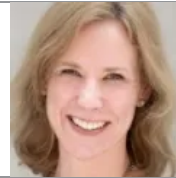




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Willkie Farr Discusses Final CFTC Guidance on Voluntary Carbon-Credit Derivatives Contracts

By Kari Larsen, Neal Kumar, Tamika Bent and Imani Martinez October 29, 2024

Comment

In recent years, the U.S. Commodity Futures Trading Commission (“CFTC”) has expressed concern about the lack of cohesive product standards and the potential for fraud within the voluntary carbon markets. Just this month, the CFTC announced its first enforcement actions against a voluntary carbon credit (“VCC”) project developer and two of its executives for violating the antifraud provisions of the Commodity Exchange Act (“CEA”) and issued orders settling charges against the company and one of its executives.^[1] In addition, in 2022 and 2023, respectively, CFTC Chairman Rostin Behnam held two Voluntary Carbon Markets meetings to discuss issues related to the supply and demand of voluntary carbon credits, including product standardization and private sector initiatives concerning high-quality carbon credits, seeking market participants’ perspectives on the CFTC’s role in promoting integrity in the voluntary carbon markets.^[2]

Continuing its focus on these markets, on September 20, 2024, the CFTC approved Final Guidance directed at designated contract markets (“DCMs”) seeking to list for trading derivatives contracts with a VCC as the underlying commodity (“Final Guidance”).^[3] A VCC is an intangible tradable instrument issued by a carbon-crediting program that represents a specific amount of greenhouse gas emissions reduction or removal.^[4] The market for VCC derivatives contracts is novel and evolving, and the underlying VCC commodity market does not have global standard methodologies for the issuance of credits or any single protocol standard to certify VCCs, which the CFTC contends can lead to inaccurate pricing and an uncertainty in the underlying VCC market, which provides the reference price for VCC derivatives contracts.^[5]

According to the CFTC, the agency worked with various stakeholders in adopting a Final Guidance aimed at supporting transparency, liquidity, and accurate pricing in the VCC market through guidance for exchanges listing VCC derivatives products.^[6] Notwithstanding the extensive work done by the CFTC, the Final Guidance does not come without criticism. Although the Final Guidance is not mandatory, market participants and exchanges have expressed concerns that these guidelines will limit VCC-related offerings by placing unnecessary burdens on DCMs, thus increasing the cost of listing and supporting VCC contracts. Commissioner Summer K. Mersinger’s dissent echoes these sentiments, arguing that there was no need to provide guidance on a singular class of derivatives contracts when the CFTC’s regulations already provide broad guidance to DCMs.^[7] Rather, DCMs should focus on their existing regulatory obligations, and the question of how to validate and promote high-integrity VCCs should be left to those with the appropriate technical and industry expertise.

Current Product Listing Requirements for DCMs

DCMs must comply with the Core Principles set forth in the CEA and CFTC regulations and any other relevant rules when listing derivatives for trading. For example, Core Principle 3 and related guidance states that DCMs must only list contracts that are not readily susceptible to manipulation.^[8] Core Principle 4 requires DCMs to have the capacity and responsibility for using market surveillance, compliance, and enforcement practices and procedures to prevent manipulation, price distortion, and disruptions to the delivery or cash settlement process.^[9] CEA Section 5c(c) and Part 40 of the CFTC’s regulations detail product submission requirements.

Concerns About the Need for DCM Guidance

In response to the proposed guidance, certain commenters, particularly exchanges, questioned whether the DCMs were the right target for such guidance because DCMs are not responsible for developing and maintaining VCC programs. As a result, DCMs do not necessarily have the technical and environmental expertise to ensure a crediting program’s policies and procedures are sufficient to validate high-integrity VCCs.^[10] One exchange

suggested the Final Guidance was unnecessary because “the existing DCM regulatory framework ... already provides the appropriate requirements, guidance, and flexibility to manage the listing of VCC derivatives.”^[11] Additional exchanges noted that “the existing contract listing framework is effective, and already enables DCMs to develop contract terms and conditions that account for relevant market factors, and that are appropriately designed to the characteristics of the underlying asset.”^[12] Other commentators suggested that other standard-setting bodies, crediting programs, or market participants would be better positioned than DCMs to establish VCC integrity standards.^[13]

Although the CFTC emphasized that the Final Guidance is not binding, exchanges will likely feel pressure to comply with the Final Guidance in order to ensure timely review of new products.

