



February 16, 2023

To: Commodity Futures Trading Commission

Re: Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment, 88 Fed. Reg. 89,410 (proposed December 4, 2023)

The Institute for Policy Integrity at New York University School of Law (Policy Integrity)¹ respectfully submits the following comments to the Commodity Futures Trading Commission (CFTC or Commission) on the Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment (Guidance). Policy Integrity is a non-partisan think tank dedicated to improving the quality of government decisionmaking through advocacy and scholarship in the fields of administrative law, economics, and public policy.

The Guidance is an important step toward improving the market for voluntary carbon credit (VCC) derivatives, as it identifies for designated contract markets (DCMs) key features of high-integrity VCCs. In finalizing the Guidance, the Commission should:

- Highlight additional sources of its legal authority over VCC derivatives, including Sections 2 and 7 of the Commodity Exchange Act (CEA).
- Expand its definition of additionality and provide specific examples of projects² that would or would not meet financial additionality.
- Recommend that DCMs consider whether crediting programs account for leakage risk, either as a new recommendation or as part of its recommendation on robust quantification.
- Clarify its recommendation that DCMs consider whether crediting programs apply a “conservative” methodology to quantify projects’ emissions reductions or removals, by, for example, suggesting an uncertainty ratio as an element of a conservative methodology.
- Address additional issues related to reversal risk, including how timing may affect the number of VCCs needed to account for harm attributable to reversal.
- Remind DCMs of their discretion to implement more stringent quality standards for VCC derivatives, including requirements that the underlying VCCs possess the characteristics of high-integrity VCCs.

¹ This document does not purport to present the views, if any, of New York University School of Law.

² This document uses project(s) throughout to refer to both projects and activities.

Although the Guidance is an important step forward, it extends only to the relatively small market for VCC derivatives and does not directly address many of the integrity problems in the much larger markets for VCCs themselves. It could potentially improve these other markets, but it would do so only indirectly by identifying key characteristics of high-integrity VCCs for market participants to consider.

The Commission should explore whether it has additional authority to further address these problems with VCC integrity, and it should collaborate with peer regulators to understand any existing authority they have. If the Commission deems existing statutes insufficient to rectify these problems with VCC integrity, the Commission (and its peer regulators) should identify the best-positioned agency or agencies to fill the regulatory gap and should seek any additional authority needed from Congress to ensure well-functioning markets for high-integrity VCCs.

Background

Voluntary carbon markets³ enable buyers (often corporations with net-zero pledges) to purchase VCCs that represent greenhouse gas (GHG) emissions reductions or removals from project developers.⁴ A third-party crediting program certifies each project and issues the VCCs based on an estimate of the emissions reductions or removals the project will generate.⁵

In 2011, the Interagency Working Group for the Study and Oversight of Carbon Markets published a report (the Working Group Report) that distinguishes among three components of voluntary carbon markets: primary markets, secondary markets, and derivative markets.⁶

Primary markets refer to the introduction of VCCs into the marketplace through certification by crediting programs.⁷ After VCCs are certified but before they are retired, market participants can purchase and trade them on secondary markets.⁸ Secondary markets feature both spot and

³ Carbon markets include both compliance markets and voluntary carbon markets. Compliance markets “are established and regulated by national, regional, or international governmental bodies”; by contrast, buyers and sellers in the voluntary carbon markets engage in these markets voluntarily. 88 Fed. Reg. 89,410, 89,412 (proposed Dec. 4, 2023) [hereinafter Guidance].

⁴ The Guidance defines a VCC as a “tradeable intangible instrument that is issued by a carbon crediting program” as part of a voluntary carbon market. One VCC typically represents an emissions reduction or removal equivalent to one metric ton of carbon dioxide. *Id.*

⁵ *Id.* The crediting program engages a third party to review the project and verify the accuracy of the crediting program’s estimate of the VCCs the project will generate. Once the crediting program certifies the VCCs, it typically adds them to its registry. The crediting program uses the registry to track both VCCs and the projects associated with them. After the crediting program issues the VCCs, market participants can purchase and trade them. Once a buyer uses a VCC to compensate for an equivalent GHG emission, the VCC is retired. *Id.* at 89,413; Silvia Favasuli and Vandana Sebastian, *Voluntary carbon markets: how they work, how they’re priced and who’s involved*, S&P Global (June 10, 2021), <https://perma.cc/EHY6-VW8L>.

