ESG Developments in Financial Markets – Legal and Policy Implications

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Legal Issues in Carbon Credit Markets and Trading

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for the ESG Developments in Financial Markets – Legal and Policy Implications Panel of the

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Today, we see significant momentum to address climate change as governments, quasi-governmental entities and companies pledge to reduce their carbon footprints and aim to achieve net-zero carbon emissions. Although reducing emissions of carbon remains of primary importance, carbon trading is a key part of our collective effort on the path to net-zero. Reductions alone are not enough.

In this note, we explore some of the many legal issues and risks that arise in the development of carbon trading markets and should be considered in transactions in carbon credits. We explore these issues with a primary focus on voluntary markets.

Background - Overview of Carbon Markets and Carbon Trading

> Carbon markets can be classified into two markets: (i) mandatory compliance schemes or markets and (ii) voluntary markets. Compliance markets impose a mandatory framework and are regulated by national, regional or international regimes (*e.g.*, the Regional Greenhouse Gas Initiative in the eastern United States, California's greenhouse gas trading scheme, the UK Emissions Trading Scheme or the EU Emissions Trading Scheme.) Within the compliance mechanisms of these markets, offset credits provide an alternative compliance mechanism to direct emission reductions or allowances and are used by compliance entities to meet their requirements under the imposed emissions cap.
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> Voluntary markets exist separately from these mandatory schemes. They offer a market-based approach in the effort to control greenhouse gas emissions. As the name suggests, voluntary markets allow companies and individuals to purchase offset credits on a voluntary basis. Market participants that purchase and retire these offsets are not using them for compliance purposes. Companies such as Microsoft or Google may purchase and retire them to satisfy a claim in respect

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of carbon neutrality (or being on the path toward carbon neutrality) and private individuals aiming to reduce the carbon footprint of their recent transatlantic flight may likewise purchase and retire. These purchases finance the avoidance or reduction of emissions from other sources, or the removal of greenhouse gases from the atmosphere. Although earlier transactions in carbon credit offsets were entered into, voluntary markets started to develop in a more sustained manner after 2005, as the clean development mechanism of the Kyoto Protocol took effect under the United Nations Framework Convention on Climate Change ("***UNFCCC***") and corporate social consciousness more broadly recognized the applicability of offset credits beyond any mandatory framework.

In both markets, a carbon credit is a transferrable instrument issued and/or certified by an independent certification body or a governmental body to represent an emission avoidance, reduction or removal of one metric tonne of CO_2, or equivalent. A voluntary carbon credit ("***VCC***") will be issued for each metric tonne avoided, reduced or removed. This is the standard unit of measurement in both markets. Although the compliance and voluntary markets operate separately, they do interact. For example, compliance offset credits may in certain circumstances be purchased by non-regulated entities and certain compliance markets permit regulated entities to purchase and use voluntary offset market credits to satisfy their compliance requirements.

A variety of activities that reduce or avoid greenhouse gas emissions or increase carbon sequestration can produce carbon offset credits: limiting deforestation, reforestation, funding renewable energy projects and carbon capture and storage. These are a combination of nature-based and technology-based solutions.

A project that has been certified under a credit certification standard will have VCCs issued for its avoidance, reduction or removal activities. Current standards include the Verified Carbon Standard Program, the Voluntary Carbon Standard, Plan Vivo, the Gold Standard, the American Carbon Registry and Climate Action Reserve. Each industry standard involves different methodologies for measuring and verifying emissions reductions. Rules of a relevant carbon standard may also be specific to a project type.

VCCs may be credited to individual accounts in a registry maintained by the standard under which the project was certified. There is no centralized voluntary carbon market. The developer can either retire the credits, which is a process through which they claim the avoidance, reduction or removal they represent, or sell them to another entity. The purchase and sale is reflected by the transfer to the account of the purchaser at the registry. Credits can be sold directly in a bilateral transaction to buyers, sold via brokers or sold on an exchange or other trading platform, and may be linked to other instruments such as tokens or repacking notes. Where a project developer sells the credit in the first sale, this is referred to as the primary markets. Secondary markets cover on-sale transactions of existing credit which have not been retired.

The majority of voluntary credits are purchased by the private sector, where corporate social responsibility goals and industry leadership are typically the key drivers of credit purchases. As the decarbonization of the global economy accelerates, demand for voluntary offsetting will likely increase. That demand is more likely to be met if a large-scale, voluntary carbon market takes shape, one which is able to help companies achieve net zero goals.

The voluntary carbon market has made strides in both market functioning and credit integrity since its early days. However, structural challenges remain to be solved as buyers struggle to navigate various standards to find high-quality carbon credits at transparent prices, and financial intermediaries and data players have not entered the market at scale, leading to a current state of low liquidity and limited data transparency. Recognizing these issues and others in the voluntary market combined with a recognition that these markets are essential such that they need to significantly increase in size, the Taskforce on Scaling Voluntary Carbon Markets (the "***TSVCM***" or "***Taskforce***") was established with the aim to scale an effective and efficient voluntary carbon credit market.

The Focus on Scaling Carbon Markets

Following an initial step of developing and publishing a blueprint for voluntary carbon markets in January 2021[1], the TSVCM's work has focused on critical governance requirements for voluntary carbon markets, legal principles and contracts and recommendations for core carbon principles ("***CCPs***"). These topics were the subject of a consultation process ("***Phase II Consultation***") launched in May 2021 and reported out of the consultation in July 2021. This report, the "***Phase II Report***",[2] was a further step in the TSVCM's engagement. The Phase II Report includes four chapters, reflecting the areas of focus of the Taskforce: (i) Objectives and focus of the TSVCM; (ii) Governance: Addressing the oversight needs for an at-scale market; (iii) Legal principles and

[1] A copy of the Final Report can be found at this link: https://www.iif.com/tsvcm. A copy of White & Case's overview summary of this Final Report can be found at this link: https://www.whitecase.com/publications/alert/scaling-voluntary-carbon-markets-final-report.

[2] A copy of the Phase II Report can be found at this link: https://www.iif.com/Portals/1/Files/TSVCM_Phase_2_Report.pdf. A copy of the White & Case's overview of the Phase II Report can be found at this link: https://www.whitecase.com/publications/alert/scaling-voluntary-carbon-markets-phase-two-report.

contracts: Harmonization and liquidity; and (iv) Credit-level integrity: Core carbon principles and additional attributes.

In its most recent step, in September 2021, the Taskforce launched the Integrity Council for Voluntary Carbon Market ("***ICVCM***")[3], a new independent governance body responsible for progressing the work of the Taskforce. The ICVCM will develop and implement the CCPs with the guidance of a panel of experts. The CCPs will establish new high quality benchmark standards, which will surpass current certifications requirements.

Categories and Different Forms of ESG Derivatives

It must be admitted that terminology in this space lacks uniformity. Indeed, the very label of "ESG derivatives" has been used in respect of variety of different types of transactions. Some of these transactions have existed for some time and for completeness and, at some level, convenience they are referred to as ESG derivatives. A broad application of the term ESG derivatives would capture the following categories of transactions: sustainability-linked derivatives; bilateral and exchange-traded derivatives; emission trading under cap and trade regimes; renewable energy and renewable fuels transactions (RECs, PPAs, RINs, Wind Index forward transactions); catastrophe derivatives and risk transfer transactions; and weather derivatives.[4]

We will focus primarily on bilateral trading and derivatives and discuss the legal issues market participants should consider in drafting and of which they should be aware in transacting in carbon credits. We have outlined the broader universe of ESG derivatives here to highlight how many of the issues we discuss in this article are applicable to a broader range of transactions, not simply the purchase and sale of credits (either on a spot or forward basis).

Concerns with Market Structure Relevant to Documentation

The market for carbon credits and environmental attributes has been created through our own ingenuity. It does not otherwise exist outside of the framework we have collectively established by agreements, laws, rules and regulations. International, national and regional schemes have established the frameworks within which credits, offsets, allowances and other attributes are currency. These frameworks are however developing with some inconsistencies from a legal and regulatory perspective; this is often historically the case with any new developing market. Further,

[3] Note that the ICVCM was established in September 2021 and then named in October 2021.

[4] For a further discussion of ESG derivatives, ISDA has published an overview article on the topic. This article can be found at the following link: https://www.isda.org/2021/01/11/overview-of-esg-related-derivatives-products-and-transactions/.

the market is fragmented, which is reflected in a lack of fungibility of credits, where non-standard terms and methodologies are used. Insufficient published pricing data combined with a significant number of registries, and with no centralized registry, has resulted in little transparency in the market. Importantly, there are also concerns with carbon credit level integrity. These concerns with the market today are central to TSVCM's work and are highlighted in the Phase II Report of the Taskforce. Also, the International Swaps and Derivatives Association ("***ISDA***") discussed similar concerns with the market in a recent publication entitled *Legal Implications of Voluntary Carbon Credits*[5].

As noted, the market is fragmented and lacks standardization. However, in the case where this is occurring with the very commodities that are the subject of the transactions, the impact of this fragmentation and the developing standards results in significant legal issues and burdens on market participants. The documentation entered into needs to address the characteristics of the underlying credits and hence the issues carry forward from the primary markets into secondary markets. For example, there are considerations we highlight below that are applicable to spot purchase and sales transactions, longer term forward purchase agreements, brokerage agreements, repack transactions and financings, to highlight a few. The issues are made more complex with the involvement of intermediaries (*i.e.*, brokers, registries, exchanges) in these transactions.

With this as the backdrop, market participants are required to address many of these concerns in their contracts. The risks to be addressed can be classified into three types: (i) risks relating to the carbon credit themselves (*e.g.*, a lack of carbon credit integrity and a lack of regulatory oversight and protections); (ii) risks relating to the marketplace (*e.g.*, development of key performance metrics, uncertain liabilities, risk of fraud, double counting and registry risks such as hacking); and (iii) risks impacting or relating to participants in these markets (*e.g.*, reputational risks and greenwashing.)

Many of the issues addressed in contracts for carbon credits are not novel to these markets but, because of heightened risks, market participants must currently often rely on contractual provisions to a greater extent than in other markets. Note that a good reference point for some of these legal considerations can be found in the TSVCM's Phase II Report[6].

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[5] ISDA Legal Implications of Voluntary Carbon Credits, December 2021. Please find this publication at the following link: https://www.isda.org/2021/12/01/legal-implications-of-voluntary-carbon-credits/.

[6] See the Phase II Report at page 57 and following.

Legal Issues to Consider in Carbon Credit Documentation

Offset credit identification and transfer risks. Proper identification of, title to and rights with respect to the underlying credits of a transaction clearly are of paramount importance. Contracts should include representations and warranties to address these and they should address whether and to what extent liability may result from any claims of title, including related to the chain of title prior to that held by the current seller. Having rights to audit and access to all logs related to title should be considered, including the scope of any audit rights, as well as obligations to maintain transaction records for an agreed period of time. Related to these issues are clearly defined liability and indemnity clauses and whether the contract should include any limitation on liability. The transfer of title itself and related risk of loss should also be addressed, as is customary in commodity contracts.

Contracts should also include covenants, where relevant, addressing use of the credits, any existing claims for the credits, and double counting. It is important to ensure, in primary market transactions, that the credits are not registered to more than one registry under more than a single standard and, in all purchase and sale transactions, to have the seller confirm that credits being transferred have not been otherwise sold to another party or encumbered.

