February 16, 2024

VIA ON-LINE SUBMISSION
Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment
(Federal Register Vol. 88, No. 247, 89410)
RIN 3038–AF40

Dear Mr. Kirkpatrick:

CME Group Inc. ("CME Group") appreciates the opportunity to comment on the Commodity Futures Trading Commission's (the "CFTC" or "Commission") Request for Comment related to Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts ("Proposal"), which was published in the Federal Register on December 27, 2023.[1] In the Proposal, the Commission outlines factors that designated contract markets (''DCMs'') should consider when listing voluntary carbon credit ("VCC") derivatives contracts for trading.

CME Group is the parent of four U.S.-based DCMs: Chicago Mercantile Exchange Inc. ("CME"), Board of Trade of the City of Chicago, Inc. ("CBOT"), New York Mercantile Exchange, Inc. ("NYMEX") and Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). These Exchanges offer a wide range of products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural, and environmental commodities. Notably, within CME Group's broad portfolio, NYMEX currently lists for trading multiple VCC derivatives contracts. CME is also registered as a derivatives clearing organization ("DCO") (also known as "CME Clearing") which provides clearing and settlement services for exchange-traded and over-the-counter derivatives transactions.

CME Group appreciates the Commission's efforts to address evolving carbon markets. We caution, however, that the development of standards in the voluntary carbon markets ought to be a coordinated effort among all international standard setters given the global nature of the risks. To this end, we encourage the CFTC to engage with the myriad global stakeholders and take account of their standards and processes related to voluntary carbon markets to ensure they are reliable and properly harmonized. We appreciate that the Proposal relies on evolving industry standards, but emphasize that these standards

[1] Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts, 88 Fed. Reg. 89,410 (December 27, 2023)

are indeed evolving with the market, and so we encourage any action by the Commission to be flexible and principles-based to adjust appropriately.

CME Group Exchanges understand the obligations placed on them by the Commodity Exchange Act ("CEA") and the CFTC regulations thereunder when designing derivatives contracts to list for trading. In addition, the Exchanges have deep experience with the standards set forth in Appendix C to Part 38, including that a contract's design meets the risk management needs of prospective users and promotes price discovery of the underlying commodity. We have applied these standards to all of our derivatives contracts, including contracts that have served as global benchmarks, for decades. We have also applied these standards to our VCC contracts.

The Proposal, however, raises concerns that we wish the Commission to consider. We recognize the Commission's exclusive jurisdiction over DCMs, but note that its rulemaking authority does not extend to spot markets. We further believe that the principles-based regulatory regime applicable to all DCM-listed products today, including VCC derivatives products, is effective. This Proposal, although characterized as "Guidance," layers in prescriptive standards specific to the VCC spot markets. Because voluntary carbon markets are nascent and rapidly evolving, the granular prescriptions in the Proposal would likely inhibit their growth. The CFTC is neither best situated nor authorized to set cash market standards, yet the Proposal would effectively require DCMs to do so. As discussed below, we urge the Commission to scale back the Proposal and separately note that to the extent the agency adopts the Proposal, its scope should extend to Foreign Boards of Trade ("FBOTs") to ensure that the Commission is fostering fair competition as set out in the CEA. Given the global nature of these markets, the Commission runs the risk of inadvertently encouraging development of the markets off DCMs, if the Proposal is not applied equally.

I. <u>Background</u>

The Proposal observes at the outset that "the CFTC exercises the authorities granted to it under the CEA to promote market integrity, prevent price manipulation and other market disruptions, protect customer funds, and avoid systemic risk, **while fostering responsible innovation and fair competition in the derivatives markets**" (emphasis added).[2] Consistent with the purposes of the CEA, the Commission's longstanding principles-based regulatory regime has advanced such innovation.[3] Under this flexible regime, the CEA grants DCMs reasonable discretion to determine the manner in which they will comply with statutory "Core Principles." In some instances, the Commission has adopted rules and guidance governing the exercise of the DCMs' discretion. By establishing the core-principle regime, Congress struck a careful balance between preserving the DCMs' ability to act responsibly as the SROs of their own markets and the Commission's oversight of their compliance with the Core Principles. The certification procedure for a DCM to list a new product for trading, a feature of the CEA since 2000, exemplifies this balance, reposing initial responsibility and judgment for designing a new derivatives product in the DCMs, including the determination whether the product complies with the core principles.

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[2] See CEA section 3(b), 7 U.S.C. 5(b).

