US REGULATOR ISSUES FIRST GUIDELINES FOR CARBON CREDIT DERIVATIVES

- US regulator takes first steps to improve the credibility and transparency of the voluntary carbon market. This market, in effect, is an economic framework that facilitates the buying and selling of financial instruments that represent reductions, avoidance or removals of GHG emissions. These activities are key to climate change mitigation objectives.
- Carbon markets can support a compliance regime (cap-and-trade) or be voluntary.
- Specifically, the CFTC has issued guidance for derivatives exchanges that list voluntary carbon credit (VCC) derivatives to ensure that the exchanges conduct due diligence on the underlying quality of the VCCs on which the derivatives are based. VCCs represent a measurable reduction, avoidance or sequestration of GHG emissions to compensate for emissions elsewhere. They have a monetary value and, as such, may be traded. As underlying assets of derivative contracts, they are "commodities" and subject to CFTC regulation based on its authority over derivative trading platforms (the exchanges).

Last month, the Commodity Futures Trading Commission ("CFTC"), the agency that regulates the US derivatives market, issued final guidance for designated contract markets ("DCMs") – also known as futures exchanges – that list climate-related financial contracts. The financial contracts that are the subject of the CFTC guidance are known as voluntary carbon credit ("VCC") derivative contracts.

DCMs are CFTC-regulated exchanges that provide participants in the derivatives markets with the ability to execute or trade derivative contracts with one another. The guidance is designed to manage risk, promote price discovery and, ultimately, facilitate the allocation of capital towards achieving net zero. The guidance emphasizes governance and transparency in the voluntary carbon credit market, with the onus falling on the DCMs.[1] In short, the DCMs are to undertake due diligence before listing derivative contracts, consistent with their general obligations as regulated exchanges, to bring better transparency to the market.

The Voluntary Carbon Market

The voluntary market is an unregulated market in which companies voluntarily set goals to reduce or offset their GHG emissions (these are known as "projects"). NGOs issue credits to project developers who undertake mitigation projects to reduce GHG emissions into the atmosphere or remove GHGs from the atmosphere. The credits measure the reduction, avoidance or sequestration of GHG emissions to compensate for emissions elsewhere. The regulated analogue to the voluntary market is known as the compliance market, which is

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[1] The guidance, which is not binding, provides a roadmap for DCMs to comply with Core Principle 3 (listed derivatives should not readily be susceptible to manipulation) and Core Principle 4 (DCMs must have the capacity to prevent manipulation, price distortion and disruptions of the physical delivery or cash-settlement process through market surveillance, compliance and enforcement practices and procedures). The Commodity Exchange Act sets forth 23 Core Principles.

regulated by national, regional or international carbon reduction regimes. The compliance markets operate under so-called "cap-and-trade" systems. The compliance market is based on a limited number of carbon credits, while the voluntary market is unlimited. (*See generally*, Carbon Credits.com and the CRS Report on Carbon Credit Markets.)

According to Morgan Stanley, as cited in a recent article in the Financial Times, the unregulated market for carbon credits is estimated to grow from $2 billion this year to $100 billion by 2030. However, the voluntary market has languished largely due to concerns about the lack of transparency and credibility. Cathy Fallon, of the Clean Air Task Force, characterized the voluntary carbon market as facing an existential threat, citing "fake credits, over-inflated corporate claims of carbon neutrality and weak protocols issued by carbon credit registries." The credibility of the market may have suffered another blow with the announcement last week of settled charges and civil and criminal complaints involving a carbon-credit project developer and three of its executives (see below).

In May, the Secretaries of the Treasury, Agriculture and Energy, the President's Senior Advisor on Climate Policy, the National Economic Advisor and the National Climate Advisor issued a Voluntary Carbon Markets Joint Policy Statement and Principles (the Joint Statement"). The seven voluntary principles set out are:

- to ensure credible atmospheric integrity standards, carbon credits should be unique and "additional," and represent real, quantifiable decarbonization that would not otherwise have occurred;
- activities that generate carbon credits should avoid inadvertent negative impacts on the environment and social harm;
- corporate buyers that use carbon credits should prioritize measurable reductions of GHG emissions within their own corporate supply chains;
- detailed public disclosure by credit users of the nature of purchased and retired credits should be made at least annually and include details that enable outside observers and relevant stakeholders to assess whether purchased and retired credits are of high integrity and avoid negative environmental and social harm;
- public claims by credit users should accurately reflect the climate impact of retired credits and only rely on credits meeting high integrity standards;
- market participants should use their best efforts to improve market integrity; and
- policymakers and market participation should facilitate efficient market participation and seek to lower transaction costs.

As part of the climate-related legislation enacted in California, the legislature set out to promote greater transparency and integrity in the voluntary carbon markets by enacting AB 1305 – the Voluntary Carbon Market Disclosures Business Regulation Act. The Act imposes mandatory disclosure requirements on participants in the voluntary carbon market. The legislation has three sets of disclosure requirements – one aimed at businesses marketing or selling VCCs in California, a second aimed at purchasers and users of VCCs operating in California or that purchase/use VCCs sold in California, and a third aimed at companies

operating in California that make net-zero claims in California. (See my October 2023 briefing note.)

