

The CFTC Adopts Voluntary Carbon Markets Guidance: What It Means for You

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On September 20, 2024, the Commodity Futures Trading Commission (CFTC) released final guidance (the Guidance) applicable to designated contract markets (DCMs) regarding requirements for listing voluntary carbon credit (VCC) derivatives contracts on CFTC-regulated exchanges.¹ The purpose of the Guidance is not to create new requirements for DCMs or to amend or replace existing CFTC guidance for regulated exchanges, but instead to address applicability of certain provisions of the Commodity Exchange Act (CEA) and related CFTC regulations (the CFTC Regulations) to the design and listing of VCC derivatives contracts. The Guidance will also assist participants in derivatives markets in understanding the relative utility of hedging risks or seeking opportunistic returns with these instruments, given the Guidance's focus on the nature of the VCCs themselves. This Client Alert provides a brief background of VCCs, an overview of the Guidance, and a summary of Commissioner Summer K. Mersinger's dissenting statement.

Practical Impact

For derivatives markets, the Guidance will undoubtedly influence future listings of VCC derivatives contracts. Additional scrutiny of those contracts by the CFTC staff is to be expected, given the novelty of the Guidance—to our knowledge, the first of its kind for any specific type of derivative—and CFTC's recent approval of rule changes affecting new derivatives contracts for review or certification by the CFTC prior to listing.²

For market participants, the Guidance also highlights issues that are already known to present special challenges in trading VCCs, whether directly or in derivatives markets. The CFTC has broad anti-fraud and anti-manipulation authority over trading of actual commodities (like VCCs) and derivatives contracts, so, however such instruments are traded, the Guidance's discussion of issues like additionality, transparency, permanence of risk reversal and the like will likely inform how the CFTC Division of Enforcement will view market activity in relevant instruments.

We expect that the Guidance will effectively be treated as if it has the force of law. Although styled as advisory in nature, CFTC policy statements like this one often serve as the standard against which conduct is measured, whether in the operation of derivatives markets or in the trading of VCCs and derivatives contracts by even sophisticated market participants. In our view, persons active in the VCC space will be well-served by understanding and seeking to adhere to the Guidance.

¹ The CFTC Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts [hereinafter, CFTC Guidance] is available at <https://www.cftc.gov/PressRoom/PressReleases/8969-24>.

² CFTC, Amendments to Provisions Common to Registered Entities (Sept. 12, 2024).

Voluntary Carbon Credit Derivative Contracts

A VCC is “a tradeable intangible instrument that is issued by a carbon crediting program” and generally represents the removal of one metric ton of carbon dioxide from the atmosphere.³ VCCs are not subject to legal or regulatory requirements regarding carbon emissions reductions, and are purchased and sold on a voluntary basis by market participants seeking to offset their carbon emissions or to supplement efforts to reduce carbon emissions.⁴ VCCs are issued by a crediting program that certifies activities or projects that reduce or remove carbon emissions, and are held in a central repository or registry pursuant to which the crediting program tracks the relevant activities or projects and their related VCCs.⁵ Registered VCCs may be purchased by participants in the VCC trading market.⁶

Participants in developing VCC markets have expressed concerns regarding the lack of standardization and accounting mechanisms in the VCC crediting process. Differences in methodologies or protocols used by carbon reduction removal activities or projects make it difficult to compare the impact of such activities or projects, resulting in different crediting programs issuing different amounts of VCCs for carbon reduction removal/activities or projects that have the same impact on emissions reduction/removal. Differences in standards used by crediting programs make it difficult to compare the quality of VCCs issued by different crediting programs. Because of these differences (among others) it is difficult to determine the quality of VCCs, which makes it difficult to price VCCs.⁷

Notwithstanding the foregoing, DCMs have developed a market in VCC derivatives contracts, with 29 derivatives contracts on VCCs listed for trading as of August 2024.⁸

Overview of the CFTC’s Guidance on Listing VCCs

The Guidance builds on the CFTC’s earlier Proposed Guidance Regarding the Listing of VCC Derivatives Contracts published on December 4, 2023. It focuses principally on issues relevant to DCMs in addressing their obligations to: (1) prevent manipulation of VCC trading markets; (2) monitor the terms and conditions of VCCs; and (3) ensure compliance with applicable laws and regulations when listing new VCCs.

1. **Preventing Manipulation:** DCMs are subject to statutory Core Principles (the **Core Principles**) set forth in the CEA and related CFTC regulations that are designed to promote the integrity of derivatives markets.⁹ The Core Principles permit DCMs to list only derivatives contracts that are not readily susceptible to manipulation, and DCMs must be able to attest to compliance with the Core Principles when certifying for listing, or when requesting CFTC approval for listing, a new derivative contract on its exchange.¹⁰

For listed derivatives contracts that are physically-settled—including VCC derivatives contracts¹¹—the Core Principles further require that DCMs “describe or define all of the economically significant characteristics or attributes of the commodity underlying the contract.”¹² The CFTC views the description of such characteristics as necessary to avoid confusion among market participants as to the quality, features, and pricing of VCC

³ CFTC Guidance at Page 9.

