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THE ESG ENTANGLEMENT: POLICIES AND LAWS AFFECTING FUTURES INTERMEDIARIES

*By Sarah V. Riddell and Erin E. Martin**

I. Investors Continue Investing in ESG Initiatives, Despite Concerns about the Effectiveness and Integrity of Environmental Products

Recent figures reveal that 56% of investors intend to increase their investments in environmental, social, and governance ("ESG") initiatives in 2024, reflecting a "fundamental shift" in the investment mindset.[1] As investors seek to invest in ESG initiatives, futures intermediaries are increasingly becoming entangled in enforcement policies, regulatory pushes, and even state laws in the area of environmental regulation. Many of these efforts address the effectiveness of carbon credit programs, which is relatively low according to at least one report.

Researchers from the University of California, Berkeley, issued a report (the "Berkeley Report") assessing the effectiveness of REDD+ carbon credit programs at reducing deforestation, protecting forest communities, and generating high-quality carbon credits.[2] The researchers found that the crediting methodologies that have generated almost all REDD+ carbon credits to date under Verra, the largest registry for voluntary carbon markets ("VCMs"), generate credits that represent a small fraction of their claimed climate benefit, with estimated emissions reductions "exaggerated across all quantification factors" that the researchers reviewed compared against published literature and the researchers' independent quantitative assessment.[3] For example, the researchers found:

- The REDD+ baseline methodology estimates a project's impacts and credits as the difference between monitored changes in forest carbon and the predicted loss of carbon stocks based on historical deforestation and degradation rates without project intervention looking backward in time, rather than forecasting the baseline at the start of the project to determine the deforestation and degradation rates that were

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likely to occur without the REDD+ project. By using a backward-looking baseline, the project results in a greater number of credits than it would otherwise if using a different baseline methodology.[4]

- The project methodologies did not deduct for leakage (i.e., a deduction for the risk that a project causes production of a commodity (e.g., timber) to shift to another location).[5]
- The project methodologies underestimated durability (i.e., reversal risk, or the risk that the carbon that a project has credited will be released into the atmosphere as a result of natural or human causes during a 100-year period).[6] Although the Berkeley researchers used an estimate only taking into account one type of natural disturbance, they calculated the mean of the reversal risk to be 28%.[7] Verra, however, estimated reversal risk to be 2%.[8]

The Berkeley Report's conclusions find that projects issued 13 times more credits than their climate benefit. According to the Berkeley Report, the over-crediting for projects occurs primarily because the methodologies that the registries use produce this result, but also because projects' incentives are misaligned with climate goals.[9] In addition, the researchers pointed out that Verra was overhauling its REDD+ program with important improvements, yet even these remain vague.[10]

In light of the findings in the Berkeley Report, it should not be surprising that various organizations have initiatives to standardize carbon credit methodologies underway. States and federal agencies are exploring ways to enhance the integrity of VCMs and to protect consumers. This article provides a brief overview of the evolving legal and regulatory landscape, the Commodity Futures Trading Commission's (the "CFTC's" or the "Commission's") jurisdiction in environmental markets, environment-related policies that the CFTC has announced during the past year, and regulatory efforts that have the potential to cause intermediaries to reevaluate their compliance programs.

II. The Rapidly Evolving Regulatory Landscape for Environmental Products

Currently, there is no federal regulatory regime that exists solely with respect to the purchase and sale of physically settled carbon credits that settle through the delivery of the underlying certificate or document of record from seller to purchaser. That said, the landscape concerning regulation of ESG investment practices is evolving at a rapid pace. Many states have launched pro- or anti-ESG campaigns, while California has continued to lead an effort to combat climate change through disclosure laws. In addition, the Securities and Exchange Commission ("SEC") has introduced ESG-related rules over the past several years, with the CFTC not far behind.

A. State ESG Efforts

As of September 4, 2023, 41 states have effective or pending ESG investing rules.[11] Texas, for example, has an anti-boycott law that prohibits governmental entities from investing in financial companies that boycott energy companies and requiring governmental entities to divest of any such investments if the relevant financial company does not cease to boycott energy companies.[12]