⁶ Interagency Working Group for the Study on Oversight of Carbon Markets, *Report on the Oversight of Existing and Prospective Carbon Markets* 12–16 (Jan. 18, 2011). <https://perma.cc/W9DN-PWGT> [hereinafter Working Group Report]. Other organizations have characterized these markets differently. For example, the International Swaps and Derivatives Association distinguishes between only primary markets (initial purchases of carbon credits) and secondary markets (“all subsequent trading,” including spot and derivatives contracts). See Int’l Swaps and Derivatives Ass’n, *Role of Derivatives in Carbon Markets* 4 (Sept. 2021), <https://perma.cc/QGL8-PBTP>.

⁷ Working Group Report at 12.

⁸ *Id.* at 13, 42.

forward transactions.⁹ A spot transaction involves the immediate or near-immediate delivery of and payment for VCCs. In a forward contract, the parties agree to a price or price-fixing method and future delivery of VCCs.¹⁰

The derivatives markets are the third component. A derivative is “a financial instrument whose value is based on, or derived from, the value of an underlying asset (e.g., a stock), commodity (e.g., wheat and oil) or measurable event (e.g., weather or a bankruptcy).”¹¹ Instead of trading VCCs, derivatives market participants trade contracts whose prices derive from the spot value of VCCs in the secondary markets.¹² Market participants mainly use derivatives for hedging (managing exposure to “the risk of disadvantageous movements in the price of an underlying asset”) or speculation (gaining exposure to an underlying commodity’s price to earn profits by successfully predicting price movements).¹³ Derivatives based on VCCs are a “new and evolving class of products.”¹⁴

The Commission issued the Guidance to highlight factors that CFTC-regulated DCMs should consider when listing VCC derivatives. The Guidance aims to help these DCMs ensure that the VCC derivatives they list comply with existing statutory and regulatory requirements for all derivatives listed on DCMs.¹⁵

The Guidance identifies several problems related to the integrity of VCCs. For example, some VCCs may not actually represent “additional” emissions reductions or removals that would not have occurred without “the added monetary incentive created by the revenue from the sale of carbon credits,”¹⁶ while others may represent emissions reductions or removals at risk of reversal (as when a wildfire destroys reforested trees associated with a carbon credit). A VCC that lacks additionality or permanence, or whose integrity is jeopardized by any of the other problems the Guidance identifies, may not “reflect the nature and level of GHG emission reductions or removals that [it is] intended to represent.”¹⁷

These problems with VCC integrity most directly concern the primary markets, where crediting programs issue VCCs, and the secondary markets, where most trading of VCCs occurs.¹⁸ The

⁹ *Id.* at 14–15, 42.

¹⁰ *Id.* at 42; COMMODITY FUTURES TRAD. COMM’N, *Futures Glossary*, <https://perma.cc/QG5D-LD6R>; Matthew F. Kluchenek, *The Status of Environmental Commodities under the Commodity Exchange Act*, 5 HARV. BUS. L. REV. 39, 40 n. 4 (2015), <https://perma.cc/ZJR6-MUEU> (citing *Dunn v. CFTC*, 519 U.S. 465, 472 (1997)).

¹¹ Working Group Report at 15.

¹² Guidance at 89,414.

¹³ Working Group Report at 16–17.

¹⁴ Guidance at 89,410, 89,415.

¹⁵ *Id.* at 89,415.

¹⁶ *Id.* at 89,417.

¹⁷ *Id.* at 89,413.

¹⁸ See Int’l Swaps and Derivatives Ass’n, *supra*, note 6 at 21.

Guidance addresses these problems only to the extent that they affect VCC derivatives¹⁹ listed on DCMs.²⁰ Only three such derivatives had open interest as of November 2023.²¹

I. The Commission should highlight additional sources of its legal authority over VCC derivatives listed on DCMs.

To avoid any misconceptions about the scope of its authority, the Commission should consider underscoring additional CEA provisions that demonstrate its legal authority over VCC derivatives listed on DCMs. In particular, Section 2 of the CEA grants the CFTC exclusive jurisdiction over these derivatives, empowering the Commission to proactively regulate them.²² And Section 7 further specifies that the Commission can define how DCMs must comply with the CEA’s Core Principles,²³ which is exactly what the Guidance does.²⁴ This broad legal authority applies to derivatives based on environmental commodities.²⁵

II. The Commission should expand its Guidance on additionality, leakage risk, quantification, risk of reversal, and DCM discretion to set stringent standards.