⁴ CFTC Guidance at Page 9.

⁵ CFTC Guidance at Pages 10-11.

⁶ CFTC Guidance at Page 11.

⁷ See CFTC Guidance at Pages 11-13.

⁸ CFTC Guidance at Page 15.

⁹ CFTC Guidance at Page 3. The statutory Core Principles applicable to DCMs are set forth in CEA Section 5(d), 7 U.S.C. 7(d), and the applicable CFTC regulations are set forth at 17 CFR Part 38 (Designated Contract Markets). Appendix B to 17 CFR Part 38 sets forth guidance and acceptable practices with respect to the Core Principles.

¹⁰ See Core Principle 3 (17 CFR 38.200); 17 CFR 40.2–40.3. Appendix C to 17 CFR Part 38 provides guidance for DCMs in demonstrating compliance with the requirement that a derivatives contract is not readily susceptible to manipulation.

¹¹ The Guidance focuses primarily on physically settled VCCs, as no cash-settled VCCs are currently listed on a CFTC-regulated exchange. However, the CFTC notes that the Guidance is also relevant to cash-settled derivative contracts. See CFTC Guidance at page 81.

¹² CFTC Guidance at Page 83, referencing Appendix C Guidance, paragraph (b)(2)(i)(A).

derivatives contracts, thereby reducing the risk that such contracts are susceptible to manipulation.

Because VCCs are a developing commodity class, the economically significant characteristics or attributes for a VCC derivatives contract are not subject to recognized standardization or accountability policies and procedures. However, the Guidance points to certain characteristics that have been broadly identified in the carbon markets (the VCC commodity characteristics) that DCMs may consider in satisfaction of their requirements under the Core Principles when preparing a VCC for listing on an exchange. Specifically, the Guidance provides that DCMs should consider the following VCC commodity characteristics:

a. **Quality Standards**

The Guidance provides that DCMs should consider transparency, additionality, permanence and risk of reversal, and robust quantification when addressing quality standards for VCCs. Furthermore, DCMs may consider whether the VCC’s crediting program has implemented measures to “ensure that credited mitigation projects or activities: (i) meet or exceed best practices on social and environmental safeguards, and (ii) would avoid locking in levels of GHG emissions, technologies or carbon intensive practices that are incompatible with the objective of achieving net zero emissions by 2050.”¹³ These Quality Standards are further described below.

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| Transparency | The terms and conditions of a VCC derivative contract should distinctly identify the crediting program and what is deliverable in the contract. VCCs with certain types of mitigation projects, such as nature-based projects, should include such information in the contract’s terms and conditions. DCMs should also consider whether the VCC’s crediting program has made information pertaining to its policies, procedures, and the underlying project or activity available to the public. |
| Additionality | DCMs should assess whether the crediting program for the underlying VCC has methods to test for additionality. The CFTC recognizes the complexity in characterizing and measuring additionality; therefore, the Guidance does not define additionality. ¹⁴ However, DCMs can use industry-recognized standards for high-integrity VCCs in their determination. |
| Permanence & Risk of Reversal | VCCs may have to be cancelled or recalled due to carbon from the project or activity being released back into the atmosphere or due to a recalculation of how much carbon was reduced. To address this, DCMs should assess whether the crediting program has a buffer reserve—a reserve of VCCs that have been set aside as a buffer for reversals, and that can be drawn upon in the event of reversal—or other measures to address risk of reversal. |
| Robust Qualification | DCMs should consider whether there is reasonable assurance that the crediting program’s method for calculating emission reductions is robust, conservative, and transparent. A robust, conservative, and transparent quantification is essential because there is currently no standardized method for quantifying emission reduction. |

¹³ CFTC Guidance at Page 33.