Change in law. The rights and obligations of the parties to a transaction should be considered in light of any potential consequences of a change in applicable law or legal regime. Contracts should specify the scope of what constitutes a change in law. Parties should also address whether the contracts could be amended to permit performance and preservation, to the extent possible, of the negotiated benefits of the transaction, whether alternative performance or settlement or assignment or novation is appropriate and when the contract may be terminated. Considering change in law implications remains important given that many transactions implicate the legal regimes of multiple jurisdictions and there remains uncertainty around the potential application of new regimes in these developing markets. Relatedly, any abandonment of scheme should also be addressed.

Delivery and failures to deliver. As may be applicable, the delivery mechanism(s) and details of accounts, registries and settlement procedures should be clearly established. Whether physical delivery (or deemed delivery) or financial delivery is elected as a primary or secondary settlement method should be agreed upfront, with all details necessary for settlement included. Contracts should clearly specify how proper delivery or deemed deliver is to be effected, and what type of carbon credit (vintage, type, project, etc.) must be transferred and whether there is any right to substitute. The consequences of a failure to deliver should be addressed with consideration given to including an indemnity, a liquidated damages clause, or a "cover damages" provision or the like. Understanding the legal implications of different settlement mechanics in relevant jurisdictions is important. For example, it is material to understand how a transaction is characterized under applicable commodity or securities laws and whether there are any related compliance obligations resulting from a given characterization.

In addition, parties should be obligated to maintain accounts for the duration of their contracts. The terms of agreements should also address, where appropriate, registry related events such as closures, hacking, insolvency and fraud.

Force majeure. Whether and how to define the scope of a force majeure event, the rights and obligations of the parties upon its occurrence, and when and which parties may terminate should be agreed to address the risk of the unforeseen. If termination is permitted, parties should also agree whether a termination payment is appropriate or not, and, if so, how to determine the amount of the payment.

Liability. There is also the consideration of whether to address and, if so, how to address credits that are determined to be problematic for having been improperly verified and issued – for lack of additionality, for example. This may arise if purportedly verified credits are reversed or challenged. Although the verifier of the project would likely be liable in this circumstance, the consequential impact on the rights and obligations of the parties to a primary or secondary transaction should be considered.

Benchmark and price sources; key performance metrics or indicators. Many ESG transactions reference KPIs or benchmarks in the determination of the payment obligations of the parties. In these instances given how the market is in development, including the relevant benchmarks, the parties should properly diligence applicable price sources for transactions to ensure they are robust. Any concerns with potential manipulation of reference prices should be carefully evaluated. With respect to KPIs, they should be as measurable and transparent as possible, such that satisfaction of the KPI can be readily established. For example, it is frequently the case that in transactions referencing a KPI the rate payable by one party under a derivative transaction or a loan may increase or decrease depending upon an agreed environmental KPI related to the borrower's overall business. As a result, any possible reputational risk should be considered in the selection of a KPI.

Dispute resolution. Given the uncertainty in the development of the market, the lack of standardization, issues around the legal nature of the credits, questions even as to the enforceability of the contracts, the risk of disputes is certainly present. Market participants would do well to consider how best to resolve eventual disputes and select an appropriate dispute forum. Possibly the special expertise and/or expediency may offer reasons for opting for alternative dispute resolution instead of allowing recourse to the courts. Also, where international market participants are contracting as they are in the offset markets, arbitration may be more acceptable and some cases more readily enforceable.

It is interesting to note that the TSVCM focused upon arbitration as the preferred options in its proposal for operational requirements for Standards' terms of use, and did so over the courts. Its noted rational for this recommendation is that it ensures the greatest possible degree of harmonization among Standards. It also considered exclusive jurisdiction and non-exclusive jurisdiction clauses.

Conflict of laws. Parties to transactions in carbon credit should be mindful of the conflict of laws considerations as they may apply to the circumstances of their trade. The jurisdiction of the registry for the credits, the law of the location of the applicable project in respect of which the credits are issued, the governing law of the contract or the jurisdiction of the parties may all be relevant to a determination of which law applies in a dispute or to determine rights upon an insolvency. Any determination of applicable law is made more complicated by uncertainty as discussed below around the legal nature of carbon credits.

Classification of Carbon Credits – Are they property?

Legal issues also arise in respect of the classification within existing legal frameworks of carbon credits, whether they may be allowances issued under cap-and-trade schemes or credits transacted in voluntary markets. In certain jurisdictions they may be viewed as property rights, administrative rights, a bundle of contractual rights or *sui generis* rights[7]. Whether, for example, they are classified as property or a bundle of rights has implications in how we transact in these instruments, how we tax them, how we account for them under accounting standards and how parties may take security interests in them. The legal nature of these instruments also impacts property rights and has implications in insolvency. The legal classification of carbon credit is also discussed in the recent ISDA paper[8].

In the European Union, the legal nature of EU ETS allowances is an issue. The European Commission, Directorate-General for Climate Action commissioned a study and report on the legal

[7] European Commission, Directorate-General for Climate Action, Reins, L., Ballesteros, M., Bart, I., et al., *Legal nature of EU ETS allowances : final report*, Publications Office, 2019, **https://data.europa.eu/doi/10.2834/014995**.

[8] See note 4 above.

nature of EU ETS allowances. From the report, the nature of the allowances traded within the EU Emissions trading system is subject to significant variability as the system leaves the classification and definition of the legal nature to the Member States. Some Member States classify them as property, while others see them as administrative authorizations to emit, others still have established mixed regimes. This has an impact on the development of the markets, particularly where one country regime conflicts with another.

In the United States, it is interesting to note that California's regulations applicable to its cap-and-trade scheme specifically state that compliance instruments issued by the State do not constitute property or a property right. California opted for this legal classification for fears of constitutional prohibitions on the taking of property without compensation and concerns legislators had at the inception of the scheme that a cancellation of allowances would otherwise have obligated the State to pay compensation to holders. The regulation reads as follows:

> (c) Each compliance instrument issued by the Executive Officer represents a limited authorization to emit up to one metric ton in CO2e of any greenhouse gas specified in section 95810, subject to all applicable limitations specified in this article. No provision of this article may be construed to limit the authority of the Executive Officer to terminate or limit such authorization to emit. A compliance instrument issued by the Executive Officer does not constitute property or a property right.[9]

However, there are different classifications for carbon offsets in other states of the United States. For example, a court in Louisiana has ruled that offset credits in that state do constitute property[10]. It stated as follows: "As discussed above, this court finds that the right to report, transfer, or sell carbon credits is a part of the bundle of rights associated with property ownership."[11] These differences raise interesting conflict of laws questions to the extent an offset from another jurisdiction can be accepted into California's cap-and-trade regime.

Nature Based Credits

Credits may be derived from avoidance projects or sequestration projects that are nature based, such as projects that limit deforestation or avoiding damage to an ecosystem, or reforestation projects. As all these projects relate to land, depending upon the country in which the project is located and applicable national or subnational frameworks, they introduce potential legal uncertainty with respect to an underlying claim from a variety of stakeholders. It is important to

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[9] Cal. Code Regs. tit. 17 § 95820

[10] *Roseland Plantation, LLC v. U.S. Fish & Wildlife Serv. et al.*, 2006 U.S. Dist. LEXIS 29334. (W.D. La. 2006)

[11] *Id.* at pp 9-10.

understand how a jurisdiction has established the link between the right to benefit from sequestered carbon or a reduction of greenhouse gas, on the one hand, and a tradable carbon credit, on the other.

To reduce legal uncertainty, where this risk may exist, parties should consider the relevant stakeholders to the carbon rights, confirm who is properly entitled to claim this right to benefit from the sequestered carbon or reduction and then analyze the foundation of a particular claim. The foundation may be established through control of the applicable asset or land or through the control of services and activities upon the land by various stakeholders, including local or national governments, private individual landowners under customary, traditional or statutory land rights, individuals with timber harvesting licenses, and possibly authorities or groups of individuals with historical claims to forested areas. Obtaining legal certainty requires attentive diligence, particularly in countries with weak land tenure systems where land conflicts exist.

A few final thoughts

The TSVCM has recognized the critical governance needs for the voluntary carbon markets and will work to further the mission of addressing these needs. The quality of the credits features prominently as a concern with the markets with a lack of environmental and social integrity being often referenced by buyers of credits.[12] The Phase II Report notes that "today's voluntary carbon market value chain is highly fragmented. It contains highly heterogeneous and mostly small project developers with more than 20 standards issuing carbon credits."[13] It is clear that for new market participants to enter the field in numbers, improvements to the legal framework are needed. The framework must provide clarity in respect of the legal nature of the credit, the terms of transactions and the enforceability of the obligations of the parties. Until then, adoption risk, regulation and political risk, ownership and title risk, governance risk and enforcement risk all present legal issues that must be considered in transactions and market participant must rely upon the terms of their agreements to address them.

[12] See p.16 of the Phase II Report.

[13] See p.16 of the Phase II Report.

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Scaling Voluntary Carbon Markets: The Final Report

February 2021

Authors: Ingrid York, Seth Kerschner, Julia Smithers Excell, Nathaniel Crowley, Connor Gray

The 'Taskforce on Scaling Voluntary Carbon Markets' (the "**Taskforce**") is a private sector initiative working to scale an effective and efficient voluntary carbon credit market to help meet the goals of the Paris Agreement.

On 10 November 2020, the Taskforce published a blueprint for a voluntary greenhouse gas or carbon market, (the "**Consultation Document**"), which was summarised in our 13 November 2020 alert here (*Voluntary Carbon Markets: A Blueprint*). The Taskforce has now published its final report (the "**Final Report**") following a public consultation throughout November and December 2020 in which the Taskforce received more than 160 responses via the consultation survey, and more than 25 letters written directly to it. The Taskforce's Final Report includes 20 recommended actions under six key topics for the scaling of existing voluntary carbon markets. The Taskforce believes publishing this blueprint can guide companies to increase their emissions-reduction goals and finance climate action. If you wish to read more about why a widely accepted blueprint is important in establishing and scaling a voluntary carbon market, please see our November 2020 client alert (see *Background*).

The Taskforce is spearheaded by Mark Carney, UN Special Envoy for Climate Action and Finance Advisor to UK Prime Minister Boris Johnson for the 26th meeting of the Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC) ("**COP26**"). The Taskforce is chaired by Bill Winters, Group Chief Executive, Standard Chartered, and sponsored by the Institute of International Finance ("**IIF**") under the leadership of IIF President and CEO Tim Adams. It is made up of more than 50 members globally, representing buyers and sellers of carbon credits, standard setters, the financial sector and market infrastructure providers including Ingrid York of White & Case, and is supported by a consultation group composed of subject-matter experts from approximately 120 institutions and relevant sector trade associations. The Final Report of the Taskforce was introduced by Bill Gates, Mark Carney, Bill Winters and Annette Nazareth at the Davos Agenda 2021.