The Contracts

Derivatives (whether futures, options or swaps) by definition have an underlying asset. The commodity underlying the derivative that is the subject of the CFTC guidance (a VCC) is a tradable intangible instrument issued by a carbon crediting program, which upon retirement represents reductions or removals of GHG emissions by a third party (a developer). Carbon credits generally fall within the definition of "commodity" under the Commodity Exchange Act ("CEA"). The crediting program issues VCCs for mitigation projects or activities satisfying program standards, subject to verification and validation. A participant in the voluntary carbon market may purchase a VCC to supplement its GHG emissions reductions or GHG removals from its own operations or activities. VCCs may be sold to end-users or intermediaries such brokers and aggregators that provide liquidity to market participants.

The Guidance

The CFTC guidance focuses principally on the listing by DCMs of physically-settled (rather than cash-settled) VCC derivative contracts, though it can apply to both. These physically-settled derivative contracts base their price on the spot price of VCCs; if the holder of a position in a physically-settled VCC derivative contract still has an open position at the expiration of trading in the contract, it must, in accordance with the rules for delivery set forth in the contract, make or take delivery (as applicable) of VCCs that meet the contract's rules for delivery eligibility. Market participants using physically-settled VCC derivative contracts to help meet their carbon mitigation goals have an interest in ensuring that, upon physical settlement, the underlying VCCs will actually reduce or remove the amount of emissions that they were intended to reduce or remove.

The guidance addresses, among other things, for example, the imperative of listing derivative contracts that are not readily susceptible to manipulation.

- Crediting programs should have measures in place to ensure that credited emissions reductions or removals are not double counted and that each credited VCC is uniquely associated with a single emission reduction or removal of one metric ton of carbon dioxide equivalent.
- DCMs should consider whether a crediting program has measures in place to address and account for the risk of reversal (*i.e.,* the risk that VCCs issued for a project or activity may have to be recalled or cancelled due to carbon removed by the project or activity being released back into the atmosphere, or due to a re-evaluation of the amount of carbon reduced or removed from the atmosphere by the project or activity).
- DCMs should consider whether a crediting program for underlying VCCs has in place a governance framework that supports the crediting program's independence, transparency and accountability. A robust, conservative and transparent quantification methodology or protocol helps to ensure that the number of VCCs that are issued for a project or activity accurately reflects the level of GHG emission reductions or removals associated with the project or activity.

- DCMs should consider whether a crediting program can demonstrate that it has procedures in place to assess or test for "additionality." These procedures should provide reasonable assurance that GHG emission reductions or removals are credited *only* if they are additional. VCCs are additional if they are credited for projects or activities that would not have been developed and implemented in the absence of the added monetary incentive generated by the revenue from the VCCs. Two commentators characterized additionality as the "cornerstone" of high-quality mitigation projects and the resulting VCCs. The CFTC declined to define additionality in the guidance, recognizing that as the markets continue to develop, industry consensus on how to characterize additionality (including, for example, whether to consider both financial additionality as well as legal additionality) may evolve.
- Inspection and certification are key to ensuring that mitigation projects or activities will achieve the claimed GHG emissions reductions or removals.

According to CFTC Chair Rostin Behman, the CFTC guidance complements work being undertaken by the International Organization of Securities Commissions (IOSCO) through its Sustainable Finance Task Force's Carbon Market Workstream, which he is leading with the Chair of the European Securities and Markets Authority (ESMA).

Enforcement Action Relating to VCCs

Last week, the CFTC announced its first enforcement action alleging fraud in the voluntary carbon market. The action was brought against a carbon credit project developer, its former COO and its former CEO in respect of alleged fraud and false, misleading or inaccurate reports relating to VCCs. The firm undertook projects to generate carbon credits by reducing GHG emissions, and on-selling the credits to third parties seeking to offset the impact of their own GHG emissions. The firm and the COO settled with the CFTC, and a complaint has now been filed by the CFTC against the CEO in the Southern District of New York. The SEC brought a civil action against the firm for violations of the securities laws in connection with an equity offering to institutional investors, and the Department of Justice brought a criminal action against the former CEO and the head of the firm's Carbon & Sustainability Accounting Team.

In July, the CFTC announced that a District Court had entered an order granting summary judgment in favor of the CFTC in a case involving an allegedly fraudulent crypto and carbon investment program (the latter involving misappropriation of funds from carbon offsets as part of the alleged Ponzi scheme).

Concluding Thoughts

Development of the voluntary carbon market has been hampered by legitimate concerns over the integrity and credibility of VCCs. As the Joint Statement noted, "Put simply, stakeholders must be certain that one credit truly represents one tonne of carbon dioxide (or its equivalent) reduced or removed from the atmosphere, beyond what would have otherwise occurred." Ultimately, concerns over the widespread use of VCCs that do not in fact reduce GHG

emissions in the atmosphere undermine not only the market but more significantly the climate change policy objectives around mitigation.

Efforts to boost confidence in the voluntary carbon market are to be applauded. Similarly, we should hope that the SEC can move forward on its climate-related disclosure rules, currently stayed pending litigation. Among other things, those rules address disclosure of carbon offsets and renewable energy credits or certificates to the extent they constitute a material part of a reporting company's plan to meet its disclosed climate-related targets or goals.

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