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The CFTC starts moving on Voluntary Carbon Credits

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OCTOBER 25, 2024

The Commodity Futures Trading Commission ("CFTC") has been hard at work implementing a scheme to more effectively regulate and govern Voluntary Carbon Credits ("VCCs") and related derivatives through enforcement and guidance.

Carbon contracts, often referred to as carbon credits or emissions reduction contracts, are environmental commodities in the form of an agreement aimed at reducing greenhouse gas emissions by setting specific targets for businesses or organizations. They can take various forms, but generally, they fall into two buckets: mandatory (compliance) carbon markets and voluntary carbon markets.

The CFTC appears to be transitioning away from its more passive listening and learning posture and into a period of increased enforcement activity and publishing guidance.

Mandatory markets are government-regulated and established as part of national, regional, or international policies to meet legally binding emissions reduction targets. Companies, industries, or sectors that are subject to the requirements must demonstrate compliance by either reducing their emissions or purchasing eligible credits representing emissions reductions by others.

Voluntary carbon markets, on the other hand, are not established or regulated by any government body, and consist instead of companies or organizations that voluntarily purchase carbon credits to offset their emissions as part of their environmental or social responsibility efforts. VCCs are tradeable certificates that represent the reduction or removal of one metric ton of carbon dioxide equivalent (CO_2e) from the atmosphere.

The CFTC's journey with VCCs began on June 2, 2022, with its first voluntary carbon markets convening (https://bit.ly/4e02dVd), which focused on supply and demand, product standardization, and the data needed to support the market. A year later, on June 29, 2023, the CFTC's Division of Enforcement announced (https://bit.ly/4ffnhYM) the creation of its Environmental Fraud Task Force to "combat environmental fraud and misconduct in derivatives and relevant spot markets."[1]

A few weeks later, on July 19, 2023, the CFTC held its second voluntary carbon markets convening (https://bit.ly/4fg7WHs). As a part of his remarks (https://bit.ly/3YhgVkV) at the second convening, CFTC Chairman Behnam summarized the feedback received from participants at the first, describing his two main takeaways as follows: "one, the Commission should use [its] anti-fraud and anti-manipulation enforcement authority to the fullest extent possible; and, two, the Commission should support the development of standards to promote the growth of high integrity carbon offsets."[2] Those remarks turned out to be foreshadowing, as the CFTC has been executing on both points with great speed recently.

CFTC guidance to DCMs (and other market participants)

In September of 2024, the CFTC announced (https://bit.ly/3UlR6Pe) the "Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts" (the "VCC Guidance"). The VCC Guidance was recently published in the Federal Register (https://bit.ly/3YmONwv).[3] The CFTC worked closely with market participants to develop the VCC Guidance and expects market participants to consider it when addressing regulatory requirements under CFTC regulations.

The VCC Guidance states that it applies to Designated Contract Markets ("DCMs"), but market participants should be familiar with the core message of the CFTC's VCC Guidance: the listing of VCC derivatives should be carefully analyzed under DCM Core Principles and, as a result, the broader market will ultimately benefit from the increased standardization and transparency of VCC derivatives.[4] The VCC Guidance also notes the relevance of the guidance for Swap Execution Facilities ("SEFs") seeking to permit trading in VCC swaps contracts, whether cash-settled or physically-settled.[5]

DCMs are self-regulatory organizations and must comply with statutory "Core Principles."[6] These Core Principles include obligations to establish and enforce rules for trading on the DCM, provide a competitive, open and efficient market for trading, and monitor trading activity. DCM Core Principle 3 (https://bit.ly/48nmeDZ) and Core Principle 4 (https://bit.ly/3YjudNG) are the CFTC's primary focus in the VCC Guidance.

Core Principle 3 requires DCMs to list contracts that are not readily susceptible to manipulation, while Core Principle 4 requires DCMs to have the capacity and responsibility to prevent manipulation,

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price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices.

Core principle 3

When considering a VCC derivative's susceptibility to manipulation, the CFTC's Guidance points to Appendix C to Part 38, Title 17 (https://bit.ly/3YifuT7). Specifically, the CFTC notes that to "promote accurate pricing and help reduce the susceptibility of the contract to manipulation" DCM's should consider a VCC contract's (1) quality standards, (2) delivery points and facilities, and (3) inspection provisions.

Quality standards

When looking at quality standards, DCMs should consider transparency, additionality, permanence and risk of reversal, and robust quantification. Transparency means that the DCM should, at a minimum, provide information about the VCCs that are eligible under the contract.

