CLIENT ALERT

Building Trust in Markets via Regulation: The CFTC's Proposed Guidance on Listing Voluntary Carbon Credit Derivatives

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The U.S. Commodity Futures Trading Commission (the "**CFTC**") has been intensifying its attention on the voluntary carbon markets over the past few years.[1] In particular, the CFTC is increasing its focus on environmental commodity spot, forward, and derivatives products, analyzing how it can support and supervise the deeper development of the regulated environmental derivatives markets. Over the past two years, the CFTC collaborated with academia and industry, and held two carbon markets public meetings, established a Climate Risk Unit, an Environmental Fraud Enforcement Task Force, and published a carbon market-specific Whistleblower Alert.[2] Each engagement sought information regarding potential misconduct and fraud in the carbon markets as well as factors that would promote liquidity, trust, and integrity in such markets. On December 4, 2023, the CFTC published proposed guidance for exchanges to list voluntary carbon market derivatives, marking the next phase in its effort to further a robust, standard, and transparent derivatives market ("**Proposed Guidance**").[3] As CFTC Chair Rostin Behnam noted, this Proposed Guidance represents

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1 By one estimate, "the [voluntary carbon credit] market size in 2030 could be between $5 billion and $30 billion at the low end and more than $50 billion at the high end." Christopher Blaufelder, *et al.*, *A blueprint for scaling voluntary carbon markets to meet the climate challenge*, MCKINSEY SUSTAINABILITY (Jan. 29, 2021), available here.

2 *See CFTC Announces Voluntary Carbon Markets Convening* (June 2, 2022), available here; *CFTC Announces Second Voluntary Carbon Markets Convening on July 19* (July 19, 2023), available here; *CFTC Division of Enforcement Creates Two New Task Forces* (June 29, 2023) (the "**Task Force Announcement**"), available here; *CFTC Acting Chairman Behnam Establishes New Climate Risk Unit* (Mar. 17, 2021), available here; *CFTC Whistleblower Alert: Blow the Whistle on Fraud or Market Manipulation in the Carbon Markets* (June 20, 2023), available here.

3 *CFTC Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment*, RIN 3038-AF40 (proposed Dec. 4, 2023), available here. Scrutiny surrounding matters of credit integrity will likely intensify following the failure to forge meaningful consensus on key

"the most significant step of a financial regulator to promote fundamental standards for high integrity voluntary carbon credits ("**VCCs**")."[4]

The Proposed Guidance outlines considerations for designated contract markets ("**DCMs**") seeking to list VCC derivatives. DCMs are self-regulatory organizations, and each DCM must adhere to its Core Principle obligations set forth in the Commodity Exchange Act, as amended ("**CEA**"), and the regulations promulgated thereunder.[5] The Proposed Guidance also seeks to supplement CFTC Regulation Part 38, Appendix C, which sets forth relevant considerations for a DCM when developing derivative contract terms and conditions for the contracts being listed, and CFTC Regulation Part 40, which governs the process of submitting new products to the CFTC.[6] The Proposed Guidance concentrates on setting standards specifically for VCC derivatives contracts, including the relevant terms and conditions and DCM rules for trading VCC derivatives, all based on the underlying voluntary carbon market.

The CFTC explained the need for the Proposed Guidance by citing various ongoing challenges in the VCC market and emphasizing that the Proposed Guidance may help advance product standardization to promote transparency and liquidity. According to the Proposed Guidance, a lack of standardized methodologies in the steadily growing VCC markets has the potential to lead to inaccurate pricing, mischaracterized quality, or facilitate "greenwashing."[7] Ultimately, the CFTC views a liquid and trusted voluntary carbon market as a "tool to assist in the emissions reduction efforts," and that by promoting clear standards for VCC derivatives, the CFTC plays a valuable role in supporting voluntary carbon market transparency, liquidity, scaling, and integrity.[8]

Overview of the Voluntary Carbon Credit Market

The CFTC considers VCC derivatives to be an innovative instrument that has emerged as a key element of climate risk management.[9] There are two main types of carbon markets: mandatory/compliance markets and voluntary markets. Mandatory carbon markets are created by governmental policy and regulatory requirements, such as the California Air Resources Board's Cap-and-Trade Program, and may be implemented under multinational agreements, such as the UN

carbon market issues under Article 6 at COP28 in Dubai, where friction surfaced over credit methodologies, registry design, use of carbon removals, and other nuance. *See* Genevieve Redgrave, *COP28: Carbon markets rue Article 6 negotiation 'failure'*, ENVIRONMENTAL FINANCE (Dec. 13, 2023), available here.

