements, the Supervisory Body's proposal left some questions open such as how offsets would be quantified and which projects would qualify for crediting, which became sticking points at COP28. Some participants believed that the carbon crediting mechanism fell short of the directive to ensure integrity in the carbon markets, while others believed that imposing stricter standards would increase costs of projects and introduce increased complexity. With the negotiations having failed, carbon market participants will be left to rely on the guidance provided by governments and organizations such as ICVCM to determine the integrity of VCCs for the time being.

Article 6 will be up for negotiation again at COP29, which will convene in November 2024 in Baku, Azerbaijan.

IV. INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

ISDA has taken steps to develop standard documentation for the voluntary carbon market. In 2022, ISDA released its Verified Carbon Credit Transactions Definitions which included a standard definitional booklet for VCC transactions and template confirmation for VCC spot, forward, and option transactions.[42] The release of this documentation followed the publication of ISDA's Legal Implication of Voluntary Carbon Credits whitepaper. ISDA issued a comment letter on the CFTC's Request for Information.

ISDA's contributions to the voluntary carbon market space were cited throughout the Proposed Guidance. For example, ISDA's whitepaper was cited in the Proposed Guidance to illustrate the evolving nature of VCC products.[43] Further, the Proposed Guidance preamble noted that ISDA's comment letter supported public sector recognition and support of private sector and multilateral initiatives in the VCC space. Commissioner Goldsmith Romero additionally cited to ISDA's comments that the CFTC should take a "leading role" in voluntary carbon markets.[44]

V. CALIFORNIA VOLUNTARY CARBON MARKET DISCLOSURE ACT

In November 2023, the state of California adopted Assembly Bill 1305, or the Voluntary Carbon Market Disclosures Act, ("AB 1305") which creates disclosure requirements for entities buying or selling VCCs in California and for those making claims regarding net zero emissions or carbon neutrality and which have a nexus to California. The disclosures required under AB 1305 aim to reduce "greenwashing," and with the Climate Corporate Data Accountability Act (SB 253) and the Climate-Related Financial Risk Act (SB 261) which California also adopted, increases dramatically the climate-related disclosures that entities operating in California will need to make. Notably, Governor Gavin Newsom vetoed AB 1305's companion bill, SB 390, which would have made it unlawful to verify a voluntary carbon offsets ("VCO") project, certify or issue a VCO, maintain a VCO on a registry, or market, offer for sale, or sell without certain disclosures and substantiation. California's passage of this suite of climate-related disclosure laws may lead to similar legislation in other states, but they will likely face legal challenges wherever they are adopted, including the extent to which state laws and regulations are preempted by the federal government's efforts to regulate in this area.

VI. DEVELOPMENTS IN THE EU

In the EU, the key development to monitor is the finalization and enactment of the proposed regulation for an EU framework for the certification of carbon removals (the "EU Proposal").[45]

The EU proposal would (i) lay down certain quality criteria that carbon removals would need to comply with in order to be certified for purposes of the new regulatory framework; (ii) establish a framework for the creation of context-specific certification methodologies that would be applied in order to assess whether carbon removals satisfy the relevant quality criteria; and (iii) introduce rules for the verification and certification of carbon removals, including rules for the certification process, for certification schemes, and for certification bodies.

While the timing of legislative processes is, as usual, uncertain, the EU's co-legislators reached their negotiating position on the draft text on November 17[46] and November 23,[47] 2023, respectively, meaning that the process will now progress to inter-institutional negotiations on finalizing the proposed regulation.

VII. DEVELOPMENTS IN THE UK

In January 2023,the UK's Department for Business, Energy and Industrial Strategy ("BEIS") published an independent review of the UK government's net-zero goals (the "Independent Review").[48] The Independent Review recognized the importance of voluntary carbon markets in reaching climate related goals, and recommended that the UK government should endorse international VCM standards as soon as possible and consult on formally adopting regulated standards for VCMs and setting up a regulator for VCCs and offsets by 2024.