Key guiding principles

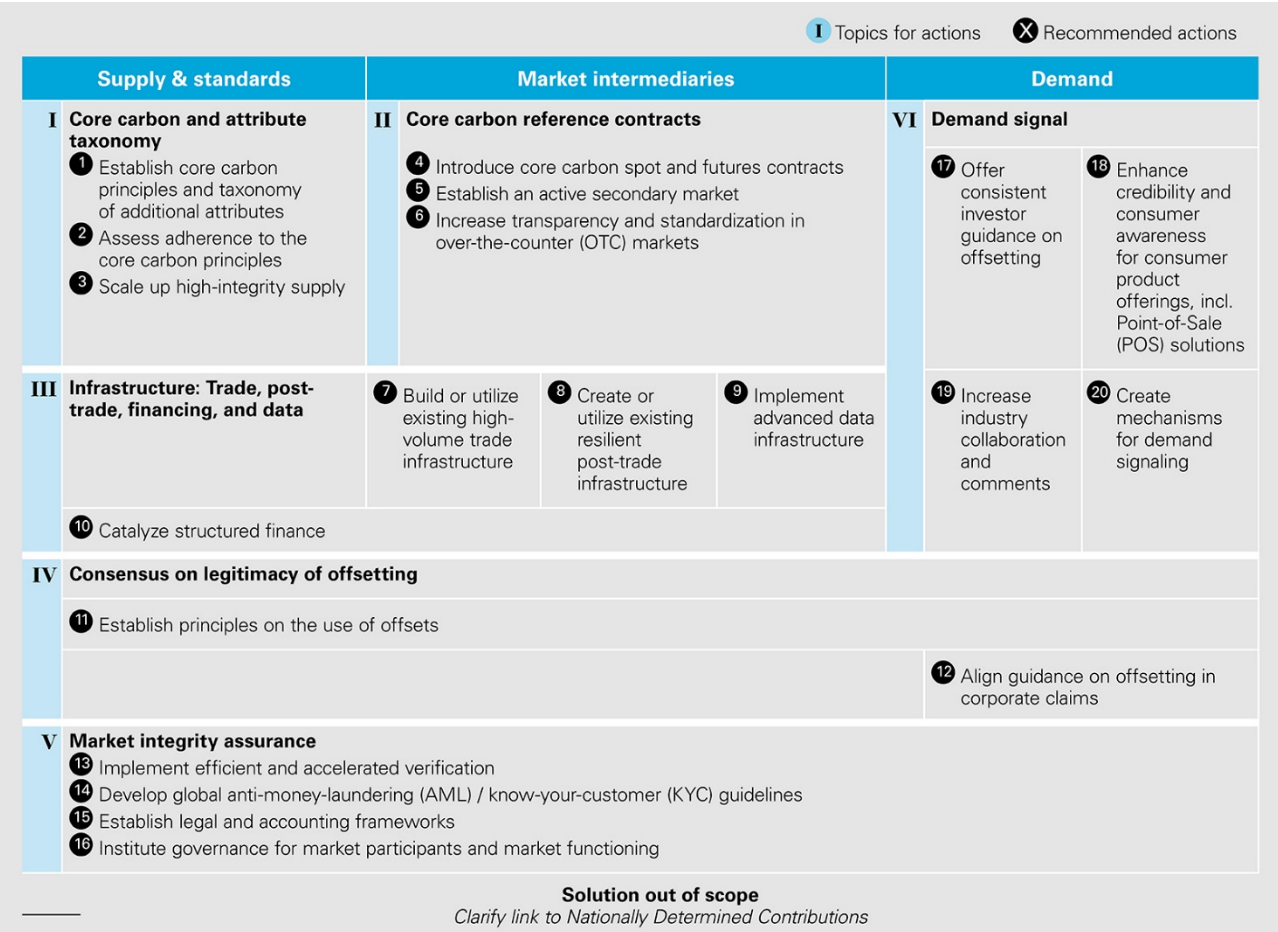
The Taskforce has developed this blueprint according to four key principles:

- **Producing open-source solutions for private-sector organisations to take forward**. The Taskforce hopes the solutions suggested in the Final Report can work alongside other initiatives to scale up voluntary carbon markets globally.
- **Voluntary carbon markets must have high environmental integrity and seek to do no harm.** In the past, carbon markets have occasionally allowed projects that generate carbon credits to cause harm to local communities and ecosystems. The Taskforce argues carbon markets should be designed to ensure emissions-reductions projects benefit local communities, preserve or strengthen ecosystems and avoid doing harm.
- **Amplify existing and ongoing work of parallel initiatives**. The Taskforce membership includes players from many ongoing related initiatives and incorporates lessons learned from these efforts into

the Final Report. Future efforts arising from the Final Report need to be carried out in tandem with parallel initiatives to ensure emissions-reduction efforts learn from and support one another.

- **Avoid disincentivising emissions reduction efforts**. Carbon markets need to be designed in a way that does not reduce the incentive for businesses to reduce their own emissions. The Taskforce recognises that to meet the Paris Agreement targets, all sectors must reduce their absolute emissions and carbon markets must also enable companies to become carbon-negative.

Recommendations



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To support the scaling-up of voluntary carbon markets, the Taskforce has developed 20 underlying recommended actions, grouped under six topics, for action across the value chain (including supply and standards, market intermediaries and demand), as summarised below. Note that there remain open items for further consideration and several important questions that will be part of the Taskforce's "Roadmap for Implementation" over the next 12 months.

Topic One: Core carbon principles and attribute taxonomy

- **Establish core carbon principles and taxonomy of additional attributes**. The Taskforce is focused on creating a market with both integrity and liquidity. It accordingly recommends the establishment and maintenance of core carbon principles ("**CCPs**") by an independent third party which would set out threshold quality criteria against which carbon credits and their supporting standards and methodology can be assessed. The Implementation Roadmap in the Final Report, as further outlined below, sets out the organisational steps required to establish the correct body for CCP governance. The independent third party would also define a set of additional attributes, *e.g.* vintage, project type (*i.e.* avoidance / reduction, nature-based removal, technology-based removal), additional benefits beyond emissions reductions (*i.e.* co-benefits), location and inclusion of corresponding adjustments. The Taskforce believes establishment of CCPs in such a manner would build confidence and credibility in voluntary carbon markets, allowing the market to develop more successfully.

- **Assess adherence to the CCPs**. The Taskforce also recommends the need for an independent third party organisation to be tasked with assessing carbon credit standards and methodologies for validation against the CCPs and additional attributes. While it is noted that it may be possible for this to be carried out by the same body hosting the CCPs, the recommendation is for separate expert verification agencies (accredited by the International Accreditation Forum) to undertake this role. Ideally, all relevant carbon-market standards entities would adopt the taxonomy and make clear whether their methodologies are certified. The clear challenge will be to balance the level of detail needed for methodology assessments against the administrative burden. However, this is clearly key to address significant quality concerns that exist across the value chain.

- **Scale-up high integrity supply**. The Taskforce recommends rapid market upscaling (15 fold by 2030) but with a focus on ensuring market integrity and project local community impact. The impetus for such scale-up will need to derive from smaller-scale project developers as well as large multinationals and technology projects (in particular, new technologies being brought to market). To help achieve this and support small-scale developers, the Taskforce recommends a supplier to financier matching platform for proposed projects. Ideally, this platform would allow for the upload of suppliers' previous project development history and credit score for buyers to conduct due diligence and be subject to the same standards and controls as would apply to any other voluntary carbon market infrastructure. For negative emissions technology and other maturing climate technologies, the Taskforce encourages the development of new methodologies in a timely and robust manner.

Topic Two: Core carbon reference contracts

- **Introduce core carbon spot and futures contracts**. Development and listing of standardised spot and futures core (physically delivered) carbon contracts is seen as vital by the Taskforce in order to match suppliers' products and buyers' preferences more efficiently and, critically, provide a daily reference carbon price for standardised products.

- These contracts would be physically settled, traded on exchange and cleared via clearing houses. Futures contracts should be fungible to allow for trading across all markets and multiple platforms and could potentially also be cash settled. Over time, the Taskforce envisages that exchanges could also develop reference contracts which combine the core carbon contract with additional attributes that are separately priced. The Taskforce also encourages large buyers to purchase a share of their voluntary credits on exchange, through reference contracts, to encourage the development of liquidity. This would also reinforce the efficacy of the published carbon price. There is also discussion regarding the development of a separate and complementary over-the-counter (off exchange) market for carbon contracts in both standardised and bespoke format, which will benefit from the establishment of a reference contract.

- **Establish an active secondary market**. This will be core to the success of voluntary carbon markets by providing a number of benefits across the value chain, such as:

  - increasing the transparency and reducing the volatility of pricing;
  - allowing market participants to manage and hedge risks that can arise from, for example, carbon projects or carbon reduction commitments;
  - increasing flexibility such that firms are able to change their strategy more efficiently. This is likely to increase the number of firms committing to voluntary carbon markets given they know they can exit a carbon credit position if their circumstances change;
  - increasing access to carbon markets for those participants who would not traditionally be present in financial markets and/or may not be able to easily access exchanges or clearing houses; and
  - increasing investor attraction and liquidity, thereby tightening the bid-ask spread.

Additional services in the secondary market may also arise such as the development of indices, which would facilitate longer term hedging and financial investment.

- **Increase transparency and standardisation in over-the-counter (OTC) markets**. The Taskforce argues OTC markets will benefit from the development of reference contracts given they will be tightly linked to them. It is posited that, when negotiating OTC contracts, parties can use the price of the liquid core carbon contracts, as well as the price signal, as a starting point; this can assist in forming a more general consensus in the market. Upgraded contracts (based on currently existing agreements such as the emissions trading annex published by the International Swaps and Derivatives Association, Inc.) are needed to help facilitate negotiations, and enable more efficient trading of credits, in primary and secondary OTC markets (see further discussion of this in *Topic Five: Market integrity assurance*). Other items are noted which will be beneficial to this market such as further digitisation of voice-brokered OTC services, the use of post-trade risk reduction services (*e.g.* trade compression) and increased transparency through the use of, *e.g.* price reporting agencies.

Topic Three: Infrastructure: Trade, post-trade, financing and data

The Taskforce recommends that a set of infrastructure components must be in place that is resilient, flexible and able to handle large scale trading of core carbon reference contracts. The recommended actions to develop the target infrastructure are:

- **Build or utilise existing high-volume trade infrastructure**. Exchanges should provide market participants with access to market data and adhere to suitable cybersecurity standards. Likewise, OTC brokers should provide enhanced transparency through market data access to market participants.

- **Create or utilise existing resilient post-trade infrastructure**. Clearing houses should be used to facilitate an exchange traded market, provide counterparty default protection and offer access to relevant data. Meta-registries should be established to provide custodian-like services and generate standardised issuance numbers for projects across existing registries (similar to the ISIN concept). This would allow for more project transparency and market participants to conduct due diligence on certain projects. If possible, the meta-registry should connect to international registries as well as the voluntary independent registries to maximise the use of the data. As with exchanges, meta-registries and the underlying registries should adhere to suitable cybersecurity standards. The infrastructure should be aligned to the Committee on Payments and Market Infrastructures – International Organization of Securities Commissions (CPMI-IOSCO) Principles for Financial Market Infrastructures.

- **Implement advanced data infrastructure**. Data providers and meta-registries should work together to offer transparent reference and market data, as well as historic carbon project or project developer performance and risk data. Intermediaries (such as exchanges and clearing houses) should include trading information in their existing data flows.

