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WHITE PAPER

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The CFTC Finalizes Guidance on Voluntary Carbon Credit Contracts for Derivatives Markets

The Commodity Futures Trading Commission ("CFTC" or "Commission") has inserted itself in recent years into efforts to scale the cash market for "high integrity" voluntary carbon credits. On September 20, 2024, the Commission approved final guidance regarding designated contract markets ("DCMs") listing for trading voluntary carbon credit ("VCCs") derivative contracts. The guidance outlines factors for DCMs to consider when addressing relevant Commodity Exchange Act Core Principles and Commission regulations. Although the guidance couches its content as factors for consideration by DCMs, the tone and other aspects of the guidance seem to indicate, at least in some cases, an expectation by the Commission that designated contract markets will treat those factors as requirements. The guidance will likely increase scrutiny of VCCs from both DCMs and the Commission, which the existing recordkeeping and record production obligations that the Commission emphasized in the guidance will facilitate.

Given the outcome of the presidential election, the Commission might attempt to withdraw the guidance, though other agencies have failed in this regard due to Administrative Procedure Act shortcomings.

BACKGROUND

As discussed in our December 2023 *Commentary*, "The CFTC Proposes 'Guidance' for Derivatives Markets on Listing Voluntary Carbon Credit Derivatives," investors, regulators, and lawmakers have raised questions about the integrity and quality of VCCs. For both buyers and sellers, a key concern has been whether VCCs, which are issued by carbon crediting programs, accurately represent the nature and level of GHG emission reductions or removals that they are intended to represent. The CFTC observed that challenges in determining VCCs' quality and associated pricing concerns can undermine confidence in voluntary carbon markets. It did note that there are emerging private-sector and multilateral initiatives to address these challenges that are focused on developing standards for high-integrity VCCs.

These issues drew the attention of CFTC Chairman Rostin Behnam, who has made the voluntary carbon markets and energy transition a CFTC priority (see our December 2023 *Commentary* for a brief history of the CFTC's prior engagement in this area). Chairman Behnam stated that the goal of the guidance is ultimately to promote standardization and efficient capital allocation to scale the underlying cash market for high-integrity VCCs by driving transparency, liquidity, and market integrity in the VCC derivatives markets.

On December 4, 2023, the CFTC released proposed guidance outlining factors that DCMs should consider when listing VCCs. The proposed guidance focused on physically settled VCC derivatives, but according to the CFTC, may also be relevant to cash-settled VCC derivatives. Similarly, although the proposed guidance was directed to DCMs, the CFTC stated that the guidance may also be relevant to swap execution facilities that list VCC swaps.

While many commenters expressed general support for the proposed guidance, DCMs expressed concerns that the guidance would establish new obligations, perhaps with an eye to the 2023 CFTC Whistleblower Alert soliciting tips regarding potential fraud and manipulation in the carbon markets, the formation of the new CFTC Division of Enforcement Environmental Fraud Task Force, and the recent CFTC actions for fraud in voluntary carbon markets. In response, the Commission emphasized that its guidance neither establishes new obligations for DCMs nor is intended to modify or supersede existing statutory or regulatory obligations or Commission guidance addressing listing derivative contracts. Although one DCM commented that the existing framework already provides sufficient guidance and flexibility, the CFTC went ahead and provided the guidance anyway.

Overall, the Commission adopted the final guidance largely as proposed. The agency did make several modifications in response to commenters; however, some of those may lack sufficient clarity for market participants. For example, despite commenters indicating that there is no industry consensus on what constitutes "additionality," the guidance maintains that DCMs should consider whether a crediting program's additionality testing procedures "provide a reasonable assurance that . . . emission reductions or removals are credited only if they are additional."

THE GUIDANCE

On October 15, 2024, the Commission published final guidance for derivatives markets concerning the listing of VCC derivative contracts.[1] The guidance focuses principally on how DCMs can comply with certain of their obligations ("Core Principles") under the Commodity Exchange Act ("CEA"). At a high level, the guidance addresses DCMs' role in: (i) preventing price manipulation; and (ii) monitoring the relationship between contract terms and conditions and the underlying commodity to prevent misconduct, market disruptions, and distortions. It also highlights certain submission criteria when DCMs list new VCC derivatives contracts.

In comments to the proposed guidance, DCMs and some market participants were concerned that a DCM could be required to independently confirm the sufficiency of a crediting program's policies and procedures for ensuring high-integrity VCCs—a responsibility for which DCMs may not have the requisite expertise. In the final guidance, the CFTC clarified that although DCMs do have statutory and regulatory obligations that are relevant to the design and listing for trading of derivative contracts, as a general matter, industry-recognized standards for high-integrity VCCs can serve as tools for DCMs in connection with their consideration of the VCC commodity characteristics outlined in the final guidance.

