

Voluntary Carbon Markets: Analysis of Regulatory Oversight in the US

EXECUTIVE SUMMARY

Voluntary carbon markets are widely considered to have an important role to play in achieving greenhouse gas (GHG) emissions goals. Market demand from entities and individuals purchasing carbon credits that are created through investments in nature-based or technology-based projects have fueled growth of the sector, with demand projected to increase by a factor of 15 or more by 2030 and a factor of 100 by 2050.

High-quality voluntary carbon credits (VCCs) are essential to the future development of the voluntary carbon market. In response, work is under way through the Integrity Council for the Voluntary Carbon Market¹, the International Emission Trading Association² and ISDA to establish globally consistent standards and best practices on the generation of credits. This is intended to address any criticism of a perceived lack of veracity and uniform criteria, and to proactively address the threat of greenwashing.

ISDA is focused on developing strong legal standards to encourage consistency in the definition of VCCs, as well as provide clarity on the bankruptcy and regulatory treatment in key jurisdictions for both primary and secondary markets.

Consistent with this objective, this whitepaper has been published to: (i) discuss some legal and regulatory questions relating to voluntary carbon markets; (ii) describe the oversight of primary and derivatives markets under Commodity Futures Trading Commission (CFTC) rules; and (iii) explain why VCC derivatives are considered commodity derivatives by the CFTC. The paper also recommends the CFTC could use its experience in regulating commodity derivatives markets as a blueprint for enhancing its oversight of voluntary carbon derivatives markets by employing a combination of private-sector and regulatory tools.

¹ The Integrity Council for the Voluntary Carbon Market (ICVCM) is an independent governance body for the voluntary carbon market. The ICVCM's purpose is to ensure the voluntary carbon market accelerates a just transition to 1.5°C. It does this by setting and enforcing definitive global threshold standards, drawing on the best science and expertise available. The intention is to ensure high-quality carbon credits channel finance towards genuine and additional greenhouse gas (GHG) reductions and removals that go beyond what can otherwise be achieved, and contribute to climate resilient development, <https://icvcm.org/>

² The International Emissions Trading Association's (IETA) mission is to empower business to engage in climate action, advancing the objectives of the United Nations Framework Convention on Climate Change and the Paris Agreement, as informed by Intergovernmental Panel on Climate Change science, and establish effective market-based trading systems for GHG emissions and removals that are environmentally robust, fair, open, efficient, accountable and consistent across national boundaries, www.ieta.org/Our-Mission

BACKGROUND

Carbon markets exist as mandatory (compliance) schemes and voluntary programs. Mandatory carbon markets (which are also referred to as cap-and-trade programs, emissions trading systems (ETSs) or allowance trading) represent a market-based approach to reducing carbon emissions. While emissions trading involves other greenhouse gases, such as methane and nitrous oxide, the predominant form of emissions trading encompasses CO₂.

The voluntary carbon markets function alongside compliance schemes and enable companies, governments, non-profit organizations, universities, municipalities and individuals to purchase carbon credits (offsets) on a voluntary basis. Currently, the majority of VCCs are purchased by the private sector, where corporate social responsibility goals are typically the key drivers.

Market participants use carbon credits to offset emissions that are caused by their activities and cannot or have not yet been eliminated. Firms across the globe either utilize VCCs that are sold by registries (primary markets) or enter into VCC derivatives contracts (secondary markets), such as the CME GEO futures contracts, among others. The global nature of voluntary carbon markets allows investments to be made anywhere in the world to develop new, innovative sequestration technologies or to preserve critical habitats or forests by creating a market-based incentive through the growing demand for carbon offsets.

In broad terms:

- A carbon allowance or carbon credit is a tradable permit or certificate that is issued by a government under an ETS. It provides the holder with the right to emit one ton of CO₂ or an equivalent amount of another GHG.
- A carbon offset is a certificate awarded for a proactive initiative that reduces or removes emissions. Carbon offsets can be used for voluntary carbon reduction commitments and for compliance within certain cap-and-trade programs up to a certain level.

In addition to compliance and voluntary markets, it is important to distinguish between primary and secondary carbon markets. Primary markets involve the distribution of allowances to: (i) parties in compliance carbon schemes that must comply with an ETS; and (ii) entities in compliance and voluntary markets that purchase carbon credits generated by emissions reduction projects.