In its 2023 Green Finance Strategy,[49] the UK government confirmed that it would consider the recommendations of the Voluntary Carbon Markets Initiative and the ICVCM, and, in particular, the extent to which they could be incorporated within relevant regulatory regimes. It also stated that it would consult specific steps and interventions needed to mobilize additional finance through high-integrity voluntary markets and protect against the risk of greenwashing. The UK government also highlighted that, through engagement with leading stakeholders via international fora, it would seek to address remaining uncertainties on the interface between voluntary carbon markets and Article 6 of the Paris Agreement.

With regard to the use and reporting of VCCs, the UK government indicated that the UK Transition Plan Taskforce will provide clarity on the use of high-integrity VCCs within its framework.

FURTHER IMPLICATIONS OF THE PROPOSED GUIDANCE

I. EFFECT ON MARKET PARTICIPANT ENGAGEMENT WITH VCCS

The institutional market has been slow to engage in VCC transactions, and market participants have expressed reservations regarding the lack of regulation and the potential for fraud and misconduct. The CFTC has indicated that market participants should not rely only on the diligence performed by crediting agencies to prevent manipulation and fraud in the carbon markets, and so some market participants have taken a more direct role in conducting diligence and have prioritized these issues in contract negotiations. This is a concern especially where an entity learns of an issue with the quality of a VCC subsequently to purchasing and reselling such VCC, since they could then be accused of creating a fraudulent market.

The Proposed Guidance and the CFTC's previous Whistleblower Alert are aimed at addressing quality concerns. To some extent, the Proposed Guidance institutionalizes the CFTC's Whistleblower Alert by placing an affirmative obligation on DCMs to perform diligence on VCCs underlying listed derivatives. However, it is unclear whether the Proposed Guidance will lead to meaningfully increased engagement from the market, since DCMs are likely already performing much of the diligence contemplated by the Proposed Guidance, especially in light of the fact that DCMs are already subject to the Core Principles and the Proposed Guidance is consistent with existing best practices.

We also note that DCMs may push some of the diligence burden to crediting programs, which have better access to the relevant information (for example, whether a given emissions reduction program is additional). In fact, much of the Proposed Guidance is focused on encouraging DCMs to push crediting agencies toward robust quality standards, tracking mechanisms, and internal governance. Still, it is not clear that DCMs will be able, effectively to conduct verification of such diligence performed by crediting programs, and by extension, the extent to which market participants in bilateral OTC markets can reasonably rely on diligence performed by DCMs.

II. POTENTIAL FOR REGULATION OF INTANGIBLE COMMODITIES BY ENFORCEMENT

The CFTC's approach to regulation of the VCC market may evolve in a similar fashion as its regulation of the digital asset market. CFTC authority over the spot market for commodities such as digital currencies and VCCs, is limited to antifraud/manipulation. As a result, the CFTC has outsourced regulation of crypto and VCCs to self-regulatory organizations (i.e., DCMs, exchanges, and clearinghouses).

Intangible commodities such as VCCs and digital assets are particularly susceptible to fraud and manipulation, and in recent years, we have seen the CFTC aggressively use its enforcement power to regulate crypto and crypto markets. Although the CFTC has not yet brought an enforcement action related to VCCs, there are signs that the CFTC may take a similar approach to regulation by enforcement with respect to VCCs.[50] In addition to the CFTC's Whistleblower Alert, the CFTC in June established the Environmental Fraud Task Force, signaling VCC enforcement as an area of emphasis.[51]

Commissioner Johnson's statement about the need for a "comprehensive approach" to voluntary carbon market regulation further shows the CFTC's appetite to regulate VCCs more broadly. Commissioner Johnson specifically highlighted that material risk disclosures, good faith and fair dealing, and clearing as areas where further guidance could benefit voluntary carbon markets and environmental commodities as a whole, all of which happen to be areas where we have seen developments and enforcement actions in the crypto space in recent years.[52] The CFTC's next steps in regulating VCCs will very likely go beyond guidance related to its influence on the role of SROs and more directly impact the sell- and buy-sides, potentially through exercise of CFTC enforcement authority.