- **Catalyse structured finance**. Banks and other supply chain financiers should examine potential lending facilities for project development, which could be collateralised by the right to generate carbon credits. This should be supported by various measures including, *e.g.*, establishing a robust recognition system for banks that finance such projects. In the medium to long term, a carbon credits spot and futures market would provide a suitable foundation for a structured finance market to develop as it would provide clarity on pricing and facilitate risk transfer.

Topic Four: Consensus on the legitimacy of offsetting

- **Establish principles on the use of offsets**. The Taskforce asserts that there is a lack of shared vision on the role of carbon offsets in achieving net zero goals, with many stakeholders having legitimate concerns about carbon offsetting crowding out other decarbonisation efforts (for example, reduction of a company's own emission levels). With this in mind, the Taskforce proposes two new sets of principles.

- It firstly wishes to establish 'Principles for Net Zero-Aligned Corporate Claims and Use of Offsets'. These principles are:

  - **Reduce**: companies should publicly disclose commitments and detail transition plans and annual progress to decarbonise their own operations and value chains to limit warming to 1.5 degrees

Celsius in line with the Paris Agreement, using the best available data. Companies should prioritise implementing these commitments and make public the basis on which the claims are made;

  - **Report**: companies should measure and report Scope 1, Scope 2 and, where possible, Scope 3 greenhouse gas emissions on an annual basis using third party standards for corporate greenhouse gas accounting and reporting; and
  - **Offset**: during the transition to net zero, companies should purchase and retire carbon credits generated under credible third party standards.

- The Taskforce also proposes 'Principles for Credible Use of Offsets in Products or at Point of Sale'. Most notably, these principles require companies to provide more pricing and product transparency for customers by being clear about profits they make from offset products, disclose whether the carbon offset has any co-benefits and allow end-consumers to access data that validates the retirement of the purchased credits (or they obtain third party validation and auditing of point of sale products to demonstrate use of funds to purchase and receive carbon credits).
- The Taskforce recommends that these principles should be further developed, hosted and curated by an independent body and the Final Report states an "independent High Ambition Demand Accelerator for the Voluntary Carbon Market" will take on this role.
  - **Align guidance on offsetting in corporate claims**. The Taskforce also acknowledges that there is some inconsistency in the treatment of carbon credits with regard to corporate commitments on climate action that needs to be addressed. For example, offsetting is not counted towards science-based emissions reduction targets but the Science-Based Targets Initiative does recognise the role of offsetting towards net-zero claims. It is also recommended that harmonisation of guidance is achieved in respect of both carbon accounting and corporate claims standards. Ideally, the harmonised offsetting reporting guidance will be in line with broader national and international frameworks.

Topic Five: Market integrity assurance

Growth of voluntary carbon markets can increase the risk of errors, fraud and money laundering between market participants. To create and protect market integrity, the Taskforce therefore recommends:

- **Institute efficient and accelerated verification**. The development of a shared digital data protocol across standards and registries. This system would allow for project data to be captured, protected and continuously monitored on a higher frequency basis and validated as projects are being developed. This will allow for an efficient, effective and secure verification system. The Taskforce encourages rapid innovation and continued testing and evolution of related technological solutions.
- **Develop 'anti-money laundering (AML)' and 'know your customer (KYC)' guidelines**. The development and implementation of AML and KYC guidelines for voluntary carbon markets will help minimise the risk of fraud or money laundering as the market develops. A governance body should coordinate this process in line with existing regulatory regimes at the international level (such as the Financial Action Task Force ("FATF")).
- **Establish legal and accounting frameworks**. Further coordination and support of legal and accounting frameworks is required to underpin the legitimacy and efficacy of voluntary carbon markets. The Taskforce accordingly recommends the need for standardised contractual documentation across primary and secondary markets to allow for a robust exchange and OTC market, with such documentation underpinned by appropriate legal opinions.
- The Taskforce also highlights the need for further clarity from international accounting agencies like the IFRS and GAAP on how carbon credits ought to be treated from an accounting standpoint (*e.g.* as an asset or an expense). The Taskforce encourages organisations such as the Greenhouse Gas Protocol to provide clarity as to how removal offsets are to be counted against a company's carbon footprint.

- Further to its other statements on governance, the Taskforce acknowledges that appropriate governance is required to host and curate standard contracts, financial accounting guidance and carbon accounting guidance.
- **Institute governance for market participants and market functioning**. Strong governance should be established to ensure there is the high level of environmental and market integrity needed for the voluntary carbon market to be successful. The three key areas of focus in which governance is required are:
  - participant eligibility;
  - participant oversight; and
  - market functioning oversight.
- For example, if the use of carbon credits may disincentivise alternative climate action (such as companies reducing their own emissions), governance is needed around the identification and principles-based mitigation of this risk.
- Participant eligibility could involve establishing a set of principles to be followed by buyers, suppliers and intermediaries if they wish to participate in voluntary carbon markets. Participant oversight could include the development of a new process for accrediting the validation and verification bodies that assess projects and methodologies and authorise issuance of carbon credits (with the aim being that this would also involve auditing and conducting spot checks of those bodies).
- Oversight of market functioning could include developing principles to prevent fraud across the market value chain, including by ensuring appropriate anti-money laundering practices (as mentioned above). It would also include the establishing, hosting and curating of principles for the use of offsetting, as mentioned above (see *Topic Four: Consensus on the legitimacy of offsetting*) and consideration of how long investors can retain carbon credits.

Need for end-to-end market governance:

- In connection with its recommendations on governance, the Taskforce believes governance structures will be needed in three areas:
  - overseeing the hosting, the curation and the assessment of CCPs;
  - the market principles; and
  - legal and accounting rules.
- Existing and newly established governance bodies must interact to ensure governance in these areas is as comprehensive as possible. Whilst existing bodies like the CFTC (for financial instruments), the IAF (for accreditation and verification) or the IFRS and GAAP (for financial accounting) are able to fulfil some of the governance needs for an effective voluntary carbon market, the Taskforce acknowledges that not all needs can be currently met by these bodies. It is therefore a specific undertaking of the Taskforce's Implementation Roadmap to take steps to address gaps in governance needs. This could potentially involve the development of an umbrella governance body, which could carry out particular governance needs not suited to existing bodies (such as hosting and curating the CCPs).

Topic Six: Demand signals

The Taskforce is of the view that a clear demand signal from buyers could increase liquidity in carbon markets and scale up supply. The Taskforce accordingly recommends a number of ways to increase demand for carbon credits, including:

- **Offer consistent investor guidance on offsetting**. Key investor bodies should work with reporting protocol bodies to provide clear and consistent guidance on the appropriate use of offsetting for buyers.

- **Enhance credibility and consumer awareness for consumer offerings, including point-of-sale solutions**. The ability for consumers to purchase carbon credits should be increased, allowing them to make more informed choices as to what they are purchasing. This would include the following steps:
  - requiring clear and consistent carbon claims;
  - encouraging clear carbon labelling and continuing to improve consumer education regarding the environmental and economic benefits of carbon offset in everyday life;
  - expanding existing point-of-sale carbon offsetting offerings; and
  - creating digital functionality to enable point-of-sale offset purchases.
- **Increase industry collaboration and commitments**. Further collaboration in key sectors, particularly oil and gas, would lead to significant carbon reduction activity and an increase in the demand for carbon offsets in the process. The Taskforce states in particular that tailored sector-wide standards on the use of offsets can improve industry best practices and aid buyers' transition to net zero.
- **Create mechanisms for demand signalling**. Companies sending long-term demand signals (for example, through long term agreements with suppliers or reduction commitments) in order to scale credit supply. These demand signals could be aggregated through a buyer commitment registry.

Commentary – why is this important right now?

The Taskforce argues that the global climate change mitigation goals simply cannot be achieved by way of emissions reductions alone. Instead, the Taskforce advocates that carbon offsetting must accordingly be an important part of any such transition. The Taskforce notes that voluntary carbon markets must grow by at least 15 times by 2030 to meet the necessary corporate demand. The intention of the Taskforce's Consultation Document and Final Report is to be a catalyst for such radical change.

This year's COP26 will focus investors' minds on the sustainability strategies of the companies and institutions in which they invest across the globe. Carbon credits are a key tool for boards to ensure relevant sustainability targets are met, corporate resilience is sustained and the goals of the Paris Agreement are achieved. But the usefulness of carbon credits depends on the liquidity and consistent price generation of the markets on which they are traded. This in turn depends on reliable and consistent data, taxonomies and benchmarks. The Taskforce has set out concrete steps to accelerate and scale up the development of these markets as the axis for generating liquidity, pricing, data, taxonomies and benchmarks – ultimately achieving real and swift mitigation of climate change.

Conclusion

		Objectives	Who (Subject to change)
Fully Taskforce driven	**A Stakeholder engagement**	**Builds support for the Taskforce blueprint and recommendations**, provides critical feedback from stakeholders (e.g. CEOs) to the other Working Groups, and drives the narrative on offsets, in particular through a CEO letter	**Taskforce Working Group**
	B Governance	**Publishes a governance report** detailing key needs for governance in the voluntary carbon market, roles and responsibilities, governance structure, etc. and identifies potential ways this governance body could be established **Develops eligibility principles** for suppliers, auditors/VVBs, intermediates and buyers[1] **Establishes blueprint** for high-level **digital project cycles**	**Taskforce Working Group**
	C Legal principles & contracts	**Creates standardized documentation for OTC and exchange on both the primary and secondary markets and for securitization**	**Taskforce Working Group**
	D Credit level integrity	**Defines the CCPs and Additional Attributes**, and develops the necessary assessment framework	**Taskforce Working Group**
Independent effort, with input from the Taskforce	**E Participant level integrity**	**Aligns guidance on corporate claims**, including reporting/disclosure requirements. Close coordination with ongoing initiatives required (e.g. SBTI, Oxford principles, GHG protocol, ISO). This includes guidance on what types of offsets (e.g. CCP approved, with removal attributes and specific vintage) that are required for making specific claims	**HADA-VCM (independent effort)**
Information sharing with Taskforce	**F Demand & supply engines**	Scale up demand for offsetting and commitments to develop high-quality credits	WBCSD, NCSA, Coalition for Negative Emissions, SMI
	G Traded volume & market infrastructure	Market players to develop the infrastructure and services required to scale up trading	Private market players
	H Corresponding Adjustments	Evaluates the implications of Articles 6 negotiations on the voluntary carbon market	Trove research

[1] AML / KYC principles form part of these, but would not be covered in Phase 2

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The work of the Taskforce will now turn to implementation and the establishment of a pilot market within the next 12 months. The Taskforce's Implementation Roadmap builds directly on the 20 recommended actions summarised in this alert. The graphic above highlights the eight areas of work the Taskforce will target to capture the 20 recommended actions, and sets out the objectives to be achieved within each one.

It is made clear in the Final Report that the Taskforce considers this a highly collaborative process and invites parties interested in leading or driving key action items to make themselves known. Clearly the ambition and scale of the proposal is great and will require participation of all relevant stakeholders to ensure its success. This is a global Taskforce seeking global private sector solutions for a problem which needs global cooperation; it would be a great shame if it were to be stymied by national barriers or balkanised rules and regulations. The work of the Taskforce in this next phase will be critical for the initiative as the nascent market takes shape and key positions on principles, rules, governance and infrastructure evolve.

