

Enforcement Risks Of Carbon Offsets Are Growing

By **Levi McAllister** and **Pamela Wu** (February 22, 2023, 2:56 PM EST)

ESG. Net zero. Carbon sequestration. In 2023, all of these terms will continue to be widely referenced in mainstream media publications, corporate governance and shareholder materials, and regulatory filings and issuances.

Although the terms are technically unrelated, at their core they reflect a growing social consciousness, both in the U.S. and abroad, concerning carbon dioxide concentrations in the atmosphere, and the impacts of individual and corporate actions on greenhouse gas emissions.

Corporate documents or individuals that make reference to environmental, social and governance investing criteria, achieving net-zero goals, or pursuing sequestration initiatives often do so with specific, targeted actions in mind designed to achieve certain benchmarks. Of course, that raises a threshold question of how an entity or individual can achieve reduced GHG goals or demonstrate net-zero operations.

In response to growing public and internal demands to address climate change, corporate entities and individuals are seeking to reduce carbon footprints through the generation or purchase of environmental attributes. However, regulatory exposure and the potential for enforcement oversight raise practical concerns and considerations for the entities — both purchasers and sellers — that transact in these products.

There are a few best practices that those involved in drafting the commercial purchase and sale contracts, and internal compliance and legal counsel involved in carbon offset transactions, should consider if they are delving into this commodities market.

This is even more important to look at now, as recent comments by Commissioner Christy Goldsmith Romero of the [Commodity Futures Trading Commission](#) affirm this point, and bring to the immediate forefront particularized risk that purchasers and sellers of some environmental attributes must bear in mind as they transact for the purpose of meeting corporate ESG or net-zero goals.

The CFTC's jurisdiction and enforcement authority under the Commodity Exchange Act to investigate and penalize instances of fraudulent and manipulative misconduct may well — and, in the view of at least some CFTC commissioners, does — extend to spot market transactions of certain environmental



Levi McAllister



Pamela Wu

attributes, as well as their derivative products. This is particularly relevant given the current state of the voluntary market for carbon offsets.

Environmental Attributes

The purchase and sale of environmental attributes is an established concept in the energy industry, with environmental attribute provisions having long been embedded in energy generation offtake agreements. However, environmental attributes include more than just those created by virtue of the development and operation of a renewable generating facility.

As most readers undoubtedly know, environmental attributes can include renewable energy certificates, renewable identification numbers and carbon credits. To be sure, robust and liquid transactional marketplaces exist for all of those products.

However, most recently, corporations have sought to minimize the impact of their carbon footprints through the purchase and sale of a different product: carbon offsets. As described below, purchasers and sellers of carbon offsets must be mindful of potential regulatory exposure for the transaction — in particular, U.S. regulatory oversight over instances of fraudulent and manipulative conduct.

Carbon Offsets

In order to be an effective means of demonstrating that it reflects the actual reduction of carbon emissions, a carbon offset must successfully represent a quantity of CO₂ emissions that are permanently removed from the atmosphere.

In other words, the holder of the carbon offset must have confidence that the offset commodity it has purchased can be verified to result from a project that actually removed or offset carbon emissions from the atmosphere permanently that would not otherwise have been removed but for said project.

Entities that purchase carbon offsets for purposes of demonstrating compliance with net-zero initiatives or reduced carbon footprints must, therefore, be assured that a carbon offset adheres to a generally accepted principle that it is verifiable, permanent, additional and otherwise unclaimed. To date, achieving this assurance has historically proven difficult.

Purchasers and holders of offsets proceed along a caveat emptor, or buyer beware, pathway, and must take care to consider and address several germane issues associated with the offset purchase and retirement transaction, including variability in standards, and the absence of any uniform standard; questions of permanence in many carbon offset generating projects; and the challenges of confirming additionality.

Potential Regulatory Oversight

Due to growing concerns over the quality of carbon offsets and market fragmentation noted above, the offsets market has a significant risk of fraud. The CFTC has expressed interest, in multiple instances, in how it might impose a regulatory regime over bilateral purchases and sales of carbon offsets.

Most recently, Goldsmith Romero addressed the CFTC's role in a Feb. 10 keynote address to the Futures Industry Association and Securities Industry and Financial Markets Association Asset Management Derivatives Forum.

In her remarks, Goldsmith Romero expressed her view that products traded in the voluntary carbon market that do not reflect their representations related to carbon reductions could amount to greenwashing. In her view — and arguably the view of the CFTC as a whole — greenwashing is one type of fraud that would fall within the prohibited purview of the Commodity Exchange Act, and Rules 180.1 and Rule 180.2 of the CFTC's regulations.

And, to be sure, although the CFTC has exclusive jurisdiction over derivatives markets — which are distinct from physical carbon offset transactions — the CFTC's long-established antifraud authority encompasses both the derivatives markets and the spot market — thereby bringing carbon offset transactions within the CFTC's oversight authority.

Types of Fraud

What types of carbon offset transactions might constitute fraud or pose risks for greenwashing? In the view of the [International Organization of Securities Commissions](#), as relayed by Goldsmith Romero, these could include transactions where:

- There is a risk of fraudulent selling of carbon credits that do not exist or do not belong to the seller;
- Different methodologies are used to quantify the carbon being avoided or reduced;
- Conflicts of interests between traders and investors could lead to traders manipulating carbon credit prices by issuing buy/sell recommendations to their customers, while doing the opposite with their own credits; or
- There are unclear and misleading communications around buyers' use of carbon credits.

Looking Forward

At bottom, this regulatory exposure and potential for enforcement oversight raises practical concerns and considerations for entities transacting in carbon offsets — both purchasers and sellers.

By way of limited example, parties should ensure they have carefully considered the representations, warranties, indemnification provisions and title provisions in commercial purchase and sale contracts. It is imperative that internal compliance and legal counsel involved in carbon offset transactions be familiar with, or consult with individuals who are familiar with, CFTC oversight and evolving market trends in this space.

This is particularly important for transacting parties that have not historically transacted in commodity markets subject to CFTC oversight and, therefore, are potentially unfamiliar with the regulator.

To date, a number of corporate entities, project developers and financiers have entered into carbon offset purchase and sale agreements. While some entities may rely on an industry or corporate pro forma emissions reduction purchase agreement, it remains vital that those ERPAs be analyzed with a view toward possible implications of a CFTC investigation. The question of CFTC oversight into this area is likely not one of whether, but when.

Thus, looking at the examples already mentioned above, purchasers of carbon offsets should ensure that the seller makes the appropriate representations that the product being sold is what the purchaser expects it to be; parties should explore indemnification language for regulatory investigations; parties should also consider how to treat the standards organizations that certified the product being sold.

There is no one size fits all approach to these issues — yet. But, as we move through 2023 and beyond, the regulation of carbon offsets is certainly on the horizon.

Holders and purchasers of carbon offsets should consider two overarching items as they participate in the carbon offset market: (1) the potential for federal regulation of offset purchases and sales; and (2) contractual protection in offset purchase and sale agreements that addresses the key risks and issues, including those mentioned above.

Levi McAllister and Pamela Tsang Wu are partners at Morgan Lewis & Bockius LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.