Feb. 16, 2024

SUBMITTED ELECTRONICALLY AT *https://comments.cftc.gov*

Commodity Futures Trading Commission
Attn: Christopher Kirkpatrick, Secretary of the Commission
Three Lafayette Centre
1155 21st St. NW
Washington, DC 20581

RE: Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts (RIN 3038-AF40)

Dear Mr. Kirkpatrick,

The Natural Resources Defense Council (NRDC) welcomes the opportunity to comment on the Commodity Futures Trading Commission's (the "Commission") proposed guidance and request for comment titled "Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts" (the "Proposal").[1] We strongly support the Commission's action "to strengthen market integrity, transparency, and liquidity for derivatives with an underlying [voluntary carbon credit] that are real, additional, permanent, verifiable, and represent unique metric tons of [greenhouse gas] emissions reduced or removed from the atmosphere."[2] We agree that the Commission "has a significant role to play in the voluntary carbon markets."[3]

NRDC is an international nonprofit environmental organization with more than three million members and online activists. Since 1970, our lawyers, scientists, and other environmental specialists have worked to protect the world's natural resources, public health, and environment. NRDC has offices in New York City, Washington D.C., Los Angeles, San Francisco, Chicago, Montana, New Delhi and Beijing. Through its finance and legal experts, NRDC advocates for sensible

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1 Commodity Futures Trading Commission, *Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment,* 88 Fed. Reg. 89410 (Dec. 27, 2023) (the "Proposal").

2 Statement of Support of Chairman Rostin Behnam, Proposal at 89422, Appendix 2.

3 *Id*.

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financial regulation that allows our financial system to incorporate financial risks from climate change into day-to-day risk management.

Our comment will address:

- The Commission's authority to issue the proposed guidance;
- Structural weaknesses in the primary market for carbon offsets that render the related futures and derivatives markets vulnerable to abusive practices;
- Additionality, and
- Sustainable development benefits and safeguards.

Introduction: Carbon Offsets

Voluntary carbon credits ("carbon offsets," or "VCCs" as referenced in the Proposal) are tradeable instruments awarded for an initiative or project designed to reduce emissions of climate-warming greenhouse gases. There are two main types of VCCs: removal or sequestration credits, where the underlying project absorbs GHG emissions out of the atmosphere (for example, reforestation and direct air capture initiatives); and reduction or avoidance credits, where the project prevents the release of GHG emissions into the atmosphere (for example, renewable energy projects like solar and windfarm installations).[4] Each VCC is associated with a specific project's emission reduction or removal. A VCC typically represents the reduction or removal of one metric ton of carbon dioxide.[5]

The voluntary carbon markets enable businesses and individuals to purchase VCCs directly, or enter into VCC derivatives contracts, to "offset" emissions generated through their own activities.[6] Although we believe that corporate purchases of carbon offsets are generally a poor substitute for direct efforts to reduce carbon emissions, we recognize that they currently have a role in carbon emissions reduction, and believe it is important that the offsets sold and traded in the voluntary carbon markets be of high quality.

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[4] *2022 ISDA Verified Carbon Credit Transactions Definitions FAQs,* International Swaps and Derivatives Association, Inc. (June 2023), 4, https://www.isda.org/a/jBXgE/2022-ISDA-Verified-Carbon-Credit-Transactions-Definitions-FAQs-061323.pdf

[5] Proposal at 89412.

[6] *See, e.g., Voluntary Carbon Markets: Analysis of Regulatory Oversight in the US,* International Swaps and Derivatives Association, Inc. (June 2022), 3, https://www.isda.org/a/93WgE/Voluntary-Carbon-Markets-Analysis-of-Regulatory-Oversight-in-the-US.pdf

The Commission's Authority Over VCCs and VCC Derivatives Markets

VCCs are commodities under the Commodity Exchange Act (the "Act")[7], and the Commission has broad authority to police fraud and market manipulation in spot commodity markets.[8] In this regard, we commend the Commission's launch last year of the Environmental Fraud Task Force and its work to promote the integrity of spot VCC markets.[9]

The Commission has broader authority over VCC futures and derivatives markets. As discussed in the Proposal, the Commission regulates designated contract markets ("DCMs") on which VCC derivative contracts are traded. The Core Principles set forth in the Act require DCMs to, among other things:

- List only contracts that are not readily susceptible to manipulation (Core Principle 3)[10]; and
- Establish and enforce rules to protect markets and market participants from abusive practices, and to promote fair and equitable trading (Core Principle 12)[11].