[3] In 2007, then-Acting CFTC Chairman Walt Lukken stated "[t]he [Commodity Futures Modernization Act] replaced the prior 'one-size-fits-all' regulatory model with a flexible, practical, principles-based model for exchanges. U.S. exchanges also were given the authority to approve new products and rules through a self-certification process without prior CFTC approval, which encouraged innovation and enabled exchanges to act quickly in response to fast-changing market conditions." *Hearing to Review Trading of Energy-Based Derivatives: Hearing Before the Subcomm. on General Farm Commodities and Risk Management of the H. Comm. on Agriculture*, 110th Cong., 1st Sess. 13 (July 12, 2007).

In support of the Proposal, the CFTC has focused on Core Principles 3 and 4, and their related rules and guidance in Part 38. Core Principles 3 and 4 provide as follows:

> ***(3) Contracts not readily subject to manipulation***
> The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.[4]
>
> ***(4) Prevention of market disruption***
> The board of trade shall have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures, including—
> (A) methods for conducting real-time monitoring of trading; and
> (B) comprehensive and accurate trade reconstructions.[5]

The CFTC promulgated CFTC Regulations 38.200-38.201[6] and CFTC Regulations 38.250-38.258[7] to implement Core Principles 3 and 4, respectively and adopted guidance to help DCMs focus on "important concerns which the Commission believes should be considered in complying with the Core Principle." At the same time, the guidance "is illustrative only of the types of matters that a DCM may address, and is not intended to be used as a mandatory checklist."[8]

II. <u>Comments</u>

1. *The CFTC does not have rulemaking authority over spot markets*

The CEA does not provide the Commission with jurisdiction to regulate markets involving cash commodity (i.e., spot market) transactions. And the Commission cannot do indirectly what it cannot do directly, by dictating standards for the VCC cash market and registries via DCM Core Principles. While the CFTC has general anti-fraud and anti-manipulation authority over this spot market, that authority does not empower the agency to impose requirements on this market any more than it does on any other commodity markets.[9] To the extent the Commission identifies fraudulent or manipulative conduct in the spot VCC market in the course of its oversight of exchange listed derivatives contracts based on that market, we would support the Commission in its exercise of this important enforcement tool.

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[4] CEA section 5(d)(3), 7 U.S.C. 7(d)(3).

[5] CEA section 5(d)(4) 7 U.S.C. 7(d)(4).

[6] 17 CFR 38.200–201.

[7] 17 CFR 38.250–258.

[8] 17 CFR part 38, Appendix B.

[9] See CEA Section 6(c)(1), 7 U.S.C. § 9(1), enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) (Dodd-Frank). Commodity Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 217 (E.D.N.Y.), reconsideration denied, 321 F. Supp. 3d 366 (E.D.N.Y. 2018) ("CFTC's broad authority extends to fraud or manipulation in derivatives markets and underlying spot markets.")

2. *Principles-based regulation will be effective as applied to VCCs in the same way it has been effective for other derivative products*

We believe that the existing principles-based regulatory regime has allowed the Commission to fulfill its mandate to promote market integrity, protect customer funds, avoid systemic risk, and foster responsible innovation and fair competition. Particularly for product development, the principles-based regime has enabled DCMs to grow and maintain their leadership positions in the global marketplace. And the Commission has recognized the link between this flexible approach and the strength of U.S. derivatives markets. For example, in the wake of the Commodity Futures Modernization Act's enactment, the Commission stated, "[t]he [product] certification procedure was established by the [CFMA], in order to permit exchanges to react quickly in a competitive and dynamic business environment."[10] In 2005, then-Acting CFTC Chairman Sharon Brown-Hruska touted the benefits of the self-certification process, stating, "[n]ew product and rule amendment certification procedures in the CFMA have also lowered regulatory barriers and fostered innovation by providing exchanges greater flexibility in listing contracts and reacting to developments in the cash markets . . . . In short, the innovation, competition, and customer choice envisioned by Congress in passing the CFMA is bearing fruit."[11] Two decades later, the Commission has continued to recognize the merits of this regime.[12]

While styled as guidance, this Proposal is actually quite prescriptive and granular, a departure from the principles-based regime that has served the Commission and the industry so well for decades. Derivatives contracts may have, from time-to-time, incidentally helped contribute to the standardization of underlying cash markets, but they cannot be used as a vehicle to advance or enforce norms for cash markets. The CEA expressly authorizes DCMs to design derivatives products to list for trading. To this end, DCMs must conduct careful due diligence and analysis of the underlying cash market before bringing a new derivatives product to market, and on an ongoing basis monitor cash market developments and revise contract terms and conditions when necessary or appropriate *in response* to developments in the spot market. Consistent with this approach, the CFTC has not imposed a prescriptive design for a derivatives contract and should not do so now based on an underlying cash market where standards continue to be developed. Indeed, the CFTC's acknowledgment in the Proposal that it may be appropriate "to revisit the guidance or to issue additional guidance in the future, as VCCs and voluntary carbon markets continue to develop and mature" implicitly recognizes this.[13]