The listing of VCC derivatives should be carefully analyzed under DCM Core Principles.

The VCC contract should clearly identify what is deliverable under the contract and who the crediting program is from which the VCCs can be issued. Additionality is also considered to be a key component of a high-quality VCC and, while the CFTC declines to provide a concrete definition, the term generally means that the project which created the VCC would not have happened without the incentive of the expected revenue from the VCCs.

Permanence and risk of reversal means that DCMs should evaluate whether the crediting program for underlying VCCs has measures in place (e.g. a buffer reserve or pool) to address and account for the risk that the project tied to the VCC has to be recalled or canceled. The CFTC notes that given the "current absence" of standardized methods to quantify emissions reductions, DCMs should assess whether there are reasonable assurances the crediting agency has robust quantification methods for emission reductions.

Delivery points and facilities

For physically-settled VCC derivative contracts, the CFTC believes that DCMs should consider the governance framework, tracking mechanisms, and controls to prevent double counting. A crediting program's governance framework could include provisions clearly addressing accountability, conflicts of interest, reporting and disclosures, public and stakeholder engagement, risk management, and anti-money laundering policies.

DCMs should have reasonable assurances that a credit program's tracking mechanisms makes use of a registry and tracks the issuance, transfer and retirement of VCCs, to determine who owns or retires a VCC, and to confirm that each VCC is unique, securely identified, and tied to a single emission reduction of one metric ton of carbon dioxide equivalent. Obviously, for VCCs to effectively achieve their goals of reducing carbon, they cannot be double counted. As such, DCMs should ensure each VCC is unique and may consider procedures to cross-check multiple carbon credit registries.

Inspection provisions

According to the CFTC's VCC Guidance, each VCC contract should specify in its terms and conditions any inspection or certification procedures that must be followed to confirm quality requirements or other related delivery requirements for physically-settled VCC derivatives. DCMs should also weigh whether the crediting program has up-to-date, robust and transparent procedures for verifying credited mitigation projects or activities that meet the credit program's requirements.

Core principle 4

DCMs are required to prevent price manipulation, price distortion and disruptions of the physical delivery and cash-settlement process through market surveillance, compliance, and enforcement practices and procedures. Because VCC derivatives are a relatively new product, the CFTC notes that DCMs should continue executing on the traditional methods of monitoring and looking at whether the crediting program for the underlying VCC has had related changes and whether the VCC conforms with any of the latest certifications. DCMs must also have rules that require (upon request) their market participants to provide them with trade records in the underlying VCC cash markets.

Product submission requirements

Because VCCs are a relatively a novel innovation, the CFTC has reminded DCMs that they may elect to list new derivatives contracts (including VCC derivatives) for trading either by certifying to the CFTC that the contract complies with applicable regulatory requirements, or by seeking prior approval from the CFTC.

In either case, prior to listing a derivative contract, the DCM must submit to the CFTC certain information related to the contract, including (1) an "explanation and analysis" of its compliance with Commodity Exchange Act and DCM Core Principles;[7] (2) supporting documentation to establish a basis for compliance with applicable law; and (3) any additional evidence and information that the contract meets the requirements of the Commodity Exchange Act and CFTC's regulations and policies.

Although nonbinding and a reminder of current requirements, the VCC Guidance sets the framework for DCMs and SEFs to support the development of standards to promote the growth of high integrity carbon offsets.

The CFTC's first carbon credit related enforcement action

On October 2, 2024, the CFTC filed its first carbon credit related enforcement action (https://bit.ly/3U9pPQf) — a complaint in the US District Court for the Southern District of New York against

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Kenneth Newcombe alleging that he, as former CEO for a VCC project developer called CQC Impact Investors, LLC (the "Project Developer"), engaged in a fraudulent scheme by reporting false and misleading information to at least one U.S.-based carbon credit registry, third-party reviewers, and others to "present a misleading impression" of the Project Developer's emission reduction projects.

VCCs are tradeable certificates that represent the reduction or removal of one metric ton of carbon dioxide equivalent (CO2e) from the atmosphere.

The CFTC cited, among other statutory and regulatory provisions, its authority under 17 CFR § 180.1, which "prohibits the use or attempted use of any manipulative or deceptive device, untrue or misleading statements or omissions, or deceptive practice, in connection with any swap or contract of sale or any commodity in interstate commerce, or for future delivery."[8] The CFTC's complaint states that carbon credits are commodities under the definition of "commodity" in 7 U.S.C. § 1a(9).