Congress further assigned to the Commission the authority and the responsibility under the Act to promulgate rules and regulations to effectuate these and other provisions of the Act.[12] It is therefore appropriate for the Commission to provide guidance to DCMs on the application of these Core Principles to the listing for trading of VCC derivatives contracts.

Because the prices of VCC derivative contracts are based on the underlying VCC spot prices, if economically significant attributes of VCCs are not clear, the

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7 Commodity Exchange Act § 1a(9), 7 U.S.C. § 1a(9) ("all services, rights, and interests . . . in which contracts for future delivery are . . . dealt in").

8 Commodity Exchange Act § 6(c)(1), 7 U.S.C. § 9(1) (prohibits any person from using or employing, or attempting to use or employ, in connection with a contract for sale of any commodity in interstate commerce, any manipulative or deceptive device or contrivance, in contravention of rules and regulations promulgated by the CFTC); Commodity Exchange Act § 9(a)(2), 7 U.S.C. § 13(a)(2) (makes it a felony for any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce); 17 C.F.R. part 180.

9 *See* "CFTC Division of Enforcement Creates Two New Task Forces," Release No. 8736-23, June 29, 2023; "CFTC Whistleblower Office Issues Alert Seeking Tips Relating to Carbon Markets Misconduct," Release No. 8723-23, June 20, 2023.

10 Commodity Exchange Act § 5(d)(3), 7 U.S.C. § 7(d)(3).

11 Commodity Exchange Act § 5(d)(12), 7 U.S.C. § 7(d)(12).

12 Commodity Exchange Act § 8a(5), 7 U.S.C. § 12a(5).

related derivatives contracts may be susceptible to price distortion or manipulation. Abusive or misleading practices that result in mispricing of VCCs – including inadequate or misleading disclosure – will undermine fair and equitable trading in VCC derivatives. This is especially so because, as explained by the Interagency Working Group for the Study on Oversight of Carbon Markets, the standardization and easy transferability of offsets make offset futures a close economic substitute for the underlier, with the result that the secondary and derivatives markets for offsets should tend to be very closely linked.[13] Availability, clarity, accuracy and completeness in the documentation of the terms of VCC derivatives – particularly terms relating to the economically significant attributes of the underlying VCCs – is thus critical to the transparency and smooth functioning of the DCMs that list those derivatives.[14]

Perverse Incentives in the Carbon Offsets Primary Market

The structure of the primary market for carbon offsets gives considerable reason for concern about the quality of information relevant to the pricing of offsets and, in turn, the pricing of VCC derivative contracts. Project developers, crediting programs (the standard setters for VCCs), and the third parties that verify and validate VCCs all have incentives to *overstate* the extent to which VCCs offset emissions. Project developers make more money the more tons of emissions their projects are believed to offset. Crediting programs are compensated by project developers based on how many offsets they certify.[15] And third-party verifiers are hired and paid by project developers, and accredited by crediting programs as eligible to participate in the business, giving them incentives to cater to the preferences of both of these sets of players in the market, and thus to inflate offsets.[16] With no independent and reliable mechanism to confirm the emissions reduction claims of a particular project, buyers cannot confirm the relationship of

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[13] *Report on the Oversight of Existing and Prospective Carbon Markets,* Interagency Working Group for the Study on Oversight of Carbon Markets (Jan. 2011), 33-34, https://www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf

[14] *See also id.* at 24 ("For markets to operate effectively, it is important that they are free of manipulative and fraudulent activities. . . [F]raud in the market [may] cause erroneous price signals to enter the market, leading participants to transact at prices that do not reflect underlying supply and demand conditions. In addition . . . such events can erode confidence in the market, leading to a decline in liquidity, price discovery, and the overall economic efficiency of the markets").