Listing Only Contracts Not Readily Susceptible to Manipulation

Core Principle 3 requires DCMs to list only for trading derivative contracts not readily susceptible to manipulation. To effectuate that Core Principle, existing CFTC guidance in Appendix C to Part 38 of the CFTC's regulations states that the terms and conditions of the contract "should describe or define all of the economically significant characteristics or attributes of the commodity underlying the contract." At a high level, the CFTC stated that—to comply with the requirement in existing guidance calling for DCMs to describe the economically significant features of the commodity underlying a DCM contact in the contract's terms and conditions—DCMs should take into account that VCC standardization and accountability mechanisms are still developing and should update the terms and conditions of a VCC derivatives contract to reflect the latest standards and mechanisms and other VCC market developments applicable to that VCC.

Quality Standards. Like the proposed guidance, the final guidance highlights four characteristics that DCMs should consider when designing quality standards for VCC derivative contracts: (i) transparency; (ii) additionality; (iii) permanence and accounting for the risk of reversal; and (iv) robust quantification of GHG reduction/removal.

The Commission also stated that "the measures that a crediting program has in place with respect to social and environmental safeguards[] and net zero alignment[] may impact market participants' evaluat[ion] [of] the quality of the VCCs … issued by the crediting program." Therefore, it may be appropriate for a DCM to determine, when addressing quality standards, whether the crediting program has implemented measures to help ensure that credited mitigation projects: (i) meet or exceed social and environmental safeguards best practices; and (ii) are incompatible with achieving net zero GHG emissions by 2050. Commissioner Mersinger dissented in part on this basis, characterizing the guidance as "includ[ing] veiled attempts to propagate controversial political ideologies best left to debate by voters and elected officials" because "ESG[] compliance and Net Zero goals are completely immaterial to the ability of … [DCMs] to meet their regulatory obligations."

Transparency. The contract terms should clearly specify key features of the VCCs eligible for delivery, including specifying the permitted crediting programs from which VCCs may be issued and whether deliverable VCCs are associated with certain categories of projects (e.g., nature-based). When designing a VCC derivatives contract, DCMs should also consider whether the underlying VCC crediting program makes detailed information about its policies and procedures and the projects or activities that it credits—such as relevant project documentation—publicly available in a searchable and comparable manner.

Additionality. Although the CFTC did not define "additionality" in the guidance (because comments reflected variation in how "additionality" is defined and sought to apply different definitions), a DCM should consider whether underlying VCC crediting programs have additionality assessment or testing procedures. Instead, DCMs were encouraged to use "industry-recognized standards" (the CFTC cited several but did not mandate any particular one or state how one should be chosen) for assessing additionality in crediting programs.

Permanence and Accounting for the Risk of Reversal. A DCM should consider whether: (i) underlying VCC crediting programs have measures (including buffer reserves) in place to address and account for the risk of reversal; (ii) they regularly review the buffer (or other) calculation methodology; and (iii) the continuing sufficiency of the reserve (or other measure) is audited.

Robust Quantification of GHG Reduction/Removal. Given the current lack of a standardized methodology or protocol to quantify GHG emission reductions or removals levels, a DCM should consider whether there is reasonable assurance that the quantification methodology(ies) or protocol(s) used by the crediting program for calculating emission reductions or removals is "robust, conservative, and transparent."

Delivery Points and Facilities. DCMs should consider the governance framework and tracking mechanisms of crediting programs, as well as the crediting program's measures to prevent double-counting.

Governance. A DCM should consider whether the crediting program for underlying VCCs has a governance framework in place that supports the crediting program's independence, transparency, and accountability and whether the governance framework is public. Relevant factors in this regard could include, without limitation:

- The program's decision-making procedures, including who is responsible for program administration and conflict of interest measures;
- Reporting and disclosure procedures;
- Public and stakeholder engagement processes, including whether there are appeals mechanisms; and
- Risk management policies, such as financial resources/reserves, cybersecurity, and anti-money laundering policies.

Tracking. A DCM should consider whether: (i) the VCC crediting program has processes and procedures in place to help ensure clarity and certainty with respect to the issuance, transfer, and retirement of VCCs; (ii) the crediting program operates or makes use of a registry; and (iii) there is reasonable assurance that the registry has effective measures in place to:

- Track the issuance, transfer, and retirement of VCCs;
- Identify who owns or retires a VCC; and
- Ensure that each VCC is uniquely and securely identified and associated with a single emission reduction or removal of one metric ton of carbon dioxide equivalent.