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Two other state ESG laws became effective in early 2024. As of January 1, 2024, investment managers must provide a new disclosure to each public agency, pension fund, retirement system, or governmental unit in Illinois prior to the award of a contract.[13] The disclosure consists of a description of the investment manager's process that integrates sustainability factors into the manager's investment decision-making or analysis, portfolio construction, due diligence, and investment ownership to
(1) maximize anticipated financial returns on a risk-adjusted basis; (2) identify projected risk; and (3) execute the manager's fiduciary duties.[14] South Carolina's ESG Pension Protection Act became effective on February 5, 2024. Under this law, the South Carolina Retirement System Investment Commission may engage with a company on the exercise of shareholder proxy votes as long as the engagement is "based solely on pecuniary factors and for the sole purpose of maximizing shareholder value" (unless the proposal does not have a pecuniary impact).[15] In addition, when making an investment decision or allocating capital to an investment strategy, the South Carolina Retirement System Investment Commission "only shall consider pecuniary factors" under the new law.[16] The Chief Executive Officer of the South Carolina Retirement System Investment Commission must certify that the decision to make an investment is based on pecuniary factors and that it "is not being made to promote, further, or achieve any nonpecuniary goal, objective, or outcome"—this certification must be included in the investment's closing documents.[17]

While many states have targeted ESG investments as the focus of their laws, others are focused on disclosure laws. For example, the California legislature passed three environmental disclosure laws on October 7, 2023. The first of these California bills provides that U.S.-based business entities with total annual revenues in excess of $1 billion and that do business in California will be required to publicly disclose and obtain an assurance engagement on Scope 1 and Scope 2 greenhouse gas emissions starting in 2026 and, starting in 2027, Scope 3 greenhouse gas emissions.[18] Another bill, S.B. 261, requires U.S.-based companies with annual revenues exceeding $500 million and doing business in California to publicly disclose climate-related financial risk reports that include climate-related vulnerabilities concerning their employees, supply chains, consumer demand, and shareholder value, among others.[19]

Finally, the California Voluntary Carbon Market Disclosure Act, which became effective on January 1, 2024, requires entities to comply with specific public website disclosure requirements when (1) a business entity is marketing or selling voluntary carbon offsets within the state; (2) an entity purchases or uses voluntary carbon offsets and makes claims (a) regarding the achievement of net zero emissions, (b) that the entity, related entity, or a product is "carbon neutral," or (c) implying the entity, related entity, or a product does not add net carbon dioxide or greenhouse gases to the climate or has made significant reductions to carbon or greenhouse gas emissions;[20] and (3) an entity makes claims (x) regarding the achievement of net zero emissions, (y) that the entity, a related or affiliated entity, or a product is "carbon neutral," or (z) implying that the entity, related or affiliated entity, or a product does not add net carbon dioxide or greenhouse gases (i.e., carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons,

sulfur hexafluoride, and nitrogen trifluoride) to the climate or has made significant reductions to its carbon dioxide or greenhouse gas emissions.[21] Depending on an entity's activities, more than one disclosure requirement may apply. For example, if an entity makes net zero or carbon neutral claims and, in connection with these claims, purchases carbon offsets, the entity would be subject to the second and third disclosure scenarios. In all cases, disclosures must be updated at least annually.

B. The SEC's ESG Focus

The SEC has taken various actions that affect the financial services industry and, in particular, investment advisers, sponsors of registered investment companies, and public issuers. While the SEC has long been focused on the governance aspects of ESG, in 2010, the Commission published interpretative guidance that outlined how its existing public issuer disclosure rules may require specific climate-related disclosure to the extent material to an issuer. In recent years, the SEC's focus on ESG has become even more pronounced. In 2021, the SEC took steps to prioritize ESG and, in particular, actively address ESG-related misconduct by participants in the U.S. capital markets. For example, during 2021, the SEC announced the establishment of the Climate and ESG Task Force within the Division of Enforcement, which was initially focused on material misstatements or omissions regarding climate-related risks in issuers' disclosure.[22] The Division of Examinations subsequently issued a Risk Alert on ESG Investing, explaining that the Examinations staff would focus on ESG disclosure and compliance practices of investment advisers, registered investment companies, and private funds related to portfolio management practices, performance advertising and marketing, and compliance programs.[23] Also in 2021, the then-acting chair of the agency released a statement soliciting public input on climate change disclosures,[24] and later that year, the Division of Corporation Finance published a sample letter to public companies outlining the types of climate-related issues that public company issuers should consider in their disclosure.[25]

In 2023, the SEC adopted amendments to Rule 35d-1 (i.e., the Names Rule) under the Investment Company Act of 1940 to apply to a registered investment company.[26] Any fund name that includes terms that suggest a focus in investments that have, or investments whose issuers have, "particular characteristics"—such as ESG—will require an 80% investment policy for such funds, subject to certain exceptions.[27] While not yet adopted, the SEC has also proposed an ESG rulemaking for investment advisers and funds, which is intended, in part, to address the SEC's growing concerns regarding greenwashing.[28] By establishing a new ESG disclosure framework for prospectuses, annual reports, and adviser brochures, the proposed amendments would provide more standardized disclosures and reporting of ESG information not only to investors, but also to the SEC.

