March 2, 2024

International Organization of Securities Commissions (IOSCO)

Public Comment on Voluntary Carbon Markets – Consultation Report

Americans for Financial Reform Education Fund (AFREF) is pleased to submit public comment on The Board of the International Organization of Securities Commissions (IOSCO)'s Consultation Report outlining a proposed set of Good Practices to promote the integrity and orderly functioning of Voluntary Carbon Markets (VCMs). This Consultation Report discusses the feedback that IOSCO received on the VCM Discussion Paper,[1] particularly regarding the Key Considerations, to inform and further develop a set of proposed Good Practices addressed to relevant regulators and other authorities as well as market participants and looks to offer support to/in jurisdictions that have established or may be seeking to establish VCMs.

We appreciate the opportunity to provide feedback on the Good Practices for VCMs where these fall within the scope of financial market integrity (i.e., sound market structures, sound and orderly trading, and transparency and data availability and accessibility) as well as the Key Considerations which describe other initiatives underway. IOSCO has appropriately developed a proposed set of 21 Good Practices in the categories of regulatory frameworks, primary market issuance, secondary market trading, and use and disclosure of use of carbon credits.

There are significant shortcomings in the unregulated VCMs with respect to quality standards, verification processes, and incentive structure that together create significant potential for fraud and manipulation—as evidenced by many well documented cases of systematic over-crediting and misrepresentations. In its Consultation Report, IOSCO acknowledges that, "Many offset projects are failing to deliver promised emission reductions and some carbon credits may amount to little more than greenwashing. Concerns over integrity and transparency are one reason that demand for carbon credits decreased between 2021 and 2022, even as supply continued to grow."[2] In recognition of those concerns, outlined largely in Chapter 3 - Potential

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[1] "Voluntary Carbon Markets Discussion Paper," *IOSCO*, November 2022. https://www.iosco.org/library/pubdocs/pdf/IOSCOPD718.pdf

[2] Pg. 69: "Voluntary Carbon Markets Consultation Report, CR06," *IOSCO*. December 2023. [Hereafter referenced as "Consultation Report, Pg. #"]. https://www.iosco.org/library/pubdocs/pdf/IOSCOPD749.pdf

Vulnerabilities,[3] IOSCO is putting forward Good Practices because it believes that, "As with any other traded asset market, VCMs should be fair and orderly, economically sound as to pricing and information flow, and structurally resilient. VCMs should also have appropriate customer protections and sufficient access to market participants."[4]

Background

AFREF and partners have previously recommended that carbon credit derivatives trading not be allowed unless and until the integrity problems within the underlying markets are reasonably resolved.[5] In the absence of such a restriction, the Good Practices represent a positive step toward acknowledging and addressing risks in VCMs, but all jurisdictions should consider regulatory action needed to address the persistent problems in the VCMs, which will require significant additional coordination by all market participants and authorities. Improving integrity in VCMs and preventing fraud and manipulation is important to protect the market and all market participants.

Continued Integrity and Transparency Problems with Voluntary Carbon Credits

Corporations have been directly purchasing carbon credits since the 1980s, and the voluntary market for them has been around for more than two decades,[6] and yet integrity issues persist. Many commentators have expressed skepticism that the integrity problems in the VCM can ever be solved given the lack of regulatory oversight, race-to-the-bottom alignment of incentives, and opaque market structure with most trades occurring off-exchange. In recognizing the extent of the problems within the underlying VCMs, IOSCO should continue to caution relevant regulators and other authorities in the strongest possible terms about well-founded concerns on transparency, credibility, greenwashing, and environmental injustice in VCMs.[7]

In the last year alone, there have been several troubling reports of core integrity issues in VCMs resulting in further pushback against them. In 2023, a massive scandal emerged around the carbon credit developer –South Pole – which cut ties, as a result of reporting from The New Yorker and others, with one of its carbon projects (Kariba) for not meeting the purported environmental and social outcomes it claimed, with both parties implicated for integrity issues

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[3] Consultation Report, Pgs. 32-43

[4] Consultation Report, Pg. 59

[5] "Comment in Response to the CFTC's Climate-Related Financial Risk RFI," *Amazon Watch, Americans for Financial Reform, and 65 additional organizations*, November 2022. https://ourfinancialsecurity.org/wp-content/uploads/2022/11/CFTC-Carbon-Offsets-Sign-On-Letter-final.pdf

[6] Aruna Chandrasekhar, Design by Joe Goodman, "Timeline: The 60-year history of carbon offsets," *Carbon Brief*, September 24, 2023. https://interactive.carbonbrief.org/carbon-offsets-2023/timeline.html

[7] Zelikova, Jane, Freya Chay, Jeremy Freeman, and Danny Cullenward. 2021. "A Buyer's Guide to Soil Carbon Offsets." *CarbonPlan*, July 15, 2021. https://carbonplan.org/research/soil-protocols-explainer; West, Thales A. P., Jan Börner, Erin O. Sills, and Andreas Kontoleon. 2020. "Overstated Carbon Emissions Reductions from Voluntary REDD+ Projects in the Brazilian Amazon. *Proceedings of the National Academy of Sciences* 117, no. 39 (September): 24188–194. https://www.pnas.org/doi/full/10.1073/pnas.2004334117; "Evicted for carbon credits: Norway, Sweden, and Finland displace Ugandan farmers for Carbon Trading," *Oaklandinstitute.org*. (2020, October 14). Retrieved July 12, 2022, from https://www.oaklandinstitute.org/evicted-carbon-credits-green-resources

and potential fraud.[8] SB 1036, reintroduced in the U.S. California legislature in 2024, would subject voluntary carbon offsets to the state's False Advertising Law by making it illegal to sell, certify, or maintain on a registry an offset that a person knows — or should know — is unlikely to be quantifiable or real.[9]

Carbon Credit Markets Feature High Hidden Costs and May Distract from Real Emissions Reductions

The high administrative costs associated with carbon credit transactions are expenditures that may be better put to use by carbon credit buyers (e.g,, corporations) on reducing their own greenhouse gas emissions including by transitioning away from fossil fuels. For example, carbon credit brokers' fees may range from 5-20%,[10] and it's estimated that only about 10% of the exchanges, brokers, resellers and cryptocurrency vendors that act as intermediaries in the VCM share their precise commissions and profits.[11] These transparency problems around high administrative costs within the spot market are obscured even further for carbon credit derivatives markets.

Provisions of the Good Practices to Maintain

"Carbon Credits" Preferable to "Verified Carbon Credits"

In recent comments to the U.S. Commodity Futures Trading Commission (CFTC) on its proposed guidance for VCM derivatives, we supported the CFTC's use of the term "voluntary carbon credits" as opposed to "verified carbon credits." Similarly, we appreciate IOSCO's use of "carbon credits" in the Consultation Report rather than "verified carbon credits" given that "verification" implies a determination on the credits in the underlying market, and does not imply that IOSCO has "verified" the credits which could create confusion. "Verified" or "certified" carbon credits are also outside of IOSCO's authority to make a determination on. Those terms are usually applied by third-party organizations that specialize in greenhouse gas accounting and verification and the validity of those credits in voluntary carbon markets is still under immense debate.

