Safe, Efficient Markets

1 March 2024

ISDA response to IOSCO Consultation Report on VCMs

The International Swaps and Derivatives Association (ISDA) appreciates the opportunity to comment on IOSCO's consultation report on voluntary carbon markets (VCMs).

About ISDA

Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

ISDA has over 1000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

Key issues

In addition to the comments set out in our responses to the questions below, we also have the following comments:

- **Clear regulatory categorisation of VCCs is key**. In order to support scaling the VCMs and provide clarity regarding the regulatory categorisation and treatment of VCCs, regulators need to confirm the regulatory categorisation of VCCs in their jurisdiction. While it may not be possible to identify a harmonised approach to categorisation at an international level, regulators should be encouraged to provide clear categorisation in their jurisdiction.
- **VCMs should not be subject to duplicative regulation**. Where aspects of trading VCCs are already addressed by existing financial services regulation (e.g., with respect

to trading in OTC derivatives), IOSCO should not propose additional or duplicative regulation specific to VCCs.

- **Financial regulation should focus on the financial market integrity issues associated with trading VCCs, and not on regulation of the underlying projects**. IOSCO and its members should aim to ensure that principles regarding financial regulation are focussed on the financial market integrity issues associated with trading in VCCs, without creating barriers to entry for non-financial participants or otherwise hindering the development of the nascent VCMs. The issues with respect to integrity, effectiveness and verifiability of the projects underpinning VCCs are being addressed by bodies other than IOSCO and may be best supervised by authorities other than financial regulators. Similarly, the issues with respect to use of VCCs are best addressed through measures aimed at the entities using the VCCs (e.g., in line with the disclosure obligations proposed by the ISSB which are in the process of being implemented in a number of jurisdictions).
- **It is too early to assess next steps with respect to use of DLT**. We support IOSCO's decision not to propose any specific way forward in connection with the use of DLT, given the early stages of developments in this area.

Question 1: Does the Consultation Report use the correct and commonly accepted terminology? Are terms defined appropriately in the report and its glossary? Does the Consultation Report acknowledge all instances of inconsistent and conflicting terminology used in the industry? Are there any terms that have not been defined but which should be defined or alternatively, that should not be defined by IOSCO?

ISDA agrees that the Consultation Report uses the correct and commonly accepted terminology and that terms are defined appropriately in the report and its glossary, subject to the comments set out below.

In relation to the definition of Voluntary Carbon Market (VCM), while we agree with the definition as currently drafted, we consider that it should be amended either to remove the reference to the purpose for which entities might be buying VCCs, or else to clarify that as well as being able to offset their own carbon emissions they may also be able to contribute to climate change mitigation. Our proposed amendment is set out below:

Voluntary Carbon Market (VCM)	A type of carbon market where entities voluntarily buy credits generated from projects that either (i) avoided GHG ~~CO2~~ emissions, (ii) assisted in the reduction of emissions, or (iii) permanently removed emissions from the atmosphere, thereby allowing these buying entities to offset some

	or all of their own carbon emissions <u>or contribute to climate change mitigation</u>.

We would also welcome encouragement from IOSCO for more consistent use of the term "voluntary carbon credit" or VCC in place of other terms that are currently used interchangeably (e.g., "offset credit"), potentially leading to confusion with other types of credit or with similar terminology used in the compliance carbon markets.

Question 2: Is the description of the issuance of carbon credits accurate? Are all key market participants properly reflected in the Consultation Report?

We consider that the description of the issuance of carbon credits is accurate. We also consider that most of the key market participants in the trading ecosystem are properly reflected.

However, while we generally agree with the description we would like to note a couple of points:

- **Validation and verification**: while we agree that there are multiple terms for the bodies that carry out validation and verification, using the term "third-party entities" for these bodies does not seem particularly helpful in resolving any confusion. We suggest that IOSCO uses a more descriptive term (e.g., validation / verification bodies) in its final report.
- **Involvement of financial institutions at the issuance stage**: while the Consultation Report refers to insurance companies as potentially being an important stakeholder in the future to promote private investments in VCMs, we note that other financial market participants (e.g., investment firms, banks etc) also play a critically important role in structuring and financing projects, underwriting issuance of credits and building the liquidity needed for these markets to develop further. Without this role being taken on by investment banks and other financial market participants, funding these projects would become significantly more challenging.

Question 3: Is the description of secondary market trading of carbon credits accurate? Are all key market participants properly reflected?