Secondary markets include all subsequent trading of emission allowances and offset credits. Market participants can trade both spot and derivatives contracts based on emissions allowances and offsets (in the case of derivatives, primarily through standardized contracts like futures and options)³.

Compliance markets exist in the US at the state and regional level. For example, the Regional Greenhouse Gas Initiative (RGGI) was the first cap-and-trade program established in the US in 2005⁴, while the California Cap and Trade Program (CCaTP) was launched in 2013⁵.

³ ISDA has published several papers that provide detailed analysis of issues in carbon markets, including: (i) Legal Implications of Voluntary Carbon Credits (December 2021), which investigates the legal treatment of VCCs and sets out recommended steps that can be taken to further develop legal certainty in VCCs at both a global and jurisdictional level; and (ii) Role of Derivatives in Carbon Markets (September 2021), which describes how derivatives function in carbon markets – in particular, exchange-traded and over-the-counter carbon derivatives – and explains how carbon markets and carbon derivatives are used by firms to meet compliance objectives, achieve corporate social responsibility goals, and manage risk

⁴ The Regional Greenhouse Gas Initiative (RGGI) was established in 2005 and administered its first auction of CO₂ emissions allowances in 2008. It includes 11 member states: Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island and Vermont. Pennsylvania is expected to join the RGGI this year. The RGGI is focused on the power sector in the respective member states

⁵ The California Cap and Trade Program goes a step further than the RGGI in that it is multi-sector cap-and-trade program, as opposed to being focused on the power sector alone. The program covers 450 entities and about 80% of the emissions in California. California's Air Resources Board (ARB) administers the auction of CO₂ emissions allowances among covered entities, while the registration and verification of carbon offsets is carried out by independently operated offset project registries and verification bodies approved by the ARB

While compliance markets make use of independently operated registries, a central regulator establishes or approves all standards used by these independent entities. The independent registries then typically have discretion in how to implement the regulatory standards in a manner most appropriate to the markets they oversee⁶.

In contrast to the highly regulated mandatory carbon market, voluntary carbon markets do not currently involve any direct government or regulatory oversight. VCCs are issued by multiple non-governmental issuing bodies globally, known as carbon standards. Each carbon standard has unique rules that all projects must follow in order to be certified. Examples of established carbon standards include the Verified Carbon Standard (VCS or Verra), the Gold Standard, the American Carbon Registry and the Climate Action Reserve. There are no legal, regulatory or other third-party restrictions on entities setting the standards or on how the standards are set and maintained for any particular type of VCC.

VCCs are recorded on various registries, each with different rules. These are centralized recordkeeping systems of all registered projects for which VCCs are issued. The registry tracks the generation, issuance, transfer, retirement and cancellation of VCCs. The methodology, location and specific social and environmental benefits associated with each project all have a direct impact on the quality of the resulting VCCs and the price at which the VCCs are marketed.

Many corporate buyers purchase VCCs intending to cancel or retire them⁷ as a means to offset their own emissions. Once cancelled or retired, a VCC is removed permanently from circulation and cannot be traded anymore or used to offset further emissions. Currently, no universal registry for VCCs exists⁸, although the World Bank has been promoting a global climate warehouse or 'meta registry'⁹. The registries generally act as standard setters and lack direct oversight by a third party except when the registries also house regulated credits, such as California's Offset Project Registries¹⁰.

⁶ See, for example, Offset Project Registries, ARB, ww2.arb.ca.gov/our-work/programs/compliance-offset-program/offset-project-registries

⁷ The terms 'cancel' and 'retire' are often used interchangeably in this context

⁸ Registries and Enforcement, Carbon Offset Guide, www.offsetguide.org/understanding-carbon-offsets/carbon-offset-programs/registries-enforcement/

⁹ Climate Warehouse, World Bank, www.theclimatewarehouse.org/work/climate-warehouse

¹⁰ Supra notes [5] and [6]

CHALLENGES FACING VOLUNTARY CARBON MARKETS

It is generally recognized that VCCs face certain challenges versus credits issued under regulated carbon markets. There are a fragmented set of issuers, as well as concerns over the quality of the credits that are issued. The issuers of the credits tend to be private companies (ie, not national governments or regulators), and the rules governing the issuance of the credits are established outside of government regulated schemes and generally tend to be less transparent. In addition, certain project credits that are associated with carbon savings may not always be permanent (eg, credits linked to forestry development projects, but forests may be lost to wildfires).