[4] *Statement of Chairman Rostin Behnam on the Proposed CFTC Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts* (Dec. 4, 2023) (the "**Chairman's Statement**"), available here.

[5] *See generally* CEA section 5(d), 7 U.S.C. 7(d), 17 CFR § 38.100.

[6] 17 CFR § 38, Appendix C; CEA section 5c(c)(1). *See also* 17 CFR § 40.

[7] Proposed Guidance at 12-13. For the purposes of the CFTC, "greenwashing" focuses "on addressing fraud and manipulation in carbon credit markets … including material misrepresentations about ESG investment strategies." Task Force Announcement.

[8] Proposed Guidance at 14.

[9] *Id.* at 8-11.

Climate Change conventions.[10] Unlike their regulated counterparts, voluntary carbon credits are mostly unregulated, intangible instruments issued by nongovernmental, greenhouse gas crediting programs. Each VCC typically represents the estimated reduction or removal of the atmosphere equivalent to one metric ton of carbon dioxide.

The typical process for listing VCCs involves project developers, financing entities, validator entities and standard-setting bodies working together to craft, develop, and monitor products that meet established carbon reduction methodologies. First, project developers will create a project aimed at reducing greenhouse gas ("**GHG**") emissions and then enlist a crediting program to review and certify the project. A crediting program will conduct the review and certify the project's credits based on its own standards and/or engage a third-party validator to review the project. The crediting programs will issue the related carbon credits to projects that meet the standards, and such VCC can then be sold, transferred, or retired (taken out of circulation) via a VCC registry. VCCs listed on the registry can also be bought or sold by end users or intermediaries. Title to the VCC transfers when the VCCs move between accounts on the applicable registry.

Current Product Listing Requirements for DCMs

DCMs are CFTC-regulated exchanges that list derivatives for trading, such as futures and options products, and are required to comply with the Core Principles set forth in the CEA and CFTC regulations, and any additional CFTC guidance or policies. The Proposed Guidance supplements and provides further detail regarding DCMs' responsibilities for listing products under Core Principles 3 and 4, Part 38 Appendix C Guidance, and Part 40 of the CFTC's Regulations.[11] Core Principle 3 requires that DCMs only list derivative contracts that are not readily susceptible to manipulation.[12] Part 38 Appendix C Guidance expands on Core Principle 3 for particular derivative instruments, by setting forth relevant considerations for a DCM developing its product contract terms and conditions, and provides recommendations regarding the provision of supporting documentation and data in connection with the submission of the new derivative contract to the CFTC.[13] Core Principle 4 provides that DCMs are responsible for preventing manipulation, price distortion, and supporting physical delivery through market surveillance, compliance, and enforcement processes.[14] The Proposed Guidance also provides more details for the process of listing VCC derivatives as new products under Part 40 Regulations and CEA section 5(c).

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[10] CAL. CODE REGS. tit. 17, § 95801; *Mandatory and voluntary Carbon Markets*, FAIR CLIMATE FUND (last visited Dec. 12, 2023), available here. *See also* Kyoto Protocol to the United Nations Framework Convention on Climate Change, art. VI, Dec. 10, 1997, 2303 U.N.T.S. 162; Paris Agreement to the United Nations Framework Convention on Climate Change, Dec. 12, 2015, T.I.A.S. No. 16-1104.

[11] Proposed Guidance at 3-5.

[12] CEA section 5(d)(3), 7 U.S.C. 7(d)(3).

[13] *See generally* Appendix C.

[14] CEA section 5(d)(4), 7 U.S.C. 7(d)(4).

Listing VCC Derivatives Contracts Under the Proposed Guidance

Through the Proposed Guidance, the CFTC seeks to support and promote certainty and trust in the environmental markets by bolstering the rulemaking process for VCC derivatives products. Below we describe the CFTC's proposed recommendations for crafting VCC derivative contract terms and conditions.

