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FIA Public Response to the IOSCO Consultation Report to Promote the Integrity and Orderly Functioning of the Voluntary Carbon Markets

The Futures Industry Association (FIA)[1] welcomes the opportunity to respond to the IOSCO public consultation outlining a proposed set of Good Practices (Good Practices) to promote the integrity and orderly functioning of Voluntary Carbon Markets (VCMs). FIA commends IOSCO for continuing to foster a much-needed dialogue among public and private stakeholders across jurisdictions and regions on the important, and complex, issues surrounding the development of VCMs.

VCMs and related voluntary carbon credit ("VCC") derivative contracts are playing a critical role in helping the global economy navigate and manage risks associated with the energy transition and reduction of greenhouse gas ("GHG") emissions. In just the last few years, we have witnessed rapid growth in carbon, climate and sustainability-linked markets. We are excited about these developments and expect this growth to continue, and indeed accelerate, in the years to come as new technologies emerge and markets evolve.

There are also many public and private-sector initiatives that are aiming to bring increased standardization and integrity to VCCs and related derivatives markets. These initiatives are critical to help commercial firms and market participants that are striving to meet ambitious carbon-reduction targets in both the near- and long-term.

Although progress has been made to develop and apply objective, reliable standards to VCMs and VCCs, opportunities for improvement remain, aided by emerging technologies, further scientific dialogue, a more uniform adoption of standards, and international coordination – such as the ongoing efforts and engagement of IOSCO. This can take time and is to be expected for any new commodity market. FIA is committed to help both the public and private sectors in this process.

It must also be acknowledged that there have been press reports and academic publications that have raised questions about the methodologies employed by certain third-party validators to calculate the emissions reduced and/or avoided by carbon offset projects. While these findings have been disputed by the subjects of the reports, the uncertainty creates challenges – regulatory, commercial and reputational – both for exchanges that are developing innovative products to meet growing demand and for market participants seeking access to these markets to fulfil climate commitments. The reports also highlight that carbon registries and third-party validators currently lack oversight and standard operating principles and that the infrastructure in the underlying spot market could benefit from improvements. FIA would welcome further work by IOSCO on matters related to custody and registries for carbon credits, drawing on the experience in applying IOSCO principles for digital assets as well as price reporting agencies (PRAs).

Fundamentally, FIA believes in the power of markets and innovation to solve these challenges over time. The listed derivatives markets have a strong track record of success in scaling markets for a variety of asset classes and product types. Futures markets, in particular, provide an efficient way for companies and financial firms to hedge exposure to owned asset or manage risk with an asset class without entering the primary cash market and

[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, DC. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.

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without actually owning the asset. We are confident that new and existing exchanges, in collaboration with market participants, regulatory and self-regulatory authorities, and industry-led efforts and multinational projects[2] that seek to bring greater integrity to carbon markets, will contribute positively to the development of derivatives products necessary to support robust VCMs.

IOSCO's Discussion Paper on VCMs from November 2022

FIA welcomed the opportunity to respond[3] to the IOSCO VCM and Compliance Carbon Markets (CCMs) Discussion Papers[4] from November 2022, which included Key Considerations for relevant regulators and other authorities as well as market participants to foster sound and effective VCMs.

When considering recommendations for integrity and orderly functioning of VCMs, FIA encouraged IOSCO to:

- highlight the different treatment of carbon offsets in different jurisdictions and promote a coordinated approach;
- support the efforts of international bodies to develop standards for emerging environmental products;
- urge authorities to coordinate with these international bodies and other jurisdictions to implement clear regulatory frameworks that recognize the global nature of carbon markets and market participants; and
- engage with regulated financial participants to increase institutional participation.

IOSCO's Consultation Report on VCMs

FIA appreciates IOSCO publishing its most recent Consultation Report on VCMs and for continuing to engage, in a transparent public process with the private sector. In particular, FIA would like to acknowledge and thank IOSCO for incorporating many of our recommendations and comments from the November 2022 Discussion Paper into the latest Consultation Report, including:

- highlighting the different treatment of carbon offsets in different jurisdictions and promote a coordinated approach;
- supporting efforts – including public and private sector led efforts - to bring greater standardization to VCMs on a global basis.