A robust voluntary carbon market must also be grounded on strong legal foundations. As the market grows in size and complexity, the quality of VCCs would be significantly enhanced if national regulators provided clarity on the legal nature of these credits.

As with any intangible asset, the legal nature determines how VCCs as a fungible instrument can be created, bought, sold and retired. It affects what type of security may be taken and enforced in relation to VCCs and how that can be achieved, as well as how VCCs would be treated following an insolvency (including with regard to netting). It may also have an impact on broader considerations, including the regulatory, tax and accounting treatment of VCCs. In short, understanding the legal treatment of VCCs is necessary to achieve deep and liquid secondary markets. This, in turn, will enable the development of a clear price signal for carbon and allow funds to be efficiently channeled to emissions-reducing projects. Last year, ISDA published a whitepaper that explores these issues in detail and recommends steps that can be taken to further develop legal certainty in VCCs at both a global and national level¹¹.

To increase trading volumes in these markets, it is necessary to safeguard the integrity and soundness of the registries, and establish transparent standards for eliminating double counting of credits to ensure these credits are not claimed by multiple parties once applied or retired.

¹¹ www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf. The United Nations Commission on International Trade Law (UNCITRAL) has also addressed the legal nature of carbon credits and referenced ISDA's paper on legal enforceability of carbon credits (<https://uncitral.un.org/en/commission>). ISDA also submitted a proposal to the International Institute for the Unification of Private Law (UNIDROIT) to link the issue of the legal nature of VCCs with the organization's ongoing project on digital assets and private law, www.unidroit.org/meetings/governing-council/101st-session-rome-8-10-june-2022-2/

US REGULATORY CONSIDERATIONS FOR VCCS

In the context of US financial regulation, VCCs are commodities for the purposes of the Commodity Exchange Act (CEA)¹² given the broad definition of the term ‘commodity’ under the CEA¹³. This gives the CFTC varying degrees of regulatory and enforcement authority over primary and secondary markets in VCCs.

In recent years, there have been significant efforts by the CFTC to take steps to assess its potential role in supervising carbon markets.

- In September 2020, the CFTC’s Climate-Related Market Risk Subcommittee released a report detailing actions the CFTC could take to address climate change, including surveying “market participants about their use of climate related derivatives, the adequacy of product availability and market infrastructure, and the availability of data to incorporate climate impacts into existing and new instruments”¹⁴.
- In March 2021, then acting CFTC chairman Rostin Behnam established a Climate Risk Unit “to support the agency’s mission by focusing on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low carbon economy”¹⁵.
- Addressing the CFTC’s Energy and Environmental Markets Advisory Committee (EEMAC) in June 2021, then CFTC commissioner Dan M. Berkovitz acknowledged that “the CFTC must be aware of how the various primary, secondary, and derivative carbon markets are interacting and how companies use these markets to meet their compliance obligations, manage risks, and discover prices”¹⁶.
- In September 2021, the EEMAC recommended the formation of a new subcommittee to produce a report on the guiding principles for voluntary carbon markets in the US¹⁷. The report is expected to provide a clearer idea of how regulation may be imposed on voluntary carbon markets and other carbon instruments¹⁸.

¹² Section 1a(9) of the Commodity Exchange Act (CEA) broadly defines a commodity to mean “wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by section 13–1 of this title) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in”

¹³ For example, the Intercontinental Exchange’s California Carbon Offset Futures are contracts for the future physical delivery of certificates for California carbon offsets, www.theice.com/products/71544060/California-Carbon-Offset-Futures

¹⁴ See *Report of the Climate-Related Market Risk Subcommittee: Market Risk Advisory Committee of the US Commodity Futures Trading Commission Managing Climate Risk in the US Financial System*, Commodity Futures Trading Commission (CFTC) (September 9, 2020), 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

¹⁵ *CFTC Acting Chairman Behnam Establishes New Climate Risk Unit*, CFTC (March 17, 2021), www.cftc.gov/PressRoom/PressReleases/8368-21

¹⁶ See Daniel M. Berkovitz, CFTC commissioner, *Prepared Remarks before the Energy and Environmental Markets Advisory Committee* (June 3, 2021), www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement060321

¹⁷ See Daniel M. Berkovitz, CFTC commissioner, *Prepared Remarks before the Energy and Environmental Markets Advisory Committee* (September 15, 2021), www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement091521

¹⁸ *ISDA VCC Report*, *supra* note [3] at 14

- In May 2022, CFTC chairman Rostin Behnam noted there is a place for the CFTC to be involved in the development of the VCC markets¹⁹. He added that “[w]e really want this to be a public-private partnership... But I do want to think about how we can scale this market in a productive way and how we involve the CFTC to support that growth”²⁰.