A. Products Not Susceptible to Manipulation Are Described as High Integrity — Characteristics to Consider

According to Appendix C Guidance, DCMs can adhere to Core Principle 3 by defining or describing all economically significant characteristics of the commodity underlying the contract.[15] The CFTC noted in the Proposed Guidance that terms and conditions for VCC derivative contracts should, at a minimum, define or describe the quality standards, delivery integrity, and inspection of third-party validators.[16] It also pointed out that a significant economic characteristic of the VCC market is that it is still developing standards and accountability mechanisms.[17] Below are the areas of consideration for crafting listed VCC derivatives contract rules under the Proposed Guidance:

i. *Ensuring Quality via Transparency, Additionality, Permanence, and Quantification*

The CFTC determined that the relevant "quality standards" for these contracts are the transparency, "additionality," permanence (risk of reversal), and robust quantifications of the underlying VCC commodity. The key considerations proposed that DCMs should be evaluating when crafting the terms and conditions for VCC derivative contracts are:

- **Transparency**.[18] Information on VCCs eligible for delivery should include the specific crediting programs, project types, and whether the project documentation is available for public search and comparison.
- **Additionality**.[19] DCMs should consider whether a program has procedures in place to assess or test for additionality—meaning that the GHG emission reduction or removal would not have occurred without the financial incentives provided by the carbon credit market. The CFTC indicates that it views additionality as a "necessary element of a high quality VCC."[20]

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[15] Appendix C Guidance, paragraph (b)(2)(i)(A).

[16] Proposed Guidance at 23.

[17] *Id.* at 22.

[18] *Id.* at 24-25.

[19] *Id.* at 25.

[20] *Id.* at 26.

- **Permanence and Risk of Reversal**.[21] VCCs may be recalled or canceled due to a project's failure to create permanent removals or due to a reevaluation of the project. For example, a forest fire affecting a reforestation project or the failure of a project's technology releasing carbon back into the atmosphere may cause a reconsideration of certain VCCs issued or to be issued. To avoid impacting the risk management needs of market participants, DCMs should consider whether crediting programs have buffer reserves to mitigate the impact if a project fails or reverses, in order to ensure the permanence of GHG emission reductions.

- **Robust Quantification of GHG Reductions**.[22] DCMs should consider whether the methodology or protocol used by a crediting program to calculate GHG emission reductions or removals is robust, conservative and transparent and allows for a reliable and verifiable quantification of the carbon credits issued.

ii. *Ensuring Delivery Integrity via Review of Governance, Tracking, and Preventing Double Counting*

The Proposed Guidance recommends DCMs also evaluate three attributes of a crediting program's delivery procedures: the governance framework, tracking mechanisms, and double counting prevention.

- **Governance Framework**.[23] DCMs should evaluate whether crediting programs' governance framework bolsters the program's independence, transparency, and accountability. Frameworks should include protocols ensuring that the crediting program's registry can effectively facilitate the physical settlement of a VCC derivative contract. Scrutiny of governance frameworks includes reviewing decision-making processes, the independence of key functions, and the public disclosure of reporting, engagement, and risk management policies– all of which contribute to the contract's credibility.

- **Tracking Mechanisms**.[24] Crediting programs should ensure precise issuance, transfer, and retirement (removal from circulation) of credits. The Proposed Guidance suggests that DCMs verify whether crediting programs utilize a registry with robust mechanisms to track these activities effectively.

- **Double Counting**.[25] Crediting programs should have effective measures to guarantee that emission reductions or removals are credited to and remain on a single registry and are not reused post-retirement or after cancellation.

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[21] *Id.* at 26-28.

[22] *Id.* at 28-29.

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

[24] *Id.* at 31.

[25] *Id.* at 32.

iii. *Underlying Crediting Programs Should Inspect and Diversify Third-Party Validators*

DCMs should evaluate whether underlying crediting programs uphold "best practices" with respect to third-party validators.[26] This involves a thorough review of validators' performance and established procedures to address performance issues. The Proposed Guidance provides that crediting programs should not rely on a single third-party validator across various project types, but should have ongoing independent third-party verification. This may involve deeper inquiries by the DCM into crediting entities/registries' validator methodologies, procedures, and processes. When commenting, DCMs (and market participants) should consider whether and how DCMs may obtain information and methodologies from registries to conduct the analyses discussed in the Proposed Guidance.