CME Group believes that the Commission's existing rules and guidance appropriately govern its oversight of DCMs' responsible design of derivatives contracts and continued compliance with the Core Principles and implementing regulations. Among these, in addition to various provisions in Part 38

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10 Review Commodity Futures Trading Commission Regulatory Issues: Hearing Before the S. Comm. on Agriculture, Nutrition, and Forestry, 108th Cong., 2d Sess. 35 (May 13, 2004).

11 To Consider the Reauthorization of the Commodity Futures Trading Commission: Hearing Before the S. Comm. on Agriculture, Nutrition, and Forestry, 109th Cong., 1st Sess. 47 (Mar. 8 & 10, 2005).

12 In 2018, then-CFTC Chairman Giancarlo highlighted market-driven innovations that the self-certification process for exchange-traded derivatives products has enabled, noting that while 793 products were approved from 1922 until the CFMA was signed into law in 2000, exchanges self-certified 12,016 products in the subsequent 17 years. Remarks of Chairman J. Christopher Giancarlo before the Market Risk Advisory Committee Meeting (Jan. 31, 2018), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement013118#P19_4317.

13 88 Fed. Reg. 89,416

identified above, is CFTC Regulation 38.252, which requires DCMs to monitor contract terms and conditions as they relate to the underlying market and convergence between the futures and underlying for physically-delivered contracts. These principles-based regulations and related guidance, coupled with market-based solutions to develop cash market standards, continue to be the appropriate path forward. In this regard, we note that the Proposal does not identify any examples of (i) VCC derivatives contracts listed on a DCM that the CFTC has found to be readily susceptible to manipulation or (ii) market disruption in a VCC derivatives contract listed on a DCM.

3. *Voluntary carbon markets are nascent and international coordination should be pursued*

We recognize and commend the Commission's prior engagement with the voluntary carbon credit market and note that those earlier efforts, as evidenced by Chairman Behnam's statements, were aimed at supporting market-based initiatives and an orderly transition to a net zero economy.[14] We believe that the Proposal as drafted will not advance these goals.

As noted in the Proposal, as of November 2023, there are only eighteen futures contracts on VCCs listed by DCMs and, of those, only three – all products listed on the NYMEX DCM – have open interest.[15] VCC futures are a nascent market, important to those that believe VCCs are integral in the transition to a net zero economy. The prescriptive requirements set forth in the Proposal risk stifling growth and participation in the VCC derivatives market by both DCMs and market participants, which in turn would negatively impact the underlying VCC spot market by affecting price discovery and access to risk management tools.

Equally important, the Commission has recognized the international nature of VCCs as tradable products and highlighted the CFTC's efforts in "increasing U.S. participation in *international* cooperative efforts."[16] The Proposal acknowledges that multilateral and private sector initiatives have focused on developing standards for high-integrity VCCs.[17] We welcome the development of multiple cross-registry standards, such as the Integrity Council for Voluntary Carbon Markets ("ICVCM") and the Carbon Offsetting and Reduction Scheme for International Aviation ("CORSIA"); these standard setting bodies are well positioned to establish industry-wide frameworks to address many of the considerations that the Commission raises in its Proposal. Similarly, we look forward to monitoring developments around the International Organization of Securities Commissions ("IOSCO") consultation related to voluntary carbon markets. We support the CFTC's prior approach and the Commission's continued efforts to engage and coordinate at an international level.

[14] "In March 2021, I created the Climate Risk Unit (CRU) within the CFTC to leverage the agency's resources and expertise to better understand the role of derivatives in pricing and mitigating climate-related risk, and support the orderly transition to a net zero economy through market-based initiatives." Remarks of Chairman Rostin Behnam at the July 28, 2022 Financial Stability Oversight Council Meeting.

[15] 88 Fed. Reg. 89,414.

[16] Opening Statement of Chairman Rostin Behnam at the CFTC Voluntary Carbon Markets Convening, Washington, DC (Jun. 2, 2022) (emphasis added).

[17] 88 Fed. Reg. 89,414.