Listing VCC Derivatives Contracts Under the Final Guidance

A. A DCM Shall Only List Derivatives Contracts That Are Not Readily Susceptible to Manipulation

Under Core Principle 3, DCMs can only list derivatives contracts that are not readily susceptible to manipulation.^[14] To avoid ambiguity in the contract pricing and limit how susceptible the contract is to manipulation or distortion, the existing guidance in Appendix C to Part 38 states that the terms and conditions of a physically settled derivatives contract “should describe or define all of the economically significant characteristics or attributes of the commodity underlying the contract.”^[15] Under the Final Guidance, a DCM should consider the quality standards, delivery point and facilities, and inspection provisions for a VCC, as summarized below.^[16]

1. Quality Standards

The CFTC states that consideration of the following factors will help DCMs support a VCC derivatives contract meeting appropriate quality standards:

- **Transparency.** The terms and conditions of a physically settled VCC derivatives contract should identify (1) which VCCs are eligible for delivery under the contract, including the specific crediting programs or specific category of mitigation projects associated with the VCC, and (2) whether the crediting program(s) for the VCCs makes information about its policies, procedures, and projects or activities it credits publicly available.^[17]
- **Additionality.** Additionality generally involves an assessment of whether a certain project would have occurred but for the VCC marketplace incentives. Given the wide range of what industry looks to when considering what constitutes “additionality” and the varying perspectives of developers and market participants, the CFTC did not include a definition for additionality. The CFTC acknowledges that descriptions of such analyses are not the type of information typically included in a derivatives contract’s terms and conditions, while still including the recommendation that DCMs consider a VCC crediting program’s characterization of and processes for evaluating additionality when designing a VCC derivatives product.^[18]
- **Permanence and Risk of Reversal.** A DCM should consider whether the crediting program has measures in place to address situations where VCCs are recalled or cancelled.^[19] For example, crediting programs frequently use “buffer reserves” composed of VCCs that are set aside and can be drawn upon to mitigate the effects of a failed project or activity.^[20] DCMs should consider whether a crediting program regularly reviews or audits its buffer reserve to ensure it has a sufficient amount of VCCs.^[21]
- **Robust Quantification.** DCMs should consider whether the quantification practices used by the relevant crediting program to calculate emission reductions or removals are robust, conservative, and transparent so that the amount of VCCs issued reflects the actual amount of greenhouse gas emission reductions or removals associated with a project or activity.^[22]

2. Delivery Point and Facilities

DCMs should consider the following factors when reviewing a crediting program’s policies and procedures in crafting a contract’s delivery procedures:

- **Governance.** DCMs should consider whether the relevant crediting program has a governance framework that supports its independence, transparency, and accountability to ensure the overall quality of the VCCs.^[23]
- **Tracking.** DCMs should consider whether the crediting program has processes and procedures that ensure the VCCs are precisely issued, transferred, and retired.^[24]
- **Double-counting.** DCMs should consider whether the crediting program has measures in place that ensure “credited emission reductions or removals are not double counted” and cannot be used after retirement or cancellation, including across multiple jurisdictions.^[25]

3. Inspection Provisions

DCMs should consider whether the crediting program has up-to-date, robust, and transparent procedures for validating and verifying that the mitigation projects or activities meet the crediting program’s rules and standards and that the crediting program upholds “best practices” with respect to third-party validators.^[26] These “best practices” can include “crediting program reviews of the performance of its 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.”^[27]