Financial market integrity vs. environmental integrity

IOSCO's VCM consultation report is appropriately focused on regulators applying a set of regulatory good practices where those practices fall within the scope of financial market integrity and the relevant regulator's existing authority and mandates. While jurisdictional considerations matter in this context, financial regulators are not in a position to facilitate the quality of the carbon credit tied to a traded product (environmental integrity). This authority would be better left to an environmental regulator or oversight body with experience and expertise in determining whether the carbon credit characteristics are valid.

FIA supports the efforts of private-sector-led initiatives, such as those of the Integrity Council for Voluntary Carbon Markets (ICVCM) with respect to the development of Core Carbon Principles and the International Swaps and Derivatives Association with respect to development of documentation and definitions to support bilateral VCMs. State compliance schemes serve as thought leaders in designing and implementing carbon

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[2] Such as the Sustainable Stock Exchanges Initiative (https://sseinitiative.org/)
[3] https://www.fia.org/fia/articles/fia-responds-iosco-consultation-carbon-markets
[4] IOSCO Voluntary Carbon Markets and Compliance Carbon Markets (CCMs) Discussion Papers, November 2022, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD718.pdf.

market infrastructure, including setting standards for carbon projects and credits validation and retirement. These efforts will promote greater standardisation and integrity of VCCs. There may be opportunities for additional private-sector-led efforts to build on the positive direction set by the voluntary standards working group announced at COP 28 to develop more consistent accounting principles. FIA encourages IOSCO to closely monitor, coordinate, and support these initiatives where appropriate.

Legal Requirements and Uncertainties

FIA agrees that a lack of a common understanding of the nature of carbon credits as traded instruments has led to uncertainty related to the legal requirements across jurisdictions. FIA was pleased to see that most respondents (although not all) "compared carbon credits to physical commodities for a number of reasons, including: (i) they can be physically delivered, (ii) they can be conveyed in some manner, (iii) they can be consumed (when they are retired or forced to be retired, in case of expiration), (iv) they are produced and used at different points in time and stored in warehouse (registries) in between production and use, and (v) they require an initial investment and involve a risk of non-production."

FIA also would like to acknowledge and thank IOSCO for including our comments that "it is important to distinguish between the legal treatment of VCMs themselves and the nature of transactions in VCMs (e.g., derivatives transactions with a carbon credit underlying, such as listed futures, options on futures, or swaps)," that "robust regulation of derivatives already exists in all major jurisdictions and any regulation of carbon credits as an asset class should not duplicate or undermine this regulation" and that "with respect to futures on voluntary carbon credits, that these are pervasively regulated as derivatives in virtually all major jurisdictions and thus should be regulated like all other futures."

FIA agrees that when seeking to address concerns related to legal uncertainty, "rather than recommend a specific definition or approach applicable to all IOSCO members, IOSCO should strongly encourage its members to clarify the regulatory treatment of an offset credit, as well as standard reporting definitions and methodologies, within members' respective regulatory regimes."

Standardization

FIA agrees with IOSCO's assessment that "a further Key Consideration for VCMs is how to standardize, to the extent possible, carbon credits in order to promote greater liquidity." Standardization is important to enhance the credibility, transparency, and comparability of VCCs which, ultimately, benefits both commercial market participants and exchanges and trading venues alike. Ultimately, FIA agrees with the IOSCO Consultation Report that "standardization helps provide clarity and confidence to buyers, sellers, and other stakeholders participating in carbon credit transactions." Such standardisation could be supported by private-sector-led initiatives mentioned above.

IOSCO's Proposed Set of Good Practices

FIA generally supports the Good Practices identified by IOSCO that may be helpful to relevant regulators and other authorities and market participants, as they may promote VCM integrity and help to overcome some of the present limitations in these markets.

Regulatory Frameworks

- Good Practice 1 – Regulatory approach and scope: Consistent with their respective mandates, relevant regulators and other authorities could consider ways to apply appropriate and effective regulation, supervision, and oversight to VCMs, covering, among other things, the issuance, trading, and retirement of carbon credits.
    - Relevant commodity derivative regulators and other authorities should use existing regulatory frameworks and authorities to supervise and oversee the emerging VCMs. As part of supervising the VCMs, market regulators could support efforts to standardize and increase transparency across carbon crediting programs and methodologies, recognizing that the issues related to issuance and conflicts of interest are not unique to carbon markets and can be addressed using similar tools available in other markets. IOSCO could play a key role in supporting the coordination of market initiatives that address these issues. To support ongoing industry efforts to enhance transparency, FIA would welcome further separate work by IOSCO on matters related to custody and registries for carbon credits, drawing on the experience in applying IOSCO principles for digital assets as well as price reporting agencies (PRAs).