[15] *See, e.g.,* Battocletti et al., *The Voluntary Carbon Market: Market Failures and Policy Implications*, European Corporate Governance Institute–Law Working Paper No. 688/2023 (July 2023), 18, http://ssrn.com/abstract_id=4380899

[16] *Id.* at 3.

VCC price to quality, i.e. to actual emissions reductions, and will tend simply to seek lower prices.

Commentators have observed that these "widespread perverse incentives"[17] result in a "race to the bottom"[18], and evidence of quality problems in the voluntary offsets markets has mounted. A much-cited investigation by the Guardian, Die Zeit and Source Material, based on three separate peer-reviewed studies, concluded that more than 90% of rainforest offset credits approved by the largest crediting program in the voluntary market did not represent "genuine carbon reductions."[19] Most recently, a 2023 meta-analysis synthesizing empirical studies of more than 2,000 offset projects concluded that only an estimated 12% of the total volume of existing carbon credits constitute real emissions reductions.[20]

Viewed in this light, the lack of a primary regulator over the VCC market leaves a regulatory gap that is deeply problematic. In addition to the Commission's antifraud and anti-manipulation jurisdiction, since 2010, the Federal Trade Commission (FTC) has provided guidance on the marketing of VCCs in its "Guides for the Use of Environmental Marketing Claims".[21] There is, however, no comprehensive regulatory regime applicable to issuances and secondary market trading of VCCs. It is thus critical that the Commission provide guidance in the VCC

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[17] Commodity Futures Trading Commission's Second Voluntary Carbon Markets Convening (July 19, 2023) (Statement of Todd Phillips, Roosevelt Institute).

[18] See, for example, Matthew Bell and Mihir Baxi, *Fixing Failing Carbon Offset Markets,* Frontier Economics (2021), https://www.frontier-economics.com/uk/en/news-and-insights/articles/article-i17296-fixing-failing-carbon-offset-markets/# ("In the absence of a rigorous mechanism to check whether the claims of a particular vendor of carbon credits are real, any faintly credible scheme has found buyers. . . [U]nable to verify quality, providers of credits are selling large volumes at low prices").

[19] Patrick Greenfield, *Revealed: more than 90% of rainforest carbon offsets by biggest certifier are worthless, analysis shows,* The Guardian (Jan. 18, 2023), https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe ; Patrick Greenfield, *Carbon credit speculators could lose billions as offsets deemed worthless,* The Guardian (Aug. 24, 2023), https://www.theguardian.com/environment/2023/aug/24/carbon-credit-speculators-could-lose-billions-as-offsets-deemed-worthless-aoe

[20] Probst et al., *Systematic review of the actual emissions reductions of carbon offset projects across all major sectors,* ETH Zürich (2023), https://doi.org/10.3929/ethz-b-000620307 . This analysis was limited to empirical studies that assess additionality using a "credible control group", meaning one with similar characteristics to the project's relevant group – as contrasted with the historical baselines often used by third party offset verifiers, which in many circumstances may be inappropriate baselines. *Id.* at 9.

[21] 75 Fed. Reg. 63552 (Oct. 15, 2010), http://www.ftc.gov/os/fedreg/2010/october/101015greenguidesfrn.pdf

derivatives market as its authority permits, in order to ensure fair and equitable trading in VCC derivatives.

We believe the proposed guidance appropriately identifies characteristics of underlying VCCs that are relevant to fair and equitable trading in VCC derivatives and to the prevention of abusive practices – in particular, characteristics that can affect pricing and potential mispricing of related VCC derivatives. Below we address questions posed in the Proposal as to *additionality* and *sustainable development benefits and safeguards.*

Additionality

7. Are there particular criteria or factors that DCMs should take into account when considering, and/or addressing in a VCC derivative contract's terms and conditions, whether the procedures that a crediting program has in place to assess or test for additionality provide a reasonable assurance that GHG emission reductions or removals will be credited only if they are additional?

8. In this proposed 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. Is this the appropriate way to characterize additionality for purposes of this guidance, or would another characterization be more appropriate?

