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Client Note:

CFTC Proposed Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts

December 4, 2023

Executive Summary –

The CFTC has [proposed guidance](#) for designated contract markets (DCMs, or futures exchanges) to “consider” when listing voluntary carbon credit (VCC) derivatives products (futures, options, and swaps).

The proposed guidance is structured around:

- CFTC DCM Core Principle 3 (*a DCM shall only list for trading derivative contracts that are not readily susceptible to manipulation*),
- CFTC DCM Core Principle 4 (*a DCM shall prevent manipulation, price distortion, and disruptions of the physical delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures*), and
- various requirements under Part 40 of the CFTC’s rules and Commodity Exchange Act Section 5c(c) related to an exchange’s submission of new contracts to the CFTC.

The release concludes with a wide range of questions and requests for comment (including a section of questions on sustainable development benefits and safeguards), and ***the comment period is set to end on February 16, 2024.***

Below we provide a few general observations on the release, and at the end we include a longer “general checklist” outlining the core provisions of the proposed guidance.

A few preliminary observations on broader CFTC themes in the release –

- *Extension of Guidance to Financially Settled Contracts and SEFs* - The guidance is directed to physically settled VCC futures contracts listed on DCMs; however, the release indicates that the CFTC “preliminarily believes” that the guidance should also be considered:
 - when DCMs are listing cash-settled derivative contracts that settle to the price of a VCC, and



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- by swap execution facilities (SEFs) that seek to list similar products.
- *Comments on the Forward Contract Exclusion and the regulation of VCC Spot Markets* -
 - In assessing whether an agreement, contract or transaction in an environmental commodity may qualify for the forward exclusion from the “swap” definition in Commodity Exchange Act, the release points generally to the 2012 product definitions final rule, which includes an extensive CFTC discussion of the forward contract exclusion. *See Further Definition of ‘Swap,’ ‘Security-Based Swap,’ and ‘Security-Based Swap Agreement’; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, 77 Fed Reg 48208 (August 13, 2012).*
 - As a reminder, in that rulemaking the CFTC noted: “The CFTC believes it is not necessary to define the term ‘environmental commodity’ because any intangible commodity—environmental or otherwise—that satisfies the terms of the [forward contract exclusion] interpretation provided herein is a nonfinancial commodity, and thus an agreement, contract or transaction in such a commodity is eligible for the forward exclusion from the swap definition.” And: “The ownership transfer and consumption features render such environmental commodity transactions similar to tangible commodity transactions that clearly can be delivered, such as wheat and gold.”
 - Referencing comments on the CFTC’s June 2022 Request for Information on climate related financial risk as pertinent to derivatives markets and underlying commodities market, the CFTC observed: “While there were comments expressing different views on the reach of the Commissions’ jurisdiction to regulate voluntary carbon markets, many commenters supported the Commission utilizing its spot market anti-fraud and anti-manipulation authority in the voluntary carbon market space.”
- *Market Color* - As of November 2023, eighteen futures contracts on voluntary carbon market products have been submitted by DCMs to the Commission for listing, and three of those contracts currently have open interest.

General Checklist of the Proposed Guidance –

- I. A DCM Shall Only List Derivative Contracts That Are Not Readily Susceptible to Manipulation
 - A. Quality Standards



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1. Transparency - Publicly Available Data to Promote Transparency
 - a) The DCM should provide, in the terms and conditions of a VCC derivative contract, information about the VCCs that are eligible for delivery under the contract.
 - b) The contract terms and conditions should include information that readily specifies the crediting program or programs – and, as applicable, the specific types of projects or activities – from which VCCs that are eligible for delivery under the contract may be issued.
 - c) DCMs should also consider whether the crediting program for the underlying VCCs is making detailed information about the crediting program’s policies and procedures and the projects or activities that it credits, such as relevant project documentation, publicly available in a searchable and comparable manner.
 - d) Information regarding the crediting program’s policies and procedures for making program information publicly available may constitute an economically significant attribute of the underlying VCC that should be described or defined in the terms and conditions of the VCC derivative contract.