Primary Markets in VCCs

The CEA provides the CFTC with broad enforcement authority to pursue claims of fraud and manipulation in the commodities markets. This includes activities that involve physical commodity transactions (ie, trading on a spot or forward basis) and commodity derivatives (ie, futures, options and swaps)²¹. Common violations under these provisions include fraud, market manipulation and false reporting.

This is an important aspect of regulatory oversight in the context of VCC markets given the challenges associated with greenwashing. At the September 2021 EEMAC meeting, it was noted that “[t]he word ‘manipulation’ is a touchstone [outside of a state-mandated emission regime]”²². However, as in every market, enforcement actions only address issues retrospectively and through deterrence. Enforcement alone is rarely sufficient to provide the regulatory standards necessary for the development of complex products and well-functioning markets.

Secondary Markets in VCCs

Commonly traded types of carbon derivatives include futures, options and swaps. In 2011, then CFTC chairman Gary Gensler suggested in a report produced by the Interagency Working Group for the Study of Oversight of Carbon Markets that the secondary carbon markets will be regulated like derivatives on physical commodities²³. However, the report noted that “no set of laws currently exist that apply a comprehensive regulatory regime – such as that which exists for derivatives – specifically to secondary market trading of carbon allowances and offsets. Thus, for the most part, absent specific action by Congress, a secondary market for carbon allowances and offsets may operate outside the routine oversight of any market regulator.”²⁴

¹⁹ See *Regulators Can Help Fix Carbon Offsets’ Credibility Problem – ISDA AGM*, International Financing Review (May 11, 2022), www.ifre.com/story/3362021/regulators-can-help-fix-carbon-offsets-credibility-problem-isda-agm-7xjxmpj1b2

²⁰ *Id*

²¹ 7 U.S.C. §§ 6c(a), 9, 12(a)(5) and 15 and CFTC regulation § 180.1

²² Virtual meeting transcript, CFTC Energy and Environmental Markets Advisory Committee (September 15, 2021), www.cftc.gov/sites/default/files/2021/09/1633045446/eemactranscript091521.pdf, at 29

²³ See *Interagency Working Group for the Study of Oversight of Carbon Markets, Report on the Oversight of Existing and Prospective Carbon Markets*, CFTC (January 18, 2011), www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf

²⁴ Further Definition of ‘Swap’, ‘Security-Based Swap’, and ‘Security-Based Swap Agreement’; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208, 48233 – 48235 (August 12, 2012) (the 2012 Product Rule)

a) Exchange-traded VCC futures and options

Standardized, exchange-traded and cleared carbon futures can provide the transparency and liquidity needed for reliable price discovery and effective price risk management for future carbon credit purchases²⁵. Even when more bespoke over-the-counter (OTC) arrangements are needed, OTC counterparties could still benefit from exchange-traded markets, as they can use exchange prices as a baseline and then separately negotiate pricing for bespoke features of the OTC contract²⁶. Key to developing liquidity in VCC futures markets will be ensuring the veracity of the underlying credits, enhancing fungibility of credits and listing contracts that allow for financial and physical settlement.

The CFTC has exclusive jurisdiction over the regulation of futures markets, including oversight of the listing of new contracts on futures exchanges²⁷. The CFTC has delegated some of its authority on futures contracts to self-regulatory organizations (SROs), including futures exchanges (designated contract markets (DCMs)²⁸) and clearing houses (derivatives clearing organizations (DCOs)²⁹). SROs are authorized to list and clear futures contracts based on their requirements, conduct market surveillance and enforce violations of their rules, among other things³⁰.

DCMs classified as SROs have the ability to list contracts through a self-certification or approval process. To maintain their status as an SRO, the relevant DCM or DCO must comply with CEA core principles and CFTC regulations³¹. SROs must therefore take these requirements into account when listing new products for trading, and the CFTC ensures these requirements are met when it reviews new SRO rules. As long as these requirements are met, DCMs have discretion in how to implement the core principles through the exchange's governance structure and rule book.