Further details regarding the Taskforce can be located here.

The Final Report can be located here.

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Scaling Voluntary Carbon Markets: Phase II Report

July 2021

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The 'Taskforce on Scaling Voluntary Carbon Markets' (the "**Taskforce**") is a private sector initiative working to scale an effective and efficient voluntary carbon credit market to help meet the goals of the Paris Agreement.

The Taskforce is spearheaded by Mark Carney, UN Special Envoy for Climate Action and Finance Advisor to UK Prime Minister Boris Johnson for the 26th meeting of the Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC) ("**COP26**"). The Taskforce is chaired by Bill Winters, Group Chief Executive, Standard Chartered, and sponsored by the Institute of International Finance ("**IIF**") under the leadership of IIF President and CEO Tim Adams. It is made up of more than 250 members and consultation group institutions, representing buyers and sellers of carbon credits, standard setters, the financial sector, market infrastructure providers, including Ingrid York of White & Case, civil society, international organisations, academics and relevant sector trade associations. The Phase I final report of the Taskforce (the "**Phase I Final Report**") was introduced by Bill Gates, Mark Carney, Bill Winters and Annette Nazareth at the Davos Agenda 2021.

On 21 May 2021, the Taskforce launched a new consultation process (the "**Phase II Consultation**") on three core topics:

1. the establishment of a new umbrella governance body to oversee the growth of voluntary carbon markets;
2. the development of legal principles and contracts; and
3. recommendations relating to the definitions of Core Carbon Principles ("CCPs") for credit level integrity.

Following the completion of the Phase II Consultation on 21 June 2021, the Taskforce has now published four documents as part of the Phase II Final Report (the "**Phase II Final Report Documents**") including:

1. a 'Phase II Report' (the "**Report**");
2. governance 'Terms of Reference' and a call for expressions of interest;
3. a 'Technical Appendix' containing analysis of the material in the previous two documents; and
4. a summary document of the Report.

The Phase II Final Report Documents were developed with the extensive engagement of Taskforce members and working groups. Overall, the Taskforce received 130 responses to the Phase II Consultation, including 58 open letters and 72 completed responses to the Phase II Consultation survey. The Taskforce has published each response at https://www.iif.com/tsvcm.

The Taskforce asserts that the Phase II Consultation revealed strong support amongst respondents for the mandate and mission of the governance body, which include setting legal principles to guide the market and setting the criteria for carbon credit integrity via the CCPs. Respondents also emphasised the importance of the governance body in unifying the currently fragmented market and ensuring the quality and integrity of carbon credits.

In particular, responses to the Phase II Consultation have provided the Taskforce with a clearer indication of where the potential obstacles and points to resolve are before the implementation of the Report findings. These issues are discussed in further detail below.

The Report represents the next output of Phase II of the Taskforce's project to scale-up voluntary carbon markets, being the 'Development and Implementation' phase and follows on from the Phase II consultation launched on 21 May 2021, which was summarised in our 16 June 2021 client alert here (*Scaling Voluntary Carbon Markets: Phase II Public Consultation*).

White & Case has also previously published client alerts on the Phase I consultation on an initial blueprint for a voluntary greenhouse gas or carbon market, published on 10 November 2020, which was summarised in our 13 November 2020 client alert here (*Voluntary Carbon Markets: A Blueprint*), as well as on the Phase I Final Report after such initial consultation in November and December 2020, which was summarised in our February 2021 client alert here (*Scaling Voluntary Carbon Markets: The Final Report*).

Timeline

10 November 2020	Taskforce publishes Phase I Consultation Document
13 November 2020	White & Case publishes client alert on Phase I Consultation Document
28 January 2021	Taskforce publishes Phase I Final Report and Summary on Taskforce
18 February 2021	White & Case publishes client alert on Phase I Final Report
21 May 2021	Taskforce publishes the Phase II Consultation Documents
16 June 2021	White & Case publishes client alert on Phase II Consultation Documents
21 June 2021	Deadline for market participants to provide feedback on Phase II Consultation Documents
8 July 2021	Taskforce publishes the Phase II Final Report Documents including: • The Report • Governance Terms of Reference • Technical Appendix • Report Summary
9 August 2021	Interested parties to submit final expressions of interest for participation in the new umbrella governance body
September 2021	Taskforce's Advisory Board to recommend participants to assume roles on the new governance body

Phase II Report Overview

The Report is structured across the same four chapters detailed in the Phase II Consultation and supplements these key topics with the responses from the Phase II Consultation as well as further input from Taskforce Working Groups and members. The four chapters include:

- **Objectives and Focus of the Taskforce**. The Taskforce has set a dual ambition of ensuring high-integrity carbon credits and robust, transparent and liquid markets. The remaining chapters of the Report set out in greater detail the methods to be adopted in achieving this ambition.

- **Governance**. Building on the set of concrete recommendations for the mandate, organisational design and implementation path for the new umbrella governance body, this chapter goes into further detail on the structural aspects of the new body. The Taskforce is also seeking further feedback and recommendations from market participants on five key topics underpinning the body's operating model and principles which will be further developed ahead of the governance body's establishment.
- **Legal Principles & Contracts**. This chapter focuses on the work of the Taskforce Working Group on Legal Principles and Contracts, of which Ingrid York was a workstream lead, which aims to standardise the legal framework underpinning the issuance of carbon credits and thereby promote liquidity. The working group has addressed this aim by defining use cases to drive awareness of the methods by which participants can utilise the market and by clarifying operational requirements for standard setters' terms of use and also developing general trading terms.
- **Credit Level Integrity**. The new umbrella governance body will draw on the expertise of the Taskforce Credit-level Integrity Working Group, which was established to support the governance body on the development and curation of CCPs in particular. This process will be operationalised through an assessment framework for standards as well as a set of credit eligibility guidelines. The working group has also set out a proposal for the taxonomy of additional attributes for each CCP credit.

Topic One: Governance

The Taskforce Governance Working Group has set out in a separate, deep-dive document the governance Terms of Reference and the call for expression of interest from interested parties to assume roles within the new governance body, which are published alongside the Report.

The development of the governance Terms of Reference are supplemented by the Taskforce's technical appendix, which provides in-depth analysis on how the new body can draw on some of the key features of other governance bodies operating in the carbon markets or financial markets. This analysis has informed the blueprint for the new governance body's design and framework as set out in the governance Terms of Reference.

Mission and Mandate

The new umbrella governance body has a mandate that covers four main areas:

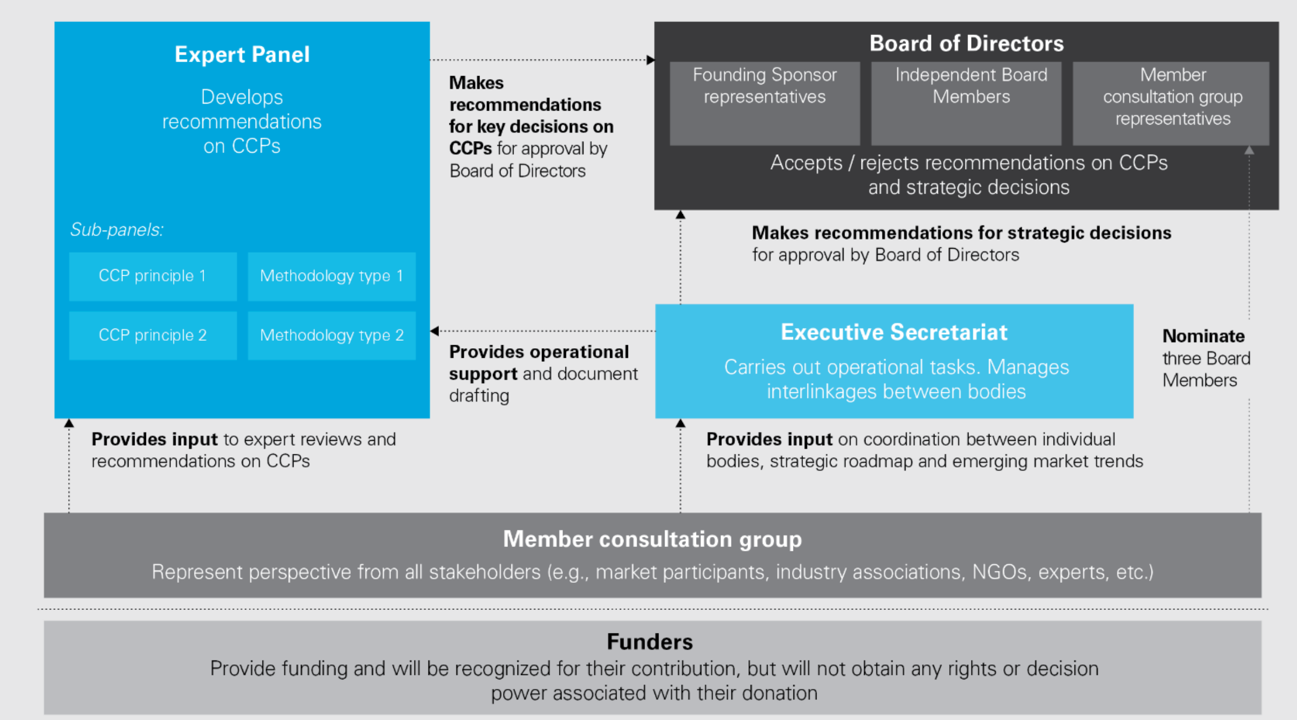
- **Greenhouse Gas Reduction and Removal**. The new body will ensure that the voluntary carbon market serves its primary purpose of reducing and removing greenhouse gas emissions and accelerating the transition to net zero to mitigate climate change.
- **Core Carbon Principles**. The new body will be responsible for the establishment, hosting and curating of:
    - CCP eligibility guidelines for different project and methodology types and additional attributes;
    - CCP assessment framework for new and existing standard setters; and
    - eligibility principles for existing market bodies including suppliers and Validation and Verification Bodies ("**VVBs**").
- **Oversight**. The new body will provide oversight over standard setters on adherence to the CCPs. The body will be responsible for approving standard setters that apply for eligibility and conducting regular spot checks to ensure adherence.
- **Coordination**. The new body will coordinate the work of, and manage the interlinkages between individual bodies and serve as a steward for, and endeavour to foster the responsible growth of, the voluntary carbon market by defining a roadmap for success.

Organisational Design

As part of the Report, the Governance Working Group has refined the proposed structure and composition of the new umbrella governance body by making more specific reference to the role that Funders (*see* 'Funding' section below) will play in its setup and steady state phases.

The new umbrella governance body will comprise five parts, each with their own tasks, composition and nomination process.

Design of the New Umbrella Governance Body



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As noted in our previous client alert, it remains to be seen how credits developed in accordance with CCPs recommended under the new governance structure will interface with existing regulations in the financial services sphere – and, in particular, different jurisdictions' approaches to regulating specific types of financial instruments and the activities and services relating to these.

Further Recommendations: Five Key Topics

The publication of the governance Terms of Reference provides the market with clarity on the role this future umbrella governance body will play to oversee the growth of voluntary carbon markets.