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[8] Heidi Blake, "The Great Cash-for-Carbon Hustle," *The New Yorker*, October 16, 2023. https://www.newyorker.com/magazine/2023/10/23/the-great-cash-for-carbon-hustle; Susanna Twidale, "Carbon offset firm South Pole cuts ties with Zimbabwe forest project," *Reuters*, October 27, 2023. https://www.reuters.com/sustainability/cop/carbon-offset-firm-south-pole-cuts-ties-with-zimbabwe-forest-project-2023-10-27/

[9] "Introduced Bill Title: SB 1036: Voluntary carbon offsets: business regulation," *California State Legislature*, February 7, 2024. https://legiscan.com/CA/text/SB1036/id/2917368

[10] April L., "Carbon Credit Brokers: What They Are and How They Work," *CarbonCredits.com*, April 4, 2023. https://carboncredits.com/carbon-credit-brokers-what-they-are-and-how-they-work/

[11] John Cannon, "Carbon market intermediaries act with little transparency, according to report," *Mongabay*, February 24, 2023. https://news.mongabay.com/2023/02/carbon-market-intermediaries-act-with-little-transparency-according-to-report/

Avoiding Delegation of Authority

In its Good Practices, IOSCO should be explicit about regulators maintaining standard setting authority and not suggesting that market regulators delegate standard setting authority to any carbon credit-related private standard setters because these entities lack regulatory oversight and are often affiliated with or advised by carbon market participants (e.g., buyers, sellers, verifiers, and intermediaries) which typically benefit from a market that features a high volume of low quality, inexpensive credits.

IOSCO has developed its Discussion Paper and now Consultation Report on carbon markets utilizing definitions, principles, and concepts borrowed in part from from VCM market entities such as the Integrity Council for Voluntary Carbon Markets (ICVCM) and the Voluntary Carbon Markets Integrity Initiative (VCMI), as major sell-side and buy-side actors in VCMs respectively, and others. The ICVCM is an evolving entity, and although many crediting programs are now collaborating in support of this standard setter,[12] it should not be considered the final authority on carbon credit integrity or standards in the VCMs. ICVCM and other entities have made efforts to improve confidence in carbon credit markets by attempting to improve integrity, transparency and price discovery; however, the Good Practices should not recommend that market regulators delegate standard setting authority to a non-governmental entity with a financial interest in the market. Similar to IOSCO's approach, the U.S. CFTC's proposed guidance on voluntary carbon credits[13] which is currently under review, also borrows definitions from ICVCM but does not point to ICVCM as the de facto authority on integrity of carbon credits.

Disclosure and Regulator Alignment

VCMs are largely unregulated, but they are utilized by corporate buyers or derivatives market participants who are regulated by relevant regulators and other authorities, so IOSCO should continue engaging with these authorities on legal and appropriate use of carbon credits. Dialogue and cooperation from regulators across jurisdictions should also be encouraged (as discussed in Good Practice 3)[14] especially in requiring disclosures regarding an entity's use of carbon credits to achieve any net GHG emission targets (Good Practice 21)[15] or net zero commitments. IOSCO should recommend that relevant regulators and other authorities require robust disclosures, anti-greenwashing measures, and consumer protections around the generation, sale, and use of carbon credits — including within the context of net zero transition plans.

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[12] "Press Release: Independent Crediting Programmes Announce Ground-Breaking Collaboration to Increase the Positive Impact of Carbon Markets," *ACR, ART, CAR, GCC, GS, Verra/VCS*, December 4, 2023. https://ieta.b-cdn.net/wp-content/uploads/2023/12/Press-release-ICP-Joint-Statement.pdf

[13] "Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment," *Commodity Futures Trading Commission*, December 27, 2023. https://www.cftc.gov/LawRegulation/FederalRegister/proposedrules/2023-28532.html

[14] Consultation Report, Pg. 62

[15] Consultation Report, Pg. 70

Recommendations and Comments

Environmental Integrity

IOSCO's Good Practices should explicitly acknowledge that for VCMs, and indeed for any environmental spot or derivatives products, environmental integrity is a critical component of the market integrity of the product. IOSCO has wrongly framed the VCM consultation work as, "...not focused on environmental integrity; instead, the proposed set of Good Practices presented in this report are practices that relevant regulators and other authorities or market participants could consider in addressing vulnerabilities described in the paper. While not legally binding, they are intended to support sound market structures and enhance financial integrity in the VCMs such that carbon credits can be traded in an orderly and transparent way."[16] In addition to carbon-related goals, VCMs typically purport to promote environmental integrity which must be considered when assessing market integrity and market risks, and the Good Practices should reflect this explicitly. Indeed, elsewhere in the Consultation Paper, IOSCO makes this case: "Environmental integrity aspects are critical for the general functioning and robustness of VCMs and for carbon credit price formation. The lack of environmental integrity creates uncertainties and can undermine market participants' confidence that carbon credits purchased in VCMs accurately represent emission reduction or mitigation. This undermines the credibility and effectiveness of VCMs, reducing the demand for carbon credits, damaging liquidity and, ultimately, leading to lower prices that can have a significant negative impact on the success of VCMs in contributing to achieve climate change mitigation goals."[17]

Integrity Related to Social and Environmental Safeguards and Human Rights

The Good Practices for VCMs must acknowledge social and environmental goals and safeguards, beyond its note in the Consultation Report that, " In VCMs companies, governments and others may purchase carbon credits on a voluntary basis, with the aim of supporting corporate social responsibility or financial activities."[18] 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 carbon credits issued by the crediting program. Those safeguards are material terms and conditions and required by most reputable private sector and multinational development initiatives to improve the chances that financed projects will not be undermined by violations of human, land, and labor rights.

Unfortunately, many carbon credit projects fail to adhere to social and environmental safeguards and protect human rights, even those that consider these criteria. A recent study determined that 94% of the most prominent carbon credit projects globally, are situated in Latin America, Africa,

[16] Consultation Report, Pg. 4
[17] Consultation Report, Pg. 55
[18] Consultation Report, Pg. 11

and Asia.[19] The operations of many of these projects have faced criticism, and related legal and reputational risks, in part due to their poor environmental outcomes, but also because of their poor track record in safeguarding the human rights of those impacted.[20] In 2021 The Guardian[21] highlighted an example of these human rights abuses: A major U.S. based company bought a $45 million forest-based carbon credit in Peru to prevent the deforestation of 8,226 acres of the Peruvian Amazon that brought adverse effects to local communities. Numerous residents were forced from their homes due to actions carried out by park authorities during a series of removals.[22]

In another example, despite two companies' claims that they carried out assessments to ensure that the carbon credit projects they purchased benefited local communities, an Associated Press[23] investigation determined that the related projects had devastating consequences for Indigenous communities. In one instance, land that has historically been used for sustenance for the Kichwa people in Peru was sold for carbon credits. All the Kichwa interviewed maintain that they were not informed about the sale of the land and many of them were banned from hunting leading to hunger in their community.[24] Recently, Carbon Brief[25] mapped the impacts of carbon credit projects around the world and found that over 70% of those they reviewed resulted in harm to Indigenous populations and/or nearby communities.

