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# *CFTC Approves Final Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts*

OCTOBER 02, 2024

On September 19, 2024, the Commodity Futures Trading Commission (Commission or CFTC) approved final guidance regarding the listing of voluntary carbon credit (VCC) derivative contracts (the Final Guidance).<sup>1</sup>

The Final Guidance comes a few months after the Department of the Treasury and the Biden Administration issued their “Voluntary Carbon Markets Joint Policy Statement and Principles.”<sup>2</sup> The Final Guidance demonstrates the CFTC’s effort to position itself at the forefront of the administration’s carbon, energy, and green policy agenda. CFTC Chairman Rostin Behnam described the publication of the Final Guidance as “a critical step in support of the development of high-integrity voluntary carbon markets” representative of “a whole-of-government approach in coordination with our partners across the U.S. federal complex.” The Final Guidance was also received positively by Treasury Department leadership. The Treasury Department leads the Financial Stability Oversight Council (FSOC), which has expressed interest in integrating environmental considerations into the financial markets during the Biden Administration.<sup>3</sup>

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<sup>1</sup> CFTC Release No. 8969-24, CFTC Approves Final Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts (Sept. 20, 2024) <https://www.cftc.gov/PressRoom/PressReleases/8969-24>. VCC derivative contracts are an emerging class of climate-related derivative contracts listed for trading by DCMs where the underlying commodity is a VCC. VCCs are tradeable, intangible instruments issued by carbon-crediting programs that on retirement represent certified reductions or removals of greenhouse gases (GHGs) from the atmosphere. Participants in voluntary carbon markets purchase VCCs to supplement their own GHG emissions reduction or removal efforts.

<sup>2</sup> See <https://home.treasury.gov/system/files/136/VCM-Joint-Policy-Statement-and-Principles.pdf>

<sup>3</sup> CFTC Chairman Rostin Behnam acts as a voting member of the FSOC. Deputy Secretary of the Treasury Wally Adeyemo described the Final Guidance as “the exact kinds of steps [the Biden Administration has] to take to achieve the ambitious goals” in its “aggressive climate agenda.” <https://home.treasury.gov/news/press-releases/jy2611>. Treasury Department Under Secretary for Domestic Finance Nellie Liang noted that “[a] more robust futures market will also help support market integrity, particularly with respect to price transparency.” <https://home.treasury.gov/news/press-releases/jy2614>.

The Final Guidance comes after almost a year of deliberation since the proposed guidance was issued in December 2023. The Final Guidance joins previously issued guidance and acceptable practices for designated contract markets (DCMs) to consider with respect to certain of the Commodity Exchange Act (CEA) core principles in Appendix B to Part 38 of the CFTC's rules,<sup>4</sup> as well as guidance that addresses whether derivatives contracts are not readily susceptible to manipulation in Appendix C to Part 38 of the CFTC's rules (Appendix C).<sup>5</sup> The CFTC's Division of Market Oversight and Division of Clearing and Risk previously issued a joint staff advisory "that gives exchanges and clearinghouses registered with the CFTC guidance for listing virtual currency derivative products."<sup>6</sup>

The Final Guidance will become effective upon publication in the Federal Register.

This alert provides a preliminary analysis of the CFTC's Final Guidance and the Commissioners' published views. The WilmerHale Futures & Derivatives Group will continue to follow developments in this area and would be glad to discuss any questions you may have.

## **Overview of the Final Guidance**

The CFTC's Final Guidance addresses the listing of VCC derivative contracts. Specifically, the Final Guidance speaks to how registered DCMs can comply with DCM Core Principles 3 and 4 and with certain of the Commission's DCM submission requirements in connection with the listing of VCC derivative contracts.

Importantly, however, the Final Guidance is not a binding rule and does not establish new obligations for DCMs. Instead, the Final Guidance is a statement of the Commission's views regarding factors that may be relevant in its evaluation of DCM compliance with respect to the contract design and listing process for VCC derivative contracts.

### ***1. DCM Core Principle 3 (Not Readily Susceptible to Manipulation)***

DCM Core Principle 3 requires that DCMs only list derivative contracts for trading that are not readily susceptible to manipulation.<sup>7</sup> Appendix C outlines general requirements for listing derivative contracts consistent with DCM Core Principle 3, including that the terms and conditions of the contract "should describe or define all of the economically significant characteristics or attributes of

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<sup>4</sup> 17 CFR part 38, Appendix B.

<sup>5</sup> 17 CFR part 38, Appendix C.

<sup>6</sup> CFTC Staff Advisory No. 18-14, "Advisory with respect to Virtual Currency Derivative Product Listings" (May 21, 2018), available at <https://www.cftc.gov/PressRoom/PressReleases/7731-18>.