More recently, in March 2024, the SEC finalized long-awaited rules requiring public companies to disclose climate-related information in registration statements and annual reports, such as climate-related risks and how they are managed and overseen, climate-related targets or goals, if any, and material impacts on financial estimates and assumptions as a result, and certain financial statement disclosure related costs, expenditures and losses incurred as a result of se-

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vere weather events and other natural conditions and/or related to carbon offsets or renewable energy certificates.[29] In a critical pivot from the SEC's proposed version of the rule, the SEC removed the requirement that issuers disclose Scope 3 GHG emissions and instead the final rules only require larger public companies to disclose Scope 1 and Scope 2 GHG emissions, if material.[30] Shortly after the final rules were released, numerous petitions were filed with federal appellate courts seeking intervention. Following the Fifth Circuit's administrative stay of the rules, the SEC filed a multicircuit petition to determine the forum based on a random draw, and the Eighth Circuit was selected on March 21, 2024 to hear the consolidated petitions for review.[31] Following these events, the SEC issued a voluntary stay of the rules pending the completion of the judicial review of the consolidated petitions, but emphasized that such action was not intended to contradict its view that the rules are consistent with its authority and mandate disclosure that is important to investors in making informed investment decisions.[32] While the ongoing legal challenges cast a shadow of uncertainty over the SEC's climate-related disclosure rules, companies may still take proactive measures to ensure compliance and identify where competing regulatory frameworks (e.g., those of the European Union and certain states) can be leveraged.

III. The CFTC's Environmental Policies and Other Initiatives

CFTC Chairman Rostin Behnam has taken an important interest in the carbon markets. In addition to hosting two carbon markets convenings, Chairman Behnam has issued a request for information on climate change and established a Climate Risk Unit within the CFTC. Under his oversight, the CFTC's Division of Enforcement has indicated that it will pursue carbon market fraud and manipulation. Although futures exchanges have offered environmental contracts for nearly 20 years, the CFTC increasingly has signaled that it intends to become involved in environmental markets, specifically focusing on carbon markets.

A. CFTC Authority to Police Commodity Markets

The Commodity Exchange Act ("CEA") 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.[33] The CEA broadly defines a "commodity" such that carbon, carbon offsets, renewable energy certificates, and other environmental offsets, credits and allowances are considered commodities. In addition, CFTC-regulated futures exchanges offer futures and options contracts on commodities that originate on VCMs and compliance carbon markets ("CCMs"). For example, ICE Futures U.S. lists physically delivered California Air Resources Board ("CARB") greenhouse gas emissions offset credits that are CARB-issued certificates (or that are issued by a linked program) that each represents one metric ton equivalent of greenhouse gas emission reduction or removal enhancements. Likewise, CME Group lists futures on California carbon allowances and the Regional Greenhouse Gas Initiative CO_2 allowances. The CFTC's jurisdiction to oversee and regulate these futures and similar derivative products is exclusive under the CEA.

Although the CFTC does not have full author-

ity to oversee commodities in the spot market, it has antifraud and antimanipulation jurisdiction over spot commodities. Pursuant to Section 6(c)(1) of the CEA, the CFTC has antifraud and antimanipulation jurisdiction with respect to any commodity in interstate commerce (in addition to swaps and futures contracts), and Section 9(a)(2) of the CEA makes it a felony to manipulate or attempt to manipulate the price of any commodity in interstate commerce, futures contract, or swap (among other things).[34] CFTC Regulation 180.1 codifies the statutory directive, making it unlawful for any person to intentionally or recklessly, in connection with any contract of sale of any commodity in interstate commerce, futures contract or swap, to use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud.[35] The regulation also makes it unlawful for any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, futures contract or swap, whether directly or indirectly.[36] Through this jurisdictional trigger, the CFTC's jurisdiction extends to the purchase and sale of physically settled commodity contracts for the purpose of policing potential instances of fraud and manipulative activity.