- Good Practice 2 – Regulatory treatment: Where possible and consistent with their respective mandates, relevant regulators and other authorities could consider ways to provide clarity regarding the regulatory treatment of carbon credits.
    - FIA agrees that derivatives on carbon credits should fall under the regulatory framework applicable to commodity derivatives;\ however, there is less certainty about the underlying credits themselves. FIA would support, where possible, relevant regulators considering ways to provide regulatory clarity to the underlying VCCs (not to be confused with setting the quality characteristics of the underlying carbon credit, which we believe is best left to the purview of entities with environmental and scientific expertise).

- Good Practice 3 – Domestic and international consistency and cooperation: To foster the global development of VCMs, where possible and if consistent with domestic processes and mandates, regulators and other relevant authorities could consider seeking both domestic (between various domestic authorities) and international consistency and alignment when developing their own regulatory approach to carbon credits, including with regards to cross border cooperation for enforcement.
    - FIA agrees regulators and other relevant authorities should consider seeking both domestic and international consistency and alignment when developing regulatory approach to VCCs, including cross border coordination on enforcement.

- Good Practice 4 – Participants' skill and competence: Consistent with their respective mandates, relevant regulators and other authorities could consider promoting the need for firms and senior management to have adequate skills and competence, including an understanding of the benefits and risks of trading in VCMs, and how existing regulatory frameworks may, or may not, apply. In addition, they could consider developing investor education programs to improve the public's knowledge of carbon credits.
    - FIA would support efforts to further investor education programs aimed at improving the public's knowledge of VCCs. It is important that education comes from the industry and leverages industry best practices. At this time, however, FIA does not see a need for a bespoke certification regime for industry participants, such as traders or project developers.

Primary Market Issuance

- Good Practice 5 – Standardization: Consistent with their respective mandates, relevant regulators and other authorities could consider engaging with carbon crediting programs, spot exchanges, derivatives exchanges, private sector initiatives, and other market participants to standardize a taxonomy of carbon credit attributes, strengthen verification methodologies, and streamline verification processes.
  - FIA supports industry-led efforts to standardise a taxonomy of carbon credit attributes, strengthen verification methodologies, and streamline verification processes. FIA has welcomed and supported private-sector-led efforts to bring greater integrity to these markets through increased standardization and transparency. FIA supports regulators' continued engagement with these private-sector-led efforts, as well as with spot and derivatives exchanges and market participants, recognising that market regulators generally do not have the expertise or authority to drive the conversation around standardizing carbon credit attributes and verification practices. At the same time, FIA acknowledges that there are different types of carbon reductions and removals, with different atmospheric outcomes and different costs of production, and therefore how the market evolves in terms of 'standardisation' remains to be seen. Ultimately, FIA recommends that regulators leverage industry expertise and support industry efforts to continue to enhance standardization of carbon credit types and quality characteristics and drive towards improving best practice principles around transparency and integrity.

- Good Practice 6 – Transparency: Consistent with their respective mandates, relevant regulators and other authorities could consider appropriate ways to promote transparency around the creation of a carbon credit. This could include comprehensive disclosures on the project development process, verification and auditing methodologies, and the entities responsible for measurement, reporting, and verification. Transparency of contracts and pricing in the primary market could also be encouraged.
  - FIA supports industry-led efforts to promote transparency around the creation of a carbon credit but recognizes that these areas may fall outside of the remit and expertise of market regulators. Transparency around the creation of a carbon credit is facilitated by the registry and information related to the project and carbon life cycle is made available by the crediting program. Therefore, environmental integrity would fall outside the jurisdiction and expertise of most market regulators. It may make sense for projects to display the validation/verification bodies (VVBs) responsible for verification.