No Double-Counting. A DCM should consider whether the VCC crediting program has measures in place that provide reasonable assurance that credited emission reductions or removals are not double-counted.[2]

Inspection Provisions. The Commission believes that any inspection or certification procedures for verifying compliance with quality requirements or any other related delivery requirements for physically settled VCC derivative contracts should be specified in the contract's terms and conditions for transparency. DCMs should consider whether there is reasonable assurance that the VCC crediting program:

- Has up-to-date, robust, and transparent procedures for validating and verifying that credited mitigation projects or activities meet the crediting program's rules and standards; and
- Has procedures reflecting best practices with respect to third-party validation and verification, which may include:
  - crediting program reviews of the performance of its validators;
  - procedures for remediating performance issues;
  - not using the same third-party validator to verify every project type or project category; and
  - using separate third parties to conduct initial and ongoing validations and verifications.

Monitoring the Relationship of a Contract's Terms and Conditions to the Underlying Market

Core Principle 4 requires a DCM to prevent manipulation, price distortion, and disruptions of the physical delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures. DCMs should monitor contract terms and conditions to ensure that the underlying VCCs continue to reflect the latest applicable certification standard(s) in order to satisfy Core Principle 4's requirement to monitor contract terms and conditions to prevent manipulation, price distortion, and settlement disruption. The CFTC also reminded market participants of existing recordkeeping obligations and that those records are subject to review by DCMs on which they trade and by the CFTC.

DCMs Must Satisfy Product Submission Requirements

Part 40 of the CFTC's regulations specifies two processes by which a DCM may list a new VCC derivatives contract for trading. The DCM may provide a "self-certification" that the contract complies with the CEA and CFTC regulations, or it may elect voluntarily to seek prior CFTC approval of the contract. Although all of the submission requirements apply to the listing by a DCM of any derivative contract, in the final guidance, the CFTC highlighted three existing contract submission requirements of importance in a submission for a VCC derivative contract.

First, a contract submission to the Commission must include an "explanation and analysis" of the contract and the contract's compliance with applicable provisions of the CEA, including core principles and the CFTC's regulations thereunder.

Second, the relevant requirements provide that the explanation and analysis of the contract either be accompanied by the documentation relied upon to establish the basis for compliance with applicable law, or incorporate information contained in such documentation, with appropriate citations to data sources.

Third, the relevant requirements provide that, if requested by Commission staff, a DCM must provide any additional evidence, information, or data that demonstrates that the contract meets, initially or on a continuing basis, the requirements of the CEA or the Commission's regulations or policies thereunder.

The CFTC anticipates that, in connection with the submission for a VCC derivative contract, a DCM may provide qualitative explanations and analysis to assist in addressing the three above-described requirements. The CFTC expects that the information—including supporting documentation, evidence, and data—provided by the DCM to describe how the contract complies with the CEA and applicable Commission regulations will be complete and thorough.

KEY POINTS

1. The CFTC will expect heightened focus on the unique and developing aspects of VCCs and the VCC derivatives markets when DCMs address compliance with submission requirements for listing new VCC derivatives contracts.
2. DCMs will also be expected to update the terms and conditions of listed VCC derivatives contracts as the VCC markets evolve in response to changes to the crediting programs, development of new standards of certifications, or other factors.
3. The CFTC made it clear—including by emphasizing existing recordkeeping and record-production requirements—that it expects DCMs to play a significant role in improving the underlying VCC markets.
4. The reference to recordkeeping and record-production obligations put market participants on notice that the CFTC will be able to uncover misconduct through its access to their records and issue sanctions for not maintaining or producing required records.
5. The CFTC provided its view in several contexts that "industry-recognized standards" can serve as tools for DCMs to utilize as a benchmark to measure against, but the CFTC did not specify if any standards mentioned by the Commission or commenters are acceptable, if other standards not mentioned by the CFTC or commenters are acceptable, or what to do if standards conflict.
6. As one DCM commenter noted, it is "possible, if not likely" that the various DCMs and market participants could have differing views on whether one of the subjective CFTC standards in the guidance (e.g., the "robustness, conservatism and transparency" of a crediting program's removal/reduction quantification methodology) is met.
7. Given the outcome of the presidential election, the CFTC might attempt to withdraw the guidance, although other agencies have failed in this regard due to Administrative Procedure Act shortcomings.

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ENDNOTES

1 *See* 89 Fed. Reg. 83,378 (Oct. 15, 2024).

2 The Commission clarified that, in the context of physically settled VCC derivative contracts, the primary concern is "double issuance" (i.e., the same VCC is issued more than once).