In light of those challenges, IOSCO should recommend that relevant regulators and other authorities evaluate whether crediting programs have implemented measures to safeguard human rights. This must include rigorous assessments of the social and environmental impacts of carbon credit projects, particularly in regions where Indigenous populations and vulnerable communities may be disproportionately affected, and these assessments should occur whether or not a crediting program claims to have implemented such measures. By incorporating such considerations into VCMs, regulators can play a role in promoting responsible and ethical practices and improve the integrity of carbon credits issued by the crediting program.

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[19] Greenfield, Patrick. "Revealed: More than 90% of Rainforest Carbon Offsets by Biggest Certifier Are Worthless, Analysis Shows." *The Guardian*, January 18, 2023. https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe.
[20] "COP27: Governments Should Reject Weak Carbon Market Rules." Human Rights Watch, November 14, 2022. https://www.hrw.org/news/2022/11/14/cop27-governments-should-reject-weak-carbon-market-rules.
[21] Greenfield, Patrick. "'Nowhere Else to Go': Forest Communities of Alto Mayo, Peru, at Centre of Offsetting Row." *The Guardian*, January 18, 2023. https://www.theguardian.com/environment/2023/jan/18/forest-communities-alto-mayo-peru-carbon-offsetting-aoe.
[22] Ibid.
[23] Davey, Ed. "In Peru, Kichwa Tribe Wants Compensation for Carbon Credits." *AP News*, January 4, 2024. https://apnews.com/article/business-peru-forests-climate-and-environment-2c6cddb1707a12c31c14d9a226699068.
[24] Ibid.
[25] Quiroz, Yanine, and Daisy Dunne. "Mapped: The Impacts of Carbon-Offset Projects around the World." *Carbon Brief*, September 26, 2023. https://interactive.carbonbrief.org/carbon-offsets-2023/mapped.html.

ICVCM's Core Carbon Principle 9 (CCP 9), for example, requires mitigation projects "have clear guidance, tools and compliance procedures to ensure mitigation activities conform with or go beyond widely established industry best practices on social and environmental safeguards while delivering positive sustainable development impacts."[26] Compliance with social and environmental safeguards fundamentally impacts carbon crediting program success, reputational risk, resulting credit characteristics and market value. ICVCM Assessment Framework Criterion 7.1-7.11 further clarify the basic guardrails carbon crediting programs should use to implement CCP 9. These requirements include: 1) free prior and informed consent for affected communities – making terms and conditions of any contract clear and transparent; 2) assessment and minimization of impacts to the environment like water, air and hazardous waste pollution; and 3) explanation of how their Sustainable Development Goal impacts are consistent with the host country's goals, among others. These elements are consistent with best practices recommended, though not always sufficiently enforced, by other international development financing frameworks, including USAID, World Bank, the Green Climate Fund, and CORSIA.[27]

Social and environmental safeguard systems and requirements can be subject to fraud and manipulation. Failure to include guidance in the Good Practices reflecting widely established industry best practices on social and environmental safeguards limits IOSCO's promotion of stakeholder protection against this prevalent type of fraud, and exposes market participants to significant risk.

Need to Expand Definition of Additionality

The Consultation Report includes three definitions of additionality,[28] all of which are too vague in their description of additionality — as whether the emissions reductions or removals would not have occurred in the absence of the incentive created by carbon credit revenues. IOSCO should expand the definition of additionality, and specify that additionality must also include, but is not limited to, regulatory, legal, and financial additionality. We agree with the respondent noted by IOSCO who stated that, "...the climate change mitigation project should be additional to legal and regulatory requirements of the jurisdiction in which the project is being undertaken."[29] The Good Practices should add that carbon credits should result from 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.[30] Additionally, it is well understood that carbon markets are divided into compliance

[26] "The Core Carbon Principles," *ICVCM*, https://icvcm.org/the-core-carbon-principles/
[27] *See, e.g*. USAID; https://www.usaid.gov/environmental-procedures/sectoral-environmental-social-best-practices; World Bank; https://www.worldbank.org/en/projects-operations/environmental-and-social-frameworkGreen Climate Fund Environmental and Social Safeguards; https://www.greenclimate.fund/projects/sustainability-inclusion/ess; CORSIA Safeguards Systems and Sustainable Development Criteria; https://www.icao.int/environmental-protection/CORSIA/Documents/ICAO_Document_09.pdf
[28] Consultation Report, Pgs. 20, 33, 75
[29] Consultation Report, Pg. 49
[30] See e.g., The California Air Resources Board cap-and-trade regulation defines additionality as both financial and regulatory:

and voluntary markets,[31] and given that the subject of the Good Practices is voluntary carbon markets, IOSCO should repeat the distinction between voluntary and compliance carbon credits in describing additionality. IOSCO should advise that relevant regulators and other authorities for VCMs do their due diligence into whether voluntary carbon credits from a foreign jurisdiction have been created as a result of compliance requirements rather than voluntarily.

Other Actions By IOSCO

In addition to the publication of Good Practices on VCMs by IOSCO, we also urge IOSCO to put forward discussion papers, consultation reports, and good practices on additional climate-related financial risk items, such as:

- Broader environmental derivatives markets. For example, we echo Commissioner Johnson of the U.S. CFTC's view that, "...a comprehensive approach that addresses the diversity of environmental derivatives emerging in our markets will improve visibility, enhance integrity, and promote carbon neutrality."[32]
- Climate risk in the exchange traded derivatives markets and the over the counter (OTC) market, paying close attention to the interconnectedness between financial institutions, and monitoring the overall growth of climate risk within the system.
- Incorporating climate-related risks into regularly conducted supervisory stress tests of central clearinghouses and other market intermediaries to ensure they can handle a range of extreme scenarios. Climate scenarios ultimately will need to incorporate climate shocks in series and in parallel, rather than as discrete perturbations.
- Conducting climate scenario analysis exercises to understand current and future climate risks in spot and derivatives markets.

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https://govt.westlaw.com/calregs/Document/I15CE12535A2111EC8227000D3A7C4BC3?viewType=FullText&originationContext=documenttoc&transitionType=CategoryPageItem&contextData=(sc.Default)

[31] Josh Gabbatiss, Daisy Dunne, Aruna Chandrasekhar, Orla Dwyer, Molly Lempriere, Yanine Quiroz, Ayesha Tandon and Dr Giuliana Viglione; Design by Joe Goodman, Tom Pearson and Tom Prater, "In-depth Q&A: Can 'carbon offsets' help to tackle climate change?," *Carbon Brief*, September 24, 2023. https://interactive.carbonbrief.org/carbon-offsets-2023/

[32] Pg. 89423: "Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment," *Commodity Futures Trading Commission*, December 27, 2023. https://www.cftc.gov/LawRegulation/FederalRegister/proposedrules/2023-28532.html

Conclusion
We appreciate IOSCO acknowledging in this Consultation Paper the current transparency and integrity challenges in the unregulated voluntary carbon markets, which create the potential for fraud and manipulation in voluntary carbon credit spot and derivatives markets, and proposing Good Practices to help financial market regulators globally navigate this new class of products. We thank IOSCO for this opportunity to comment, and note that we have provided lengthier comments this year on VCMs and voluntary carbon credit derivatives contracts to the Commodity Futures Trading Commission (CFTC) of the United States. A copy of those comments, which we believe are relevant to this consultation, has been attached below.