B. A DCM Shall Monitor a Derivatives Contract’s Terms and Conditions as They Relate to the Underlying Commodity Market

Core Principle 4 requires a DCM to monitor the contract's terms and conditions as they relate to the underlying commodity market, the convergence of the contract and underlying commodity price, and the supply of the commodity in light of delivery requirements.^[28] The Final Guidance states that a DCM's compliance with Core Principle 4 should include monitoring the terms and conditions of a contract throughout the term to ensure that the underlying VCC conforms to the latest certification standards applicable to that VCC and the adequacy of the underlying VCC to satisfy the contract's delivery requirement.^[29] For example, the terms and conditions of a contract should be amended to reflect any changes to the crediting program or types of projects or activities associated with the underlying VCC.^[30]

C. A DCM Must Satisfy the Product Submission Requirements Under Part 40 of the CFTC's Regulations and CEA Section 5c(c)

When a DCM lists a new derivatives contract for trading or amends an existing derivatives contract, it must submit specific information to the CFTC, including the terms and conditions of the contract, regardless of whether the DCM lists the contract through self-certification or with prior CFTC approval.^[31] While these listing requirements apply regardless of the underlying asset, the Final Guidance notes that because VCCs are relatively new and still evolving, the CFTC expects DCMs will provide qualitative explanations and analysis when submitting documentation in line with the submission requirements in particular.

Market Participant Recordkeeping

The Final Guidance reminds market participants that they must "keep records of their trading that include records of their activity in the underlying commodity and related derivatives markets."^[32] Such records, relating to both the VCC derivatives and underlying spot market activities, must be made available upon request to the DCM pursuant to the DCM's rules and are subject to inspection by the CFTC pursuant to applicable recordkeeping rules.^[33]

ENDNOTES

[1] *CFTC Charges Former CEO of Carbon Credit Project Developer with Fraud Involving Voluntary Carbon Credits* (Oct. 2, 2024), available [here](#).

[2] *CFTC Announces Voluntary Carbon Markets Convening* (June 2, 2022), available [here](#); *CFTC Announces Second Voluntary Carbon Markets Convening* (July 19, 2023), available [here](#).

[3] *CFTC Approves Final Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts* (Sept. 20, 2024), available [here](#); 89 FR 83378, 83380 (2024), available [here](#).

[4] *See e.g.*, Verra, Verified Carbon Units (VCUS), available [here](#).

[5] Final Guidance at 83381; for more background on the VCC Carbon Credit Market, please see our previous client alert, [here](#).

[6] Final Guidance at 83383; the CFTC believes this guidance is also relevant to swap execution facilities that engage with VCCs. Final Guidance at 83401.

[7] *See Dissenting Statement of Commissioner Summer K. Mersinger on Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts* (Sept. 20, 2024), available [here](#).

[8] CEA Section 5(d)(3), 7 U.S.C. 7(d)(3); Final Guidance at 83379; and 17 CFR part 38, appendix C.

[9] Final Guidance at 83379.

[10] *Id.* at 83385-86.

[11] *Id.* at 83385.

[12] *Id.*

[13] *Id.* at 83386.

[14] *Id.* at 83401.

[15] *Id.*; Appendix C Guidance, paragraph (b)(2)(i)(A).

[16] Final Guidance at 83401.

[17] *Id.* at 83402.

[18] *Id.* at 83391.

[19] *Id.* at 83403; A “risk of reversal” can happen when the carbon removed by the project or activity is released back into the atmosphere, or, upon reevaluation of the project or activity, it is discovered that there are fewer greenhouse gas reductions or removals than originally estimated.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.* at 83404.

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.* at 83405; 17 CFR 40.5 and 40.6.

[32] Final Guidance at 83405.

[33] *Id.*

This post comes to us from Willkie, Farr & Gallagher LLP. It is based on the firm’s memorandum, “CFTC Final Guidance on VCC Derivatives Contracts,” dated October 22, 2024, and available [here](#).