The integrity of the market has been a pervasive theme across each aspect of the Taskforce's project to scale voluntary carbon markets in order to give confidence to buyers to enter the market at scale. To ensure that the structure of the new governance body also aligns with the overarching goal of market integrity, the Taskforce has requested market participants to assist in providing recommendations on five key topics ahead of the 9 August 2021 deadline for expressions of interest for participation in the new body. The five topics focusing on the governance body's operating model and principles include:

- **Modalities and Procedures for the Board of Directors**. The development of details on the decision process of the Board of Directors, to include processes to manage conflicts of interest, ensure transparency of Board decisions and provide market participants with opportunities for rebuttal or appeal on decisions taken by the body.
- **Transparency Mechanism**. The governance body will seek to operationalise a transparency mechanism focusing on transparency of the body's procedures and that of the trading of carbon credits:
  - **Procedural Transparency**: Recommendations and decisions on CCPs, as well as the strategic roadmap of the governance body, will be publicly disclosed. It will also provide detailed finance statements, require members to disclose and address real and perceived conflicts of interest and provide public annual reports on its activities and developments.

  - **Trading Transparency**: The Board of Directors will decide on the type of information which should be publicly disclosed as part of the trading of carbon credits. The information could include which parties are participating in trades and how (for example in real time).
  - **Open Book Accounting**: The governance body may consider open book accounting to ensure each transaction is fully transparent, including the particulars of the deal, the project baseline and proof of additionality, counterparties, ultimate beneficiaries and benefit-sharing arrangements. The body should consider if there would be any cost and administrative benefit with delayed transparency.
- **Grievance Mechanism**. The governance body will seek to operationalise and implement a grievance mechanism ensuring that disputes and their resolution feed directly into decision making. Current proposals and features under discussion include:
  - provision of a publicly available complaints form to bring forward complaints against the governance body and to be reviewed by the Executive Secretariat;
  - public disclosure of complaints against the governance body with the aim of commenting on and resolving conflicts within three months of submission of the complaint form;
  - limiting grievance mechanisms dealing with disputes between market participants to conformity with the CCPs;
  - ensuring standard setters have their own grievance mechanisms in place to regulate market disputes. This may become an eligibility requirement for standard setters to operate under the CCPs;
  - the governance body assuming a mediator role for those disputes that cannot be resolved among market participants, such as disputes over adherence of projects to the CCPs, validation and verification of projects and adherence to the CCP eligibility criteria; and
  - harnessing the information from market grievances to inform any required adjustments to the CCPs, eligibility principles or the body's role in overseeing standard setters and the market more generally.
- **Transversal Approach**. The new governance body will act as the steward for the voluntary carbon markets and will therefore need clarity on how to effectively manage the relationships between the various different bodies operating in the governance of voluntary carbon markets.
- **Key Performance Indicators ("KPIs") and Definition of Success**. It is crucial that the new governance body clearly defines and measures its success in scaling voluntary carbon markets and, more generally, its overall contribution to the transition to net-zero greenhouse gas emissions. The development of KPIs and the assessment of whether these are achieved will also form the basis for the regular effectiveness review that the governance body will undergo every three years. Potential KPIs could focus on the following targets:
  - measuring the specific amount of tonnes of carbon dioxide reduced;
  - attaining a specific threshold figure of investments in high-integrity carbon credits which have been validated by the governance body;
  - the average price of carbon credits;
  - the number of methodologies reviewed by the governance body;
  - the percentage of carbon credits which qualify under the CCPs;
  - adoption rates of CCPs; for example, the number of tonnes traded by each standard setter or the number of companies purchasing high-integrity CCPs by a certain date; and
  - the number of grievances successfully settled.

The Taskforce will collect recommendations received on the five key topics above for the Taskforce Advisory Board's review. The Taskforce Advisory Board will then make a non-binding recommendation to the Board of Directors of the governance body, which will have the final say on the adoption of the proposed recommendations.

Conflicts of Interest

- **Overview**. The governance body will establish a conflicts of interest policy requiring members to disclose any conflict or potential conflict, whether real or perceived. Guardrails may be put in place for those entities who are active market participants to prevent comprising the integrity of the governance body. To support an accelerated implementation of the governance body, the Taskforce is welcoming proposals for processes to manage conflicts of interest from members and the public ahead of the 9 August 2021 deadline for expressions of interest for participation in the new body.

- **Organisational Conflicts**. The governance body will only consider Founding Sponsor and Executive Secretariat Host organisations that are not-for-profit NGOs, industry or investor associations or public organisations. These types of entities will also be required to disclose any active carbon market activities and justify how they will minimise conflicts of interest arising out of these activities. For-profit organisations generating revenue in the voluntary carbon markets will not be considered eligible for these roles but may be eligible to become member consultation group representatives.

- **Individual Conflicts of Interest**. Individuals serving on the Board of Directors and Expert Panel will act in their personal capacity and will be required to adhere to a 'Code of Conduct'. Conflicts of interest on the Board of Directors and Expert Panel will be prevented by a set of guardrails which will allow for the inclusion of market participants whilst avoiding significant conflicts of interest.

Call for Expressions of Interest

As part of the publication of the Report, the Taskforce is also calling upon interested parties to share expressions of interest in assuming roles on the new umbrella governance body. The Taskforce is also calling upon corporates, philanthropic institutes and public sources to aid with funding contributions.

The governance Terms of Reference set out in more detail the following key points:

- **Timelines and Process for Implementation of the Governance Body**. Interested parties have until 9 August 2021 to express their interest in adopting one of the roles in the governance body. The Taskforce Principals will provide the Taskforce Advisory Board with draft recommendations, at which point the Taskforce Advisory Board will devise a shortlist of interested parties. Following the selection process detailed below, the Taskforce Advisory Board will recommend Founding Sponsors, Independent Board Members, Expert Panel Members and the Executive Secretariat Host in September 2021. At this point, the Taskforce will also elect member consultation group representatives, whose role will be to provide regular input to the Expert Panel and Executive Secretariat.

- **Recommendation Guidelines**. The Taskforce has set out governance design and recommendation guidelines to help inform on which parties would be capable of fulfilling the specific roles in the new body. These recommendations in respect of each role are set out in further detail in the governance Terms of Reference and include criteria such as whether parties will be able to contribute funding, whether their experience and expertise is sufficient for the given role and which specific areas of the value chain parties wish to represent.

- **Submission of Interest**. Parties who are interested in fulfilling roles in the new body are requested to submit an expression of interest form for their desired role at www.iif.com/TSVCM. Following this, the expressions of interest received will be examined against the recommendation guidelines using a scoring matrix to assess the candidate's expression of interest against the guidelines, with special consideration granted to the encouragement of representation across all stakeholders and all geographies. The Taskforce is also encouraging parties to submit joint expressions of interest for the Founding Sponsor and/or Executive Secretariat Host roles.

The specific forms provided by the Taskforce for each of the different roles on the new body are oriented around the recommendation guidelines mentioned above in order to assist in evaluating each potential party's suitability for the role in question.

Funding

The new body will operate on a not-for-profit basis, with a phased-approach to its funding requirements as follows:

- **Setup Phase (First Three Years)**. The initial setup phases will require seed funding of approximately USD 23 to 33 million, with responsibility for securing this funding falling on the Founding Sponsors of the new body and the Taskforce. Key sources of funding will include governments, contributions from corporates and philanthropic donations. The setup phase will see the new body focus on establishing, hosting and curating CCPs, as well as on providing oversight over standard setters on adherence to CCP principles.
- **Steady State Phase**. The steady state phase will require approximately USD 7 to 10 million per year to cover the new body's expenses. Funding schemes may include membership fees and/or a service-based user fee; *e.g.* based on CCP credit issuance or retirement which could potentially be levied on CCP credit purchasers. If expectations of the predicted voluntary carbon market growth come to fruition, the steady state funding requirements will amount to less than 0.4 per cent. of the predicted voluntary carbon market size in 2024.

Transition

The Taskforce believes that the first three to six months of the setup phase represents the critical ramp-up phase for the new umbrella governance body to oversee the growth of voluntary carbon markets. During this time, the body will take decisions on topics that are key to establish it as a legal entity and enable its functioning as well as on five key topics mentioned above that will be further developed ahead of the establishment of the governance body.

As the governance body transitions to steady state operations, the focus and specific objectives of the new body will shift once the foundations for the body and its role within the global voluntary carbon market have been laid. The shift will see the new governance body adopt a more coordination-focused role within the voluntary carbon market and manage interlinkages between existing bodies. It is anticipated that the new body will transition from the setup phase to the steady state phase after three years, with the transition applying across all aspects of the body, including the mission and mandate, organisational design and funding needs.

Topic Two: Legal Principles and Contracts

Current Legal Landscape

- The Taskforce asserts that the current legal landscape in carbon markets is characterised by fragmentation and a lack of standardisation between the various market participants. The ambiguous legal landscape creates a significant burden on market participants, who must navigate the following issues across their portfolio of credits:
  - **Methodology Types**: Different project types make it more or less challenging to ascribe rights over carbon credits issued to the parties involved.
  - **Standards**: Different standard setters apply varying definitions of a carbon unit and the associated rights attached to it.
  - **Fragmentation**: The heterogeneous supply chain consists of small players, multiple trading venues and different contracts. The high volume of small suppliers can also make it costly and complex to interface with exchanges.
  - **Unclear Liabilities**: In most contracts, the current position is that legal liability rests with the verifier, which can prove to be an unattractive business model.
  - **Complexity from Emerging Services**: New services such as distributed ledger technology (DLT) applied through a meta-registry or trading network add further complexity to the legal underpinnings.
  - **Lack of Access to Financing**: Access to financing and the often significant lag between a project receiving financing and credit being produced provides serious challenges to market growth.
  - **Different Jurisdictions and Financial Regulatory Frameworks**: Different legal frameworks across jurisdictions have given rise to different legal rights associated with carbon credits and the rights of governments and private stakeholders to them. In relation to Article 6 of the Paris Agreement

specifically, the Taskforce has made it clear that more work will need to be done to ensure voluntary carbon markets comply with the rules of the Paris Agreement once the outcome of the hotly debated Article 6 negotiations becomes clearer.

- **Fraud Risks**: The presence of bad actors in the market can pose risks of money laundering, tax fraud (*e.g.* EU ETS-related incidents), consumer fraud and double counting.

Current Legal Nature of Carbon Credits

- **Market Scaling**: Market scaling is hindered by the hesitancy of market participants to commit to transactions, where the legal implications of doing so are unclear.
- **Fungibility**: The divergence of treatments of carbon credits across regimes hinders liquidity and trading.
- **Existing Documentation**: Providing the necessary legal underpinning to general trading terms by way of sound legal opinions presents a challenge given the uncertain and fragmented legal treatment.
- The Working Group on Legal Principles has sought to address these legal issues by:
  - providing clarity over use cases which demonstrate how harmonised contracts and standard clauses and procedures can help scale the market. These use cases are discussed further in the accompanying technical appendix;
  - providing operational requirements for standard setters' terms of use; and
  - providing key general trading terms.
- The Taskforce sets out an implementation phase from July to October/November 2021 during which:
  - the newly formed governance body will host and update operational requirements for standard setters' terms of use recommended by the Taskforce; and
  - external industry bodies (*e.g.* IETA, ISDA and EFET) will be able to integrate key general trading terms recommended by the Taskforce into the contract templates.

