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CFTC Issues Proposed Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts

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The VCC Proposal enumerates certain factors that a CFTC-regulated exchange, such as a designated contract market or a swap execution facility, should consider. On December 4, 2023, the Commodity Futures Trading Commission (the "CFTC" or the "Commission") approved proposed guidance and a request for public comment regarding the listing for trading of voluntary carbon credit ("VCC") derivative contracts (the "VCC Proposal").[1] The VCC Proposal enumerates certain factors that a CFTC-regulated exchange, such as a designated contract market ("DCM") or a swap execution facility ("SEF")[2] should consider in connection with the relevant Commodity Exchange Act ("CEA") requirements and CFTC regulations applicable to the design and listing of contracts. Comments on the VCC Proposal are due on or before February 16, 2024. This alert provides a high-level summary of the VCC Proposal and related considerations for participants in the voluntary carbon markets. **Overview** The VCC Proposal represents the most recent development in the CFTC's interest in the voluntary carbon markets and explains how the statutory "Core Principles"[3] apply to VCC[4] derivatives. In particular:

- Recognizing that VCC derivatives are a relatively new set of products that continue to receive an increasing amount of attention, the CFTC issued the VCC Proposal as guidance for DCMs and SEFs to consider in the context of product design and listing.
- The CFTC builds on private sector initiatives that are designed to foster the standardization of VCC derivatives and promote transparent and liquid markets. The CFTC specifically requested comment on whether it should require DCMs to incorporate any VCC standards set by the private sector into the terms and conditions of a VCC derivative contract.[5]
- The CFTC referenced its regulatory authority over environmental commodity derivatives, as established in a joint product definition rulemaking with the Securities Exchange Commission following the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[6]
- Critically, the CFTC does not have regulatory authority over the spot trading of VCCs. However, the CFTC does have enforcement authority over fraud and manipulation in the spot VCC market.[7] The VCC Proposal is an effort by the CFTC to promote integrity in the voluntary carbon markets by requiring more diligence on VCC *derivatives*, which can indirectly influence behavior in the spot market.[8]
- DCM Core Principle 3 (a requirement that a DCM only list for trading contracts that are not readily susceptible to manipulation) and DCM Core Principle 4 (a requirement that a DCM prevent manipulation, price distortion, and disruptions of the physical delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures) form the foundation of the VCC Proposal.
- The VCC Proposal addresses the product submission requirements under Part 40 of the CFTC's regulations and CEA section 5c(c), as such requirements relate to

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VCC derivatives.

- The VCC Proposal is limited in scope. As Commissioner Johnson stated, the CFTC "provides much-needed direction to DCMs (and SEFs) to facilitate their compliance with core principles when they list futures contracts (and swaps contracts) on VCCs. However, the Commission is only addressing one small aspect of the market for derivatives on these underlying assets. There is also a segment of the swaps market that is not traded on a SEF for which VCCs are underliers and an even more significant volume of environmental forwards that are not considered to be swaps. The VCC Proposal suggests the potential for a broader and more comprehensive regulatory framework… there may be several interventions that may bring similar needed reforms to over-the-counter traded environmental commodities—material risk disclosures, good faith and fair dealing, and clearing."[9]

The CFTC and Voluntary Carbon Markets The VCC Proposal states that there are now more than 150 derivative contracts on mandatory emissions program instruments listed on DCMs.[10] Eighteen futures contracts on voluntary carbon market products have been submitted to the CFTC by DCMs as of November 2023. Three of those eighteen contracts currently have open interest.[11] Chairman Benham has increased the CFTC's attention on carbon markets and environmental aspects of the derivatives and commodities markets in recent years.[12] For example:

- In June 2022, Chairman Behnam held the first-ever Voluntary Carbon Markets Convening to address product standardization, integrity, and other matters related to the supply of and demand for high quality carbon credits.
- Also in June 2022, the CFTC issued for public comment a request for information regarding the CFTC's ability to regulate climate-related financial risk relevant to the derivatives markets and underlying commodities markets.
- In July 2023, Chairman Behnam held the Second Voluntary Carbon Markets Convening to discuss private sector efforts on developing high quality carbon credits, market trends and developments, public sector initiatives, and to hear market participants' concerns.