Question 4: Should carbon credit ratings and data product providers fall within the scope of the recommendations within IOSCO's Report on ESG Ratings and Data Product Providers?

We agree that the description of secondary market trading of carbon credits is broadly accurate, although we consider that there are some aspects that are not fully reflected:

- **OTC trading and availability of public pricing information**: The Consultation Report comments (at section 2.3) on the fact that most trading of carbon credits is currently executed via OTC markets with little public pricing information available. While the Report does not suggest that the lack of public pricing information is a vulnerability in the VCMs, we would like to reinforce this point and note that while OTC markets (not just VCMs) typically have less publicly available pricing information than exchange-traded markets, this is generally considered to be appropriate given the bilateral and negotiated nature of transactions in OTC markets.

The negotiated nature of OTC transactions means that participants in OTC markets are typically sophisticated participants with sufficient knowledge and expertise to carry out the necessary due diligence before deciding to purchase a VCC. While pricing information may not be publicly available, participants can obtain quotes from multiple market intermediaries and make their decision to trade on that basis. This bilateral, negotiated approach is appropriate for markets where the product being traded is not highly standardised and where different products may have different features or risks that need to be reflected in the negotiated terms between the parties (as in the case with VCCs).

If regulators conclude that pricing information should be publicly available, it would be necessary to consider carefully what the impact of this might be on the nascent VCM, and whether a more effective approach might be to enable more trading to take place on trading venues where more pricing information is publicly available. Addressing the vulnerabilities identified in IOSCO's Discussion Paper as well as in the Consultation Report would support increased trading on trading venues, as would addressing the lack of standardisation and fungibility in the VCMs.

- **Role of financial institutions**: As with the section on primary market issuance, we would also welcome more emphasis on the role of financial institutions in secondary market trading. Section 2.3 describes financial intermediaries as playing an important role in facilitating trades between buyers and sellers, pooling client orders to facilitate trading activity, providing clients with market information and providing liquidity. We agree with this description but would welcome clear recognition of the role that financial institutions play in developing secondary markets. In particular, the paper states that "financial intermediaries are brokers", which is not always the case – financial institutions play a number of key roles in growing markets in VCCs, including providing finance to other investors, facilitating trading, market making and liquidity provision as well as developing products such as structured products to facilitate market access and providing hedging services. They may also engage in long-term or short-term investments in VCCs, although this is also true for a wide range of other investors in VCCs that are not financial institutions.

- **Recognising interactions with existing regulation**: Financial institutions and the services that they provide to their clients are already highly regulated. Similarly, derivatives markets are highly regulated in all major jurisdictions, and any regulation of carbon credits as an asset class should not duplicate or undermine this regulation.

- **Double counting**: IOSCO comments in section 3.2.1 on the potential for double-counting. We note that where IOSCO mentions double-counting elsewhere in the Report, this relates to the potential for underlying projects or emissions mitigation to be double-counted, rather than the risk of issued credits being double-counted. We agree that there is a potential risk of double-counting underlying projects – this is part of the issue being addressed in ongoing work on verification and reliability of credits. However, we do not consider that double-counting of issued credits is currently a material risk. IOSCO refers to the existence of multiple registries giving rise to the risk of double-counting of credits, but as credits are not currently transferable between registries this is not currently a risk. However, we do agree that a meta-registry would be helpful in providing a wider overview of the market, increasing the transparency of trading activity.

- **Conflicts of interest in secondary markets**: while we do agree that conflicts of interest in the carbon credit ecosystem are a potential vulnerability in VCMs, we note that where these arise in between traders and investors they are typically already addressed by existing regulation.

- **Standardised trading documentation for secondary market transactions**: we welcome IOSCO's recognition of the work that ISDA has undertaken to develop industry documentation for trading of verified carbon credits. A well-developed secondary market in VCCs is key to development of the VCMs. The development of standardised products in the secondary market helps to increase liquidity, transparency and price discovery, all of which are key ingredients for the development of a healthy market and which in turn help to increase the size and value of the primary market. Greater standardisation in the derivative markets is helping to scale VCMs and to develop safe, efficient carbon derivative markets. IOSCO quotes some commenters as stating that there may be no need to develop at the underlying project level the level of standardisation that is a feature of bond and equity markets, given the diversity of project types (and that this diversity is a positive and necessary development in VCMs). We support this statement – at the project level this is an evolving market with many different types of carbon reductions and removals, each with different atmospheric outcomes and different costs of production. It is important to distinguish between standardisation at the level of the underlying carbon project and at the level of secondary trading, and for any good practices to recognise that the needs of these two markets may be different.