Standard Setters' Terms of Use

As part of the Phase II Consultation, the Working Group on Legal Principles set out proposals which could be introduced across all standard setters' terms of use. Some of the key areas of focus are highlighted in the graphic below and discussed in further detail within the technical appendix. These provisions will be set out in more detail by the governance body and regularly updated to take account of innovation and relevant developments in the market.

Although current practice shows it is possible to trade multiple standard setters' credits under one reference contract, the Taskforce asserts that a more legally uniform product, backed by harmonised terms of use across standard setters, will provide clarity to buyers on the legal structure underpinning their investment in carbon credits.

Operational Requirements for Standards' Terms

Topic	Proposal
Uniform onboarding procedures	Standards should have in place rigorous onboarding procedures that Users undergo upon registration (to be implemented, if needed, in collaboration with third parties, such as banks); periodic spot checks will be performed on a regular basis thereafter. The governance body will have the mandate to define minimum documentation required by the standard setters.
Force Majeure	Standards will not be held liable for losses incurred under Force Majeure.

Topic	Proposal
Limitation of Liability	Registry users will assume full responsibility and risk of loss from their use of the registry and will have no claim against the Standard or any of its contractors.
Prohibited practices and suspension of service	Standards shall suspend services and/or close the User's account if they reasonably suspect that the User has engaged in fraudulent, unethical or illegal activity – the governance body will define a minimum threshold of such prohibited practices. Standards make all reasonable efforts to ensure that neither developers nor their subcontractors engage in such practices, *e.g.*, through onboarding due diligence and periodic spot checks.
Dispute Resolution	The Taskforce recommends Standards require arbitration.
Auditable logs	Standards commit to keeping auditable transaction logs and secure transfer procedures – the governance body may specify relevant best practices and/or internationally recognized security standards (e.g. blockchain-based logs).
Tax compliance	Standards ensure to the maximum degree possible that developers pay all taxes and charges imposed by governmental authorities related to the use of the Standard.
Cybersecurity	Standards should have in place cybersecurity systems adequate to minimize risks related to hacking and fraud – the governance body may specify relevant best practices and/or internationally recognized security standards.
Termination	The governance body will specify a minimum period of notice Parties will give each other before terminating the Agreement.

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General Trading Terms

The Taskforce asserts that currently, the general trading terms of carbon credit contracts lack uniformity, thereby adding to fragmentation and illiquidity in the voluntary carbon credit market.

The Working Group on Legal Principles and Contracts has set out proposals for a harmonised contractual foundation for key trading terms. Enhanced clarity over trading documentation will widen access to smaller market players in particular, allowing them to circumvent complex and redundant drafting procedures and associated legal expenses.

These general trading terms will be of more particular relevance to OTC contracts. In relation to exchange-traded contracts, the Taskforce's expectation is that exchanges may follow the recommendations in building on their existing trading rules.

The full language and analysis of the key general trading terms set out below can be found in the technical appendix. These terms can be adapted to parties' requirements and readily integrated into OTC and exchange trading contracts.

Key General Trading Terms

Topic	Proposal
Definition of Products	The product is defined as either a removal or an avoidance/reduction CCP credit – or either - that has been issued by one of the Standards approved

Topic	Proposal
	under the governance body and that meets all of the requirements of the CCPs as well as some of the additional attributes specified.
Avoidance of double counting	The Seller warrants to the Buyer that they have not and will not use or make any claims with respect to the CCPs being traded, and that they have not sold, transferred, retired, or otherwise created any interest in the CCPs other than as contemplated by the Agreement. In a primary sale, the Seller commits not to double count, i.e. not to have registered CCP credits in more than one Standard. Upon being transferred the CCP credit, the Buyer commits to use, make claims with respect to, or further sell the credit exclusively one time on behalf of either themselves or subsequent Buyers. The Taskforce recommends that potential technological solutions be explored and considered which can help avoid double counting / claiming / use (e.g. blockchain-based logs; reference number systems).
Settlement and Delivery	For OTC: Parties hold accounts in one specific Standard, agreed upon upfront. For Exchange-traded contracts: Parties hold accounts in all Standards that the Exchange shall transfer the credits from. Parties are given two options: (i) Physical delivery / deemed delivery (retirement by the Buyer) (ii) Financial settlement / retirement without deemed delivery Parties are expressly encouraged to consider the legal implications which different delivery mechanisms have in different jurisdictions (resulting in CCPs being considered commodities, securities, or other types of assets).
Failure to Deliver	(i) Where credits already exist, the Party breaching the Agreement will reimburse the other (ii) Where the credits are in development, the Parties either apply the same provisions, or negotiate appropriate remedies for non-delivery
Force Majeure	The Parties choose one among three modalities of termination payment: (i) No termination payment (ii) Partial termination payment (iii) Full termination payment
Limitation on Liability	Neither Party is liable for any loss of income, loss of profits or loss of contracts, or for any indirect or consequential loss or damage.
Compensation	Each party compensates the other for claims directly incurred in connection with: (i) any violation of applicable law, regulation or order by such party; and/or

Topic	Proposal
	(ii) any breach of a representation or warranty by such party.
Change in Law	Parties are given two options: (i) if changes in law do not materially impact on the quantity of credits to be delivered, it is the Seller's responsibility to comply with those changes; if they do, the Buyer may terminate the Agreement. (ii) if any of the Parties is prevented by the change of law from complying with its obligations under the Agreement, the Parties seek to agree on amendments in good faith; if such agreement cannot be found, either Party may terminate the Agreement.
Dispute Resolution	Parties are given two options based on standard ISDA language, which they can adjust to their needs (choice of court, choice of jurisdiction, Arbitration Body): (i) Jurisdictional clause (exclusive / non-exclusive) (ii) Arbitration clause.
Benchmark price/source	In the long term, if benchmark prices are used for CCP credits, they should comply with IOSCO principles.
Tax Compliance	The Seller will pay all taxes arising prior to delivery; the Buyer will pay all taxes after delivery. Where the Seller is required by law to pay taxes that are the Buyer's responsibility, the Buyer will reimburse the Seller.

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Commentary

Role of Market Participants

The process of harmonising standard setters' terms of use and general trading terms will require the assistance and expertise of a wide-range of market participants, including in respect of trading terms for example the input of international industry bodies such as the International Swaps and Derivatives Association, Inc. (ISDA), the International Emissions Trading Association (IETA), the European Federation of Energy Traders (EFET) and the Futures Industry Association (FIA) and intergovernmental bodies such as UNFCCC, UNCITRAL and UNIDROIT who have significant expertise in the development of nascent markets and model laws.

The expertise of these entities will need to be complemented by the experience of various other existing and new market participants within the voluntary carbon markets in order to ensure wide acceptance and usage of the respective terms.

We note that the Taskforce has specifically called upon external industry bodies (*e.g.* IETA, ISDA and EFET) to integrate key general trading terms recommended by the Taskforce into their contract templates, as well as such entities to commission legal opinions on the legal nature of carbon credits, and on international governmental bodies (*e.g.* UNFCCC, UNCITRAL and UNIDROIT) to provide respective recommendations.

Legal Framework

As noted above, it remains to be seen how credits developed in accordance with CCPs recommended under the new governance structure will interface with existing regulations in the financial services sphere – and, in particular, different jurisdictions' approaches to regulating specific types of financial instruments and the activities and services relating to these.

In addition, current financial market infrastructure global principles and post-crisis regulation applicable to trading platforms and financial market utilities will similarly need review and potential revision in order to clarify their application to and interface with rapidly scaling voluntary carbon markets and to ensure that they do not stifle these innovative markets as they grow and develop.

Such reviews will also inevitably consider these markets' interoperability with wider trading and post-trade ecosystems across areas such as clearing, settlement, reporting and market surveillance. They will also likely draw regulators' post-pandemic focus on these markets' operational resilience, third-party risk management, cybersecurity and use of risk-concentrated cloud services.

A major challenge in these reviews will be determining how aligned current and any amended regulatory frameworks are and can be, taking into account the global and cross-border nature of climate change risks, together with many governments' policy drivers to encourage all industry sectors to focus on mitigating them, both directly and indirectly.

Governments may take the view that the financing of reduction and removal projects overseas is just as impactful as domestic investment and direct their regulators in legislation, via mandated regulatory objectives or otherwise, to seek global regulatory alignment.

In this regard, we note that the Taskforce has invited jurisdictional regulators to review their treatment of voluntary carbon credits with the aim of providing further guidance on their legal nature, aligned across jurisdictions.

Topic 3: Credit-level Integrity

The newly formed Credit-level Integrity Working Group was established to support the new umbrella governance body by providing input on the key documentation it would need, including in both developing and operationalising the CCPs. The main purpose of the CCPs is to provide for a threshold standard for high quality credits at the credit level and to ensure integrity of the bodies assessing these thresholds at the participant level. The Taskforce asserts that tackling these issues around credit quality and credit assessment will foster confidence in the market and drive buyer demand.

In this Phase II, the Credit-level Integrity Working Group has produced a draft assessment framework for standard setters, an analysis of a set of credit eligibility guidelines and an initial set of additional attributes that will act as an identifier of each CCP credit based on its specific characteristics. The intention is that the development of these initiatives will enable the CCPs to have a tangible impact on the integrity of credits and the voluntary carbon credit market. The governance body will refine the proposed assessment framework for standards and take this framework to the next level.

Assessment Framework for Standards

The assessment framework for standards will be used by the new governance body to evaluate which standard setters may issue CCP credits. The aim of further developing CCPs has been both to harmonise and also exceed quality standards currently in the market. The below proposal is a first draft that the governance body will refine and develop.

Assessment Framework for Standard Setters:

- **Additionality**: Projects or activities yielding CCP credits must demonstrate additionality before credits are issued to them, including:
    - **Financial Additionality Test**: This ensures the environmental gain would not have occurred without the revenue from carbon credits.
    - **Penetration Level Test**: The penetration level of project activity must be below an appropriate threshold to demonstrate low availability. This only applies to avoidance/reduction type carbon credits.
    - **Regulatory Additionality Test**: In order to demonstrate regulatory additionality, the project must not be in response to legal or regulatory obligations under laws or regulations in a jurisdiction and the project must not be in response to legal or regulatory obligations arising from laws that have already been approved but have not yet taken effect.