- Good Practice 7 – Disclosure: Consistent with their respective mandates, relevant regulators and other authorities could consider appropriate requirements to promote complete, accurate, and understandable disclosure of information related to the primary issuance of carbon credits as well as transparent disclosure of any associated risks.
  - FIA encourages jurisdictions to lean on industry best practices to promote complete, accurate, and clear disclosure of information related to the primary issuance of carbon credits as well as transparent disclosure of any associated risks.
  - Registries should be responsible for these disclosures so that the risk disclosure is uniform.

- Good Practice 8 – Soundness and accuracy of registries: Consistent with their respective mandates, relevant regulators and other authorities could consider appropriate requirements, that registries, as custodians of carbon credits, are accurate, complete and current in order to serve as reliable sources of information regarding the price at issuance, tracking and/or retirement of carbon credits.
  - It should be noted that some market solutions that perform omnibus type services (developing standard operating principles for carbon registries that are used for settlement in carbon credit derivative contracts) exist today. FIA encourages IOSCO to learn more about existing market

- solutions and coordinate with private-sector-led efforts as they consider additional action. As noted above, IOSCO could draw on prior experience in applying IOSCO principles for digital assets as well as PRAs.
- FIA suggests that IOSCO should more clearly delineate between the registry's role in tracking the certification of projects, and the issuance and retirement of carbon credits and its role in the secondary market. While there are similarities to the role of custodians and registries, the role of the custodian is not to provide information on price; IOSCO should remove references to registries serving as a reliable source of information regarding the price at issuance.
- Finally, registries should display for any retirement a) who retires and b) on whose benefit the carbon credits are retired, and c) provide the option for users to indicate what purpose they are retired.

- Good Practice 9 – Due diligence: Consistent with their respective mandates, relevant regulators and other authorities could consider appropriate requirements to ensure that carbon crediting programs perform adequate levels of know-your-customer (KYC) and due diligence procedures to prevent the use of carbon credits for money laundering.
  - FIA supports efforts to ensure that carbon crediting programs perform adequate levels of KYC and due diligence procedures to prevent the use of carbon credits for money laundering.

Secondary Market Trading

- Good Practice 10 – Access to VCMs: Consistent with their respective mandates, regulators and other relevant authorities could consider requirements or policies to ensure open and fair access to secondary market trading on VCMs for interested market participants.
  - FIA supports ensuring open and fair access to secondary market trading on VCMs for interested market participants.

- Good Practice 11 – Integrity of trading: Consistent with their respective mandates, relevant regulators and other authorities could consider requirements to ensure that VCM participants observe high standards of integrity and fair dealing with respect to business activities relating to carbon credits.
  Regulators and other authorities should ensure that all market participants – including VCM participants -- observe high standards of integrity and fair dealing. IOSCO has suggested that regulators promote requirements to ensure that "only carbon credits satisfying established and recognised standards for quality and integrity are eligible for trading on regulated trading venues." IOSCO should be mindful that established and recognised standards for quality and integrity in carbon credits are in the early phases of implementation by standard setting bodies (*e.g.*, the Integrity Council for Voluntary Carbon Markets (ICVCM)).

- Good Practice 12 – Public reports: Consistent with their respective mandates, relevant regulators and other authorities could consider requiring that trading venues and registries, including for OTC trading, make public reports which disclose, on an equal basis to all market participants, relevant data regarding trading, including, but not limited to, pre- and post-trade price transparency, trading volume, bid-ask spreads, and deliveries of carbon credits.
  - FIA believes that public reporting of derivatives VCC should be consistent with and not diverge from, the trading of other commodity derivatives. IOSCO should remove the suggestion that registries should be involved in disclosing trading data/information. Registries are explicitly not

a part of trading in terms of pricing, listing, execution, etc., and therefore have no access to trading data.
    - IOSCO should more explicitly specify that any OTC trading disclosure requirements follow what is required in other products/markets; there need not be separate requirements for VCM contracts.
    - While regulators should have access to information regarding the holding of positions to fulfill their supervisory roles, any public disclosure considerations should take into account applicable privacy laws and protection of market participants from a harmful disclosure of open positions, which could threaten market integrity.
    - OTC markets (given the bilateral nature of transactions) typically have less publicly available pricing information than exchange-traded markets. Existing transaction reporting obligations on derivative transactions should be able to give national regulators enough information to exercise oversight over these markets. Any additional transparency requirements should be carefully assessed to ensure their benefits outweigh their costs and that they do not have unintended negative impacts on the market. Additionally, OTC disclosure trading disclosure requirements should follow what is required in other products/markets. Therefore, market participants should be required to report OTC information to regulators and not to trading venues, the latter of which are typically private/commercial organisations.