In earlier, separate guidance, the Commission stated that DCMs should “describe or define all of the economically significant characteristics or attributes of the commodity underlying the contract” in the terms and conditions of any contracts they list.²⁶ The Guidance outlines several “economically significant” characteristics of VCCs, many of which concern crediting programs’ standards and procedures for issuing VCCs: crediting programs’ transparency about their policies and the projects they credit; their procedures for assessing VCCs’ additionality and permanence; and their methodologies for quantifying the emissions reductions or removals that projects will yield, to name a few.²⁷ The Guidance recommends that DCMs require related

¹⁹ More specifically, the Guidance applies to physically-settled derivative contracts, though it suggests that the same recommendations would likely apply to cash-settled VCC derivatives as well. Guidance at 89,415–16.

²⁰ The Guidance defines “designated contract markets” as “CFTC-regulated exchanges that provide participants in the derivatives markets with the ability to execute or trade derivative contracts with one another.” *Id.* at 89,410–11. Although the Guidance applies only to VCC derivatives listed on DCMs, the Commission suggested that “the proposed guidance also should be considered by any [swap execution facility] that may seek to permit trading in swap contracts that settle to the price of a VCC, or in physically-settled VCC swap contracts.” *Id.* at 89,416.

²¹ *Id.* at 89,414.

²² Commodity Exchange Act, 7 U.S.C.A. § 2(a)(1)(A). The jurisdiction clause limits CFTC jurisdiction over futures to commodities-based futures (“contracts of sale of a commodity for future delivery”). 7 U.S.C.A. § 2(a)(1)(A). The Guidance refers to VCCs as environmental commodities. *See* Guidance at 89,412.

²³ *See* 7 U.S.C.A. § 7(d)(1)(B).

²⁴ *See* Guidance at 89,415. The Guidance does not address how the forward exclusion might apply to certain transactions that would otherwise fall within the Commission’s exclusive jurisdiction. *Id.* at 89,416, n. 68; *see also* 77 Fed. Reg. 48,208, 48,233–35; Kluchenek, *supra* note 10.

²⁵ *See, e.g.,* 77 Fed. Reg. 48,208, 48,233–34 (Aug. 13, 2012) (implying that the CFTC has exclusive jurisdiction over environmental commodities as long as the forward exclusion does not apply); Working Group Report at 49 (after the Dodd-Frank Act’s implementation, “there will be comprehensive regulation of carbon and other environmental derivatives whether they are traded on an exchange, a [swap execution facility], or executed bilaterally”); Kluchenek, *supra* note 10. In fact, as the Guidance notes, “[d]erivative contracts on environmental commodities have been trading on CFTC-regulated exchanges for decades.” Guidance at 89,414.

²⁶ 77 Fed. Reg. 36,717, 36,723 (June 19, 2012).

²⁷ Guidance at 89,417–18.

disclosures in VCC derivatives' terms and conditions. The Guidance's recommendations provide a solid foundation, but the Commission should expand its Guidance in several key ways. The points below respond to the Commission's request for comment.

A. The Commission should expand and clarify its definition of additionality, including by providing specific examples of financial additionality.

In the Guidance, “the Commission recognizes VCCs as additional where they 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.”²⁸ Scholars often refer to this definition as financial additionality.²⁹ In its request for comment, the Commission asked if additionality should instead “be recognized as the reduction or removal of GHG emissions resulting from projects or activities that are not already required by law, regulation, or any other legally binding mandate applicable in the project's or activity's jurisdiction.”³⁰ Scholars often refer to this definition as regulatory additionality.³¹ The Commission should not confine its definition to one or the other. In particular, the Commission should not limit its definition to regulatory additionality.

Additionality is generally viewed as consisting of both financial and regulatory additionality.³² But financial additionality is arguably the more important of the two components and potentially broad enough to capture regulatory additionality: A project that would be implemented regardless of the revenue from selling VCCs—because the project is legally required or already planned as part of another business activity (public relations, for example), to generate other environmental credits (such as wetland mitigation credits), or for some other pre-existing reason—does not represent a real, additional reduction or removal of GHG emissions.

