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Inside CFTC's Latest Push To Regulate Carbon Markets

By **Levi McAllister, Pamela Wu and Sarah Riddell** (December 13, 2023, 6:02 PM EST)

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The Commodity Futures Trading Commission issued proposed guidance Dec. 4 intended to increase the transparency and bolster the integrity of voluntary carbon credits that underlie derivative contracts subject to CFTC jurisdiction.

The CFTC's proposal is the latest effort in its 2023 push to regulate the carbon markets. As more derivative contracts on voluntary carbon market products are traded on CFTC-regulated exchanges, the CFTC has taken steps to identify ways in which it can address climate-related financial risk in the derivatives markets and underlying spot markets.

The proposed guidance identifies criteria that should be addressed clearly in the design of a voluntary carbon credit derivative contract to help ensure that trading in the contract is based on accurate information about the underlying voluntary carbon credit.

It identifies quality standards, delivery points and facilities, and inspection provisions as the criteria that exchanges should address to promote accurate pricing and to help to reduce the susceptibility of the contract to manipulation.

The proposed guidance follows the CFTC's novel whistleblower alert, issued in June, describing the types of misconduct that market participants should be on the lookout for in the carbon markets. In this alert, the CFTC asked market participants to voluntarily provide the CFTC with original information about such misconduct.

The same month, the CFTC announced the establishment of an environmental fraud task force to combat environmental fraud and misconduct in relevant derivatives and spot markets.

On the heels of these announcements, the CFTC held its second Voluntary Carbon Markets Convening in July to discuss ways to enhance the integrity of voluntary carbon markets, among other initiatives. At this convening, Chairman Rostin Behnam previewed that the CFTC was working on carbon market guidance.

The proposed guidance and its implications for futures exchanges are described below.

Background

The Commodity Exchange Act gives the CFTC exclusive jurisdiction over futures contracts, options on futures contracts, and swap transactions, but limits the CFTC's jurisdiction over commodities in the spot market to antifraud and antimanipulation jurisdiction.[1]

Keenly aware of its jurisdictional limitations, the CFTC explicitly states that the guidance is "not intended to modify or supersede existing statutory or regulatory requirements, or existing Commission guidance that addresses the listing of derivative products by CFTC-regulated exchanges, including the Appendix C Guidance."

The CFTC finds support for its proposal in various core principles set forth in the Commodity Exchange Act that require futures exchanges to have rules to prevent market manipulation and to adopt position limits or accountability levels for contracts that they offer.[2]

The proposed guidance applies solely to exchanges that offer derivatives on voluntary carbon credits. The CFTC distinguishes between mandatory, or compliance, markets (e.g., cap-and-trade programs, emissions trading systems, and allowance trading systems established by national, regional, or international governmental bodies) and voluntary carbon markets that are not established by any governmental body.

Voluntary carbon credits are tradeable, intangible instruments issued by a carbon crediting program that represent a greenhouse gas emissions reduction to or removal from the atmosphere equivalent to one metric ton of carbon dioxide.

Currently, the New York Mercantile Exchange is the only U.S. exchange that offers futures contracts on voluntary carbon credits with open interest, but ICE Futures U.S. offers futures contracts on carbon credits issued under mandatory markets.

Voluntary carbon credits have existed for more than 20 years, but there is no standardized methodology or protocol to quantify emissions reduction or removal levels. The lack of standardization makes it possible for different levels in reductions to be calculated, creating incentives for project developers to use the methodology or seek the certification from the crediting program that results in the issuance of a greater number of credits.

According to the CFTC, the integrity and purpose of voluntary carbon markets are undermined when calculation methodologies lack transparency. It is the CFTC's belief that the proposed guidance may create standardization of voluntary carbon credits, thereby promoting transparency and liquidity.

The Proposal Seeks to Apply Existing Guidance to Carbon Credit Derivatives

The CFTC goals are to enhance the transparency, market integrity, accurate pricing and liquidity of voluntary carbon credit markets, and to help ensure that position holders will receive underlying carbon credits with the expected quality and other characteristics.

To achieve these goals, the CFTC has proposed that futures exchanges apply Appendix C to Part 38 of the CFTC's regulations (i.e., guidance on the requirement that a designated contract market list for trading contracts that are not readily susceptible to manipulation) to derivatives on voluntary carbon credits when developing such derivatives' contract terms and conditions.[3]

When determining whether a crediting program for a voluntary carbon credit is a reliable source of highintegrity credits, an exchange should evaluate (1) quality standards; (2) delivery points and facilities; and (3) inspection provisions. The proposed guidance elaborates on how an exchange should evaluate these characteristics.