2. Additionality - The Underlying VCC Represents GHG Emission Reductions or Removals That Would Not Have Been Developed and Implemented in the Absence of the Added Monetary Incentive Created by the Revenue from the Sale of Carbon Credits
 - a) According to the CFTC, additionality is viewed by many as a necessary element of a high quality VCC: if a VCC does not represent emission reductions or removals that would not have occurred in the absence of the added monetary incentive created by the revenue from the sale of carbon credits, then the VCC will not serve a market participant’s goals of contributing to emissions mitigation.
 - b) The DCM should consider whether the underlying VCCs represent GHG emission reductions or removals that are “additional” – in other words, whether the VCCs are credited only for projects or activities that result in GHG emission reductions or removals that would not have been developed and implemented in the absence of



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the added monetary incentive created by the revenue from the sale of carbon credits.

- c) The DCM should consider whether a crediting program can demonstrate that it has procedures in place to assess or test for additionality.
- d) The DCM should consider whether those procedures are sufficiently rigorous and reliable to provide a reasonable assurance that GHG emission reductions or removals are credited only if they are additional.
- e) Information regarding a crediting program's procedures for assessing or testing for additionality may constitute an economically significant attribute of the underlying VCCs, which should be described or defined in the terms and conditions of a VCC derivative contract.

3. Permanence and Accounting for the Risk of Reversal

- a) The DCM should consider whether the crediting program for the underlying VCCs can demonstrate that it has measures in place to address and account for the risk of reversal (i.e., the risk that VCCs issued for a project or activity may have to be recalled or canceled due to carbon removed by the project or activity being released back into the atmosphere, or due to a reevaluation of the amount of carbon reduced or removed from the atmosphere by the project or activity).
- b) Information regarding a crediting program's measures for estimating, monitoring, and addressing the risk of reversal may constitute an economically significant attribute of the underlying VCCs that should be described or defined in the terms and conditions of a VCC derivative contract.
- c) The DCM should consider whether the crediting program for a VCC has measures in place that provide reasonable assurance that, in the event of a reversal, the VCC will be replaced by a VCC of comparably high quality that meets the contemplated specifications of the contract.
- d) The DCM should consider whether a crediting program has a buffer reserve or other measures in place that provide reasonable assurance that, in the event of a reversal, the VCCs intended to underlie the derivative contract would be replaced by VCCs of



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comparable high quality that meets the contemplated specifications of the contract.

(1) (As relevant to this point the CFTC observes that most crediting programs have established VCC “buffer reserves” to address the risk of credited GHG emission reductions or removals being reversed. Under this approach, VCCs are set aside into a common buffer reserve (or “pool”).

Reserved VCCs can be drawn upon to compensate for reversals associated with a project or activity. If a reversal occurs, VCCs are drawn upon from the buffer reserve to replace VCCs that are canceled, proportional to the size of the reversal.)

- e) The DCM could also consider whether the crediting program regularly reviews the methodology by which the size of its buffer pool is calculated in order to address evolving climate risks that may heighten the risk of reversal, and whether there is a mechanism in place to audit the continuing sufficiency of the buffer pool.

4. Robust Quantification

- a) As part of its contract design market research, a DCM should consider the methodology or protocol used by a crediting program to calculate the level of GHG emission reductions or removals associated with credited projects or activities.
- b) A DCM should consider whether the crediting program for the underlying VCCs can demonstrate that the quantification methodology or protocol that it uses to calculate emission reductions or removals for the underlying VCCs is robust, conservative, and transparent.
- c) Information about the quantification methodology or protocol used by the crediting program to calculate GHG emission reductions or removals for projects or activities associated with the underlying VCCs may constitute an economically significant attribute of the underlying VCCs that should be described or defined in the terms and conditions of a VCC derivative contract.
- d) The CFTC observed that to establish exchange-set position limits, a DCM should derive a quantitative estimate of the deliverable supplies of the underlying commodity for the delivery period



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specified in the contract. . . . Where the quantification methodology or protocol used to calculate the amount of VCCs is robust, conservative, and transparent, the DCM should have a more reliable basis from which to form its deliverable supply estimate. That deliverable supply estimate, in turn, can be used as the basis for effectively setting the DCM's exchange-set speculative position limits to help reduce the possibility of corners or squeezes that may distort or manipulate the price of the derivative contract.

- e) For a cash-settled VCC derivative contract, a DCM may similarly consider the deliverable supply of the underlying VCCs when setting exchange-set speculative position limits or historical open interest when establishing non-spot month position accountability levels.