VCC futures are subject to the CFTC's exclusive jurisdiction. Therefore, exchanges and clearing houses in the US that list and clear VCC futures and options should ultimately ensure the CFTC's rules are met, and listed contracts "are not readily susceptible to manipulation"³².

²⁵ See, for example, *Phase 1 Final Report*, the Taskforce on Scaling Voluntary Carbon Markets (TSVCM) (January 2021), www.iif.com/Portals/1/Files/TSVCM_Report.pdf, at 14-15

²⁶ See *id.* The TSVCM Phase II Report, published on July 8, 2021, sets out a number of goals and objectives for scaling carbon markets. Phase II Report, TSVCM (July 8, 2021), www.iif.com/Portals/1/Files/TSVCM_Phase_2_Report.pdf (the TSVCM Phase II Report). Among these are a number of goals that require an existing body or a new organization to be created. For example, one objective is increased and standardized governance, with an organization providing oversight and creating standards for carbon credits. Others are harmonization of legal principles and contracts, and establishing high-quality standards for carbon credits, each of which are best done by a single governing body. The TSVCM proposal is for a global governance body with membership of companies and organizations active in all segments of the voluntary carbon market that will engage with industry groups, investor alliances, government agencies and non-governmental organizations, members or activities of which are involved with the market. While this paper focuses on carbon derivatives rather than spot markets, efforts to enhance the integrity of the underlying credits are critical to guarding against manipulation and fraud for derivatives referenced to those credits

²⁷ 7 U.S.C. § 2(a)(1)(A)

²⁸ 7 U.S.C. § 7(a)

²⁹ 7 U.S.C. § 7a-1

³⁰ Heath P. Tarbert, *Self-Regulation in the Derivatives Markets: Stability through Collaboration*, 41 Nw. J. Int'l L. & Bus. 175 (2021), at 193

³¹ 7 U.S.C. § 7(d) and CFTC Part 38

³² 17 C.F.R. § 38.200

b) Bilateral carbon swaps and other OTC derivatives

Carbon swaps are OTC contracts that involve the exchange (or a series of exchanges) of allowances, offsets or cashflows at a given time (or for a set period). Offset-allowance swaps allow companies that have not yet reached their quota of allowed offsets to sell their allowances and buy offsets, therefore taking advantage of the price difference, as opposed to companies that may have more offsets than allowances and are already over their quota. Swaps are usually settled by payment rather than physical delivery³³.

Bilateral carbon derivatives between eligible contract participants could potentially be subject to the CFTC's trading, clearing, reporting and recordkeeping regulations, as well as mandatory non-cleared margin requirements.

c) Physical carbon transactions

Spot contracts: These are contracts of sale resulting in immediate settlement and delivery of a commodity. In practice, settlement and delivery must occur within a period of time that is typical commercial practice in cash or spot markets for the commodity involved, but in no event more than 28 days after execution³⁴. Spot contracts are not subject to the CFTC's regulatory authority, but remain liable to potential CFTC enforcement, including through the anti-fraud and manipulation provisions of the CEA.

Forwards: These are contracts for the purchase and sale of a physical commodity where shipment or delivery is deferred for commercial purposes. Forward contracts are excluded from regulation as futures, options or swaps, provided they satisfy certain requirements set out by the CFTC in various rules and through interpretive guidance³⁵. To qualify for the exclusion, parties to a forward contract do not ultimately need to make and take delivery of the commodity but must intend for the transaction to result in delivery at the time of execution³⁶. In other words, the transaction can be reversed or 'booked out' prior to delivery based on changed circumstances, but, at the time of execution, the parties must have intended for physical delivery to occur. Carbon offsets and other environmental products are physical commodities, so transactions involving these projects are potentially eligible for the forward contract exclusion from CFTC regulations.

The parties' intent to make and take delivery is a key factor in this analysis. As additional counterparties join the carbon markets and new structures develop – including where there is a possibility the transaction may be rolled over or cash settled or may have embedded optionality – market participants may need to retest their analysis on whether delivery is intended at the time of contracting. For example, they may wish to consider whether counterparties are able to make or take delivery of the credits (eg, whether they are on-boarded with relevant carbon credit registries) and whether transfers between accounts constitute physical delivery.

