

An Early Step Toward Regulation Of Carbon Offset Market

By **Levi McAllister and Pamela Tsang Wu** (June 17, 2022, 5:19 PM EDT)

With the push to transition to a low-carbon economy, carbon offsets have become an option that many have turned to in order to decarbonize and achieve their climate goals.

The demand for carbon offsets is quickly increasing, and industry has recognized the need for quality standards applicable to a carbon offset, the ability to monitor, report and verify carbon offsets, and mechanisms that ensure market integrity.

Indeed, with the exponential growth of the carbon offset markets and demand for carbon offsets, a primary question among market participants has been: How can we ensure and enhance the credibility and integrity of the voluntary carbon markets?

Private sector-led initiatives have been established to, among other things, scale an effective and efficient voluntary carbon market and accelerate the growth and adoption of voluntary carbon markets.

However, the success of these initiatives are inherently limited by market participant confidence in the integrity of the various components in a voluntary carbon market.

Many market participants have emphasized the need for transparency and harmonization in the voluntary carbon markets and believe that additional transparency and harmonization will spur confidence and participation in the markets and enable the markets to be more liquid and resilient.

As is often the case, progress is incremental. The intrinsically unregulated nature of a voluntary carbon market coupled with the absence of any meaningful U.S. federal regulatory role in this area has rendered it difficult to achieve such transparency and harmonization.

However, recent steps in this space are promising.

The Commodity Futures Trading Commission held the Voluntary Carbon Markets Convening on June 2 to discuss issues related to the supply and demand for high quality carbon offsets and to solicit input from market participants on the CFTC's role in regulating the carbon offset markets.



Levi McAllister



Pamela Tsang Wu

Multiple carbon offset derivatives contracts are listed on the CFTC's regulated exchanges, and more are expected to be listed.

In his opening remarks, CFTC Chairman Rostin Behnam acknowledged that the derivatives markets are implicated by the voluntary carbon markets and stated that the CFTC must build its capacity to ensure the integrity and credibility of the carbon offset markets, to identify and pursue potential fraud or other abusive practices, and to promote responsible innovation and fair competition.

Overview of Carbon Offsets

A carbon offset is a credit that represents the reduction or removal of one ton of carbon dioxide emissions from the atmosphere.

Emissions-reducing projects can generate a carbon offset by capturing and destroying a greenhouse gas that would otherwise be emitted or by capturing and storing a greenhouse gas that would otherwise be released into the atmosphere. They can also generate a carbon offset by producing energy with a clean, renewable resource.

A carbon offset can be purchased or sold to allow the holder of the carbon offset to mitigate or negate the impact of the greenhouse gas emissions from its own activities to achieve its climate goal of reducing emissions.

Carbon offsets can be traded in both mandatory compliance carbon markets and in voluntary carbon markets. Compliance carbon markets are marketplaces through which regulated entities can purchase and sell emissions allowances or offsets to meet established regulatory obligations.

On the other hand, voluntary carbon markets function independent of compliance carbon markets and allow companies to purchase and sell carbon offsets voluntarily without an intent to use the offset for compliance purposes.

Companies may wish to voluntarily purchase carbon offsets to compensate for emissions that cannot be reduced through direct emissions reductions to meet their climate commitments and emission reduction goals.

CFTC Voluntary Carbon Markets Convening

The Voluntary Carbon Markets Convening served two primary purposes: to allow the CFTC to achieve a better understanding of the voluntary carbon markets and how they operate, and to solicit feedback from market participants on what role they believe the CFTC should play in the voluntary carbon markets.

The CFTC previously recognized the need for standardization in the voluntary carbon markets to help scale up trading and to create a role for regulators to ensure market integrity. With the continued development of voluntary carbon markets and the emergence of CFTC-regulated derivatives that reference cash offset markets, the question is no longer if the CFTC will be involved in the regulation of carbon offsets and carbon markets.

The question has become how the CFTC will be involved in the regulation of carbon offsets and carbon markets. Behnam stated that as the regulator of derivatives, the CFTC must understand how the carbon

offset markets operate and must be able to ensure, where appropriate, that voluntary carbon markets grow in a responsible way with appropriate supervision, guidance and guardrails.

The Need for Transparency, Integrity and Standards

The integrity of the voluntary carbon markets is a primary focus of many market participants and was a key part of the discussion during the Voluntary Carbon Markets Convening. Voluntary carbon markets play and will continue to play an important role to enable companies to achieve their climate goals.