Sincerely,
Americans for Financial Reform Education Fund

Americans for Financial Reform Education Fund is a U.S.-based nonprofit organization which fights to eliminate inequity and systemic racism in the financial system in service of a just and sustainable economy. Formed in the wake of the 2008 financial crisis, we are working to lay the foundation for a strong, stable, and ethical financial system. AFREF works in coalitions alongside environmental justice, civil rights, consumer, labor, business, investor, faith-based, and civic and community groups.

ATTACHMENT
Copy of Americans for Financial Reform Education Fund's response to the Commodity Futures Trading Commission (CFTC) of the United State's proposed guidance regarding the listing of voluntary carbon credit derivative contracts and factors that designated contract markets should consider when listing those contracts.
Comment submitted on February 16, 2024 to the CFTC.

February 16, 2024

Christopher 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 (88 FR 89410; RIN 3038-AF40)

Dear Secretary Kirkpatrick, Commissioners, and Commission Staff:

Americans for Financial Reform Education Fund (AFREF) is pleased to submit comments on the proposed guidance from the Commodity Futures Trading Commission (the "CFTC" or "Commission") regarding the listing of voluntary carbon credit ("VCC") derivative contracts and factors that designated contract markets ("DCMs") should consider when addressing certain provisions of the Commodity Exchange Act ("CEA'"), and CFTC regulations thereunder, that are relevant to the listing for trading of VCC derivative contracts.

The Commission 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. There are significant shortcomings in the unregulated voluntary carbon markets (VCM)'s quality standards, verification processes, and incentive structure that create significant potential for fraud and manipulation—as evidenced by many well documented cases of systematic over-crediting and misrepresentations—and that would compromise corresponding VCC derivatives contract markets. Given this, the Commission has appropriately determined that DCMs would benefit from guidance around this new and evolving class of products.

First, the Commission should strengthen and finalize this guidance as soon as possible. Second, the Commission should continue dialogue with DCMs on the risks of VCC derivatives and the underlying VCM throughout the process of translating the statutory Core Principles for DCMs[33] to this evolving class of derivatives to monitor developments and determine if further guidance is necessary. Finally, the Commission should monitor for, and intervene robustly, in cases of nonadherence to the Core Principles following this guidance for VCC derivative contracts.

Background

AFREF and partners have previously recommended that the Commission disallow VCC derivatives trading generally unless and until the integrity problems within the underlying markets are reasonably resolved.[34] Instead, the Commission has chosen to provide guidance to DCMs on commodity characteristics that should be considered in terms and conditions for contracts. Although VCC derivative contracts are a very small slice of the derivatives market,[35] and small compared to the size of the VCC spot markets, the Commission has rightly decided this guidance is necessary, given that both the underlying and derivatives markets are expected to grow significantly over the coming years,[36] and because "Derivative contracts on VCCs base their prices on the spot price of VCCs, and therefore the integrity of the underlying spot market is critical to the stability of the derivatives market for those underlying VCC commodities."[37] The final guidance should be a positive step toward acknowledging and addressing risks in VCCs, but it is not the the only regulatory action needed to address the persistent problems in the VCMs, which will require significant additional efforts by the Commission and other federal regulators.

As Chair Behnam noted in his statement of support for the proposed guidance, "the Commission should act, consistent with its statutory authority under the Commodity Exchange Act (CEA), to strengthen market integrity, transparency, and liquidity for derivatives with an underlying VCC that are real, additional, permanent, verifiable, and represent unique metric tons of GHG emissions reduced or removed from the atmosphere."[38] Improving integrity in VCC derivatives and preventing fraud and manipulation is important to protect the market and all market participants. In finalizing this guidance, the Commission should be explicit about maintaining

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[33] "Final Rule: Core Principles and Other Requirements for Designated Contract Markets; Federal Register, Volume 77 Issue 118; 17 CFR Parts 1, 16, and 38," *CFTC*, June 19, 2012. https://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-12746.html

[34] "Comment in Response to the CFTC's Climate-Related Financial Risk RFI," *Amazon Watch, Americans for Financial Reform, and 65 additional organizations*, November 2022. https://ourfinancialsecurity.org/wp-content/uploads/2022/11/CFTC-Carbon-Offsets-Sign-On-Letter-final.pdf

[35] Pg. 89424: "Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment," *CFTC*. December 2023. [Hereafter referenced as "Guidance, Pg. #] https://www.cftc.gov/LawRegulation/FederalRegister/proposedrules/2023-28532.html

[36]Voluntary Carbon Market Rankings 2021," *Environmental Finance*. https://www.environmental-finance.com/content/awards/voluntary-carbon-market-rankings-2021/; "Carbon Credits Face Biggest Test Yet, Could Reach $238/Ton in 2050," *Bloomberg NEF*, February 6, 2024. https://about.bnef.com/blog/carbon-credits-face-biggest-test-yet-could-reach-238-ton-in-2050-according-to-bloombergnef-report/

[37] Commissioner Kristin Johnson. Guidance, Pg. 89424

[38] Guidance, Pg. 89422

and not delegating standard setting authority to any VCC-related private standard setters because these entities lack regulatory oversight and are often affiliated or advised by carbon market participants (e.g., buyers, sellers, verifiers, and intermediaries) which typically benefit from a market that features a high volume of low quality, inexpensive credits.

Continued Integrity and Transparency Problems with Voluntary Carbon Credits

Corporations have been directly purchasing carbon credits since the 1980s, and the voluntary market for VCCs has been around for more than two decades,[39] and yet integrity issues persist. Many commentators have expressed skepticism that the integrity problems in the VCM can ever be solved given the lack of regulatory oversight, race-to-the-bottom alignment of incentives, and opaque market structure with most trades occurring off-exchange. In recognizing the extent of the problems within the underlying VCMs, the Commission should continue to caution DCMs and its other regulated derivatives market entities in the strongest possible terms about well-founded concerns on transparency, credibility, greenwashing, and environmental injustice in VCMs.[40] The Commission should plan to engage in significant oversight to prevent fraudulent and misleading claims, market manipulation, and undisclosed financial risk.