4. *Establishing standardized derivatives contract terms is not the same as setting cash market standards*

A basic tenet of exchange listed futures contracts is that they are standardized. Appendix C to Part 38 sets out guidance on the acceptable specification of their terms and conditions. This construct has worked appropriately, as DCMs have had decades-long experience in developing derivatives contracts that incorporate cash market standards in evolving markets.[18] However, the Proposal appears to invert this construct. Although couched as guidance and presented as certain data points that a DCM must consider when listing a VCC derivatives contract, the Proposal attempts to leverage the Commission's jurisdiction over the futures market to establish standards for the VCC spot market using these criteria. While we support efforts to bring additional standardization to the VCC spot market, the CFTC should consider whether this is the appropriate time and method to facilitate that. As noted above, DCMs design derivative products based on developments in and characteristics of a spot market. Moreover, DCMs have an ongoing obligation, under CFTC Regulation 38.252, to monitor the terms and conditions of the futures contracts as they relate to the underlying market and convergence between the futures and underlying for physically-delivered contracts. The Proposal's attempt to dictate a particular cash market's standards via DCM derivatives product design risks inadvertently muddying the existing requirements of Part 38, and is inconsistent with the longstanding, principles-based regime and the Commission's limited jurisdiction. Among the many granular and prescriptive criteria under the Proposal that DCMs must consider when listing a VCC derivative contract, we identify several that are especially concerning and urge removing should the Proposal be finalized.

In particular, DCMs are not well positioned to render judgment on certain of the Proposal's criteria as they include a high degree of subjectivity and, like the Commission, DCMs do not have the authority or ability to impose standards for the cash market. For example, the Proposal would require DCMs to consider whether the underlying VCCs represent GHG emission reductions or removals that are ''additional'' and whether a crediting program can demonstrate that it has procedures in place to assess or test for additionality.[19] DCMs, however, are not in a position to determine that an underlying VCC ultimately represents GHG emission reductions. Similarly, while as a factual matter a DCM could confirm that procedures are in place to assess for additionality, it should not be expected to opine on the accuracy, robustness or appropriateness of such procedures. Further, while there may be broad consensus that additionality is an important element of a high quality VCC at a conceptual level, the question of how additionality is defined and calculated is a complex and nuanced issue and does not appear to have yet reached industry consensus. As such, even if DCMs were to invest in building the expertise to granularly evaluate a registry's procedures related to additionality, it would find itself tasked with making a subjective determination as to whether those procedures are sufficient. In this way, it would be setting standards, rather than "conform[ing] to the most common commercial practices and conditions in the cash market".[20] Neither the Commission nor DCMs should dictate these procedures, definitions, or calculations.

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[18] In our current VCC derivatives products offering, we have partnered with CBL, which is a spot exchange for environmental commodities. By virtue of this relationship, we not only stay attuned to developments at the registry level, but also to the spot market more broadly, and can align our standards accordingly.

[19] 88 Fed. Reg. 89,417.

[20] 17 CFR part 38, Appendix C.

The Proposal would require DCMs to consider whether the crediting program regularly reviews the methodology by which the size of its buffer pool is calculated.[21] Generally, a buffer pool is a mechanism that a registry may employ to ensure, to the extent possible, that previously issued VCCs deliver the promised GHG emission reduction or removal. To achieve this, a portion of the VCCs generated by a project could be set aside and placed in a "buffer pool" instead of being sold. In the event of a reversal (i.e., the release of GHG emissions which were ostensibly removed or avoided by the project), the buffer credits could be used. Similar to the above, while DCMs can confirm that a registry has a buffer pool, it would not be appropriate to require DCMs to monitor the registries to ensure that they are engaging in regular reviews of the methodology or opine on the adequacy of those reviews. As explained above, DCMs are not in a position in the cash market to do so and it would be impractical for them to develop the expertise to opine on the sufficiency of buffer pool methodology.

In some instances, the Proposal expressly requires the DCM to render subjective judgment. For example, the Proposal would require a DCM to make a determination that the crediting program for the underlying VCCs is able to demonstrate that "the quantification methodology or protocol that it uses to calculate emission reductions or removals for the underlying VCCs is robust, conservative, and transparent."[22] Not only would it be impractical for DCMs to develop the expertise to render such judgment, but it also is possible, if not likely, that various DCMs and market participants could have different views as to what level of robustness, conservatism and transparency is sufficient. We believe it is preferrable for the crediting program to publish its methodology, as is the case today, and for market participants to render their own judgment.