We note at the outset that there are a range of possible characterizations of additionality. For example:

- **Financial additionality –** The sale of offsets provides financing that the project would otherwise not have raised and that is essential to make the project viable (though the project might not be implemented even with the funding).
- **Project additionality –** The sale of offsets provides financing that is essential to make the project viable (and the project is implemented).
- **Emissions additionality –** The project results in emissions avoidance, abatement or removal that would not otherwise have occurred.
- **Marginal additionality –** each carbon offset sale results in a decrease in emissions in the project.[22]

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[22] Probst et al., *supra* n.20 at 32.

The Commission appears to be proposing either a "financial additionality" or a "project additionality" standard.[23] In the absence of a full regulatory framework applicable to the primary market for VCCs, however, crediting programs may elect to certify credits that are based on any of these characterizations, as long as their certification processes and requirements are consistent with whatever characterization they elect to use. (Verra, for example, currently appears to apply at least an "emissions additionality" standard.[24]) In the event those requirements are not consistent with that characterization, or the project misrepresents its compliance with such requirements, the Commission has the authority to pursue enforcement based on, for example, fraudulent statements relating to material terms of the carbon credit, including terms relating to additionality.

Furthermore, additionality tests, while necessarily binary for purposes of accreditation or issuance determinations, are more reasonably viewed as resulting in something like a confidence interval. Based on information about a project, it is possible to have more or less confidence – but never absolute certainty – that the project is additional, because additionality determinations fundamentally rely on unverifiable counterfactuals (for example, whether alternative financing would be available in the absence of the sale of VCCs). As a result, it is never possible to conclude with complete certainty that a project is "100% additional".[25] At best, the more information projects make available on how they assess and demonstrate additionality, the better market participants can assess differences in quality between different VCCs and consequently also between different derivative contracts thereon.[26] We suggest that the Commission, in its final guidance,

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23 Financial additionality would not require that the project be implemented. The language of the Proposal in this respect is unclear; the Additionality header on p.25 of the Proposal suggests that the project must be implemented, but the text thereunder does not appear to require this.

24 VCS Quality Assurance Principles, https://verra.org/programs/verified-carbon-standard/vcs-quality-assurance-principles/ ("Projects must exceed the likeliest 'business-as-usual' scenario and demonstrate that GHG emission reductions or removals would not occur without revenue from the sale of VCUs").

25 Henson et al., *BeZero's carbon risk factor series: Additionality* (Nov. 2023), https://bezerocarbon.com/insights/bezero-carbon-risk-factor-series-additionality

26 *Id. See also* Broekhoff, D., Gillenwater, M., Colbert-Sangree, T., and Cage, P., *Securing Climate Benefit: A Guide to Using Carbon Offsets,"* Stockholm Environment Institute & Greenhouse Gas Management Institute (2019), 20, *Offsetguide.org/pdf-download/* ("Additionality is frequently talked about in binary terms . . . In practice, however, determining whether an activity is additional requires comparing it to a scenario without revenue from the sale of carbon offsets. Such a scenario is inherently unknowable . . . The determination can also fall prey to 'information asymmetry': only a project developer can say whether the prospect of selling carbon offset credits was truly decisive, but regardless

emphasize the importance of detailed information, and publicly available information, on how projects calculate additionality, as well as how crediting programs assess and test for additionality (as discussed in sections II.A.1.a-b of the Proposal[27]).

8.* [continued] *For example, should additionality 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?

The standard the Commission suggests here as an alternative is a necessary, but not a sufficient, condition of additionality. Logically, no emissions reduction or removal is "additional" if it was already required by law. We note that the FTC's Guides for the Use of Environmental Marketing Claims ("Green Guides") provide that, among other things "[i]t is deceptive to claim, directly or by implication, that a carbon offset represents an emission reduction if the reduction, or the activity that caused the reduction, was required by law."[28] Consistent with this, the American Carbon Registry, the Climate Action Reserve, and the Verified Carbon Standard all incorporate legal/regulatory additionality into their crediting standards as one element, but also include a performance-based standard (generally based on project additionality or emissions additionality).[29] We think this demonstrates that although (as discussed above) crediting programs may be at liberty to certify credits based on a range of potential frameworks, at the same time logic requires that VCCs – which are understood by the market to represent, at minimum, an emissions reduction of some kind – must be tied to a reduction that was not otherwise required, in order to be considered meaningful. We therefore suggest that the Commission incorporate this legal/regulatory additionality standard into its guidance as a part of the additionality requirement, without eliminating the further additionality requirement discussed above.