In the last year alone, there have been several troubling reports of core integrity issues in VCMs resulting in further pushback against them. In 2023, a massive scandal emerged around the carbon credit developer –South Pole – which cut ties, as a result of reporting from The New Yorker and others, with one of its carbon projects (Kariba) for not meeting the purported environmental and social outcomes it claimed, with both parties implicated for integrity issues and potential fraud.[41] SB 1036, reintroduced in the California legislature in 2024, would subject voluntary carbon offsets to the state's False Advertising Law by making it illegal to sell, certify, or maintain on a registry an offset that a person knows — or should know — is unlikely to be quantifiable or real.[42]

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[39] Aruna Chandrasekhar, Design by Joe Goodman, "Timeline: The 60-year history of carbon offsets," *Carbon Brief*, September 24, 2023. https://interactive.carbonbrief.org/carbon-offsets-2023/timeline.html

[40] Zelikova, Jane, Freya Chay, Jeremy Freeman, and Danny Cullenward. 2021. "A Buyer's Guide to Soil Carbon Offsets." *CarbonPlan*, July 15, 2021. https://carbonplan.org/research/soil-protocols-explainer; West, Thales A. P., Jan Börner, Erin O. Sills, and Andreas Kontoleon. 2020. "Overstated Carbon Emissions Reductions from Voluntary REDD+ Projects in the Brazilian Amazon. *Proceedings of the National Academy of Sciences* 117, no. 39 (September): 24188–194. https://www.pnas.org/doi/full/10.1073/pnas.2004334117; "Evicted for carbon credits: Norway, Sweden, and Finland displace Ugandan farmers for Carbon Trading," *Oaklandinstitute.org*. (2020, October 14). Retrieved July 12, 2022, from https://www.oaklandinstitute.org/evicted-carbon-credits-green-resources

[41] Heidi Blake, "The Great Cash-for-Carbon Hustle," *The New Yorker*, October 16, 2023. https://www.newyorker.com/magazine/2023/10/23/the-great-cash-for-carbon-hustle; Susanna Twidale, "Carbon offset firm South Pole cuts ties with Zimbabwe forest project," *Reuters*, October 27, 2023. https://www.reuters.com/sustainability/cop/carbon-offset-firm-south-pole-cuts-ties-with-zimbabwe-forest-project-2023-10-27/

[42] "Introduced Bill Title: SB 1036: Voluntary carbon offsets: business regulation," *California State Legislature*, February 7, 2024. https://legiscan.com/CA/text/SB1036/id/2917368

DCM Core Principle 3 states that a DCM "shall only list for trading derivative contracts that are not readily susceptible to manipulation." Given that transparency and integrity issues within the VCMs have not been resolved to date, and because most trading occurs off-exchange with no public information disclosed, it will be difficult for a DCM to determine if a VCC derivative contract is susceptible to manipulation. Thus, the Commission should re-evaluate the current ability for DCMs to self certify these products (see recommendation below).

VCC Markets Feature High Hidden Costs and May Distract from Real Emissions Reductions
The high administrative costs associated with VCC transactions are expenditures that may be better put to use by VCC buyers (e.g,, corporations) on reducing their own greenhouse gas emissions including by transitioning away from fossil fuels. For example, carbon credit brokers' fees may range from 5-20%,[43] and it's estimated that only about 10% of the exchanges, brokers, resellers and cryptocurrency vendors that act as intermediaries in the VCM share their precise commissions and profits.[44] These transparency problems around high administrative costs within the spot market are obscured even further for VCC derivatives markets.

Provisions of the Proposal to Maintain
"Voluntary Carbon Credits" Preferable to "Verified Carbon Credits"
We agree with the Commission's use of "VCC" in the guidance to mean "voluntary carbon credits" rather than "verified carbon credits"[45] given that "verification" implies a determination on the credits in the underlying market, and does not imply that the Commission has "verified" the credits which could create investor confusion; "verified" or "certified" carbon credits are outside of the CFTC's authority to make a determination on. These terms are usually applied by third-party organizations that specialize in greenhouse gas accounting and verification and the validity of those credits in voluntary carbon markets is still under immense debate.

However, in a footnote the Commission still references the International Swaps and Derivatives Association (ISDA)'s definition of "verified carbon credits," in which ISDA explains that "verified" simply reflects a preference in the market for the term because of the assumptions of these credits reflecting projects that result in the reduction, removal, sequestration or avoidance of GHG emissions from the atmosphere based on verification from a standard setter before a credit is issued.[46] The Commission should provide ISDA as an example rather than the default in the footnote, "The Commission recognizes that market participants in the cash or secondary market for voluntary carbon credits may choose to use a set of standardized terms for the trading

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[43] April L., "Carbon Credit Brokers: What They Are and How They Work," *CarbonCredits.com*, April 4, 2023. https://carboncredits.com/carbon-credit-brokers-what-they-are-and-how-they-work/
[44] John Cannon, "Carbon market intermediaries act with little transparency, according to report," *Mongabay*, February 24, 2023.
https://news.mongabay.com/2023/02/carbon-market-intermediaries-act-with-little-transparency-according-to-report/
[45] Footnote 31: Guidance, Pg. 89412
[46] "2022 ISDA Verified Carbon Credit Transactions Definitions ("VCC Definitions") FAQs," *International Swaps and Derivatives Association*, 2023.
https://www.isda.org/a/jBXgE/2022-ISDA-Verified-Carbon-Credit-Transactions-Definitions-FAQs-061323.pdf

and retirement of "verified carbon credits," ~~as defined~~ *and can use the definition provided* by the International Swaps and Derivatives Association ("ISDA'"), in the market participants' physically-settled spot, forward or option transactions."

Avoiding Delegation of Authority

The Commission rightly sought to build its guidance not from scratch but from existing principles from entities such as the Integrity Council for Voluntary Carbon Markets (ICVCM), as a major sell-side actor in voluntary carbon markets; however, as is the case with the proposal, the final guidance should not delegate standard setting authority to a non governmental entity with a financial interest in the market. It is reasonable that the guidance, "adapts terminology, concepts and standards from the ICVCM's Core Carbon Principles (CCP) and its recently issued Assessment Framework,"[47] without delegating authority. CCP establishes requirements to be applied by the carbon-crediting programs and requirements, including specific criteria, for categories of carbon credits.

The ICVCM is an evolving entity, and although many crediting programs are now collaborating in support of this standard setter,[48] it should not be considered the final authority on VCCs integrity or standards in the VCMs. ICVCM and other entities have made efforts to improve confidence in VCC markets by attempting to improve integrity, transparency and price discovery; but although it is considered a third party actor to sellers and buyers in the market, ICVCM is still a body that benefits from the growth of the VCC market, and its board has included members from the industry.[49] Similar to the Commission's approach, IOSCO's good practices,[50] which are currently under consultation, also borrow definitions from ICVCM but do not point to ICVCM as the final authority on integrity of VCCs.

The Commission has sufficiently incorporated principles from standard setters and it should not recommend a specific standard setter in the text of the final guidance. However, the DCMs should also recognize that they have the discretion to implement more stringent requirements on VCCs than what the Commission will outline.