<sup>7</sup> 7 U.S.C. 7(d)(3).

the commodity underlying the contract.”<sup>8</sup> The specific attributes of the underlying commodity that should be described or defined “depend upon the individual characteristics of the commodity.”<sup>9</sup>

The Final Guidance outlines certain “VCC commodity characteristics”<sup>10</sup> with respect to three criteria—quality standards, delivery points and facilities, and inspection provisions. The guidance provides that a DCM should consider these criteria in designing a VCC derivative contract and in determining the characteristics or attributes of the underlying VCCs that the contract’s terms and conditions should describe or define in order to satisfy DCM Core Principle 3. We discuss each of these criteria in turn below.

#### A. Quality Standards

In the Final Guidance, the Commission identifies four VCC commodity characteristics that DCMs should consider when addressing the quality standards criteria in connection with the design of a VCC contract:

- **Transparency.** A VCC derivative contract’s terms and conditions should contain certain information about the VCCs eligible for delivery under the contract (e.g., what is deliverable, the specific crediting program issuing the underlying VCCs, and the specific category of mitigation project or activity with which the underlying VCCs are associated).<sup>11</sup> DCMs should also consider the extent to which the crediting program for the underlying VCCs makes detailed information about its policies and procedures and the projects and activities that it credits publicly available in a searchable and comparable manner.<sup>12</sup>
- **Additionality.** A DCM should consider whether the crediting program for underlying VCCs has procedures in place to assess or test for additionality.<sup>13</sup> The Commission declined to provide a definition of “additionality,” instead leaving DCMs to rely on industry-recognized standards.<sup>14</sup> Generally speaking, a project or activity is “additional” if it would not have occurred absent the economic incentive created by the revenue from the sale of carbon credits.
- **Permanence and Risk of Reversal.** A DCM should consider whether the crediting program for underlying VCCs 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

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<sup>8</sup> 17 C.F.R. Part 38, Appendix C, paragraph (b)(2)(i)(A).

<sup>9</sup> *Id.*

<sup>10</sup> Final Guidance at 84.

<sup>11</sup> Final Guidance at 86.

<sup>12</sup> Final Guidance at 86-87.

<sup>13</sup> Final Guidance at 87.

<sup>14</sup> Final Guidance at 88.

cancelled 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).<sup>15</sup>

- **Robust Quantification.** A DCM should consider whether there is reasonable assurance that the quantification methodologies or protocols used by the crediting program for calculating emission reductions or removals for underlying VCCs are robust, conservative, and transparent.<sup>16</sup> DCMs must also adopt, “as is necessary and appropriate,” exchange-set position limits for speculators.<sup>17</sup>

#### *B. Delivery points and facilities*

Appendix C states that the delivery procedures for a physically settled derivative contract should, among other things, seek to minimize or eliminate any impediments to making or taking delivery by both deliverers and takers of delivery to help ensure convergence of cash and derivative contract prices at the expiration of the derivative contract.<sup>18</sup>

With respect to VCC derivative contracts, the Final Guidance provides that a DCM should consider:

- whether the crediting program for the underlying VCCs has a governance framework in place that supports the crediting program’s independence, transparency and accountability;<sup>19</sup>
- whether the crediting program for the underlying VCCs has processes and procedures in place to ensure clarity and certainty with respect to the issuance, transfer and retirement of VCCs;<sup>20</sup> and
- whether the crediting program for the underlying VCCs has measures in place that provide reasonable assurance that credited emission reductions or removals are not double counted.<sup>21</sup>

#### *C. Inspection provisions*

Consistent with Appendix C, the Commission recommends that a VCC derivative contract’s terms and conditions should specify any inspection or certification procedures for verifying compliance with quality requirements or any other related delivery requirements for physically settled VCC

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<sup>15</sup> Final Guidance at 88–89.

<sup>16</sup> Final Guidance at 90.

<sup>17</sup> *Id.*

<sup>18</sup> 17 C.F.R. Part 38, Appendix C, paragraph (b)(2)(i)(B).

<sup>19</sup> Final Guidance at 92-93.

<sup>20</sup> Final Guidance at 93.

<sup>21</sup> Final Guidance at 93-94.

derivative contracts.<sup>22</sup> These inspection or certification procedures should be consistent with the latest procedures in the voluntary carbon markets.<sup>23</sup>

Additionally, in designing a VCC derivative contract, the Final Guidance specifies that a DCM should consider whether there is reasonable assurance that the crediting program for underlying VCCs has up-to-date, robust and transparent procedures for validating and verifying that credited mitigation projects or activities meet the crediting program's rules and standards.<sup>24</sup> That is, DCMs should consider whether there is reasonable assurance that the crediting program's procedures reflect best practices with respect to third-party validation and verification.<sup>25</sup>

## ***2. DCM Core Principle 4 (Prevention of Market Disruption)***

DCM Core Principle 4 requires a DCM to prevent manipulation, price distortion and disruptions of the physical delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures.<sup>26</sup>

For physically settled derivative contracts, the Commission's implementing regulations under DCM Core Principle 4 require a DCM to monitor the contract's terms and conditions as they relate to the underlying commodity market and to the convergence between the contract price and the price of the underlying commodity, and to monitor the supply of the underlying commodity in light of the contract's delivery requirements.<sup>27</sup> Accordingly, the Final Guidance recommends that a DCM's monitoring of the terms and conditions of a physically settled VCC derivative contract include ongoing monitoring of the appropriateness of the contract's terms and conditions that includes, among other things, monitoring to ensure that the underlying VCC conforms or, where appropriate, updates to reflect the latest certification standards applicable for that VCC.<sup>28</sup>

Additionally, the Commission's implementing regulations under DCM Core Principle 4 also require DCMs to have rules requiring their market participants to keep records of their trading that include records of their activity in the underlying commodity and related derivatives markets.<sup>29</sup> A DCM's rules must also require market participants to make such records available to the DCM upon

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<sup>22</sup> Final Guidance at 94.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Final Guidance at 95.