- Practice 13 – Pre-and post-trade disclosure: Consistent with their respective mandates, relevant regulators and other authorities could consider encouraging an entity operating a VCM, which lists carbon credits that are the underlying for regulated derivatives, derivatives exchanges, or an intermediary to provide pre- and post-trade disclosures in a form and manner that are the same as, or that achieve similar regulatory outcomes consistent with, those that are required in traditional, regulated financial markets.
    - FIA agrees that entities operating a derivatives VCM should provide pre- and post-trade disclosures in a form and manner that are the same as, or that achieve similar regulatory outcomes consistent with, those that are required in traditional, regulated derivatives markets. These disclosure requirements should not be more strict than those imposed on financial market participants.

- Good Practice 14 – Derivatives standards: Consistent with their respective mandates, regulators and other relevant authorities could consider ways to ensure that contract specifications for carbon credit derivatives include sufficient details on the standards by which the underlying credits were certified, the applicable delivery requirements, and procedures for market participants.
    - Regulators could consider ways to ensure contract specifications for carbon credit derivatives include sufficient details on the standards by which the underlying credits were certified, the applicable delivery requirements, and procedures for market participants, in the same manner that regulators require for other commodity derivative products listed by an exchange, in addition to sufficient details if there are relevant post expiration/settlement warranties.

Governance and Risk Management

- Good Practice 15 – Governance framework: Consistent with their respective mandates, relevant regulators and other authorities could consider requiring that VCM participants, including carbon credit project developers, registries, validation and verification bodies, brokers, traders, marketplaces and exchanges, rating agencies, third-party entities, and private sector supply and demand side standardization initiatives, have in place a comprehensive governance framework with clear lines of responsibility and accountability for the functions and activities they are conducting.

- As a general matter, FIA represents intermediaries and market participants in the exchange-traded derivatives markets that already have existing comprehensive governance frameworks across jurisdictions.

- Good Practice 16 – Risk management: Consistent with their respective mandates, relevant regulators and other authorities could consider requiring that carbon credit intermediaries, marketplaces, and exchanges have effective enterprise risk management frameworks in place to address any potential operational or technological risks associated with the trading of or provision of services relating to carbon credits. Appropriate enterprise management, information technology, and security protocols could be deployed by each of the key market participants, including the registries where carbon credits are transferred, to effectively guard against fraud, hacking, and other, criminal activities related to carbon credits. Regulators could consider requiring the employment of an enterprise risk officer with sufficient staffing and support resources. Regulators could also consider requiring the implementation of a business continuity disaster recovery plan and operational resilience programs with system safeguards that are developed and routinely reviewed for consistency with industry best practices.
    - As a general matter, FIA represents intermediaries and market participants in the exchange traded derivatives markets that already have existing comprehensive risk management frameworks in place.

- Good Practice 17 – Conflicts of interest rules: Consistent with their respective mandates, relevant regulators and other authorities could consider whether laws and applicable rules within their remit and jurisdiction appropriately address conflicts of interest raised by the issuance, verification, certification, transfer, and retirement of carbon credits.
    - FIA generally supports regulators and other authorities considering whether laws and applicable rules within their remit and jurisdiction appropriately address conflicts of interest raised by the issuance, verification, certification, transfer, and retirement of carbon credits.