Application to Cash-Settled VCC Derivatives Contracts and Swaps

We agree with the Commission's preliminary assessment and inclusion in the guidance that "...discussions in this proposed guidance of VCC commodity characteristics that a DCM should consider when developing the terms and conditions of a physically-settled VCC derivative

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[47] Commissioner Christy Goldsmith Romero. Guidance, Pg. 89428

[48] "Press Release: Independent Crediting Programmes Announce Ground-Breaking Collaboration to Increase the Positive Impact of Carbon Markets," *ACR, ART, CAR, GCC, GS, Verra/VCS*, December 4, 2023. https://ieta.b-cdn.net/wp-content/uploads/2023/12/Press-release-ICP-Joint-Statement.pdf

[49] "Governance Body Formed by the Taskforce on Scaling Voluntary Carbon Markets Announces New Leadership, Will Appoint Representatives from Indigenous Groups," *ICVCM*, October 29, 2021. https://icvcm.org/original-press-release-from-tsvcm-on-formation-of-icvcm/

[50] "Voluntary Carbon Markets Consultation Report," *The Board of the International Organization of Securities Commissions (IOSCO)*, December 2023, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD749.pdf

contract, should also be considered for cash-settled derivative contracts that settle to the price of a VCC, unless otherwise noted."[51]

Similar to DCMs, swap execution facilities (SEFs) are directly subject to core principles, guidance, acceptable practices, and product listing requirements, and obligated by statute only to permit trading in contracts that are not readily susceptible to manipulation. As in the proposal, the Commission should be clear that final guidance on VCCs should be considered by an SEF that proposes to trade swaps with VCCs as underlying commodities.[52]

Identified VCC Commodity Characteristics for DCMs to Evaluate

In the proposed guidance, the Commission has correctly outlined key VCC commodity characteristics that DCMs should consider when addressing quality standards for the development of terms and conditions of contracts: transparency, additionality, permanence and risk of reversal, and robust quantification. We support intense scrutiny of VCCs across these characteristics (and others, see below) by DCMs in alignment with the DCM Core Principles, and further note that these characteristics, particularly additionality and permanence/risk of reversal are critical, but may not be achievable for certain types of carbon credits at all.[53]

We support the Commission's proposal that a DCM should consider the governance framework and tracking mechanisms of the crediting program for the underlying VCCs, as well as the crediting program's measures to prevent double-counting when addressing delivery procedures for a physically-settled VCC derivative contract. We also support the inspection provisions that a DCM should consider whether the crediting program is employing best practices with respect to third-party validation and verification.

As we will discuss, we also believe the Commission's guidance should require DCMs to evaluate the potential for leakage associated with VCCs, as well as environmental and social safeguards.

Additional Recommendations

Self Certification

The Commission should not allow self-certification of VCC derivatives contracts, and should also consider a deeper examination of the self-certification of the existing, though few, VCC derivative contracts to verify alignment with the Core Principles. Given the repeated integrity and transparency problems mentioned above in VCMs and the resulting risks of fraud and

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[51] Guidance, Pg. 89416

[52] Guidance, Pg. 89416

[53] Alex Fredman and Todd Phillips, "The CFTC Should Raise Standards and Mitigate Fraud in the Carbon Offsets Market," *Center for American Progress*, October 7, 2022. https://www.americanprogress.org/article/the-cftc-should-raise-standards-and-mitigate-fraud-in-the-carbon-offsets-market/#:~:text=A%20key%20reason%20why%20permanence,quality%20are%20not%20sufficiently%20rigorous.

manipulation in VCC derivatives, the Commission should include in final guidance a formal review process for any new proposed contract.[54]

Further, we support the Environmental Defense Fund's recommendations (in their comment letter on this proposed guidance) on a heightened review framework for *any* self-certified climate-related products, as the Commissions did with derivatives on digital assets.

Need for Continued Monitoring and Enforcement

As Commissioner Johnson stated, "While the Commission's authority to introduce regulation is limited to Commodity derivatives, the Commission has broad authority to address fraud and market manipulation in the spot market."[55] In that vein we applaud the Commission's establishment of the Environmental Fraud Task Force, which was "...created to address misconduct in the regulated derivatives markets and to investigate fraud in the spot market for VCCs, in particular with respect to the purported environmental benefits of purchased carbon credits, and registrants' misrepresentations regarding purported environmental benefits and environmental, social, and governance (ESG) products or strategies."[56]

The Environmental Fraud Task Force and enforcement division of the CFTC should investigate any reporting or research which indicates fraud, manipulation, or integrity concerns in the unregulated VCC spot market. Results of subsequent investigations by the CFTC, or from the Department of Justice or other agencies (domestic or international) that indicate fraud or other integrity or liquidity problems within VCC spot or derivatives contracts should be used to inform additional guidance[57] from the Commission on VCC derivative contracts.

Alignment with Other Regulators

The derivatives market is the responsibility of the CFTC, and while the VCC spot market is largely unregulated, it is utilized by corporate buyers who are regulated by other markets and prudential regulators, so the Commission should continue engaging with these regulators on legal and appropriate use of VCCs. For example, as a large publicly-traded bank begins to evaluate and manage its climate-related financial risks in adhering to guidance from the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on risk management,[58] the bank may develop a net zero transition plan with guidance from the Department of the Treasury Principles for Net-Zero Financing & Investment. Those Principles note that, "Voluntary carbon markets (VCMs) remain relatively small and face

[54] Ibid.

[55] Guidance, Pgs. 89424-89425

[56] Guidance, Pg. 89424

[57]Additional guidance could include guidance specific to additional VCM derivatives market participants like DCOs and could also include investor alerts, investor bulletins, or customer/fraud advisories on any relevant aspects of the VCMs, see: https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/index.htm

[58] "Joint Press Release: Agencies issue principles for climate-related financial risk management for large financial institutions," *Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, & Office of the Comptroller of the Currency,* October 24, 2023. https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024b.htm

challenges related to market transparency and credit integrity"; they also make it clear that "A financial institution should provide sufficient information to give stakeholders a clear understanding of whether and/or the extent to which the voluntary use of carbon credits is part of its commitment. Any voluntary use of carbon credits should be accompanied by sufficient detail on the nature and integrity of those credits (e.g., linkages to a credible certification standard and demonstration of sufficient monitoring, reporting, and verification)."[59] The bank will then also need to adhere to the Federal Trade Commission's Green Guides for climate-related marketing claims, as well as forthcoming rules from the Securities and Exchange Commission that will likely require enhanced disclosures around details and progress towards climate-related commitments and net zero transition plan, including the intended use of VCCs.[60]

Derivatives Clearing Organizations

Should the VCC derivatives market expand, the Commission should consider providing additional guidance for derivatives clearing organizations (DCOs).[61] DCOs provide critical counterparty credit risk management through the clearing and settlement process. The Commission posits that guidance for DCOs might be challenging, "In the context of the current VCC market, significant questions arise as to whether certain elements of the DCO core principles would be easily established, including whether there are reliable prices for these carbon credits, the access to carbon credit markets, and whether there is material information about the carbon credit."[62] Given those questions around establishing VCC guidance with respect to DCO Core Principles, the Commission should act cautiously and not merely codify this guidance for DCMs, but also conduct formal review processes for VCC derivatives contracts given the clear risks.

Additional Direct Responses to Questions Posed by the Commission

Question 1. In addition to the VCC commodity characteristics identified in this proposed guidance, are there other characteristics informing the integrity of carbon credits that are relevant to the listing of VCC derivative contracts? Are there VCC commodity characteristics identified in this proposed guidance that are not relevant to the listing of VCC derivative contracts, and if so, why not?