Additionally, from a governance perspective, DCMs would be required to consider whether the crediting program for the underlying VCCs "can demonstrate that it has a governance framework that effectively supports the crediting program's independence, transparency and accountability."[23] Going further still, the Commission would have DCMs include information about the crediting program's governance framework in the terms and conditions of the VCC derivatives contract.[24] We do not believe that DCMs should determine the effectiveness of a governance framework's support of a crediting program's independence, transparency and accountability. Again, DCMs are not experts in registry governance structures, and it is impractical to expect DCMs to develop such expertise. Moreover, we are not aware of any other instances where the Commission has required a DCM to include the governance structure of a spot market infrastructure provider in the derivatives contract's terms and conditions. In fact, the closest existing requirement under Appendix C to Part 38 is a direction that contract terms and conditions should specify what conditions a delivery facility must meet in order to be eligible. Appendix C to Part 38 further calls for DCMs to consider the extent to which ownership of delivery facilities is concentrated "and whether the level of concentration would be susceptible to manipulation of the futures contract's prices."[25] The governance structure analysis proposed for VCC crediting programs, by contrast, lacks the anti-price-manipulation rationale that underpins the existing ownership analysis around delivery facilities and would constitute another overstep into the spot market and one that a DCM is ill-equipped to take.

[21] 88 Fed. Reg. 89,418.

[22] 88 Fed. Reg. 89,418.

[23] 88 Fed. Reg. 89,418.

[24] 88 Fed. Reg. 89,419.

[25] 17 CFR part 38, Appendix C.

DCMs would also be required to render judgment with respect to whether "a crediting program is employing best practices with respect to third-party validation and verification, which may include conducting reviews of the performance of validators, procedures for remediating performance issues, not using the same third-party validator to verify every project type or project category, and using a separate third party to conduct ongoing validation and verification from the third party that completed the initial validation and verification process."[26] This appears to be a requirement that a DCM validate that the validators of a crediting program are properly validating that crediting program. Serving as arbiter of validation standards of a crediting program is not the appropriate role of a DCM.

Ultimately, the Proposal appears to be an attempt to establish standards for the VCC spot market by dint of identifying various granular criteria that DCMs "must consider" when listing a VCC derivatives contract. While we support enhancing standardization in the VCC spot market, compelling derivatives market participants to take steps to achieve that objective is not within the Commission's remit. In our estimation, the lion's share of these criteria are publicly available. As such, participants in the VCC derivatives market are free to transact, or not, based on their assessment of the data points that matter to them. As noted above, there are ongoing private sector and multilateral initiatives to set industry standards, in which the CFTC should continue to participate as the industry arrives at global, market-based solutions.

5. *Any Guidance, if implemented, should apply to Foreign Boards of Trade*

Should the Commission move forward with this Proposal, it is imperative that FBOTs are expressly covered.[27] Commission regulations already hold both DCMs and FBOTs to a "not readily susceptible to manipulation" standard. For DCMs that is CFTC Regulation 38.200, as discussed above.[28] For FBOTs, it is CFTC Regulation 48.7(c)(1)(iv).[29] If this Proposal is simply guidance to further guard against listing contracts readily susceptible to manipulation, the Commission should apply such guidance to both DCMs and FBOTs. A failure to do so would subvert the Commission's mandate to foster "fair competition in the derivatives markets," all but guaranteeing an exacerbation of the regulatory arbitrage in favor of foreign trading platforms that exists today.[30]

III. <u>Conclusion</u>

CME Group thanks the Commission for the opportunity to comment on this Proposal. As discussed throughout our comments, we believe that supporting and engaging with multilateral initiatives in the development of market-based standards, which DCMs can choose to incorporate in the design of their VCC derivatives contracts, represents the appropriate path forward and the most effective one. We look

[26] 88 Fed. Reg. 89,419.

[27] The Commission raised this very question in the Proposal: "Should the VCC commodity characteristics that are identified in this proposed guidance as being relevant to the listing by a DCM of VCC derivative contracts, also be recognized as being relevant to submissions with respect to VCC derivative contracts made by a registered foreign board of trade under CFTC regulation 48.10?" 88 Fed. Reg. 89,421.

[28] 17 CFR 38.200.

[29] 17 CFR 48.7(c)(iv).

[30] See CEA section 3(b), 7 U.S.C. 5(b).

forward to working with the Commission and all other relevant regulators and international bodies to facilitate derivatives markets that continue to meet the risk management needs of market participants and promote price discovery of VCCs. In particular, we would appreciate the opportunity to further discuss our concerns with Commission staff in order to facilitate guidance that is respectful of DCMs' obligations to *reflect* quality standards in the cash market, rather than set them, and honors the Commission's principles-based regime. If you have any comments or questions, please feel free to contact me at (312) 930-2324 or via email at **Jonathan.Marcus@cmegroup.com**.

Sincerely,

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