1. Quality Standards

Exchanges should review quality standards for the following.

Transparency

The contract terms and conditions should specify the crediting program — or programs, if more than one is available — from which the voluntary carbon credit may be issued upon delivery.

Additionality

With additionality, carbon credits are credited only for projects that result in emission reductions or removals that would not have occurred in the absence of the monetary incentive created by the revenue from the sale of the carbon credits.

The CFTC has not proposed to prohibit exchanges from offering futures contracts with underlying carbon credits whose crediting programs do not have procedures in place to assess for additionality. But the CFTC says exchanges should consider whether crediting programs have these procedures and whether they are "sufficiently rigorous and reliable" such that emission reductions or removals are credited only if they are additional. This prevents the pricing of the contract from inaccurately reflecting the quality of the carbon credit, avoiding the "cheapest-to-deliver" carbon credit.

Permanence and Reversal Risk

Permanence and reversal risk is the risk that a carbon credit may be recalled or canceled because the carbon removed by the project is released back into the atmosphere or because the amount of carbon reduced or removed from the atmosphere by the project is reevaluated.

Because a crediting program's measures for estimating, monitoring and addressing the risk of reversal may constitute an economically significant characteristic of an underlying voluntary carbon credit, exchanges should describe in a futures contract's terms and conditions these measures.

The CFTC goes on to describe buffer pools that are established to address reversal risk, holding voluntary carbon credits that can be used to compensate for such risk by replacing canceled carbon credits.

Exchanges should consider whether a crediting program regularly reviews how the buffer pool's size is calculated and whether an audit mechanism for the continued sufficiency of the pool exists.

Robust Quantification

Before listing a voluntary carbon credit derivative contract, exchanges should consider whether the quantification methodology that the crediting program uses to calculate emission reductions or removals for the underlying carbon credit is robust, conservative and transparent to help ensure that emission reductions or removals associated with the project are accurate.

In addition, a robust quantification will help exchanges establish a more reliable basis for their deliverable supply estimates, which can be used to effectively set exchange position limits.

2. Delivery Points and Facilities

Exchanges should review delivery procedures for a physically settled derivative contract to minimize or eliminate any impediments to making or taking delivery and consider the voluntary carbon credit crediting program's governance framework, tracking mechanisms and measures to prevent double counting.

Governance

In reviewing a crediting program's governance framework, exchanges should consider the crediting program's decision-making protocol, including how independence of key functions is attained, as well as reporting and disclosure procedures, public and stakeholder engagement processes, and risk management policies.

The CFTC believes that exchanges may need to include governance information in a contract's terms and conditions to ensure the quality and delivery of the voluntary carbon credits.

Tracking

Exchanges should consider whether the crediting program or its registry effectively tracks the issuance, transfer and retirement of voluntary carbon credits, including identification of who owns or retires a voluntary carbon credit, and to ensure that each voluntary carbon credit is uniquely and securely identified and associated with a single emission reduction or removal of the equivalent of one metric ton of carbon dioxide.

Preventing Double Counting

To prevent the derivative contract's pricing from being distorted, a crediting program should provide reasonable assurances that each voluntary carbon credit underlying a derivative is unique, with procedures for conducting cross-checks across multiple carbon credit registries.

3. Inspection Provisions

Inspection or certification procedures for verifying compliance with quality or delivery requirements for physically settled voluntary carbon credit derivatives should be included in the contract's terms and conditions.

Whether a crediting program has up-to-date, robust, and transparent verification procedures — including whether verification is completed by a reputable disinterested party — is another consideration that the CFTC believes exchanges should take into account prior to listing a voluntary carbon credit derivative contract.

The proposed guidance also explains that exchanges should monitor deliverable supply as well as changes to a crediting program's standards and amend the relevant contract's terms and conditions to reflect any changes. The CFTC also reiterates its expectation that contract certifications that exchanges make under Part 40 of the CFTC's regulations will be complete and thorough.

Takeaways

Limited Jurisdiction, Limited Guidance

Despite the increased attention the CFTC has paid to the carbon markets, starting in 2019 with the establishment of the Climate-Related Market Risk Subcommittee, and the committee meetings and convenings held to discuss the integrity of the carbon markets and initiatives to address climate risk, the CFTC's proposed guidance is less developed and robust than expected.