Leakage

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[59] Page 13: "Principles for Net-Zero Financing & Investment," *U.S. Department of the Treasury*, September 2023. https://home.treasury.gov/system/files/136/NetZeroPrinciples.pdf

[60] "Environmentally Friendly Products: FTC's Green Guides," *Federal Trade Commission*, https://www.ftc.gov/news-events/topics/truth-advertising/green-guides; "Press Release: SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors," *Securities and Exchange Commission*, March 21, 2022. https://www.sec.gov/news/press-release/2022-46

[61] Registered Derivative Clearing Organizations, *CFTC*, Accessed: February 2024. https://www.cftc.gov/IndustryOversight/IndustryFilings/ClearingOrganizations

[62] Guidance, Pg. 89426

One addition that the Commission should make to its final guidance is inclusion of "leakage" risk as separate from additionality and permanence under quality standards.[63] Leakage occurs when efforts to reduce emissions in one place simply shift emissions to another location or sector where they remain uncontrolled or unaccounted for. It is a commonly cited integrity concern, particularly with carbon credits from land-based projects (forestry and agriculture).[64] Given that leakage is commonly evaluated component for the ability of a project to produce the carbon reduction the VCC is built on, and because there is variability amongst the VCC crediting programs on how they account for leakage,[65] DCMs should consider it as a commodity characteristic.

The Commission must also include social and environmental safeguards as commodity characteristics that DCMs should consider in the listing of VCC derivative contracts (see response to Question 16).

Question 3: In addition to the criteria and factors discussed in this proposed guidance, are there particular criteria or factors that a DCM should consider in connection with monitoring the continual appropriateness of the terms and conditions of a VCC derivative contract?

Yes. The Commission should add due diligence requirements that DCMs should investigate on an annual basis the ongoing operation and continuity of the projects for the VCCs underlying their derivatives contracts. The DCMs should also provide the Commission with market research on the health of the underlying market, including price trends and volume.

Question 5. 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?

Yes. VCC commodity characteristics that are identified in this proposed guidance as being relevant to the listing by a DCM of VCC derivative contracts, should 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. The Commission should provide the requesting registered foreign board of trade with the finalized guidance, under the recognition of its relevance to the listing of all VCC derivatives contracts.

[63] Footnote 36: Guidance, Pg. 89412
[64] Aaron Jenkins, Lydia Olander, and Brian Murray, "Policy Brief: Addressing Leakage in a Greenhouse Gas Mitigation Offsets Program for Forestry and Agriculture," *Nicholas Institute for Environmental Policy Solutions, Duke University*, March 2009. https://nicholasinstitute.duke.edu/climate/policydesign/offsetseries4
[65] Oli Parker, Linus Hiscox, Chin Chern Low, Ana Karla Nobre Dias, and Saheba Bhatnagar, "BeZero's carbon risk factor series: Leakage," *BeZero*, January 9, 2022. https://bezerocarbon.com/insights/bezero-carbon-risk-factor-series-leakage

Question 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? 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 Commission should broaden the definition of additionality in the final guidance, and specify that additionality includes, but is not limited to, regulatory additionality as well as financial additionality. The final guidance should add that VCCs should result from 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.[66] Additionally, it is well understood that carbon markets are divided into compliance and voluntary markets,[67] and given that the subject of this guidance is the listing of **voluntary** carbon credit derivative contracts, the Commission should clarify that VCC derivatives contracts should not recognize compliance credits. In the proposed guidance the Commission already states that, "Entities subject to the requirements of a mandatory market generally must demonstrate compliance by directly reducing their emissions from their own operations or activities, or by purchasing eligible **compliance** credits representing emission reductions or removals achieved by others."[68] DCMs should be doing due diligence into whether VCCs from a foreign jurisdiction have been created as a result of compliance requirements rather than voluntarily.

Question 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?

Social and Environmental Safeguards, Human Rights

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[66] See e.g., The California Air Resources Board cap-and-trade regulation defines additionality as both financial and regulatory: https://govt.westlaw.com/calregs/Document/I15CE12535A2111EC8227000D3A7C4BC3?viewType=FullText&originationContext=documenttoc&transitionType=CategoryPageItem&contextData=(sc.Default)

[67] Josh Gabbatiss, Daisy Dunne, Aruna Chandrasekhar, Orla Dwyer, Molly Lempriere, Yanine Quiroz, Ayesha Tandon and Dr Giuliana Viglione; Design by Joe Goodman, Tom Pearson and Tom Prater, "In-depth Q&A: Can 'carbon offsets' help to tackle climate change?," *Carbon Brief*, September 24, 2023. https://interactive.carbonbrief.org/carbon-offsets-2023/

[68] Guidance, Pg. 89412

Yes. The Commission should be clear in its guidance that when designing a VCC derivative contract, a DCM must consider whether a crediting program has implemented social and environmental safeguards. Those safeguards are material terms and conditions and required by most reputable private sector and multinational development initiatives to improve the chances that financed projects will not be undermined by violations of human, land, and labor rights.

Unfortunately, many VCC projects fail to adhere to social and environmental safeguards and protect human rights, even those that consider these criteria. A recent study determined that 94% of the most prominent carbon credit projects globally, are situated in Latin America, Africa, and Asia.[69] The operations of many of these projects have faced criticism, and related legal and reputational risks, in part due to their poor environmental outcomes, but also because of their poor track record in safeguarding the human rights of those impacted.[70] In 2021 The Guardian[71] highlighted an example of these human rights abuses: A major U.S. based company bought a $45 million forest-based carbon credit in Peru to prevent the deforestation of 8,226 acres of the Peruvian Amazon that brought adverse effects to local communities. Numerous residents were forced from their homes due to actions carried out by park authorities during a series of removals.[72]

Despite two companies' claims that they carried out assessments to ensure that the carbon credit projects they purchased benefited local communities, an Associated Press[73] investigation determined that the related projects had devastating consequences for Indigenous communities. In one instance, land that has historically been used for sustenance for the Kichwa people in Peru was sold for carbon credits. All the Kichwa interviewed maintain that they were not informed about the sale of the land and many of them were banned from hunting leading to hunger in their community.[74] Recently, Carbon Brief[75] mapped the impacts of carbon credit projects around the world and found that over 70% of those they reviewed resulted in harm to Indigenous populations and/or nearby communities.

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[69] Greenfield, Patrick. "Revealed: More than 90% of Rainforest Carbon Offsets by Biggest Certifier Are Worthless, Analysis Shows." *The Guardian*, January 18, 2023. https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe.
[70] "COP27: Governments Should Reject Weak Carbon Market Rules." Human Rights Watch, November 14, 2022. https://www.hrw.org/news/2022/11/14/cop27-governments-should-reject-weak-carbon-market-rules.
[71] Greenfield, Patrick. "'Nowhere Else to Go': Forest Communities of Alto Mayo, Peru, at Centre of Offsetting Row." *The Guardian*, January 18, 2023. https://www.theguardian.com/environment/2023/jan/18/forest-communities-alto-mayo-peru-carbon-offsetting-aoe.
[72] Ibid.
[73] Davey, Ed. "In Peru, Kichwa Tribe Wants Compensation for Carbon Credits." *AP News*, January 4, 2024. https://apnews.com/article/business-peru-forests-climate-and-environment-2c6cddb1707a12c31c14d9a226699068.
[74] Ibid.
[75] Quiroz, Yanine, and Daisy Dunne. "Mapped: The Impacts of Carbon-Offset Projects around the World." *Carbon Brief*, September 26, 2023. https://interactive.carbonbrief.org/carbon-offsets-2023/mapped.html.