³³ *Carbon Market Oversight Primer*, International Carbon Action Partnership (2013), https://icapcarbonaction.com/system/files/document/carbon_market_oversight_primer_web.pdf

³⁴ 7 U.S.C. § 2(c)(2)(D)(ii)(III) (2012)

³⁵ 7 U.S.C. § 1(a)(27)

³⁶ 7 U.S.C. § 1a(47)(B)(ii) (2012)

Delivery Points as a Key Aspect of VCC Futures Markets

As previously referenced, the CFTC has exclusive jurisdiction over the regulation of futures markets, including oversight of the listing of new contracts on futures exchanges³⁷. One key component of a futures contract is the ability to deliver the commodity (ie, physically settle) at the conclusion of the contract. While only a small percentage of futures contracts actually do result in delivery (instead of settling financially – ie, paying out in reference to the spot price), the ability to ensure delivery is a key aspect of futures contracts and markets.

The CFTC has a long established and enforced authority over delivery points, which is often linked to monitoring for potential market manipulation. In this regard, CFTC officials have noted that “[t]he specification of delivery points, deliverable grades and their corresponding price differentials has a direct bearing on the susceptibility of the futures contract to price manipulation and market congestion”³⁸.

In the context of precious metals, the CFTC frequently enforces actions for fraud against entities that promise to sell precious metals to customers without the intent to follow through or those that deliver commodities that do not match promised levels of quality. This can occur with companies that attempt to market directly to customers³⁹ and also with entities that portray themselves as exchanges without enforcing any of the safeguards required by the CFTC and implemented by associated SROs⁴⁰.

The CFTC will also pursue potential manipulation violations conducted on or through DCMs by buyers of futures contracts in order to affect the price of commodities in either futures or cash markets. For example, the CFTC prosecuted Kraft and obtained a consent order in 2019 related to allegations of market manipulation, excessive speculation and wash sales⁴¹.

The CFTC has heightened regulatory interest in delivery points when it comes to traditional commodity futures contracts, noting that “[a] DCM or [swap execution facility] that lists a contract that is settled by physical delivery should design its contracts in such a way as to avoid any impediments to the delivery of the commodity in order to promote convergence between the price of the futures contract and the cash market value of the commodity at the time of delivery”⁴².

In addition, SROs must ensure they “prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices [...]”⁴³.

³⁷ 7 U.S.C. § 2(a)

³⁸ *Policy Statement on Price Differentials*, CFTC, www.cftc.gov/IndustryOversight/ContractsProducts/EconomicRequirements/differential.html

³⁹ See, for example, *The CFTC and 27 State Securities Regulatory Agencies Charge Los Angeles Area Precious Metals Dealer in Ongoing \$68 Million Fraud Targeting the Elderly*, CFTC (February 1, 2022), www.cftc.gov/PressRoom/PressReleases/8489-22; *Federal Court Orders Oregon Owner of Precious Metals Firm to Pay \$1.3 Million to Victims of Fraudulent Precious Metals Scheme*, CFTC (April 27, 2021), www.cftc.gov/PressRoom/PressReleases/8384-21; *Federal Court Orders Alabama Man to Pay More Than \$16 Million in Precious Metals Fraud*, CFTC (August 23, 2021), www.cftc.gov/PressRoom/PressReleases/8416-21

⁴⁰ For example, in an enforcement action brought by the CFTC in 2017 and prosecuted through the courts, the CFTC charged the Monex Deposit Company with operating an unauthorized exchange that failed to deliver commodities purchased by customers through that exchange: *U.S. Court of Appeals Rules in Favor of CFTC in Fraud Case Against Monex Deposit Company and its Principals*, CFTC (July 22, 2021), www.cftc.gov/PressRoom/PressReleases/8410-21

⁴¹ T'Shae Sherman, *CFTC Settles Wheat Manipulation Case against Kraft and Mondelēz*, Covington Financial Services (August 20, 2019), www.covfinancialservices.com/2019/08/cftc-settles-wheat-manipulation-case-against-kraft-and-mondelez/

⁴² See *Testimony of Vincent McGonagle, former Director of CFTC's Division of Market Oversight Before the Financial Institutions and Consumer Protection Subcommittee Senate Committee on Banking, Housing, and Urban Affairs*, www.cftc.gov/PressRoom/SpeechesTestimony/opamcgonagle011514#P12_5189

⁴³ 17 C.F.R. § 38.250

In particular, DCOs must “establish rules that clearly state each obligation that the [DCO] has assumed with respect to physical deliveries, including whether it has an obligation to make or receive delivery of a physical instrument or commodity, or whether it indemnifies clearing members for losses incurred in the delivery process”, and ensure the risks of each obligation are identified and managed⁴⁴.