However, those who are currently participating in or contemplating participating in the voluntary carbon markets have expressed a need for both greater transparency in the markets and for standardization of what constitutes a good or high-quality carbon offset.

Many of the panelists explained that additional transparency in the voluntary carbon markets will enhance the confidence in the markets and the ability to trust in the carbon offsets that are transacted. Additional transparency can facilitate the review and assessment of how a carbon offset is generated and how it is actually used.

Many also expressed support for the establishment of a common set of standards that all carbon offsets must satisfy. Proponents of such standards state that the standards will not only promote the integrity of the voluntary carbon markets and innovation, but it will also create confidence in the quality of the carbon offsets that are transacted in the various carbon markets.

It will help provide market participants the confidence that the carbon offset that is transacted represents the actual reduction or avoidance of carbon emissions. In turn, it will promote confidence in the prices at which carbon offsets are transacted and in the contracts that are related to such transactions.

Proponents of a common set of standards also note that the harmonization of the different standards that currently exist will help ensure fungibility and comparability across markets, which will encourage additional participation and liquidity in the voluntary carbon markets.

Notwithstanding the benefits of having a common set of standards, many recognize that a one-size-fits-all standard is difficult to achieve given the nuances in the various sectors and the differences in the approaches and thinking behind a carbon offset.

CFTC's Potential Role in Regulating the Voluntary Carbon Markets

Although the extent of the CFTC's involvement in and regulation of carbon offsets and markets remains to be seen, the Voluntary Carbon Markets Convening was the CFTC's first step toward finding its role and place in the carbon markets.

Behnam acknowledged that the CFTC is well positioned as the regulator that is at the forefront of climate-related risk management as market participants from a variety of sectors turn to the derivatives markets to manage and mitigate climate-related risk and facilitate the transition to a net-zero economy.

Some of the panelists expressed support for the CFTC to facilitate and promote coordination, interoperability and standardization across the voluntary carbon markets by working with other global regulators across the world. Some panelists also support the development of regulations that establish

how carbon offsets should be treated across different jurisdictions and how carbon offsets can be created, transferred and retired.

These regulations would help address the potential for fraud in the voluntary carbon markets. Because carbon registries have been established individually and in a fragmented manner, there is no centralized location in which one can ascertain whether a project has already received a carbon offset. This has created the potential for fraud through the double counting of a carbon offset.

Some also expressed support for the CFTC to regulate products tied to voluntary carbon markets and added that the CFTC should provide regulatory clarity on the treatment of financial instruments related to carbon offsets.

Takeaways and Next Steps

The Voluntary Carbon Markets Convening confirmed the need for additional transparency, standardization and integrity in the voluntary carbon markets. It also confirmed that many market participants believe that the CFTC can play a critical role in facilitating standardization and harmonization across the various voluntary carbon markets.

As market participants continue to turn to carbon offsets as a critical tool to reduce their carbon emissions, it is clear that there is a need for standards that allow market participants to be confident that the carbon offsets they hold are high quality and represent a true and meaningful reduction or avoidance of carbon emissions.

Separately, and on the same day as the Voluntary Carbon Markets Convening, the CFTC released a request for information on June 2 to better inform its understanding and oversight of climate-related financial risk related to the derivatives markets and underlying commodities markets. Among the areas that the request for information seeks information are the voluntary carbon markets.

In particular, the CFTC seeks information on:

- Whether there are ways in which the CFTC could enhance the integrity of voluntary carbon markets and foster transparency, fairness and liquidity in those markets;
- Whether there are aspects of the voluntary carbon markets that are susceptible to fraud and manipulation and/or merit enhanced commission oversight; and
- Whether the CFTC should consider creating some form of registration framework for any market participants within the voluntary carbon markets to enhance the integrity of the voluntary carbon markets, and if so, what a registration framework would entail.

In addition to soliciting feedback on its potential role in the voluntary carbon markets, the CFTC has indicated that it is considering establishing a registration framework for market participants in the voluntary carbon markets.

The CFTC stated that it may use the information gathered through its request for information, which is due by Aug. 8, to issue new or amend existing guidance, policy statements and regulations or take other action.

Levi McAllister is a partner and Pamela Tsang Wu is an associate at Morgan Lewis & Bockius LLP.

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