Market Abuse

- Good Practice 18 – Enforcement actions: Consistent with their respective mandates, relevant regulators and other authorities could consider bringing enforcement actions if there are fraudulent or abusive practices in VCMs, such as false and misleading statements regarding the attributes of carbon credits. In anticipation, consistent with their respective mandates, relevant regulators and other authorities as well as trading venues could consider implementing rule enforcement programs with disciplinary mechanisms to discourage trade practice violations, including monetary sanctions to deter recidivism. This would include putting in place measures to ensure the avoidance of fraud with respect to any systems used to issue, track, record, and/or register ownership of a carbon credit.
    - Markets should be safe and free from manipulative and deceptive conduct, and bad actors should be prosecuted to the fullest extent of the law to stop and deter such conduct. As noted earlier, however, the primary challenges with VCMs today are not with the derivatives markets, but rather with the underlying VCCs, specifically the lack of consistency in methodologies employed by third-party validators and quality of the credits. When considering enforcement actions, FIA urges regulators to focus on clear instances of misconduct. Prosecution of market participants – whether platforms, intermediaries or end users – that rely in good faith on the representations of purported third-party experts and validators as to the quality of VCCs may risk chilling the growth and development of VCMs. It would be troubling for commercial

market participants to be subject to increased enforcement risk for taking steps in good faith to reduce their emissions and, over time, transition to a more sustainable economy.
  - FIA would encourage IOSCO to think about issues related to market abuse and fraud in separate buckets. Market abuse would apply only to VCM secondary market trading activity or to those actions that have the capacity to impact this activity. By contrast, misleading statements regarding the attributes of carbon credits impact the primary market issuance and fit best in the definition of fraud (rather than being understood as a type of market abuse).

- Good Practice 19 – Market surveillance and monitoring of trading: Consistent with their respective mandates, relevant regulators and other authorities and trading venues could consider appropriate ways to conduct market surveillance and trade monitoring to identify fraud, manipulation, price distortion, and/or other market disruptions.
  - FIA supports encouraging regulators and trading venues to consider appropriate ways to conduct market surveillance and trade monitoring in derivatives VCMs – just as they do in all commodity derivatives markets -- to identify fraud, manipulation, price distortion, and/or other market disruptions.

- Good Practice 20 – Trading venue resources: Consistent with their respective mandates, relevant regulators and other authorities could consider ensuring that trading venues maintain adequate resources to detect and investigate fraudulent or manipulative practices, including a Chief Compliance Officer and Chief Regulatory Officer.
  - FIA supports encouraging regulators and trading venues to consider appropriate ways to maintain adequate resources to detect and investigate fraudulent or manipulative practices in derivatives VCMs – as they do in all commodity derivatives markets -- to identify fraud, manipulation, price distortion, and/or other market disruptions. However, we do not believe it is necessary or advisable to prescribe specific roles or titles, as relevant trading venues need flexibility to address the particular needs and attributes of their markets and any prescribed functions with respect to VMCs may not conform to the venues' obligations with respect to other regulated activities.

- Good Practice 21 – Disclosure of Carbon Credits Use: Consistent with their respective mandates, relevant regulators and other authorities could consider, consistent with their jurisdiction's laws and domestic legal requirements, encouraging or requiring disclosures regarding an entity's use of carbon credits to achieve any net GHG emission targets.
  - FIA suggests that IOSCO should draw a clearer legal distinction between the use and disclosure of a carbon credits and overall market integrity. Financial intermediaries, project developers, and other players in the ecosystem do not have control over how a credit is used or disclosed. While we aren't asking IOSCO to strike good practice #21, it rests on an assumption that carbon credit use is tied to overall market integrity, which is not necessarily accurate. For example, the relevant VCM could still be a high-integrity market (transparent, liquid, proper price discovery, etc.) separate and apart from how the credits are used and disclosed.
  - We believe further transparency around the purpose of retirements and carbon credits is important to strengthen the VCM, while not overburdening companies with reporting requirements.
  - As noted in our response to Good Practice 8 - FIA suggests that IOSCO should more clearly delineate between the registry as a function of tracking the retirement and characteristic of the credit and its role in the secondary market. Registries should display for any retirement a) who

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retires and b) on whose benefit the carbon credits are retired, and c) provide the option for users to indicate for what purpose they are retired.

- Finally, given that IOSCO has endorsed the International Sustainability Standards Board's (ISSB) sustainability-related financial disclosures standards, FIA would encourage jurisdictions considering adopting standards to align, and not diverge, from the ISSB standard.

Closing

FIA members are committed to working with the public and private sectors to strengthen the integrity of the voluntary carbon markets. Thank you for the opportunity to comment on this important consultation about the future of carbon markets.

Most respectfully,

Walt L. Lukken

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