Despite the CFTC's limited jurisdiction over spot commodities, the CFTC's authority to prosecute alleged violations of fraud or manipulation in a commodity in interstate commerce is not limited to those commodities that underlie futures contracts or swap transactions. The CFTC's enforcement actions in digital assets markets have solidified this expansive scope of authority. In 2015, the CFTC settled an enforcement action against a digital asset platform and its chief executive officer for various violations of the CEA and CFTC regulations in connection with the operation of a bitcoin options exchange.[37] In this settlement order, the CFTC found that, irrespective of whether a commodity was the underlying of a futures or other commodity interest contract, "Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities."[38] Subsequently, a federal court agreed with the CFTC's position, making it clear that the CFTC may exercise its jurisdiction when there is potential fraud in a spot market, even if the fraud does not involve a commodity traded in the spot market that underlies a derivative.[39]

B. Initiatives from 2019 to 2022: The CFTC Shows Greater Interest in Climate Policy

Beginning in 2019, then-Commissioner Behnam established the Climate-Related Market Risk Subcommittee of the Market Risk Advisory Committee. In 2020, this subcommittee adopted a "first-of-its kind" report on managing climate risk in the U.S. financial system, with various recommendations for further studies and reports on climate risk.[40] Chairman Behnam subsequently organized the CFTC's first Voluntary Carbon Markets Convening with the goal of discussing opportunities and challenges in carbon offsets and carbon derivatives markets and issues related to the supply and demand for high-quality carbon offsets, including product standardization and data integrity.[41] The CFTC issued a climate-focused request for information the same month as the convening "to better inform its understanding and oversight of climate-related financial risk as pertinent to the derivatives markets and underlying commodities markets."[42] In response to this request for information, Commissioner Mersinger and some commenters addressed whether the Commission possesses the statutory authority to engage in environmental-related rulemaking.[43]

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C. Initiatives in 2023: Ramp-Up in CFTC Policymaking Efforts

Although the CFTC has engaged in a limited rulemaking exercise since its request for information, it has pursued an enforcement approach in environmental markets, which raises little doubt about the CFTC's authority. The CFTC's interest in prosecuting fraud and misconduct in carbon markets became apparent in mid-2023. The CFTC's Whistleblower Office, in a first-ever effort, issued an alert seeking whistleblowers who become aware of misconduct, including manipulative trading in futures contracts with carbon credit underlyings (including wash trading), fraud in the underlying carbon markets (e.g., ghost or illusory credits), double counting carbon credits, and fraudulent statements in connection with material terms of a carbon credit (e.g., quality, quantity, project type, environmental benefits), among other types of misconduct.[44] Double counting can occur if a carbon credit is not deregistered after it is sold and it is subsequently resold. Ghost, or illusory, credits create the illusion of market activity and manipulate pricing and may not have any real value attached to them. Whistleblowers can become eligible for financial awards and certain protections by voluntarily providing original information about potential misconduct under and violations of the CEA that leads the CFTC to bring a successful enforcement action that results in monetary sanctions of more than $1 million.

Shortly after issuing the whistleblower alert, the CFTC established the Environmental Fraud Task Force to examine fraud and other misconduct in derivatives and spot markets (e.g., VCMs or CCMs) and material misrepresentations related to ESG products or strategies.[45] The Environmental Fraud Task Force will examine fraud related to the purported environmental benefits of purchasing carbon credits and registrants' material misrepresentations about their ESG products or strategies. It is likely that the Environmental Fraud Task Force will pursue fraud and misconduct involving the types of activity for which the Whistleblower Office asked market participants to provide.

The CFTC held a second Voluntary Carbon Markets Convening in July 2023 at which further policy announcements were made. Commissioner Goldsmith Romero continued to recommend that the CFTC adopt a heightened review framework of any self-certified environmental products that are listed on exchanges and adopt a similar approach as that adopted for digital assets.[46] In her opening remarks at the second Voluntary Carbon Markets Convening, she reiterated her belief that bringing more of the VCMs onto exchanges would increase transparency and bring greater confidence to the market.[47] The heightened review would include consideration of whether a contract is readily susceptible to manipulation and factors specific to carbon markets, including an information-sharing agreement with the carbon registry, baseline standards for carbon offsets, and reference to the Integrity Council for Voluntary Carbon Markets' core carbon principles.[48]

During this convening, CFTC Chairman Behnam announced that the CFTC's Climate Risk Unit is leading a workstream to draft agency guidance addressing standards in the VCMs.[49] The CFTC subsequently issued the proposed guidance in another step toward exercising oversight over the carbon markets.[50] The proposed guidance applies solely to exchanges that offer

derivatives on voluntary carbon credits. When determining whether a crediting program for a voluntary carbon credit is a reliable source of high-integrity credits, the proposed guidance explains that exchanges should evaluate (1) quality standards; (2) delivery points and facilities; and (3) inspection provisions. The proposed guidance adopted some of Commissioner Goldsmith Romero's recommendations, but did not incorporate the information sharing or other recommendations. Commissioners Johnson and Goldsmith Romero expressed their desire for the CFTC to play a greater role in overseeing voluntary carbon credit markets.[51] Commissioner Johnson pointed out that swap dealers are subject to disclosure and fair-dealing requirements and, therefore, the material risks, characteristics, and incentives, as well as conflicts of interest, about the underlying commodity on which a derivative is priced should be part of a fulsome disclosure to provide counterparties with adequate information to understand how the price of the derivative could be impacted by the carbon credit.[52]