- **Permanence**: Standard setters should ensure credits are issued only for projects and activities in which greenhouse gas reductions or removals are permanent or, for those activities which carry a 'reversal risk', adhere to a minimum permanence timeframe and a comprehensive risk mitigation and compensation mechanism.
  - Standard setters must require monitoring and safeguards for any reversals for the duration of the minimum permanence timeframe.
  - Standard setters will be expected to maintain a reversal compensation procedure; for example, through insurance or a buffer pool in order to compensate for any reversal events (intentional and unintentional) during a credit's minimum permanence period for methodology types that include storage.
  - Minimum buffer requirements by methodology type will be defined by the new governance body and will vary depending on the level of the reversal risk associated with the different methodology types. The governance body will conduct stress tests on standard setters' buffer pools to ensure they are sufficient for their project portfolio risk.
  - In case of a reversal event, the relevant standard setters will retire the same number of credits as are affected by the reversal event from the buffer pool to which the invalidated credits belong.
  - Standard setters must include the requirement to project or activity owners to notify likely reversals within a specified number of days (to be defined by the governance body) of their discovery, indicating whether the reversal is avoidable or unavoidable.
- **Leakage Minimisation**: Standard setters must require leakage assessments for those projects or activities where leakage is identified as a risk. Credit issuance volumes should be adjusted to mitigate for any increase in emissions outside the boundary of the project or activity. Leakage must be monitored on a continual and systematic basis during the credit period where standard setters are using the confirmed leakage approach for deductions and standard setters must require the publication of leakage estimates and monitoring results in the interest of transparency.
- **Baseline Setting Approach**: Standard setters must require the estimation and use of conservative and independently audited baselines for any activity or project aiming to receive CCP credits.
  - At the start of each new crediting period, standard setters must ensure developers revise baselines where necessary and indicate triggers for revisions of baselines.
  - Baselines must be independently audited and endorsed by third-party specialist experts.
  - The Taskforce has published in the Report the results of the differing market views on realistic and credible baselines for forestry credits specifically. Baselines for forestry credits have the added difficulty in calculating baselines due to the requirements for extrapolation of deforestation rates across time and regions.
- **Verification**: Assessments of projects and activities must be calculated in a conservative and transparent manner, based on accurate measurements and quantification methods. The monitoring of emissions reductions and removals must be validated and verified by accredited validation/verification bodies.
- **Real**: No CCP credits can be issued on an ex-ante basis on the basis of potential emissions reductions or removals. Equally, CCP credits must not be issued for activities where the decision to initiate them occurred before the decision to pursue credit revenue.
- **Do No Net Harm**: Any emission reductions or removals against which CCP credits are issued must be the result of activities that, at a minimum, do no net environmental or social harm.
  - Standard setters can ensure the projects' overall impact prevents any net social or environmental harm by conducting impact assessments and regular community or stakeholder consultations.
  - Standard setters must indicate the safeguards in place to prevent social and environmental risks and define dispute resolution mechanisms to address issues relating to the net impact of projects.

Market Debate: Financial Additionality Requirements

- **Background**: Not all standard setters currently require project developers to demonstrate financial additionality and instead make use of a variety of types of additionality tests, including also regulatory additionality and performance against benchmarks. Respondents to the Phase II Consultation identified the tension between financial additionality adding an extra layer of verification and integrity to projects versus the burden developers will face in demonstrating and proving financial additionality.
- **Pros**: Arguments in favour of requiring financial additionality include:
  - **Additional Requirement**: Financial additionality should be a requirement on top of other additionality tests and not simply one of many ways to demonstrate overall additionality. In the latter case, developers are often incentivised to choose the path of least resistance, with projects becoming validated that would have failed the remainder of the additionality tests.
  - **Added Protection**: Although financial additionality tests can be difficult to calculate, when used in conjunction with other additionality requirements, they constitute an added layer of protection against low quality and non-additional credits.
- **Cons**: Arguments against requiring financial additionality include:
  - **Subjectivity**: Estimating and proving financial additionality may be subjective and open to manipulation by developers.
  - **Misrepresentative**: Under the old Kyoto Protocol's Clean Development Mechanism, projects that proved their overall additionality solely through financial additionality were often found to be non-additional.
  - **Tailored Approach**: The requirement for financial additionality should be decided at a methodology-type level. For example, removal methodologies may not be suitable for a financial additionality requirement.
  - **Rewarding Incumbent Players**: Requiring financial additionality rewards incumbent players making small adjustments towards avoided, reduced or removed emissions instead of smaller players with disruptive technologies that would become profitable in the short term.
  - **Increased Costs**: Demonstrating financial additionality added to both the workload and costs of developers.
  - **Achieving Financial Additionality**: Financial additionality may be hard to implement in regions where financial parameters such as required rates of return are volatile.

Market Debate: Financial Additionality Testing

- **Background**: Linked to the requirement of financial additionality is the issue of the methods of testing and demonstrating financial additionality. In order to demonstrate financial additionality, many players in the voluntary carbon markets use common practice tests (certifying that the project activity is not widespread in the market and hence does not represent a commonly available technology), investment barriers tests or positive-lists to pre-determine financially additional methodologies. One of the current talking points is whether financial analysis tests would be a more accurate method of assessing financial additionality.
- **Pros**: Arguments in favour of requiring financial analysis tests include:
  - **Objective Basis**: Financial analysis tests are required in order to establish an objective basis for negative profitability or lower returns on capital of projects without carbon credit revenue. Investment-related tests are not as effective, since the purpose of carbon credit revenue should not be to ease investment barriers for profitable projects with high returns on capital.
  - **Present Leniency**: Many market participants believe current formulations of financial additionality are too lenient and that only projects which show that profitability would not be possible without carbon credit revenue should have CCP status.

- **Cons**: Arguments against requiring financial analysis tests include:
  - **Sufficient Existing Methodologies**: Common practice tests which certify that the project activity is not widespread in the market and hence does not represent a commonly available technology, as well as investment barriers tests, are sufficient for measuring and demonstrating financial additionality.
  - **Subjectivity**: Financial analysis tests can be highly subjective and therefore open to manipulation by developers.
- **Concluding Remarks**: The Taskforce believes that the responses above to the Phase II Consultation have now provided the future governance body with a picture of where the market tension in respect of financial additionality lies. It will be one of the tasks of the governance body to assess the requirements and methodologies for financial additionality and adopt a position for the benefit of voluntary carbon markets as a whole.

Operational Considerations for Standard Setters:

- **Programme Governance**: Standard setters must be managed by government or nonprofit organisations which set out in a transparent manner their governance structure.
- **Programme Transparency**: Regulatory documents (*e.g.* standards), core normative references (*e.g.* statutes, bylaws and principles) and the different quantification methodologies must be made publicly available. Standard setters are also obliged to put in place provisions for public stakeholder consultation on the development of programme rules and procedures, accounting methodologies and project and governmental programmes.
- **Independent Third-party Verification**: The standard setter must publish requirements for independent third-party verification, including provisions to assess and avoid conflicts of interest, and for accreditation and oversight of validation and verification bodies.
- **Legal Underpinning**: Standard setters must ensure a robust legal framework to underpin the creation and ownership of credits.
- **Publicly Accessible Registry**: Standards setters must establish a publicly available registry that tracks the credits issued and provides the basic functionality to:
  - provide access to all underlying project information;
  - transparently issue, retire and cancel credits;
  - individually identify the credits through unique serial numbers to avoid practices such as double counting;
  - identify unit status; and
  - track the chain of custody, from creation to retirement and keep auditable transaction logs and secure transfer procedures.
- **Registry Operation**: Standard setters must establish procedures to ensure all account holders meet rigorous onboarding procedures and agree to legal requirements regarding the use of the registry. The registry must guard against service provider conflicts of interest and also have robust security and provisions for matters such as redundant data storage, regular security audits and systems backups.
- **Mis-issuance of Credits**: The governance body will be tasked with defining a mechanism for withdrawing CCP status where mis-issuance of CCP credits has occurred. The governance body will also have a mandate to strip standard setters' of their ability to issue CCP credits where a standard setter falls short of compliance with the Assessment Framework.
- **Registry Terms & Conditions**: Some of the key provisions for standard setters to consider include dispute resolution procedures, tax compliance and termination provisions. The terms and conditions should also set out the circumstances where a user's account may be suspended or closed; for example, following engagement in fraudulent or illegal activity.

Credit Eligibility Criteria

- The Credit-level Integrity Working Group has carried out an analysis of the current credit eligibility guidelines used by standard setters in the market today.
- The analysis highlights issues around which methodology types require greater degrees of assessment in order to give effect to the CCPs. For example, the Credit-level Integrity Working Group identified that the CCP relating to the permanence of reductions or removals from a project would require a greater degree of assessment for afforestation projects than it would for renewable energy generation activities.
- By taking a tailored approach to designing individual methodology protocols, standard setters will be able to evaluate and identify which specific methodologies comply with the relevant credit eligibility guidelines and CCPs. Market participants can therefore be confident that CCP credits achieve their intended purpose.
- The Credit-level Integrity Working Group has set out within the technical appendix detailed analysis in relation to each of the CCPs mentioned above, explaining the current market practices across standard setters. In conjunction with this analysis, the working group has provided some key questions for the future governance body to take into account in seeking to define credit eligibility guidelines.

Taxonomy of Additional Attributes

- The Credit-level Integrity Working Group has identified proposed additional attributes which will serve as mandatory tags, thereby codifying attributes that all standard setters must specify in issuing CCP Credits. Additional attributes allow for CCP credits to be easily differentiated by buyers and sellers in the market and provide clear price signals and price differentiation for CCP credits.
- Additional attributes will not substitute any information attached to a carbon credit; rather, they will act as mandatory additional labels to enhance the categorisation of CCP credits.
- The additional attributes put forward by the Credit-level Integrity Working Group in this Phase II include:
  - **Type of Credit**: Specifies whether a CCP represents a tonne of carbon dioxide which has been avoided/reduced or removed.
  - **Removal/Reduction Method**: Identifies the methodology used in removing or reducing carbon dioxide – for example, nature-based or tech-based methodology types.
  - **Storage Method**: Allows buyers to select credits with storage methods that may carry a lower reversal risk.
  - **Co-benefits**: Buyers may want credits that deliver wider benefits beyond the specific removal or reduction project, such as achieving Sustainable Development Goals or achieving broader ESG targets. As the market scales, more granular attributes must be considered.
  - **Corresponding Adjustments**: Buyers may require CCP credit with letters of authorisation from host countries specifying that steps have been taken to avoid issues such as the double counting of credits.
- Exchanges will be capable of creating contracts for CCP credits from different standard setters that share common underlying additional attributes. In the OTC market, additional attributes will allow credits to have standard supplements with price signals from the exchange market.
- Specifically labelled CCP credits will permit corporate participants to take a more targeted approach to achieving their corporate claims, whether that be achieving net zero, carbon neutral status or individual corporate claims. This will have a corresponding effect on suppliers, who will be incentivised to develop projects in line with the demand profile in the market.
- The new governance body will ultimately be responsible for finalising the recommendations of the Credit-level Integrity Working Group into a standard taxonomy of additional attributes and will provide oversight over standard setters to ensure credits are labelled appropriately. The governance body will also need to

specify questions such as, the appropriate redress mechanisms for credits with incorrectly labelled additional attributes.

- As the carbon markets grow, the governance body may need to consider how it strikes a balance between retaining the flexibility to adjust and update CCP credit labels as technologies and climate objectives shift, whilst also providing a consistent and reliable identification system for buyers and sellers.

Concluding Remarks

Commentary

The strong support in favour of the governance body's mission and mandate is a positive outcome from the Phase II Consultation.

The Phase II Consultation also helped to draw out some of the key points and arguments in those areas of debate in the market, particularly in respect of the development and implementation of an assessment framework for standards. Responsibility for deciding on the outcome of these debates will fall on the governance body.

Achieving the ambitions of the setup phase of the governance body will require key market stakeholders to heavily engage from the outset in the development of the new voluntary carbon market infrastructure and trading terms. This engagement will require stakeholders to provide both their knowledge and expertise, as well as (in some cases) their financial support.

Further details regarding the Taskforce can be located here.

The Report can be located here.

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