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CFTC Actions Signal Its Lead Role In Carbon Offsets Policing

By **Levi McAllister and Pamela Wu** (July 14, 2023, 4:03 PM EDT)


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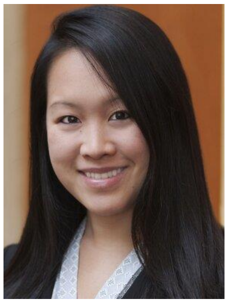
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For the last several years, corporate entities in nearly all industries have announced varying commitments to decarbonization and carbon neutrality. For many, achieving those commitments turns on the purchase and retirement of carbon offsets derived from carbon projects that purport to remove or sequester carbon dioxide from the atmosphere.

Although some of those carbon offset transactions may occur in the paradigm of a regulated carbon compliance market, the majority do not. Instead, many of those carbon offset transactions occur within the context of the voluntary carbon market — a market that increased by over 400% between 2020 and 2021, and that continues to grow exponentially.

Indeed, some estimates predict that the volume of carbon offsets transacted in the voluntary carbon markets will reach between $10 billion and $40 billion by 2030, which is up from $2 billion in 2021 and 2022.

To date, the voluntary carbon market has been without any regulatory oversight in U.S. markets. Thus, entities that were transacting in voluntary carbon markets were doing so within the confines of a caveat emptor framework.

However, multiple indications have made clear more than ever that the proverbial party is finally going to receive a long overdue chaperone — the Commodity Futures Trading Commission. In recent weeks, the CFTC has announced several actions through which it will exercise its enforcement authority and regulatory oversight over the carbon markets, thereby solidifying itself as the regulator of those markets.

Carbon offsets are expected to play an important role in the energy transition, and in companies' ability to meet their net-zero commitments. But concerns have been raised on the quality, permanence, additionality and validity of carbon offsets that are transacted in the voluntary carbon markets.

The first announcement came from the CFTC's whistleblower program. This was followed by the CFTC chairman's announcement of the second voluntary carbon markets convening, and the CFTC Division of Enforcement's announcement of the creation of the Environmental Fraud Task Force.

Through these actions, the CFTC has dedicated additional resources and directed coordination of these resources across the agency to step up its oversight of the carbon markets.

First, the CFTC's whistleblower program issued an alert to the public on June 20, seeking tips from whistleblowers of potential violations of the Commodity Exchange Act that are connected to fraud or market manipulation in the carbon markets. The alert identified specific types of misconduct that are of interest, which include:

- Manipulative and wash trading or other CEA violations in carbon market futures contracts;
- Fraud in the underlying spot markets related to ghost or illusory offsets listed on carbon market registries;
- Double counting or other fraud related to carbon offsets;
- Fraudulent statements relating to the material terms of carbon offsets; and
- Manipulation of tokenized carbon markets.

Under the whistleblower program, individuals can become eligible for financial awards and certain confidentiality and anti-retaliation protections by blowing the whistle.

Individuals who voluntarily provide original information about violations of the CEA that leads the CFTC to bring a successful enforcement action resulting in monetary sanctions of over $1 million, or that leads to the successful enforcement of a related action brought by another governmental entity, may receive monetary awards.

The monetary awards are tied to the monetary sanctions collected, and range between 10% and 30% of the collected sanctions.

In addition to soliciting tips from the public, the CFTC's Division of Enforcement announced on June 29 that it had established a new task force — the Environmental Fraud Task Force. This task force will address fraud and other misconduct in both the regulated derivatives markets and also the relevant spot markets, including the voluntary carbon markets.

It will also examine, among other things, fraud with respect to the environmental benefits represented by carbon offsets, and material misrepresentations regarding environmental, social and governance products or strategies, as well as the types of misconduct that are of interest to the CFTC's whistleblower program.

The Environmental Fraud Task Force will be made up of attorneys and investigators across different offices within the Division of Enforcement who will prosecute cases and serve as subject matter experts. It will coordinate its efforts and resources with those in other divisions and offices within the CFTC, including the whistleblower program, to police environmental fraud.

Finally, the CFTC chairman announced that the second voluntary carbon markets convening will be held on July 19. The second convening will build on the information discussed at the first convening, was held in June 2022.

It will also be informed by comments submitted in response to the request for information that the CFTC issued concurrent with the first convening, to better inform its understanding and oversight of climate-related financial risk related to the derivatives markets and underlying commodities markets.

Topics that are expected to be covered in the second voluntary carbon markets convening include recent private sector initiatives for high-quality carbon offsets, current trends and developments in the cash and derivatives markets for carbon offsets, and market participants' perspectives on how the CFTC can promote integrity for high-quality carbon offset derivatives.

This may include the ongoing efforts aimed at establishing an integrated market integrity framework to ensure the quality, credibility, transparency and accountability in the voluntary carbon markets, as well as the new standards and guidance that are expected to be released this year.

The discussion at the second convening may inform the recommendations of the CFTC's Climate Risk Unit for any new or amended guidance, interpretations or policy statements related to the voluntary carbon markets. The Climate Risk Unit, which was created in 2021, and comprises staff from across the CFTC's operating divisions and offices, is focused on the role of the derivatives markets in addressing climate-related risk and transitioning to low-carbon economy.

Takeaways

Each of these CFTC actions are significant in several respects. They confirm that the CFTC will actively pursue and prosecute cases of fraud and manipulation involving environmental representations and credentials, in the derivatives markets as well as in the relevant spot markets — including the voluntary carbon markets.

A variety of potential misconduct may be the subject of CFTC investigations. Through its exercise of its anti-fraud and anti-manipulation enforcement authority over the carbon markets, the CFTC could pursue investigations into potentially manipulative trading in futures contract, the validity and credibility of carbon offsets that are listed on carbon registries, and fraudulent statements on the material terms of a carbon offset — including the quality, additionality, permanence or environmental benefit of the carbon offset.

The creation of the Environmental Fraud Task Force alone is notable, because it is the first formalized effort of the CFTC to establish a unit that will be focused on combating fraud in the voluntary carbon markets and other forms of greenwashing — including material misrepresentations about ESG investment strategies.

The composition of the task force, including attorneys and investigators from different offices within the CFTC's Division of Enforcement, promotes and facilitates coordination of the efforts and resources of the various offices and divisions, including the whistleblower program. Any tips received by the whistleblower program from the public on potential violations of the CEA that are connected to fraud or market manipulation in the carbon markets may lead to investigation and review by the Environmental Fraud Task Force.

In addition, the announcement of the creation of the Environmental Fraud Task Force comes on the heels of the CFTC chairman's announcement of the second voluntary carbon markets convening.

In making that announcement, the CFTC chairman noted that the voluntary carbon markets are "at a critical point in their development and growth" and that "the CFTC has an important policy responsibility to promote product innovation, price discovery, and liquidity for high-quality carbon credits that are the underlying commodity for derivatives products listed on CFTC-registered exchanges."

These announcements, along with the CFTC chairman's latest commentary on the CFTC's roles and responsibilities in the voluntary carbon markets, affirm the potential regulatory and enforcement exposure that companies transacting carbon offsets must bear in mind.

Companies that transact carbon offsets will need to ensure that the carbon offsets held reflect an actual reduction or removal of emissions of carbon dioxide or other greenhouse gases — and that such reduction or removal is permanent, verifiable and additional.

They should evaluate whether they have in hand supporting documentation that can be relied on to validate and verify the carbon offsets held, and their quality, additionality, permanence and environmental benefits as represented and used.

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