D. Initiatives in 2024: In Like a Lamb, Out Like a Lion?

The CFTC's carbon-related efforts in 2024 have been less zealous than one might have expected, but the year is far from being over. In the first several months of 2024, the CFTC held various advisory committee meetings, some of which focused on rare minerals,[53] traditional energy markets,[54] and climate-related market risk.[55] In March 2024, the Climate-Related Market Risk Subcommittee (a subcommittee of the Market Risk Advisory Committee) held a meeting to discuss market integrity, enforcement, and market and product design.[56] Although these meetings seem relatively benign, a lot can happen in the second half of the year. For example, the CFTC could adopt guidance for DCMs that offer derivatives on voluntary carbon credits or take enforcement action in connection with voluntary carbon credit markets.

Collectively, the establishment of the Environmental Fraud Task Force, the alert from the CFTC's Whistleblower Office, the discussion and announcements during the second Voluntary Carbon Markets Convening, and the proposed guidance further the CFTC's efforts to build on its expertise and ability to identify and pursue potential fraud or abusive practices in the carbon markets. Enforcement is likely to be the driving force behind the CFTC's approach to carbon markets in the near term, but the CFTC has only just begun its rulemaking efforts. Market participants, particularly intermediaries, should expect Commissioner Johnson to renew her call for disclosure requirements.

IV. The ESG Effect on Futures Intermediaries

As state and federal initiatives continue to gain momentum, futures intermediaries that offer ESG strategies and execution and clearing services in environmental products, need to determine whether their activities are in-scope for these requirements. Thus, commodity pool operators ("CPOs"), commodity trading advisors ("CTAs"), and futures commission merchants ("FCMs") need to stay current with these legal and regulatory changes. To do so, futures intermediaries should consider incorporating ESG into their periodic compliance reviews to check for legal and regulatory developments at the state and federal levels, including applicable guidance (e.g., the SEC's Division of Examination's Risk Alert on ESG Investing), and best practices. Once

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this review has been completed, futures intermediaries may need to update relevant compliance manuals and training modules to reflect these developments and best practices.

Futures intermediaries can perform a comprehensive ESG review now, focusing on recent laws and CFTC guidance that could impact their business activities. In the near term, it is likely that CFTC regulation in the environmental and carbon area will first focus on spot market fraud and manipulation, establishing a baseline of standards for carbon credits through enforcement measures. Accordingly, it is critical to consider how the CFTC has viewed fraud and manipulation historically to anticipate how it will apply its jurisdiction in the case of carbon offsets. In addition, futures intermediaries may need to enhance their policies related to trade practices to account for the CFTC's enforcement goals in environmental markets.

- For example, futures intermediaries should examine whether traditional trade practices need to be updated to account for the unique types of fraudulent or manipulative activities that could occur in VCMs. Is a futures intermediary taking steps to avoid engaging in ghost credits, double counting, fraudulent statements relating to material terms of the carbon credits, and potential manipulation of tokenized carbon markets? Has the intermediary ensured that it does not resell a voluntary carbon credit that had previously been sold without being deregistered?
- Futures intermediaries should consider whether their policies related to cross-manipulation include VCMs. Under a cross-market manipulation scheme, a market participant trades in one market (i.e., physically settled products) with the intent to impact a related product or benefit a position in a related market (i.e., financially settled derivative products whereby the price is tied to the physically settled product that the market participant trades). For example, the CFTC has conducted investigations into cross-market spoofing where a market participant engages in spoofing in one market to benefit a position in another market, where the price of the two markets is generally correlated.[57] Can a futures intermediate demonstrate that its trading in both physically settled and financially settled markets was undertaken in response to the legitimate forces of supply and demand (such as effectuating purchases and sales to meet demand for the product)?