¹⁴ In the proposal, the CFTC defined additionality as VCCs that are “credited for projects or activities that would not have been developed and implemented in the absence of the added monetary incentive created by the revenue from carbon credits.” CFTC Guidance at pages 41-42.

b. **Delivery Points and Facilities**

The Guidance provides that delivery procedures for physically settled VCC derivatives contracts should reduce obstacles to making or taking delivery of such contracts, which will ensure the convergence of cash and derivative contract prices.¹⁵ DCMs should consider the following for smooth delivery:

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| Governance | DCMs should assess whether the crediting program for the underlying VCC has an independent, transparent, and accountable governance framework. DCMs should consider the following in their assessment: <ul style="list-style-type: none">• Decision-making procedures• Conflicts of interest• Reporting and disclosure• Risk management• Extent of whether this information is public |
| Tracking | DCMs should consider whether VCCs are properly tracked at all stages of the VCC life cycle, including at issuance, during any transfer, and at retirement. A crediting program's use of a registry service can assist in identification of VCC ownership and can provide a unique identification number for each metric ton of carbon dioxide. |
| No Double-Counting | DCMs should consider whether crediting programs have procedures in place to provide reasonable assurance that credited emissions are not double counted. Crediting programs can achieve this by ensuring VCCs are associated to one registry and not used after retirement or cancellation. Cross-checking several registries for a VCC can also reduce the risk of double counting. |

c. **Inspection Provisions**

Any inspection or certification procedure verifying quality or delivery requirements of an underlying VCC should be noted in the VCC derivative contract's terms and conditions. The Guidance provides that such inspections or certifications should be completed consistent with the latest VCC market procedures. CMS should "consider whether there is reasonable assurance that the crediting program for underlying VCCs 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."¹⁶ Verification processes should be conducted by independent third parties following best practices, including:

- Review of an independent third party's assessment by crediting programs;
- Implementation of procedures to rectify any issues in the assessment process;
- Utilization of different independent third parties for each assessment by a crediting program; and
- Contracting a different independent third party to manage ongoing assessments from the independent third party that completed the initial assessment.

2. Monitoring the VCC Derivative Contract's Terms and Conditions

¹⁵ CFTC Guidance at Page 91.

¹⁶ CFTC Guidance at Page 94.

The DCM Core Principles also require DCMs “to prevent manipulation, price distortion, and disruptions of the physical delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures.”¹⁷ Given the new and evolving nature of VCCs, the Guidance states that DCMs’ ongoing monitoring of the contract’s terms and conditions should ensure that the instrument conforms to the latest certification standards for that specific VCC and any changes to the crediting program or project type should be included in an amendment.¹⁸

3. Ensuring Compliance When Listing New VCCs

The listing of new derivatives contracts on CFTC-regulated exchanges is subject to certain submission criteria, regardless of whether a DCM decides to list a new VCC derivatives contract by self-certification or subject to CFTC approval. Submission criteria includes the following:¹⁹

- Submitted derivatives contracts must provide an explanation and analysis of the contract’s compliance with the Core Principles set forth in the CEA and the related CFTC regulations.
- The DCM’s explanation and analysis must attach or incorporate supporting documentation for compliance, including relevant source citations.
- Upon the request of the CFTC, additional information regarding current and continued compliance with relevant rules and regulations must be provided.
- The Guidance also permits qualitative explanations and analysis in light of ongoing development of the VCC markets.²⁰

Commissioner Summer K. Mersinger’s Dissenting Statement²¹

Publication of the Guidance by the CFTC was accompanied by a dissenting statement (the **Dissenting Statement**) from Commissioner Mersinger describing the Guidance as unwarranted, unclear, and unhelpful in fostering transparency in the derivatives markets.

In the Dissenting Statement, the Commissioner claims that the Guidance “is a solution in search of a problem,” and that the CFTC has “no shortage of topics that warrant [its] immediate attention.” Commissioner Mersinger also questions why the CFTC released nonbinding guidance for “a commodity class that has little interest and makes up a small percentage of trading activity”²² rather than focusing on more pressing topics.

Commissioner Mersinger further argues that the purpose of the Guidance is instead to promote a political agenda, as evidenced by a statement in the Guidance that a DCM may consider, as part of a VCC derivative contract’s quality standards, whether the crediting program for such VCC ensures that the underlying carbon reduction/removal project or activity is compatible with ESG and net zero goals. In the commissioner’s view, ESG and net zero goals have nothing to do with derivatives contracts and related regulatory obligations, and “[f]ocusing on ESG and Net Zero in evaluating derivatives contracts is a backdoor attempt to inject and memorialize certain political ideologies into CFTC regulatory decisions.” Instead, she argues, controversial political beliefs should be left to voters and elected officials, and the CFTC should not give special treatment to VCC derivatives contracts.²³

¹⁷ CFTC Guidance at Page 95.

¹⁸ See Guidance at Page 96. While not new or specific to VCCs, the CFTC reminds market participants that DCMs require them to keep trading records and to have the records available upon request from the DCM.

¹⁹ CFTC Guidance at Pages 97-98.

²⁰ CFTC Guidance at Page 98.

²¹ The Dissenting Statement of Commissioner Summer K. Mersinger on Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts [hereinafter, The Dissenting Statement] is available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement092024>.

²² As of August 2024, only three of twenty-nine VCCs listed for trading by DCMs have open interest. CFTC Guidance at Page 15.

²³ See The Dissenting Statement.

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