Yet the Guidance's only example of a project that would not meet the Commission's proposed definition of additionality focuses exclusively on regulatory additionality.³³ As noted, defining financial additionality to encompass regulatory additionality may be a reasonable approach: If an activity is legally required, then it would have been undertaken even without the added monetary incentive created by the potential revenue from VCCs, and so would fail the financial additionality test). But the Guidance's current definition could cause confusion among DCMs and market participants, as it may appear that the Commission has conflated financial additionality with regulatory additionality or cares mainly about regulatory additionality.

²⁸ *Id.* at 89,421.

²⁹ Vittoria Battocletti, Luca Enriques, and Alessandro Romano, *The Voluntary Carbon Market: Market Failures and Policy Implications*, Eur. Corp. Governance Inst., 10 (July 2023), <https://perma.cc/56D6-KE7P>.

³⁰ Guidance at 89,421.

³¹ Battocletti, *supra* note 29 at 10.

³² *See, e.g., id.*

³³ *See* Guidance at 89,417, n. 74 (noting a “project or activity may not be considered to be ‘additional’ if the project or activity is already required by law, regulation, or any other legally binding mandate applicable in the project's or activity's jurisdiction”).

To rectify that potential conflation, the Commission should stress that financial additionality is a key component of additionality and also provide other examples of financial additionality. In particular, the Commission should specify that VCCs from projects planned for other business reasons, such as public relations, would not be additional. Similarly, if the monetary incentive created by potential revenue from VCCs prompts the expansion of an already-planned project, only the extra emissions reductions or removals attributable to the expansion should count as additional. Moreover, a single project can sometimes generate multiple—or “stacked”—environmental credits (for example, both wetland mitigation credits and carbon credits). If a project was already planned based on the monetary incentive created by non-carbon environmental credits, such that the project would have been implemented even without the additional monetary incentive from the VCCs, then any carbon reductions or removals achieved by that project should not count as additional.³⁴

B. The Commission should add a recommendation that addresses leakage risk.

The Commission invited suggestions for additional characteristics “relevant to the listing of VCC derivative contracts” that inform the integrity of VCCs.³⁵ The Commission should add a recommendation that addresses leakage risk.³⁶ Leakage “refers to the idea that emissions avoided at one source might shift to a different location or sector.”³⁷ For example, conserving timber forests in one place could inadvertently encourage more harvesting of timber elsewhere, because the drop in timber quantity may increase its price, incentivizing other actors to cut more timber for higher profits.³⁸ If a project avoids emissions at one source but shifts them to a different location or sector, the associated VCCs may not serve market participants’ goals of contributing to emissions reductions or removals.³⁹

Just like additionality and permanence, leakage is “a key concern for offset projects because it is essential to determine whether an emission reduction is genuine.”⁴⁰ The Commission should thus recommend that, as part of their contract design market research, DCMs consider whether crediting programs have procedures in place to assess leakage risk. The Commission should further note that information about a crediting program’s procedures for assessing leakage risk

³⁴ Just as “procedures for conducting cross-checks across multiple carbon credit registries” are important to “ensure that emission reductions or removals are not double counted,” *id.* at 89,419, procedures for cross-checking across multiple different environmental credit markets are important to ensure that credit stacking does not undermine additionality.

³⁵ *Id.* at 89,421.

³⁶ The Guidance briefly mentions leakage, but only in a footnote explaining that the amount of emissions reductions or removals associated with a project is calculated as “the difference in GHG emission reductions or removals from a baseline scenario, to the emission reductions or removals occurring under the carbon mitigation project or activity, with any adjustments for leakage.” *Id.* at 89,412, n. 36.

³⁷ Battocletti, *supra* note 29 at 12.

³⁸ Because leakage can occur across national borders, leakage risk must be assessed at the international level. *Id.*

³⁹ *Id.* See also W. Aaron Jenkins, Lydia P. Olander, and Brian C. Murray, *Addressing Leakage in a Greenhouse Gas Mitigation Offsets Program for Forestry and Agriculture*, Nichols Inst. for Env’t Pol’y Sols., Duke Univ. 3 (Apr. 2009), <https://perma.cc/CFE6-T22N>.