The Project Developer earned revenue through projects like selling enhanced efficiency cookstoves along with the project's resulting VCCs. Millions of high efficiency cookstoves were installed under this project while Mr. Newcome was both CEO of the Project Developer and sat on the board of the Carbon Credit Registry responsible for assessing and quantifying the project's carbon emissions reduction. The Project Developer provided reports concerning the cookstove project and had representations the information therein was "true, accurate, and materially complete, and not false, fraudulent, or misleading."

The CFTC, however, alleges that Mr. Newcombe and others at the Project Developer "repeatedly provided and caused to be provided false, misleading, and inaccurate information to the Carbon Credit Registry and to VVBs for the purpose of presenting a misleading impression of the quality and results of the projects, and wrongfully increasing the number of VCCs a project would be issued."[9] The CFTC claims Mr. Newcombe "set the tone" for the fraud and repeatedly talked about the scheme in email, meetings, voice calls, and chat messages. As a result of the fraud, the Project Developer was able to obtain and sell many more carbon credits than it actually produced, which Mr. Newcombe profited from.

In the same announcement of its enforcement action against Mr. Newcombe, the CFTC announced orders settling charges against Jason Steel, the Chief Operating Officer of the Project Manager the Project Developer at issue. This series of enforcement actions demonstrates the CFTC's willingness and authority to use its anti-fraud and anti-manipulation enforcement powers to the fullest extent possible to regulate VCCs.

Regulation through guidance and enforcement?

With respect to VCCs, the CFTC appears to be transitioning away from its more passive listening and learning posture and into a period of increased enforcement activity and publishing guidance. There are hints of areas the CFTC may be considering rulemakings as well (e.g., the "current absence" of standardized methods to quantify emissions reductions).[10] However, fraud and manipulation remain a key focus of the CFTC.

Right before the CFTC announced the creation of their Environmental Fraud Task Force, they issued a release (https://bit.ly/4eOMDNn) from the CFTC's Whistleblower Office seeking information related to "manipulative and wash trading, 'ghost' credits, double counting, fraudulent statements relating to material terms of the carbon credits, and potential manipulation of tokenized carbon credits."

Now that the CFTC's Environmental Fraud Task Force has a few successful enforcement actions under its belt, the CFTC will likely increase the use of its broad authorities to prevent fraud and manipulation in an effort to maintain the integrity of the VCC market.

Market participants should carefully evaluate the quality of any VCCs and VCC derivatives in their current trading portfolio and being considered in light of recent guidance and enforcement actions by the CFTC. Although not required, the CFTC's VCC Guidance presents a method for examining and confirming the quality of VCC derivatives which can be built into both contracts and compliance programs.

Following the guidance will help to protect market participants from claims of fraud and even partaking in or aiding greenwashing. Furthermore, with the creation of the CFTC's Environmental Fraud Task Force, the CFTC's request for whistleblowers on carbon contracts, and the CFTC's first carbon credit related enforcement actions, the CFTC is poised to continue exercising its anti-fraud and manipulation enforcement authority to push for high-quality and transparent markets.

Notes:

[1] CFTC Division of Enforcement Creates Two New Task Forces, Release Number 8736-23, June 29, 2023, https://bit.ly/4ffnhYM.

[2] United States Commodity Futures Trading Commission Second Voluntary Carbon Markets Convening, July 19, 2023, https://bit.ly/3YhgVkV.

[3] *Id.*

[4] Guidance Regarding the Listing of Voluntary Carbon Derivative Contracts, Commodity Futures Trading Commission, 89 FR 83378, October 15, 2024, https://bit.ly/4e4cvDL.

[5] VCC swap contracts are financial derivatives used to trade the value associated with carbon credits. They can be physically-settled, where actual VCCs are exchanged, or cash-settled, where only the price difference is paid.

[6] *See* supra note 3.

[7] *Id*.

[8] 17 CFR 180.1.

[9] *Commodities Future Trading Commission v. Kenneth Newcombe*, 24-cv-7477 (SDNY 2024), https://bit.ly/3YrQtq5.

[10] Guidance Regarding the Listing of Voluntary Carbon Derivative Contracts, at 83381, https://bit.ly/4fjkduJ.

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This article was first published on Westlaw Today on October 25, 2024.

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