B. Delivery Points and Facilities

1. Governance

- a) A DCM should consider whether the crediting program for the underlying VCCs can demonstrate that it has a governance framework that effectively supports the crediting program's independence, transparency and accountability.
- b) A DCM should consider, among other things, the program's decision-making procedures, including who is responsible for administration of the program and how the independence of key functions is ensured; reporting and disclosure procedures; public and stakeholder engagement processes; and risk management policies, such as financial resources/reserves, cyber-security, and anti-money laundering policies.
- c) The DCM also should consider whether information regarding these procedures and policies is made publicly available.
- d) It may also be appropriate for the DCM to include information about the crediting program's governance framework in the terms and conditions of a physically-settled VCC derivative contract.

2. Tracking



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- a) A DCM should consider whether the crediting program for the underlying VCCs can demonstrate that it has processes and procedures in place to help ensure clarity and certainty with respect to the issuance, transfer, and retirement of VCCs.
- b) The DCM should consider whether the crediting program operates or makes use of a registry that has measures in place to effectively track the issuance, transfer, and retirement of VCCs; to identify who owns or retires a VCC; and to make sure that each VCC is uniquely and securely identified and associated with a single emission reduction or removal of one metric ton of carbon dioxide equivalent.

3. No Double Counting

- a) A DCM should consider whether the crediting program for the underlying VCCs can demonstrate that it has effective measures in place that provide reasonable assurance that credited emission reductions or removals are not double counted (that is, that the VCCs representing the credited emission reductions or removals are issued to only one registry and cannot be used after retirement or cancellation).

4. Inspection Provisions - Third-Party Validation and Verification

- a) Any inspection or certification procedures for verifying compliance with quality requirements or any other related delivery requirements for physically-settled VCC derivatives contracts should be specified in the contract's terms and conditions (and these inspection or certification procedures should be consistent with the latest procedures in the voluntary carbon markets).
- b) The DCM should consider, among other things, how the crediting program for the underlying VCCs requires validation and verification that credited mitigation projects or activities meet the crediting program's rules and standards.
- c) The DCM should consider whether the crediting program has up-to-date, robust and transparent validation and verification procedures, including whether those procedures contemplate



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validation and verification by a reputable, disinterested party or body.

- d) A DCM should consider whether the crediting program is employing best practices with respect to third-party validation and verification, which may include conducting reviews of the performance of validators, procedures for remediating performance issues, not using the same third party validator to verify every project type or project category, and using a separate third party to conduct ongoing validation and verification from the third party that completed the initial validation and verification process.

II. A DCM Shall Monitor a Derivative Contract's Terms and Conditions as They Relate to the Underlying Commodity Market

- A. The monitoring by a DCM of the terms and conditions of a physically-settled VCC derivative contract should include continual monitoring of the appropriateness of the contract's terms and conditions that includes, among other things, monitoring to ensure that the delivery instrument - that is, the underlying VCC - conforms or, where appropriate, updates to reflect the latest certification standard(s) applicable for that VCC.
- B. The DCM must have rules requiring market participants to keep records of their trading that include records of their activity in the underlying commodity and related derivatives markets also must require market participants to make such records available upon request to the DCM.
- C. Reminder: "DCM market participants are required, upon request, to make records of their trading in underlying VCC cash markets available to the DCM, in order to assist the DCM in fulfilling its market monitoring obligations. These records also are subject to Commission inspection under applicable Commission recordkeeping rules."

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

- A. Whether submitting VCC contracts for self-certification or CFTC approval, the CFTC emphasized three specific DCM obligations:



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1. A contract submission to the Commission must include an “explanation and analysis of the contract and its compliance with applicable provisions of the [CEA], including core principles and the Commission’s regulations thereunder.”
 2. The explanation and analysis of the contract must “either be accompanied by the documentation relied upon to establish the basis for compliance with applicable law, or incorporate information contained in such documentation, with appropriate citations to data sources[.]”
 3. If requested by Commission staff, a DCM must provide any “additional evidence, information or data that demonstrates that the contract meets, initially or on a continuing basis, the requirements” of the CEA or the Commission’s regulations or policies thereunder.
- B. In connection with the submission for a VCC derivatives contract, a DCM may provide qualitative explanations and analysis to assist in addressing the three above-described requirements. The Commission expects that the information –including supporting documentation, evidence and data – provided by the DCM to describe how the contract complies with the CEA and applicable Commission regulations, will be complete and thorough.

About us:

Miller Strategic Partners LLP is a law firm headquartered in New York City. We advise clients on trading and markets regulatory and commercial matters, investigations, and crisis management scenarios.

We are a law firm member of the Futures Industry Association.

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