⁴⁰ Jenkins et al., *supra* note 39 at 3.

may constitute an economically significant attribute of the underlying VCCs, which should be described in VCC derivatives' terms and conditions.

Alternatively, the Commission could instead highlight leakage risk in its recommendation on robust quantification because accounting for leakage risk is sometimes viewed as an element of quantification.⁴¹

C. The Commission should provide an example of a “conservative” methodology for quantification, such as the inclusion of an uncertainty ratio.

The Commission recommends that DCMs consider whether crediting programs “can demonstrate that the quantification methodology or protocol that [they] use[] to calculate emissions reductions or removals for the underlying VCCs is robust, conservative, and transparent.”⁴² The Commission should clarify what it means by a “conservative” methodology.

The Guidance hints that the goals of a conservative methodology for quantification include “ensur[ing] that the number of VCCs that are issued for a project or activity accurately reflects the level of GHG emission reductions or removals.”⁴³ But the Guidance gives DCMs little guidance on how to identify a “conservative” methodology.

An appropriately “conservative” methodology could vary over time to address the most pressing integrity issues as the voluntary carbon markets evolve. Given current challenges around additionality, permanence, and related issues, at least for now a “conservative” methodology may be one that addresses uncertainty. One approach that the Commission could consider highlighting as an element of a conservative methodology for quantification, and that is currently used in some other environmental credit markets, is an uncertainty ratio. After a project’s emissions reductions or removals are estimated as accurately as possible given the best available data and tools, the total number of VCCs awarded could be counted at, for example, 90% of the estimate to provide a buffer against uncertainty. As the accuracy of estimation techniques and other integrity checks improve over time, such ratios could be adjusted or eliminated. But in the near term, such tools to address uncertainty should be considered as part of a “conservative” methodology.

D. The Commission should address issues around the risk of reversal, including how timing may affect the number of VCCs needed to account for harm attributable to reversal.

The Guidance states that “information regarding a crediting program’s measures for estimating, monitoring, and addressing the risk of reversal may constitute an economically significant

⁴¹ See, e.g., Integrity Council for the Voluntary Carbon Mkt., *Core Carbon Principles, Assessment Framework and Assessment Procedure*, 89 (Jan. 2024), <https://perma.cc/7KYB-7U78>.

⁴² Guidance at 89,418.

⁴³ *Id.* The Guidance emphasizes a similar point in other parts of its recommendations related to quality standards. See, e.g., *id.* at 89,417 (“A DCM should consider whether [a crediting program’s procedures for assessing additionality] are sufficiently rigorous and reliable to provide a reasonable assurance that GHG emission reductions or removals are credited only if they are additional.”).

attribute of the underlying VCCs that should be described or defined in the terms and conditions of a VCC derivative contract.”⁴⁴ Regarding replacement of reversed credits, the Guidance mentions that “[i]f a reversal occurs, VCCs [may be] drawn upon from the buffer reserve to replace VCCs that are canceled, proportional to the size of the reversal.”⁴⁵

But the Guidance omits an important nuance: Credits should not be mechanically replaced on a one-for-one basis; required replacements should instead be proportional to the harm attributable to the reversal. The social harm caused by the release of a marginal ton of GHG emissions varies based on several factors, including the year of the emissions, the pollutant emitted, the stress climate change has already imposed on physical and economic systems at a given point in time, and the appropriate discount rate (when comparing harms in terms of net present value).⁴⁶ An emission attributable to a reversal event may therefore cause a different amount of social harm than the original, initially-offset emission. To “address evolving climate risks that may heighten the risk of reversal,”⁴⁷ procedures to respond to reversal events should focus on offsetting the *harm* attributable to the emissions. The Commission should thus clarify that a replacement for reversed VCCs should account for the harm attributable to the reversal, not just mechanically replace credits on a one-for-one basis.

Relatedly, the Commission should clarify the meaning in this sentence in the Guidance’s background section: “Further, it can be difficult to discern the extent to which the price of any particular VCC reflects the price of one metric ton of carbon dioxide equivalent reduced or removed from the atmosphere, and the extent to which the price reflects understandings or concerns relating to the mitigation project or activity for which the VCC was issued, or other aspects of the process for issuing the VCC.”⁴⁸ The “price of one metric ton of carbon dioxide equivalent reduced or removed from the atmosphere” may be interpreted to refer to estimates of the social cost of GHGs. If by “price” the Commission instead meant the cost per ton reduced of implementing a project, the Commission should clarify that point. Similarly, the meaning of “understandings or concerns relating to the mitigation project or activity” is not clear. If the Commission intended to convey that the price of a VCC may reflect issues with the VCC’s integrity (such as lack of additionality or risk of reversal), the Commission should clarify that point.