ENDNOTES:

[1]According to the Taskforce on Scaling Vol-

untary Carbon Markets, voluntary carbon markets need to grow by more than 15-fold by 2030 in order to support the investment required to deliver the Paris Agreement's goal of limiting the global average temperature increase to below 1.5°C above pre-industrial levels. TSVCM (January 2022) at 4, available at https://www.iif.com/Portals/1/Files/TSVCM_Report.pdf.

[2]Rostin Behnam et al., Managing Climate Risk in the U.S. Financial System: Report of the Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission, Commodity Futures Trading Comm'n (2020), available at https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf (full report).

[3]Press Release, CFTC Acting Chairman Behnam Establishes New Climate Risk Unit, Commodity Futures Trading Comm'n (March 17, 2021), available at https://www.cftc.gov/PressRoom/PressReleases/8368-21.

[4]*See* Cleary's Alert Memo on the CFTC's Second Voluntary Carbon Markets Convening, available at https://www.clearygottlieb.com/news-and-insights/publication-listing/the-cftcs-second-voluntary-carbon-markets-convening.

[5]IOSCO publishes a Consultation Report to promote the integrity and orderly functioning of the Voluntary Carbon Markets (VCMs), IOSCO (Dec. 3, 2023), available at https://www.iosco.org/news/pdf/IOSCONEWS714.pdf.

[6]ISDA Launches Standard Definitions for the Voluntary Carbon Market, (Dec. 13, 2022), available at https://www.isda.org/2022/12/13/isda-launches-standard-definitions-for-the-voluntary-carbon-market/.

[7]*See* Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, Office of the Comptroller of the Currency, Federal Reserve System, and Federal Deposit Insurance Corporation (Sept. 18, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf.

[8]Proposed Guidance, Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts, Commodity Futures Trading Comm'n (Dec. 4, 2023), at 19 (citing CEA section 5(d)(3), 7 U.S.C.A. 7(d)(3)), available at https://www.cftc.gov/media/9831/federalregister120423/download.

[9]*Id.* at 25.

[10]*Id.* at 27.

[11]*Id.* at 27-28.

[12]*Id.* at 28.

[13]*Id.* at 29.

[14]*Id.* at 30-31.

[15]*Id.* at 31.

[16]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), available at https://www.clearygottlieb.com/-/media/files/decarbonization-in-the-wake-of-cop-27-the-role-of-private-capital.pdf.

[17]Proposed Guidance at 32.

[18]*Id.*

[19]*Id.* at 33.

[20]*Id.*

[21]*Id.*

[22]*Id.* at 34.

[23]*Id.* at 34.

[24]*Id.* at 35.

[25]*Id.* at 36 (citation omitted).

[26]*Id.* at 36-37 (citation omitted).

[27]*Id.* at 37 (citation omitted).

[28]Statement of CFTC Chairman Rostin Behnam (Dec. 4, 2023), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement120423.

[29]Statement of CFTC Commissioner Kristin Johnson, available at https://www.cftc.gov/PressRoom/SpeechesTestimony/johnsonstatement120423.

[30]IOSCO Voluntary Carbon Markets Discus-

sion Paper, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD718.pdf.

[31]IOSCO, Voluntary Carbon Markets Consultation Report, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD749.pdf; Press Release, IOSCO publishes a Consultation Report to promote the integrity and orderly functioning of the Voluntary Carbon Markets (VCMs), IOSCO, available at https://www.iosco.org/news/pdf/IOSCONEWS714.pdf.

[32]IOSCO considers "VCM participants" to include, at least, the following: carbon credit project developers, registries, validation and verification bodies, brokers, traders, marketplaces and exchanges, rating agencies, third-party entities, and private sector supply and demand side standardization initiatives.

[33]*See* Commission Delegated Regulation (EU) 2023/2772, available at https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L_202302772.