CFTC Guidance for DCMs Regarding the Listing of VCC Derivative Contracts The VCC Proposal is not meant to modify or supersede the existing regulatory framework regarding the listing of derivative products by CFTC-regulated exchanges. The VCC Proposal focuses mainly on physically-settled VCC derivative contracts because, to date, all listed VCC derivative contracts are physically-settled. However, the CFTC noted that it "continues to believe that, with respect to cash-settled derivative contracts, an acceptable specification of the cash settlement price would include rules that fully describe the essential economic characteristics of the underlying commodity."[13] **1. *A DCM Shall Only List Derivative Contracts That Are Not Readily Susceptible to Manipulation*.** The requirement that a DCM only list derivative contracts that are not readily susceptible to manipulation follows DCM Core Principle 3.[14] While the Commission acknowledges that "standardization and accountability mechanisms for VCCs are currently still being developed," it has identified certain criteria, present in both mandatory and voluntary carbon markets, as critical to assessing the integrity of carbon credits. The VCC Proposal explains that the Commission "preliminarily believes" that a DCM should take into consideration quality standards, delivery points and facilities, and inspection provisions (which the CFTC refers to as "VCC commodity characteristics") when designing a VCC derivative contract. **(A) Quality Standards** A DCM should consider transparency, additionality, permanence and risk of reversal, and robust quantification when addressing quality standards in the development of the terms and conditions of a VCC derivative contract.[15]

- **Transparency**. The contract terms and conditions should include information that readily specifies the crediting program(s)[16] – and, as applicable, the specific

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types of projects or activities – from which VCCs that are eligible for delivery under the contract may be issued. Whether the crediting program(s) make such information publicly available is an important consideration.

- **Additionality**. It is critical that the greenhouse gas emission reductions or removals of the underlying VCC would not have occurred but for the monetary incentive created by the sale of carbon credits. Information on the crediting program(s) assessment and testing of additionality may constitute an economically significant attribute of the underlying VCCs, which should be described or defined in the terms and conditions of a VCC derivative contract.
- **Permanence and Risk of Reversal**.
    - The crediting program(s) should be able to demonstrate that it has measures in place to adequately address the risk that VCCs issued for a project or activity may have to be recalled or cancelled due to carbon removed by the project or activity being released back into the atmosphere, or due to a reevaluation of the amount of carbon reduced or removed from the atmosphere by the project or activity.
    - A DCM should consider whether the crediting program for a VCC has measures in place, such as “buffer reserves” or other mechanisms, that provide reasonable assurance that, in the event of a reversal, the VCC will be replaced by a VCC of comparably high quality that meets the contemplated specifications of the contract. (The risk of reversal may impact the risk management needs of VCC derivative market participants.)
- **Robust Quantification**.
    - A DCM should consider the methodology or protocol used by a crediting program to calculate the level of greenhouse gas emission reductions or removals associated with credited projects or activities.
    - Given the current absence of a standardized methodology or protocol to quantify greenhouse gas emission reduction or removal levels (both across crediting programs *and* within a particular crediting program) with respect to different types of projects or activities, the Commission believes that a DCM that lists a VCC derivative contract should consider whether the crediting program for the underlying VCCs can demonstrate that the quantification methodology or protocol that it uses to calculate greenhouse gas emission reductions or removals for the underlying VCCs is robust, conservative, and transparent.
    - A quantitative estimate of the deliverable supplies can be used as the basis for effectively setting the DCM’s exchange-set speculative position limits.

(B) Delivery Points and Facilities Delivery procedures for a physically-settled derivative contract should, among other things, seek to minimize or eliminate any impediments to making or taking delivery by both deliverers and takers of delivery, to help ensure convergence of cash and derivative contract prices at the expiration of the derivative contract.[17] With respect to a physically-settled VCC derivative contract, the CFTC “preliminarily believes” that a DCM should consider the governance framework and tracking mechanisms of the crediting program for the underlying VCCs, as well as the crediting program’s measures to prevent double-counting. In particular:

- **Governance**. The CFTC stated that it may be appropriate for a DCM to include information about the crediting program’s governance framework in the terms and conditions of a physically-settled VCC derivative contract. Accordingly, in reviewing a crediting program’s governance mechanisms, a DCM should assess, at a minimum:
    - Who is responsible for administration of the program and how the independence of key functions is ensured;

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- Reporting and disclosure procedures;
- Public and stakeholder engagement processes;
- Risk management policies (including financial resources/reserves, cyber-security, and anti-money laundering policies); and
- Whether information regarding such procedures and policies is made publicly available.