⁴⁴ *Id.* at 89,418.

⁴⁵ *Id.*

⁴⁶ See, e.g., Env’t Prot. Agency, *Report on the Social Cost of Greenhouse Gases: Estimates Incorporating Recent Scientific Advances*, 78 (Nov. 2023), <https://perma.cc/XUP4-ELGA> (“Emissions further in the future produce larger incremental damages as physical and economic systems become more stressed in response to greater climatic change and because income is growing over time.”).

⁴⁷ Guidance at 89,418.

⁴⁸ *Id.* at 89,413.

E. The Commission should remind DCMs of their discretion to implement more stringent quality standards for VCC derivatives.

As explained above, the Guidance recommends disclosure of information about VCC integrity in line with existing Commission guidance that interprets the CEA’s Core Principles. But within the bounds set by the CEA and CFTC regulations, Section 7 of the CEA grants DCMs “reasonable discretion” to set additional requirements when listing VCC derivatives, beyond any requirements the Commission has authority to require.⁴⁹ This discretion furthers the CEA’s goal of promoting innovation in derivatives markets.⁵⁰

DCMs have exercised their discretion to set quality standards for the commodities that underlie listed derivatives.⁵¹ Analogously, DCMs that list VCC derivatives could go further than simply requiring disclosure of the recommended information—they could require the VCCs underlying derivatives they list to possess certain characteristics of high-integrity VCCs that the Guidance identifies. The Commission should consider reminding DCMs of their discretion to do so.

III. The Commission should explore whether it has other authority to address issues with VCC integrity and whether to seek additional authority from Congress.

Because the Guidance directly affects only VCC derivatives listed on DCMs, its impact may be limited, at least for now. In the voluntary carbon markets overall, the volume of issued VCCs amounted to 181.1 million metric tons of carbon-dioxide equivalent reduced or removed from the atmosphere in 2020.⁵² According to one estimate, the entire market size could fall between \$5 billion and \$50 billion by 2030.⁵³ But as the Guidance acknowledges, VCC derivatives are a “new and evolving class of products”: As of November 2023, DCMs had submitted just 18 futures contracts related to voluntary carbon markets products to the CFTC for listing, only three of which had open interest.⁵⁴ And, consistent with prior Commission guidance, the present

⁴⁹ 7 U.S.C.A. § 7(d)(1)(B).

⁵⁰ Among other things, the CEA’s purpose is “to promote responsible innovation and fair competition among boards of trade, other markets and market participants.” 7 U.S.C.A. § 5(b). The discretion that DCMs have under Section 7 enables them to develop new products, which they then must submit to the CFTC so that the CFTC can ensure the products meet the CFTC’s minimum standards. *See* Statement of Commissioner Caroline D. Pham on Effective Self-Regulation and Notice of Proposed Rulemaking to Amend Part 40 Regulations (July 26, 2023), <https://perma.cc/QSG6-J76X> (in light of “the mandate to promote responsible innovation and fair competition” in the CEA, “[d]erivatives markets should enable growth and progress for commercial enterprise and free markets”); Heath P. Tarbert, *Self-Regulation in the Derivatives Markets: Stability Through Collaboration*, 41 NW. J. INT’L L. & BUS. 175 (2021), <https://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1865&context=njlilb> [Permalink unavailable] (“Core principles are at the heart of self-regulation because they provide basic requirements while leaving exchanges with ‘reasonable discretion in establishing the manner in which the [exchange] complies....’”) (brackets included).

⁵¹ *See, e.g.*, NYMEX Rulebook, *Chapter 200: Light Sweet Crude Oil Futures*, <https://www.cmegroup.com/content/dam/cmegroup/rulebook/NYMEX/2/200.pdf> [Permalink unavailable] (setting quality standards, such as sulfur content and viscosity standards, for the light sweet crude oil underlying light sweet crude oil futures).

⁵² Int’l Swaps and Derivatives Ass’n, *supra* note 6 at 21.