[34]The IFRS S1 and S2 standards are available at https://www.ifrs.org/projects/completed-projects/2023/general-sustainability-related-disclosures/#published-documents.

[35]Statement of CFTC Chairman Rostin Behnam (Dec. 4, 2023), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement120423.

[36]Press Release, Integrity Council launches global benchmark for high-integrity carbon credits, ICVCM, available at https://icvcm.org/integrity-council-launches-global-benchmark-for-high-integrity-carbon-credits/.

[37]Press Release, How programs can apply for assessment, ICVCM, available at https://icvcm.org/apply-now-for-our-new-voluntary-standards-for-carbon-credits/.

[38]Statement of CFTC Commissioner Christy Goldsmith Romero (Dec. 4, 2023), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement120423.

[39]ICVCM, Core Carbon Principles, available at https://icvcm.org/the-core-carbon-principles/?utm_source=Mailchimp&utm_medium=Email&utm_campaign=CCPs_Launch.

[40]UN Climate Change, Article 6.4 Mechanism, available at https://unfccc.int/process-and-meetings/the-paris-agreement/article-64-mechanism.

[41]UN Climate Change, Unlocking Climate Ambition: the Significance of Article 6 at COP28 (Dec. 18, 2023), available at https://unfccc.int/news/unlocking-climate-ambition-the-significance-of-article-6-at-cop28.

[42]2022 ISDA Verified Carbon Credit Transactions Definitions, available at https://www.isda.org/book/2022-isda-verified-carbon-credit-transaction-definitions/; ISDA, VCC Definitions FAQ, available at https://www.isda.org/a/jBXgE/2022-ISDA-Verified-Carbon-Credit-Transactions-Definitions-FAQs-061323.pdf.

[43]Voluntary Carbon Markets: Analysis of Regulatory Oversight in the U.S. (2022), available at https://www.isda.org/2022/06/02/voluntary-carbon-markets-analysis-of-regulatory-oversight-in-the-us.

[44]ISDA Comment Letter on CFTC Request for Information on Climate-Related Financial Risk (Oct. 7, 2022), available at https://www.isda.org/2022/10/13/isda-response-to-cftc-climate-rfi/.

[45]The EU Proposal is available at https://climate.ec.europa.eu/system/files/2022-11/Proposal_for_a_Regulation_establishing_a_Union_certification_framework_for_carbon_removals.pdf. A detailed analysis of the EU proposal is available at https://www.clearygottlieb.com/-/media/files/examining-the-european-commissions-legislative-proposal-for-a-european-union-framework-for-certification-of-carbon-removals.pdf.

[46]The negotiating mandate of the Council of the European Union is available at https://data.consilium.europa.eu/doc/document/ST-15629-2023-INIT/en/pdf.

[47]The version of the legislative proposal that was adopted by the European Parliament, and represents the Parliament's position going into negotiations with the Council, is available at https://www.europarl.europa.eu/doceo/document/TA-9-2023-0402_EN.pdf.

[48]The BEIS' Independent Review of Net Zero is available at https://assets.publishing.service.gov.uk/media/63c0299ee90e0771c128965b/mission-zero-independent-review.pdf.

[49]The UK government's 2023 Green Finance Strategy is available at https://assets.publishing.service.gov.uk/media/643583fb877741001368d815/mobilising-green-investment-2023-green-finance-strategy.pdf.

[50]*See, e.g.*, Commissioner Goldsmith Romero's opening remarks at the Second Convening on Voluntary Carbon Markets, suggesting that the CFTC "follow a similar oversight and approach to environmental products as those adopted for digital assets," available at https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement071923b.

[51]Press Release, CFTC Division of Enforcement Creates Two New Task Forces, available at https://www.cftc.gov/PressRoom/PressReleases/8736-23.

[52]Statement of CFTC Commissioner Kristin Johnson, available at https://www.cftc.gov/PressRoom/SpeechesTestimony/johnsonstatement120423.