However, the proposed guidance and the comments provided in response are expected to garner further discussion toward developing a regulatory framework to oversee the carbon credit markets.

The CFTC aims to increase transparency in the underlying voluntary carbon credit markets by recommending that exchanges consider various factors about crediting programs' standards.

The CFTC does not go so far as to prohibit exchanges from listing derivatives on carbon credits issued by a crediting program that does not provide the level of transparency necessary for an exchange to consider these factors.

However, the CFTC may reject contract certifications that do not provide the level of detail that the CFTC expects an exchange to provide or delay the introduction of new contracts by requesting additional information or evidence that demonstrates that the contract meets the requirements of the Commodity Exchange Act and the CFTC's regulations or policies thereunder, e.g., the proposed guidance.

CFTC Request for Comment

The CFTC has solicited input from the industry on its proposed guidance. Many of these questions ask whether there are particular factors or criteria that exchanges should take into account when considering the quality, delivery and inspection standards that the CFTC has proposed.

The CFTC also asks whether an exchange should consider whether a crediting program has implemented best practices on social and environmental safeguards to inform the level of the voluntary carbon credit's integrity.

Notably absent from the CFTC's questions for comment is whether the CFTC could have gone further by proposing regulations applicable to intermediaries and other market participants that trade these types of environmental contracts, or whether the CFTC could have expanded the standards to disclosure requirements for non-exchange traded contracts.

What's Next?

The proposed guidance is likely just the first step in the CFTC's strategy to enhance the integrity of the voluntary carbon credit markets. The proposed guidance is likely to be adopted largely as proposed, without additional exchange responsibilities beyond what has been proposed.

CFTC Commissioners Kristin Johnson and Christy Goldsmith Romero expressed their desire for the CFTC to play a greater role in overseeing voluntary carbon credit markets.[4] Intermediaries should monitor developments in this space, particularly in light of Johnson's view that the proposed guidance is insufficient and her concern over its narrow scope, as it does not encompass swaps that are not traded on a swap execution facility, and environmental forwards that are not swaps.[5]

In addition, noting that swap dealers are subject to disclosure and fair dealing requirements, Johnson explained that disclosure of the underlying voluntary carbon credit's material information, material risks, material characteristics, material incentives and conflicts of interest are important and could be applied to all environmental derivatives products to ensure that a counterparty "has adequate information to understand how observed volatility and inherent risk in the nascent and evolving carbon credit market could impact the price of the derivative."

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[1] Section 2(a)(1)(A) of the CEA; 7 U.S.C. § 2(a)(1)(A). Specifically, the CFTC has exclusive jurisdiction over "accounts, agreements (including transactions of the character of or commonly known to the trade as an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty'), and transactions involving swaps or contracts of sale of a commodity for future delivery" that are traded or executed on a designated contract market or swap execution facility or other board of trade, exchange, or market.

[2] For example, Core Principle 4 imposes on a futures exchange, or designated contract market (DCM), the responsibility for preventing manipulation, price distortion, and disruptions of the delivery or cash settlement process through market surveillance, compliance, and enforcement practices and procedures. 7 U.S.C. § 7(d)(4). The CFTC also supports the issuance of the guidance by citing to Core Principle 3 (providing that a DCM shall only list contracts that are not readily susceptible to manipulation), Core Principle 5 (requiring a DCM to adopt for each contract position limits or position accountability levels for speculators), and Core Principle 12 (requiring a DCM to have rules to protect markets and market participants from abusive practices and to promote fair and equitable trading on the exchange). 7 U.S.C. §§ 7(d)(3), (5), (12).

[3] The CFTC notes that the proposed guidance could be leveraged by swap execution facilities that offer swaps that settle to the price of a voluntary carbon credit or that are physically settled.

[4] Statement of Commissioner Christy Goldsmith Romero on Exchange Listing Standards for Voluntary Carbon Credit Derivative Contracts (Dec. 4, 2023). Commissioner Goldsmith Romero expressed a desire to know whether market participants believe that the CFTC adapted the appropriate portions of the Integrity Council on Voluntary Carbon Markets standards and whether the proposal establishes clear expectations. Importantly, Commissioner Goldsmith Romero asked if an exchange should conduct

additional due diligence into specific projects, protocols, or categories.

[5] Statement of Commissioner Kristin Johnson: Commission Guidance Regarding Listing of Voluntary Carbon Credit Derivative Contracts (Dec. 4, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/johnsonstatement120423.