<sup>26</sup> 7 U.S.C. 7(d)(4).

<sup>27</sup> 17 C.F.R. 38.252.

<sup>28</sup> Final Guidance at 96.

<sup>29</sup> 17 C.F.R. 38.254(a).

request.<sup>30</sup> Therefore, the Final Guidance states that, upon request, DCM market participants are required to make records of their trading in underlying VCC cash markets available to the DCM in order to assist the DCM in its market monitoring obligations.<sup>31</sup>

### ***3. DCM Submission Requirements***

A DCM must submit specific information to the Commission in connection with the listing of a new derivative contract, including (i) an explanation and analysis of the contract and its compliance with the CEA, including core principles and the Commission's regulations thereunder; (ii) any documentation or information relied upon to establish the basis for the contract's compliance with applicable law; and (iii) any additional evidence, information or data demonstrating that the contract meets the requirements of the CEA or the Commission's regulations or policies thereunder upon request.<sup>32</sup> With respect to submissions for a VCC derivative contract, the Final Guidance notes that a DCM may submit qualitative explanations and analyses addressing the three requirements described above so long as they are complete and thorough.<sup>33</sup>

### ***4. Views of the Commissioners on the Final Guidance***

In voting to issue the Final Guidance, Chairman Behnam issued a statement in support of approval of the Final Guidance and Commissioner Summer Mersinger issued a statement of dissent against its approval. Commissioner Caroline Pham did not issue a statement, and the voting record is not provided in the preprint version.

#### ***A. Chairman Behnam***

In his statement supporting the Commission's approval of the Final Guidance,<sup>34</sup> Chairman Behnam describes the Final Guidance as a "critical step" in supporting the development of high-integrity voluntary carbon markets, and as the product of more than five years of engagement with a diverse group of market participants.

In particular, he emphasizes that the Final Guidance is important because VCC derivatives are a new and evolving class of products, and DCMs are responsible for ensuring that any listed derivatives comply with both the CEA and CFTC rules. He argues that the Final Guidance is helpful because it provides certain characteristics that DCMs should consider in connection with the

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<sup>30</sup> *Id.*

<sup>31</sup> Final Guidance at 96-97.

<sup>32</sup> Final Guidance at 98.

<sup>33</sup> *Id.*

<sup>34</sup> Statement of Support of Chairman Rostin Behnam on the Commission's Final Guidance Regarding the Listing of Voluntary Carbon Credit Derivatives Contracts (September 20, 2024) <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement092024>.

contract design and listing process for these new and evolving products, which will promote accurate pricing, reduce the contract's susceptibility to manipulation, prevent price distortion and foster confidence in VCC markets.

Additionally, Chairman Behnam states that the Final Guidance is the product of a strong public-private relationship and that the VCC characteristics outlined in the Final Guidance build on well-researched, private-sector-recognized standards for high-integrity VCCs.

Finally, Chairman Behnam notes that the Final Guidance complements ongoing work by the International Organization of Securities Commission's Sustainable Finance Task Force's Carbon Market Workstream focused on how regulators around the world can promote sound market structure and enhance financial integrity in voluntary carbon markets to facilitate orderly and transparent trading in high-quality carbon credits.

*B. Commissioner Mersinger*

Commissioner Mersinger dissented from the Commission's decision to adopt the Final Guidance for two primary reasons.<sup>35</sup> First, Commissioner Mersinger posits that the Final Guidance is "a solution in search of a problem" because VCCs are an emerging class of products that have very little open interest and that comprise only a small percentage of trading activity on CFTC-regulated DCMs. Meanwhile, she states, the Commission has numerous other topics requiring its immediate attention.

Second, Commissioner Mersinger states that the Final Guidance is more concerned with promoting political ideology than with providing clarity and fostering transparency with respect to CFTC rules. In particular, she emphasizes that the Final Guidance is nonbinding, creating no new obligations for DCMs. Additionally, she maintains that considering things like environmental, social, and governance compliance and Net Zero goals when addressing quality standards in connection with derivative contract design is inappropriate because none is materially related to the ability of a listed derivatives product to meet its regulatory obligations.

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<sup>35</sup> Dissenting Statement of Commissioner Summer K. Mersinger on Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts (September 20, 2024)  
<https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement092024>.

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