- **Tracking**.
  - A DCM should ensure that the crediting program for the underlying VCCs can demonstrate that it has processes and procedures in place to help ensure clarity and certainty with respect to the issuance, transfer, and retirement of VCCs.
  - A DCM should consider whether the crediting program operates or makes use of a registry that has measures in place to effectively track the issuance, transfer, and retirement of VCCs; to identify who owns or retires a VCC; and to make sure that each VCC is uniquely and securely identified. The CFTC suggested additional considerations would apply in the event that the registry also serves as the delivery point.
- **No Double Counting**. The CFTC preliminarily believes that a DCM should consider whether the crediting program for the underlying VCCs can demonstrate that it has effective measures in place that provide reasonable assurance that credited emission reductions or removals are not double counted (i.e., VCCs cannot be issued to more than one registry and cannot be used after retirement or cancelation).
  - Effective measures to ensure that emission reductions or removals are not double counted may include, among other things, procedures for conducting cross-checks across multiple carbon credit registries.

(C) Inspection Provisions – Third Party Validation and Verification 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 and should be consistent with the latest procedures in the voluntary carbon markets.

- A DCM should consider, among other things, how the crediting program for the underlying VCCs requires validation and verification that credited mitigation projects or activities meet the crediting program's rules and standards.
- Additionally, in designing a VCC derivative contract, a DCM should consider whether the crediting program has up-to-date, robust and transparent validation and verification procedures, including whether those procedures contemplate validation and verification by a reputable, disinterested party or body, and – more broadly – whether they reflect best practices.

2. *A DCM Shall Monitor a Derivative Contract's Terms and Conditions as They Relate to the Underlying Commodity Market*. DCM 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. With respect to a DCM's monitoring of the terms and conditions of a physically-settled VCC, the CFTC preliminarily believes that such monitoring would include, at a minimum:

- Ensuring that the underlying VCC reflects the latest certification standard applicable for that VCC by, among other things, amending the contract's terms to correspond to any such update and monitoring the available deliverable supply in connection with the developments regarding new standards or certifications and

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- Maintaining rules that require their market participants to (i) keep records of their trading, including records of their activity in the underlying commodity and related derivatives market, and, importantly, (ii) make such records available to the DCM upon request.

3. *A DCM Must Satisfy the Product Submission Requirements Under Part 40 of the CFTC's Regulations and CEA section 5c(c).* The VCC Proposal highlights three submission requirements in connection with the listing of VCC derivative contracts.

1. The contract submission must include an explanation and analysis of the contract and its compliance with applicable provisions of the CEA, including the DCM Core Principles and CFTC regulations.
2. The explanation and analysis of the contract must "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."[18]
3. 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 CFTC's regulations or policies thereunder.[19]

The information provided to the CFTC in connection with the above may include qualitative explanations and analysis and is expected to be "complete and thorough." **Conclusion** While the VCC Proposal's scope is limited to exchange-traded VCC derivatives, it suggests implications for the over-the-counter VCC derivatives markets, as well as the VCC spot markets, including by providing DCMs and the CFTC greater insight into trading activity in the VCC spot markets. Accordingly, the comment process and the Commission's guidance should play an important role in shaping the future of the voluntary carbon markets. _____ [1] The VCC Proposal and statements by the Chairman and Commissioners are available at: https://www.cftc.gov/PressRoom/PressReleases/8829-23. [2] As discussed in the body of the alert, the CFTC focuses on physically-settled VCC derivative contracts but "preliminarily believes that the [VCC Proposal] also should be considered by any SEF that may seek to permit trading in swap contracts that settle to the price of a VCC, or in physically-settled VCC swap contracts." VCC Proposal at 20. [3] *See*, generally, CEA Section 5(d), 7 U.S.C. 7(d). [4] In footnote 31 of the VCC Proposal, the CFTC clarifies its use of the term "voluntary carbon credits" rather than "verified carbon credits." The VCC Proposal concerns itself with "the quality and other attributes of the intangible commodity underlying a derivative," while recognizing that the cash and secondary markets for voluntary carbon credits may avail themselves of the standard terms and templates published by the International Swaps and Derivatives Association (ISDA) for the trading and retirement of "verified carbon credits,". *See* 2022 ISDA Verified Carbon Credit Transactions Definitions ("VCC Definitions") Frequently Asked Questions, *available at* https://www.isda.org/a/jBXgE/2022-ISDA-Verified-Carbon-Credit-Transactions-Definitions-FAQs-061323.pdf. [5] VCC Proposal at 38. [6] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, 77 Fed Reg 48208, 48233-48235 (August 13, 2012). ("An agreement, contract or transaction in an environmental commodity may qualify for the forward exclusion from the "swap" definition set forth in section 1a(47) of the CEA, 7 U.S.C. 1a(47), if the agreement, contract or transaction is intended to be physically settled.") However, the VCC Proposal "does not address the regulatory treatment of any underlying VCC or associated offset project or activity, including whether any such product, project or activity may qualify as a swap or be eligible for the forward contract exclusion…." *See* VCC Proposal at footnote 68. [7] *See* 7 U.S.C. § 9; 17 CFR § 180.1. [8] This approach – providing guidance to DCMs for the listing of new or novel products – is similar to the CFTC's approach to regulating Bitcoin futures and other digital assets. *See e.g.*, "CFTC Backgrounder on Self-Certified Contracts for Bitcoin Products" (2017), available here. [9] We note that swap dealers are subject to CFTC Regulation 23.600(c)(3)'s "New Product Policy" requirement and the external