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of the truth, every project developer has an incentive to argue that it was. *In light of these uncertainties, it best* [sic] *to think of additionality in terms of risk: how likely is a project to be additional?*") (emphasis in original).

27 Proposal at 24ff.

28 Guides for the Use of Environmental Marketing Claims ("Green Guides"), 16 C.F.R. § 260.5(c).

29 *See Reserve Offset Program Manual, Version 9.0,* Climate Action Reserve, (Nov. 2023), 8-9, https://www.climateactionreserve.org/how/program-resources/program-manual/ ; *ACR Methodologies,* American Carbon Registry, https://acrcarbon.org/methodologies/approved-methodologies/ ; *VCS Standard* (Dec. 2023), Verra, 35, https://verra.org/wp-content/uploads/2023/08/VCS-Standard-v4.5-updated-11-Dec-2023.pdf

Sustainable Development Benefits and Safeguards

16. Certain private sector and multilateral initiatives recognize the implementation by a crediting program of measures to help ensure that credited mitigation projects or activities meet or exceed best practices on social and environmental safeguards, as a characteristic that helps to inform the integrity of VCCs issued by the crediting program. When designing a VCC derivative contract, should a DCM consider whether a crediting program has implemented such measures?

As discussed above with respect to additionality, in the absence of a full regulatory framework applicable to VCCs themselves, crediting programs are free to implement measures requiring social and environmental benefits and/or safeguards, as long as their certification processes and requirements are consistent with whatever measures they claim to apply. At a minimum, however, in the event the crediting programs do not implement their claimed processes or requirements, or if a project misrepresents its compliance, the Commission has jurisdiction to pursue enforcement based on fraudulent statements relating to material terms of the VCC.

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We applaud the Commission for proposing this regulatory guidance as a Commission, rather than via a staff advisory. Publishing the Proposal in the Federal Register, and not merely on the Commission's website, ensures a meaningful notice and comment process for interested parties. While we appreciate the valuable role of Commission staff letters issued pursuant to Commission Regulation 140.99, advancing the Proposal by the Commission provides market participants with a level of regulatory certainty that is not afforded by staff action. We encourage the Commission to move forward with swift adoption of the Proposal – by the Commission – so market participants have constructive notice of the Commission's expectations with respect to VCC derivative contracts. We note that the Commission has previously issued guidance and, with data and experience, subsequently adopted those positions in regulation.[30] We encourage the Commission to consider the appropriateness of taking similar action for VCC derivatives in the future.

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[30] *See, e.g.*, *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations*, 78 Fed. Reg. 45292 (July 26, 2013) and *Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants*, 85 Fed. Reg. 56924 (Sept. 14, 2020). We acknowledge Commissioner Kristin Johnson's call for the "discussion and the development of a comprehensive regulatory initiative to address the deeply concerning, and nearly

Finally, whether in the form of regulation or guidance, we encourage the Commission to continue gathering information and developing expertise in VCC derivative contract markets. In 2018, when the Commission began developing policy for virtual currency derivatives, it issued a staff advisory to market participants with respect to product listings.[31] In that letter, Commission staff committed that it would "reevaluate and revisit the advisory, as necessary, to address any new or heightened concerns raised by these products and not covered under this advisory." As Commissioner Christy Goldsmith Romero noted, "it is important that the Commission remain nimble and aware of changes."[32] We respectfully submit, in the early days of VCC derivatives markets, that periodic reevaluation and consultation with market participants and the public will ensure Commission policy remains appropriately calibrated and reflective of VCC derivative contracts and VCC derivative markets as they evolve over time.

We thank the Commission for its consideration of these comments, and would be happy to provide further information on request.

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indisputable, proliferation of fraud in the carbon credit markets." *See* Proposal at 89423. NRDC welcomes the opportunity to contribute to this important initiative.

[31] See CFTC Staff Advisory No. 18-14, *Advisory with respect to Virtual Currency Derivative Product Listings*, May 21, 2018, https://www.cftc.gov/PressRoom/PressReleases/7731-18.

[32] Statement of Commissioner Christy Goldsmith Romero, Proposal at 89428, Appendix 4.