CPOs and CTAs offering ESG strategies should consider whether their disclosure documents need to be updated to properly reflect the risks involved with these strategies. In addition, for those CPOs and CTAs that are registered with the SEC as investment advisers, compliance with SEC rules or other guidance will continue to be a priority. The SEC has progressed its climate-related efforts in nearly all areas, with the exception of its proposal for investment advisers. Even amidst the legal challenges the SEC currently faces with respect to its climate rules for public companies, dually-registered CTA/investment advisers should be prepared for the SEC to adopt rules with which they must comply. To the extent that trading in VCMs or other ESG-related activities present product-related, operational, or other types of risks, FCMs may need to update their risk management program to account for these risks.

Monitoring state ESG-related laws has become

necessary, even for futures intermediaries that are organized outside of states with these laws. States that introduce anti-boycott rules could impact the ability of a commodity pool to attract investments of state pension plans' assets, whereas state disclosure laws may require futures intermediaries to conduct additional diligence to be able to make the requisite disclosures. The California disclosure laws are an example of broad laws that apply to not only companies doing business in California with a certain threshold of revenue, but also to businesses that simply market or sell voluntary carbon offsets within the state. Other states may follow California's lead and introduce similar laws. When such disclosure laws apply, any CPO or FCM trading, or CTA advising clients on making investments in, voluntary carbon credits, will need to have documentation about the projects generating the credits to comply with these laws.

V. Conclusion

The past several years of state legislative and CFTC and SEC initiatives demonstrate a concerted effort on the part of state and federal lawmakers to combat climate change, greenwashing, and fraud in environmental markets, with the financial services industry in the crosshairs of these efforts. CPOs, CTAs, and FCMs should continue monitoring for environment-related developments and consider how their activities could fall within the scope of any new legal or regulatory initiative.

ENDNOTES:

[1]deVere Group Survey; *see* Chloe Cheung, *Over Half of Investors Plan to Increase ESG Investments in 2024*, FT Adviser, Dec. 1, 2023.

[2]Barbara K. Haya, et al., Berkeley Public Policy, The Goldman School Berkeley Carbon Trading Project, Quality Assessment of REDD+ Carbon Credit Projects (Sep. 15, 2023), https://gspp.berkeley.edu/assets/uploads/page/Quality-Assessment-of-REDD+-Carbon-Crediting.pdf. The researchers acknowledged that data was not widely available due to a lack of transparency. *Id.* at 7.

[3]*Id.* at 1.

[4]*Id.* at 3-4.

[5]*Id.* at 4.

[6]*Id.*

[7]*Id.* at 5.

[8]*Id.*

[9]*Id.* at 8.

[10]*Id.* at 7.

[11]*See, e.g.*, Mana Behbin, et al., ESG Investing Regulations Across the 50 States (Jul. 21, 2023), https://www.morganlewis.com/pubs/2023/07/esg-investing-regulations-across-the-50-states.

[12]Tex. S.B. No. 13 (May 28, 2021; effective Sep. 1, 2021).

[13]Ill. H.B. 2782, amending the Illinois Sustainable Investing Act; 30 Ill. Comp. Stat. 238/10(e).

[14]*Id.* The sustainability factors include: (1) corporate governance and leadership factors; (2) environmental factors, such as greenhouse gas emissions, air quality, management of energy, waste, hazardous materials, water and wastewater, and ecological impacts; (3) social capital factors, such as human rights, customer welfare, customer privacy, data security, access and affordability, product labeling and selling practices, and community relations and reinvestment; (4) human capital factors, including labor practices, contractor policies, employee health and safety, diversity and inclusion, employee engagement, and incentives and compensation; and (5) business model and innovation factors that include supply chain management and materials sourcing and efficiency, business model resilience, physical impacts of climate change, and product design

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and life cycle management. 30 Ill. Comp. Stat. 238/10(b).

[15]S.C. H.B. 3690 (the ESG Pension Protection Act), amending S.C. Code § 9-16-10, et seq. The law establishes a definition of "pecuniary factor," defining such term to mean "a factor that a prudent person in a like capacity would reasonably believe has a material effect or impact on the financial risk or return on an investment, including factors material to assessing an investment manager's operational capability, based on an appropriate investment horizon consistent with a retirement system's investment objectives and funding policy. The term excludes "nonpecuniary factors" which is any factor or consideration that is collateral to or not reasonably likely to effect or impact the financial risk and return of the investment and include, but are not limited to, the promotion, furtherance, or achievement of environmental, social, or political goals, objectives, or outcomes." S.C. Code § 9-16-10(10).

[16]S.C. Code § 9-16-50(A)(5).

[17]S.C. Code § 9-16-330(B)(2).