⁵³ *Id.* (citing an estimate by the Taskforce on Scaling Voluntary Carbon Markets).

⁵⁴ Guidance at 89,410 89,414–15.

Guidance recommends only that DCMs require disclosures about VCC integrity, not that DCMs require VCC derivatives to be tied to high-integrity VCCs.

Despite its limited scope, the Guidance might indirectly improve VCC integrity across the primary and secondary markets by identifying VCC characteristics that buyers should consider when assessing VCC integrity.⁵⁵ And, as noted, DCMs could use their discretion to impose stricter requirements for VCC derivatives. But broader and more direct regulation may be necessary to improve the integrity of VCCs and the voluntary carbon markets overall.⁵⁶

As the Guidance implicitly recognizes, however, while the Commission has exclusive jurisdiction to regulate VCC derivatives listed on DCMs, it has more limited authority to regulate the much larger primary and secondary markets for VCCs, which are currently more in need of regulation to address market integrity concerns.⁵⁷ As early as the Working Group Report's publication in 2011, the Commission and its peer regulators recognized these limitations and recommended closing the regulatory gap.⁵⁸ Regarding the primary markets for VCCs, the Working Group Report acknowledges a lack of current "regulation and oversight for the creation and tracking" of VCCs (and other carbon offsets).⁵⁹ As for the secondary markets, the Working Group Report states, "[n]o set of laws currently exist[s] that appl[ies] a comprehensive regulatory regime—such as that which exists for derivatives—specifically to secondary market trading of carbon allowances and offsets," including VCCs.⁶⁰

In light of this regulatory gap, the Commission should explore any other sources of existing authority to address the problems it has identified with VCC integrity. In particular, it should evaluate the contours of its enforcement authority, which enables it to investigate and prosecute fraud and manipulation in the secondary markets.⁶¹ As noted in the Guidance, the Commission has used its enforcement authority to establish an Environmental Fraud Task Force to address fraud and other misconduct in the voluntary carbon markets, including "fraud with respect to the purported environmental benefits of purchased carbon credits."⁶² The Commission should explore other possible exercises of its enforcement or oversight authority.

Likewise, the Commission should work with peer regulators to determine whether they might have authority over other aspects of the primary and secondary markets for VCCs. If peer

⁵⁵ *But see* Battocletti et al., *supra* note 29 at 27–29 (buyers have incentives to purchase cheap and inflated VCCs, and even buyers who care about VCC integrity face information asymmetries).

⁵⁶ *See, e.g.*, Battocletti et al., *supra* note 29 (discussing market failures that affect the primary and secondary markets for VCCs).

⁵⁷ Guidance at 89,415; *see also* Appendix 3—Statement of Commissioner Kristin Johnson at 88 Fed. Reg. 89,423, 89,424–25 (noting "the Commission's authority to introduce regulation is limited to commodity derivatives").

⁵⁸ Working Group Report at 51. At the same time, the Working Group Report appreciates that "more detailed work may be necessary to consider the appropriate oversight regime for existing and prospective primary and secondary carbon markets." *Id.* at 52.

⁵⁹ *Id.* at 43.

⁶⁰ *Id.* at 42.

⁶¹ *See* Appendix 3—Statement of Commissioner Kristin Johnson, *supra* note 57 at 89,424; Working Group Report at 43; Kluchenek, *supra* note 10 at 49 (citing 7 U.S.C. §§ 9, 12(d), 13(a)(2), 13b, 15 and 17 C.F.R. § 180.1(a)).

⁶² Guidance at 89,415, n. 60.

regulators' existing authority does not bridge the regulatory gap, the Commission and its peers should collaborate to identify the best-positioned agency or agencies to regulate the primary and secondary markets.⁶³ They should then seek any additional authority they need from Congress to improve the integrity of VCCs and the voluntary carbon markets overall.

Respectfully,

Donald L. R. Goodson, Senior Attorney
Jason A. Schwartz, Legal Director
Erin E. Shortell, Legal Fellow

⁶³ The Commission started exploring this question as early as 2009. See *Global Warming Legislation: Carbon Markets and Producer Groups Before the S. Comm. on Agriculture, Nutrition, and Forestry*, 111th Cong. 3 (2009) (statement of Gary Gensler, Chairman, CFTC), <https://perma.cc/2HWY-CASZ>.