In light of those challenges, when designing VCC derivative contracts, DCMs should prioritize considerations of whether crediting programs have implemented measures to safeguard human rights. This must include rigorous assessments of the social and environmental impacts of VCC projects, particularly in regions where Indigenous populations and vulnerable communities may be disproportionately affected, and these assessments should occur whether or not a crediting program claims to have implemented such measures. By incorporating such considerations into VCC derivative contracts, DCMs can play a role in promoting responsible and ethical practices and improve the integrity of VCCs issued by the crediting program.

Since the Commission has already adopted other principles from ICVCM, ICVCM's Core Carbon Principle 9 (CCP 9) requires mitigation projects "have clear guidance, tools and compliance procedures to ensure mitigation activities conform with or go beyond widely established industry best practices on social and environmental safeguards while delivering positive sustainable development impacts."[76] Compliance with social and environmental safeguards fundamentally impacts carbon crediting program success, reputational risk, resulting credit characteristics and market value. ICVCM Assessment Framework Criterion 7.1-7.11 further clarify the basic guardrails carbon crediting programs should use to implement CCP 9. These requirements include: 1) free prior and informed consent for affected communities – making terms and conditions of any contract clear and transparent; 2) assessment and minimization of impacts to the environment like water, air and hazardous waste pollution; and 3) explanation of how their Sustainable Development Goal impacts are consistent with the host country's goals, among others. These elements are consistent with best practices recommended, though not always sufficiently enforced, by other international development financing frameworks, including USAID, World Bank, the Green Climate Fund, and CORSIA.[77]

As with other material terms identified by the Commission in its proposed guidance, social and environmental safeguard systems and requirements can be subject to fraud and manipulation. Failure to include guidance reflecting expectations that listed contracts include terms and conditions reflecting widely established industry best practices on social and environmental safeguards limits the Commission's ability to protect stakeholders against this prevalent type of fraud, and exposes market participants to significant risk.

Other Actions By the CFTC

In addition to the finalization of this guidance by the Commission, we also urge the Commission to take the following actions related to climate-related financial risk.

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[76] "The Core Carbon Principles," *ICVCM*, https://icvcm.org/the-core-carbon-principles/

[77] *See, e.g.* USAID; https://www.usaid.gov/environmental-procedures/sectoral-environmental-social-best-practices; World Bank; https://www.worldbank.org/en/projects-operations/environmental-and-social-frameworkGreen Climate Fund Environmental and Social Safeguards; https://www.greenclimate.fund/projects/sustainability-inclusion/ess; CORSIA Safeguards Systems and Sustainable Development Criteria; https://www.icao.int/environmental-protection/CORSIA/Documents/ICAO_Document_09.pdf

- Propose regulatory amendments under the Commodity Exchange Act governing the risk management programs of swap dealers (SDs), major swap participants (MSPs), and futures commission merchants (FCMs) in light of new challenges brought on by climate change, crypto-assets, and cybersecurity threats, among other risks.[78]
- Provide guidance on environmental derivatives. As we noted in our comment in response to the Commission's request for information on climate-related risk, more guidance is broadly needed on environmental derivatives and climate-related products.[79] We echo Commissioner Johnson's view that, "...a comprehensive approach that addresses the diversity of environmental derivatives emerging in our markets will improve visibility, enhance integrity, and promote carbon neutrality."[80]
- Conduct a horizontal supervisory review of climate risk management practices and vulnerabilities at exchanges, clearinghouses, and at market intermediaries.
- Evaluate climate risk in the exchange traded derivatives market and the over the counter (OTC) market, paying close attention to the interconnectedness between financial institutions, and monitoring the overall growth of climate risk within the system. Derivatives markets may fail to function in the face of swift, correlated losses between interconnected firms.
- Incorporate climate-related risks into regularly conducted supervisory stress tests of central clearinghouses to ensure they can handle a range of extreme scenarios. Currently, the tests do not incorporate climate-related considerations, but they should. Stress tests look at whether DCOs have sufficient reserves, whether they are collecting enough margin from their counterparties, and whether they would be able to collect new capital from their members if their reserves would not cover their needs.[81] DCOs need to be able to withstand the unique risks climate change presents to their operations and to their largest clearing members. Climate scenarios ultimately will need to incorporate climate shocks in series and in parallel, rather than as discrete perturbations.
- Work with its systemically significant regulated entities and its other largest regulated entities to conduct climate scenario analysis exercises to understand current and future climate risks in derivatives markets, in line with other financial regulators.[82]

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[78] "Comment in Response to the CFTC's ANPRM on Risk Management Program Regulations for Swap Dealers, Major Swap Participants, and Futures Commission Merchants," *Americans for Financial Reform and Public Citizen, September 18, 2023.* https://ourfinancialsecurity.org/wp-content/uploads/2024/02/CFTC-ANPRM_Risk-Management_AFR-PC_2023.pdf

[79] "Comment in Response to the CFTC's Climate-Related Financial Risk RFI," *Americans for Financial Reform and Public Citizen*, November 7, 2022. https://ourfinancialsecurity.org/wp-content/uploads/2022/11/CFTC_Climate-RFI_Americans-for-Financial-Reform-Education-Fund-and-Public-Citizen_2022.pdf

[80] Guidance, Pg. 89423

[81] Todd Phillips, "A Climate and Competition Agenda for the Commodity Futures Trading Commission," *Center for American Progress*. 1 Feb. 2022. https://www.americanprogress.org/article/a-climate-and-competition-agenda-for-the-commodity-futures-trading-commission/

[82] "Press Release: Federal Reserve Board announces that six of the nation's largest banks will participate in a pilot climate scenario analysis exercise designed to enhance the ability of supervisors and firms to measure and manage

Conclusion
We thank the Commission for acknowledging the serious transparency and integrity challenges in the underlying, unregulated VCC market, which create the potential for fraud and manipulation in the VCC derivatives market, and proposing guidance for DCMs to navigate this new class of products. This action, while important, is a small step in dealing with the persistent problems within the VCMs, which will require further action from the Commission, Congress, and other regulators to address. The Commission should strengthen and finalize this guidance as soon as possible and continue dialogue with DCMs throughout the process of translating the statutory Core Principles for DCMs to VCC derivative contracts, to monitor developments and determine if further guidance is necessary. The Commission should closely monitor and bring appropriate enforcement action in cases of DCM's nonadherence to the Core Principles.

Sincerely,
Americans for Financial Reform Education Fund

climate-related financial risks," *Board of Governors of the Federal Reserve System*, September 29, 2022. https://www.federalreserve.gov/newsevents/pressreleases/other20220929a.htm