[18]S.B. 253, the Climate Corporate Data Accountability Act. The type of assurances that must be provided ramp up from a "limited assurance" level (i.e., a baseline level of assurance where an independent auditor has sufficient and appropriate evidence to provide assurances for specific types of the reporting) until 2030 to a higher "reasonable assurance" level (i.e., the highest level of assurance, requiring evidence demonstrating that there are no material misstatements in the reporting) starting in 2030.

[19]S.B. 261.

[20]This requirement does not apply to entities that do not operate within California or do not purchase or use voluntary carbon offsets sold within California.

[21]This requirement does not apply to entities that do not operate within California or do not make claims within California.

[22]*See* SEC Announces Enforcement Task Force Focused on Climate and ESG Issues, https://www.sec.gov/news/press-release/2021-42. The task force's webpage includes examples of ESG-related enforcement actions. *See* https://www.sec.gov/securities-topics/enforcement-task-force-focused-climate-esg-issues.

[23]The Division of Examinations' Review of ESG Investing (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.

[24]*See* Lee, Allison Herren, Acting Chair, SEC, Statement: Public Input Welcome on Climate Change Disclosures (Mar. 15, 2021).

[25]*See* SEC Division of Corporation Finance, Sample Letter (Sept. 2021).

[26]Investment Company Names, Rel. No. IC-3500 (Sep. 20, 2023); 88 Fed. Reg. 70,436 (Oct. 11, 2023).

[27]*Id.* In addition, the amendments to the Names Rule introduce new compliance and reporting requirements related to departures from the 80% investment policy requirement and substantial recordkeeping requirements. By virtue of public reporting on Form N-PORT required by the amendments, SEC staff will now have visibility into a fund's compliance with the requirements of the Names Rule. *Id.*

[28]Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, Release No. 33-11068 (May 25, 2022), 87 Fed. Reg. 36,654 (Jun. 17, 2022).

[29]*See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release Nos. 33-11275, 34-99678 (Mar. 6, 2024), 89 Fed. Reg. 21,668 (Mar. 28, 2024).

[30]*See id.*

[31]*See id.*

[32]In the Matter of the Enhancement and Standardization of Climate-Related Disclosures for Investors, Order Issuing Stay, Release Nos. 33-11280, 34-99908 (Apr. 4, 2024).

[33]Section 2(a)(1)(A) of the CEA; 7 U.S.C.A. § 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.

[34]Section 6(c)(1) of the CEA; 7 U.S.C.A. § 9(c)(1). In the adopting release to Part 180 of the CFTC's regulations, the CFTC noted: "And although CEA section 6(c)(1) and final Rule 180.1 give the Commission broad enforcement authority to prohibit fraud and manipulation in connection with a contract of sale for any commodity in interstate commerce, the Commission expects to exercise its authority under 6(c)(1) to cover transactions related to the futures or swaps markets, or prices of commodities in interstate commerce, or where the fraud or manipulation has the potential to affect cash commodity, futures, or swaps markets or participants in these markets." Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,401, https://www.govinfo.gov/content/pkg/FR-2011-07-14/pdf/2011-17549.pdf (citations omitted).

[35]17 C.F.R. § 180.1(a)(1).

[36]17 C.F.R. § 180.2.

[37]*In re Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (Sep. 17, 2015), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf.

[38]*Id.* at 3.

[39]*Commodity Futures Trading Commission v. McDonnell*, 287 F. Supp. 3d 213, Comm. Fut. L. Rep. (CCH) P 34222 (E.D. N.Y. 2018), adhered to on denial of reconsideration, 321 F. Supp. 3d 366, Comm. Fut. L. Rep. (CCH) P 34289 (E.D. N.Y. 2018). *See also Commodity Futures Trading Commission v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 497-98, Comm. Fut. L. Rep. (CCH) P 34345 (D. Mass. 2018) (holding that the CFTC may allege that My Big Coin is a "commodity" under the CEA based on the CEA's general and categorical definition of "commodity"). In *My Big Coin Pay*, the court noted, "Congress' approach to defining 'commodity' signals an intent that courts focus on categories—not specific items—when determining whether the 'dealt in' requirement is met." *Id.* at 497.

[40]*See* CFTC Climate-Related Market Risk Subcommittee, *Managing Climate Risk in the U.S. Financial System* (Sep. 9, 2020), https://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.

[41]Announcement of Voluntary Carbon Markets Convening on June 2, 2022 (May 11, 2022), https://www.cftc.gov/PressRoom/PressReleases/8525-22.

[42]Request for Information on Climate-Related Financial Risk, 87 Fed. Reg. 34,856 (Jun. 8, 2022), https://www.govinfo.gov/content/pkg/FR-2022-06-08/pdf/2022-12302.pdf.