In practice, DCMs ensure entities using their services follow detailed procedures to guarantee the delivery and receipt of physical goods traded through their exchanges, such as agricultural products. Under the rules of the Chicago Board of Trade (CBOT), for example, all facilities receiving agricultural commodities must be registered with the exchange, be open to inspection, demonstrate financial capacity to operate, fulfill orders based on procedures set out in CBOT’s rules, and maintain any agricultural goods exchanged at specified grades of quality. Load-out rates of specific agricultural commodities sourced from specific locations are mandated by the exchange⁴⁵.

Similarly, the New York Mercantile Exchange regulates warehousing facilities, requires insurance, reporting and regular independent auditing, and specifies processes for the issuance of warrants verifying metal commodities meet certain specifications related to quality⁴⁶. Rules such as these assure market participants that contracts traded on the exchange will lead to the delivery of physical commodities in the form and quantity contracted.

When it comes to other commodity contracts, market participants therefore have the assurance of consistent and transparent rules on quantitative requirements and delivery (including the transfer of these commodities) via SRO requirements and the CFTC’s review of those rules.

As previously referenced, SROs are authorized to enforce violations of their rules, and they play a critical role in setting and enforcing standards for the markets they operate. There are a number of benefits to SROs acting as the first line of enforcement.

- As SROs are independent non-governmental entities, their rules tend to balance regulatory objectives with commercial concerns.
- As SROs have the best access to their markets, they are often better able to identify misconduct. In doing so, they transfer some of the oversight burden from government regulators such as the CFTC.
- Ultimately, exchanges can serve a gatekeeper, denying access to individuals and entities that do not comply with the rules.

Given the CFTC’s broad enforcement authority over delivery points, it may have a regulatory interest in ensuring carbon registries (that act as delivery points for carbon futures contracts) adopt appropriate standards for the development of VCCs. It may also want appropriate procedures for tracking the buying and selling of credits in the context of VCC futures and other bilateral markets (such as spot and physically settled forwards) where it has anti-fraud and manipulation regulatory authority to provide more effective oversight.

⁴⁴ 17 C.F.R. § 39.14(g)

⁴⁵ Chicago Board of Trade Rulebook, Chapter 7, www.cmegroup.com/content/dam/cmegroup/rulebook/CBOT/1/7.pdf

⁴⁶ New York Mercantile Exchange Rulebook, Chapter 7, www.cmegroup.com/content/dam/cmegroup/rulebook/NYMEX/1/7.pdf

As with any other futures contracts, the CFTC has a strong interest in ensuring VCC futures can be physically settled in an orderly manner. Carbon registries currently serve as the practical delivery points for carbon futures contracts. Carbon credit registries (i) track projects and issue carbon credits for each unit of emission reduction or removal that is verified and certified, and (ii) oversee the transfer of carbon credits from one party to another through tracking ownership. Currently, these registries have their own set of requirements that project designers must meet and are validated and monitored by verification entities.

It is important to ensure registries have consistent and transparent rules on how VCCs are verified, counted and transferred. Failure to correctly track and safeguard carbon credits, or a gap in standards in the creation of a carbon credit itself, could lead to fraudulent practices, such as greenwashing and double counting. As with other rules for delivery points, consistent and transparent requirements for carbon registries help guarantee the legitimacy of transactions and ensure they are entered for legitimate purposes.

Likewise, clear rules and widely agreed standards – the type that SROs are well-positioned to monitor – will make compliance easier for market participants and may reduce the need for enforcement actions. Without clear rules governing VCC registries, it becomes challenging for regulators to know if exchanges are fulfilling their objectives of encouraging emissions reductions, as well as for market participants to know if the products purchased through the exchanges perform as promised.

This is increasingly important as certain exchanges – such as CME Group and Intercontinental Exchange (ICE) – offer a variety of VCC futures contracts.