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business conduct standards applicable to swap dealers (17 CFR Part 23 Subpart H). [10] The CFTC explains that derivative contracts on mandatory emissions products have been trading since 2005, with greenhouse gas emissions-related products first listed in 2007. *See* VCC Proposal at 14. [11] *See* VCC Proposal at footnote 51. ("The NYMEX CBL Global Emissions Offset (GEO) futures contract; the NYMEX CBL Nature-Based Global Emissions Offset (N-GEO) futures contract; and the NYMEX CBL Core Global Emission Offset (C-GEO) futures contract are currently the only listed futures contacts with open interest and trading volume. Information is available at: https://www.cmegroup.com/markets/energy/emissions/cbl-global-emissions-offset.volume.html.") [12] In his statement accompanying the VCC Proposal, Commissioner Benham stated that "The publication of this [VCC Proposal] and request for public comment marks the culmination of years of work with stakeholders such as farmers, foresters, end users, energy traders and associations, emission-trading focused entities, carbon-credit rating agencies, crediting programs, CFTC-registered exchanges and clearinghouses, and derivatives trade associations." [13] VCC Proposal at 19. [14] CEA section 5(d)(3), 7 U.S.C. 7(d)(3). See also 17 CFR §§ 38.200-201. [15] The VCC Proposal should be considered in light of recent issues involving the verification of carbon credits. For more detail on one issue, involving Verra, please refer to Gibson Dunn's Carbon Markets Update – Q2 2023 at page 1, available here: https://www.gibsondunn.com/wp-content/uploads/2023/07/carbon-markets-update-q2-2023.pdf. [16] Commissioner Goldsmith Romero focused on the role of crediting programs in her remarks, asking commenters to address "whether market integrity can be improved by exchanges relying on a crediting program's processes and diligence, as assumed in the [VCC Proposal], or if there is a benefit to exchanges conducting additional due diligence into specific categories, protocols, or projects." [17] *See* Appendix C to Part 38 of the CFTC's regulations, paragraph (b)(2)(i)(B) [18] 17 CFR §§ 40.2(a)(3)(v) (for self-certification) and 40.3(a)(4) (for Commission approval). [19] 17 CFR §§ 40.2(b) (for self-certification) and 40.3(a)(10) (for Commission approval).

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding the issues discussed in this update. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Derivatives practice group, or the following authors: Jeffrey L. Steiner – Washington, D.C. (+1 202.887.3632, jsteiner@gibsondunn.com) Adam Lapidus – New York (+1 212.351.3869, alapidus@gibsondunn.com) © 2023 Gibson, Dunn & Crutcher LLP. All rights reserved. For contact and other information, please visit us at www.gibsondunn.com. Attorney Advertising: These materials were prepared for general informational purposes only based on information available at the time of publication and are not intended as, do not constitute, and should not be relied upon as, legal advice or a legal opinion on any specific facts or circumstances. Gibson Dunn (and its affiliates, attorneys, and employees) shall not have any liability in connection with any use of these materials. The sharing of these materials does not establish an attorney-client relationship with the recipient and should not be relied upon as an alternative for advice from qualified counsel. Please note that facts and circumstances may vary, and prior results do not guarantee a similar outcome.

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