[43]*See, e.g.*, Concurring Statement of Commissioner Summer K. Mersinger Regarding Request for Information on Climate-Related Financial Risk (Jun. 2, 2022), https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement060222; Letter to CFTC, from Benjamin Zycher, Senior Fellow, American Enterprise Institute, in his individual capacity, dated Oct. 6, 2022; Letter to Rostin Behnam, Chairman, CFTC, from U.S. Representatives Byron Donalds and Don Bacon, dated Sept. 16, 2022; and Letter to Christopher Kirkpatrick, Secretary, CFTC, from Tom Quaadman, Executive Vice President, U.S. Chamber of Commerce, dated Oct. 6, 2022.

[44]CFTC Whistleblower Office, CFTC Whistleblower Alert: Blow the Whistle on Fraud or Market Manipulation in the Carbon Markets (June 20, 2023), https://www.whistleblower.gov/sites/whistleblower/files/2023-06/06.20.23%20Carbon%20Markets%20WBO%20Alert.pdf.

[45]CFTC Press Release No. 8723-23 (Jun. 29, 2023), https://www.cftc.gov/PressRoom/PressReleases/8736-23.

[46]Opening Statement of Commissioner Christy Goldsmith Romero: The CFTC's Role

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with Voluntary Carbon Credit Markets (Jul. 19, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement071923b.

[47] *Id*.

[48] Remarks of Commissioner Christy Goldsmith Romero at ISDA's ESG Forum on Promoting Market Resilience: A Thoughtful Approach to the Daunting Challenge of Climate Financial Risk (Mar. 7, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/oparomero7. In at least three separate events, CFTC Commissioner Goldsmith Romero recommended that the CFTC follow a similar oversight approach to environmental products as the oversight approach adopted for digital assets. *See, e.g.*, Keynote Address by Commissioner Christy Goldsmith Romero at FIA & SIFMA Asset Management Derivatives Forum (Feb. 10, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/oparomero6; Remarks of Commissioner Christy Goldsmith Romero at ISDA's ESG Forum on Promoting Market Resilience: A Thoughtful Approach to the Daunting Challenge of Climate Financial Risk (Mar. 7, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/oparomero7; Closing Remarks of Commissioner Christy Goldsmith Romero at the Global Research Alliance for Sustainable Finance and Investment Annual Conference (Aug. 25, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/oparomero10. As described by Commissioner Goldsmith Romero, this approach would include (1) conducting consumer education for consumers on Environmental/Climate-Related products, including education related to the qualities of a high-quality carbon offset, (2) asserting the CFTC's anti-fraud legal authority, including in spot carbon offset markets, (3) increasing market intelligence to provide regulatory and enforcement insights into the markets, (4) robust enforcement over the derivatives markets as well as the cash or spot markets to prosecute fraud, manipulation, false solicitation, and other misconduct in the markets, and (5) government-wide (federal and state) and international coordination. *See id.* Each of these components was part of the CFTC's digital asset regulatory and enforcement approaches.

[49] Opening Statement of Chairman Rostin Behnam at the Second CFTC Voluntary Carbon Markets Convening (Jul. 19, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement071923.

[50] Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts (Proposed Dec. 4, 2023), https://www.cftc.gov/media/9831/federalregister120423/download.

[51] *See* Statement of Commissioner Christy Goldsmith Romero on Exchange Listing Standards for Voluntary Carbon Credit Derivative Contracts (Dec. 4, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement120423; Statement of Commissioner Christy Goldsmith Romero on Exchange Listing Standards for Voluntary Carbon Credit Derivative Contracts (Dec. 4, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement120423. 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.

[52] Statement of Commissioner Christy Goldsmith Romero on Exchange Listing Standards for Voluntary Carbon Credit Derivative Contract.

[53] Energy and Environmental Markets Advisory Committee (Feb. 13, 2024), https://www.cftc.gov/PressRoom/PressReleases/8855-24.

[54] Energy and Environmental Markets Advisory Committee (Apr. 10, 2024), https://www.cftc.gov/PressRoom/Events/opaeventeemac041024.

[55] Market Risk Advisory Committee (Apr. 9, 2024), https://www.cftc.gov/PressRoom/PressReleases/8889-24.

[56] Climate-Related Market Risk Subcommittee (Mar. 15, 2024), https://www.cftc.gov/PressRoom/PressReleases/8875-24.

[57]*E.g.*, *In re Victory Asset, Inc.*, CFTC Docket No. 18-36, Order Instituting Proceedings Pursuant to Section 6(c) and (d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (Sept. 19, 2018).

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