- ICE lists a number of sustainability-linked products involving carbon trading, renewables and sustainable indices⁴⁷, including certified emission reduction carbon offset units.⁴⁸ ICE also recently launched a Nature-Based Solutions carbon credit futures contract (NBS future)⁴⁹. The NBS future physically delivers verified carbon unit credits certified under the VCS Agriculture, Forestry and Other Land Use Projects with Climate, Community and Biodiversity Certification, with vintages between January 1, 2016, to December 31, 2020.
- In 2021 and 2022, CME listed three new environmental, social and governance-related futures contracts in its capacity as a DCM: (1) CBL Global Emissions Offset (GEO) futures; (2) Nature-based Global Emissions Offset (N-GEO) futures contracts; and (3) CBL Core Global Emissions Offset (CGO) futures.

These contracts involve the future delivery of carbon offset credits but vary in terms of contract specifications. For example, GEO uses the standards adopted by the UN for aviation carbon neutrality objectives – the Carbon Offset and Reduction Scheme for International Aviation (CORSIA) – to ensure the veracity of the credits⁵⁰. The contract is physically settled and allows delivery of CORSIA-eligible voluntary carbon offset credits from three registries: the VCS, the American Carbon Registry and the Climate Action Reserve. The contract seller chooses which qualified registry will deliver the credits.

⁴⁷ See *Connect to Global Environmental Complex*, Intercontinental Exchange, www.theice.com/energy/environmental

⁴⁸ *FAQs Carbon Markets & Indices*, Intercontinental Exchange, www.theice.com/carbon-terminology-and-product-faq

⁴⁹ See *ICE Launches its First Nature-Based Solutions Carbon Credit Futures Contract*, Intercontinental Exchange (May 9, 2022), <https://ir.theice.com/press/news-details/2022/ICE-Launches-its-First-Nature-Based-Solutions-Carbon-Credit-Futures-Contract/default.aspx>

⁵⁰ Derek Sammann, senior managing director, CME Group, *Energy and Environmental Markets Advisory Committee Meeting June 3, 2021*, at 143, www.cftc.gov/sites/default/files/2021/08/1629999884/eemactranscript060321.pdf

VCC futures contracts “[are subject to] the same regulatory oversight, [and contain] options for trade execution, counterparty risk protections, and delivery mechanisms as any other physically delivered exchange cleared contract”⁵¹. To enhance the integrity of voluntary carbon derivatives markets, it would be helpful if the relevant rule books contain more detail on how and to what standards exchanges and affiliated clearing houses vet the standard setters or registries⁵².

This information would benefit clearing members, their customers and also, indirectly, the holders and recipients of VCCs in the context of primary and bilateral contracts. Where requirements and standards for registries are included in an SRO’s rule book, this would also assist the CFTC with fulfilling its oversight responsibilities, as the SRO would require and monitor compliance. For example, it would benefit both market participants and the CFTC to ensure a particular registry:

- Has adequate financial standing;
- Can ensure delivery of VCCs and has sufficient transparency into its delivery procedures;
- Has procedures in place for the expeditious receipt of VCCs;
- Maintains sufficient records about all VCCs received and delivered;
- Establishes a notification process for failure to deliver VCCs;
- Contains disclosures on the attributes and quality of VCCs; and
- Institutes a governance structure to avoid unethical or inequitable practices.

This would be consistent with current SRO standards applied to delivery points for other futures contracts⁵³.

⁵¹ Sammann, *supra* note 50, at 143, www.cftc.gov/sites/default/files/2021/08/1629999884/eemactranscript060321.pdf

⁵² 17 C.F.R. § 39.14(g)(1)

⁵³ *Supra* notes 45 and 46

CONCLUSION

As VCC derivatives are considered commodity derivatives, the CFTC and SROs could apply the same oversight tools they use in commodity markets to ensure the integrity of VCCs. This includes conducting additional due diligence on carbon registries given they are used as delivery points for VCC futures contracts.

The increased role of established exchanges (and, by extension, the CFTC) in ensuring the integrity of registries will likely increase confidence in VCC markets. SROs can leverage existing liquidity (eg, from participants already trading on the exchange in similar asset classes) and regulatory processes established for other commodity derivatives markets to enhance the transparency of carbon registries. This would translate into better and more reliable pricing for spot and OTC derivatives markets.

In order to establish robust VCC futures markets in the US, the government and private sector must “work together to produce regulatory solutions that balance effective oversight with the flexibility needed to adapt to changing circumstances”⁵⁴. Only that will allow the voluntary carbon markets to flourish and fulfill their potential for facilitating the transition to a more sustainable economy.

⁵⁴ Tarbert, *supra* note 30 at 178

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Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 980 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In

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