B. Ongoing Monitoring May Present New Challenges

The Proposed Guidance emphasizes DCMs' ongoing obligations to monitor compliance. DCMs have an obligation to monitor the contract's terms and conditions as they relate to the underlying commodity, the convergence of market and spot price, and the supply of the commodity in light of delivery requirements.[27] The CFTC proposes that DCMs continually monitor a contract's terms and conditions, which includes ensuring that the underlying credits conform to "the latest verification standards applicable."[28] The CFTC expands on this request by giving an example where a crediting program changes "due for example to new standards or certifications."[29] Such a change would require DCMs to amend the contract's terms and conditions to reflect the change and also "ensure that it is monitoring the adequacy of the estimated deliverable supply" of the underlying credits.[30]

The Proposed Guidance also reminds DCM market participants that they have an obligation to keep records of their activity in the underlying credits in the over-the-counter markets pursuant to required DCM recordkeeping rules, and market participants must make those records available to the DCM and the CFTC for inspection under applicable rules. Records of underlying cash market transactions as well as DCM trading records provide the DCM another tool for use in fulfilling its market-monitoring obligations.

C. To List a New VCC Derivative, DCMs Must Submit "Complete and Thorough" Information to the CFTC

Under the Proposed Guidance, DCMs applying to list a VCC derivative product must provide detailed analysis and documentation. The CFTC states that it "expects the information—including supporting documentation, evidence and

[26] *Id.* at 32-33.

[27] *Id.* at 34 (citing CEA section 5(d)(4), 7 U.S.C. 7(d)(4), 17 CFR §§ 38.250-258).

[28] *Id.* at 35.

[29] *Id.* at 35.

[30] *Id.* at 35.

data . . . will be complete and thorough" and that submitted information should include the contract's terms and conditions.[31] The CFTC acknowledges that VCC derivatives are new products without sufficient standardization and so it will continue allowing qualitative explanation and analysis. The Proposed Guidance also emphasized the three submission requirements for DCMs under Part 40 of the CFTC's Regulations and CEA section 5c(c).[32]

The CFTC's Requests for Comment and Further Information

The CFTC has requested comments and additional information from market participants before publishing the final guidance.[33] The request for comments asks for additional features or standards for underlying VCC programs and DCMs' responsibilities in listing VCC derivatives. The request aims to help the CFTC better understand market needs and to enhance the integrity of VCC derivatives instruments. Commenters should evaluate the proposal and consider whether the Proposed Guidance properly reflects the VCC market process and provides guidance that would buttress a robust, high-integrity VCC market.

In particular, the CFTC requests comments on the following:

- mechanisms to evaluate underlying crediting programs' transparency, ability to assess additionality, and ability to mitigate the risk of reversal;
- criteria, factors, or methodology for assessing how crediting programs, registries, and other entities involved in the delivery process can ensure the integrity of VCCs, support accountability for physical delivery, and prevent double counting;
- whether the contract terms and conditions of physically delivered VCCs should describe the responsibilities of registries or other third parties that participate in the delivery process; and
- whether DCMs should ensure that crediting programs have taken measures to prevent locking in high levels of GHG emissions that could be detrimental to achieving the goal of net-zero GHG emissions by 2050.

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[31] *Id.* at 36-37.

[32] First, DCMs must provide an explanation and analysis of the contract's compliance with the CEA and Core Principles. Second, DCMs must provide the "'documentation relied upon to establish the basis for compliance with applicable law, or incorporation information contained in such documentation with appropriate citations to data sources[.]'" Third, upon the CFTC's request, DCMs must provide "'additional evidence, information or data that demonstrates the contract meets, initially or on a continuing basis, the requirements of the CEA or the CFTCs regulations or policies thereunder.'" *Id.* at 36-37 (citing 17 CFR §§ 40.2(a)(3)-(4), (b) 40.3(a)(4), (10)).

[33] *Id.* at 38-42.

In proposing VCC derivatives contract listing guidance, the CFTC seeks to provide the means to more deeply monitor the underlying physical carbon market, reduce fraud in VCC projects and trading, and promote the goal of robust carbon market integrity. Comments in response to the Proposed Guidance and the CFTC’s Request for Information must be received by **February 16, 2024**.

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