While ISDA would be supportive of voluntary good practice recommendations for carbon credit ratings and data product providers, we would welcome further consultation from IOSCO if it intends to include these providers within the scope of the recommendations within IOSCO's Report on ESG Rating and Data Product Providers. In particular:

- In line with IOSCO's remit, any good practice recommendations should be clear that they relate only to carbon credit ratings or data product providers where they information they provide is used in connection with trading of carbon credits on financial markets or in connection with development of financial instruments. Other bodies (such as the ICVCM) have developed standards regarding the integrity and environmental effectiveness of carbon credits, and duplicative or competing principles would not add to the safety and soundness of these markets.

- Any recommendations should also be clear that they are voluntary principles only. VCMs and related products are in the early stages of development and seeking to regulate these markets to a similar standard to established financial markets is likely to slow their development and impose barriers to entry for entities that are not already participants in financial markets.

Question 5: Is the description of the use and disclosure of use of carbon credits accurate? Are the related supply and demand issues appropriately captured?

ISDA broadly agrees with the description of the use and disclosure of use of carbon credits.

IOSCO comments that market participants also include financial market intermediaries, such as investment banks, investment funds, and shorter-term traders or speculators. In this context, we welcome IOSCO's acknowledgement in section 2.3 that short-term trading and speculation is a normal part of trading in a healthy market.

While we support the development of good practices regarding transparency on use and impact of carbon credits in order to avoid greenwashing, we note (as IOSCO also notes in its Report) that significant work has been done by other bodies, including the ISSB, in this area.

Question 6: Is the description of Article 6 mechanisms and its potential relationship to VCMs accurate? If not, please provide additional information.

ISDA agrees that the description of Article 6 mechanisms and potential impact on VCMs is accurate. We also agree with IOSCO's comment that discussions on Article 6.4 are ongoing and multiple issues remain subject to negotiations and may take several years to conclude. On this basis, we consider that it is likely to be too soon for IOSCO to factor in Article 6 and its relationship with VCMs into any good practices.

Question 7: Are the Good Practices set out under the section on Regulatory Frameworks appropriate? Is there anything else IOSCO should take into account?

ISDA agrees that the Good Practices set out under the section on Regulatory Frameworks are appropriate.

However, IOSCO should aim to draw a clear distinction between the remit and powers of financial markets regulators and areas that may be more appropriately supervised in other ways. While many of the regulatory principles applicable to securities markets may be helpful in supporting VCMs, it will be important that financial regulation is focussed on issues in the financial markets rather than in the underlying projects. There are a number of bodies and authorities undertaking work on ensuring the integrity and environmental effectiveness of voluntary carbon credits, and this work should continue to be carried out by agencies with the appropriate experience – the work of financial markets regulators should be focussed on behaviour in VCMs rather than on the features of the voluntary carbon credits themselves.

IOSCO states that "the regulatory approach should seek to achieve regulatory outcomes for investor protection and market integrity that are the same as, or consistent with, those that are required in traditional financial markets". We agree that any regulation of VCMs should be consistent with regulation that already applies in traditional financial markets, in particular where there is overlap between VCMs and traditional financial markets. For example, if VCCs are traded on trading venues then they should be subject to regulation in a similar way to other instruments already traded on trading venues. Similarly, derivatives with VCCs as an underlying should be subject to regulation in a similar way to other comparable derivatives transactions. However, when considering how to categorise and regulate VCCs, regulators should consider whether securities-style regulation for OTC spot trading in VCCs is appropriate at this stage for a nascent, developing market such as VCMs, or whether it may have a stifling effect on development and may lead to barriers to entry for entities that are not already participants in financial markets.

Question 8: Are the Good Practices set out under the section on Primary Markets appropriate? Is there anything else IOSCO should take into account?

Question 9: Are existing disclosures, third-party standards, and/or industry best practices sufficient to ensure that investors are not misled as to the environmental or carbon emissions reductions benefits? Please identify specific regulations, standards, or practices and why they are sufficient.

Question 10: Are existing standards for certifying voluntary carbon credits sufficient to promote robust validation and verification of GHG emissions reductions/removals at the project level?

Question 11: Are there existing accounting-based approaches for establishing baseline scenarios for nature-based projects to help ensure the additionality of projects and avoid double counting?

Question 12: Are there existing best practices for modeling carbon emissions reductions related to nature-based projects that take into account the effects of climate change that could affect project permanence and efficiency in terms of meeting carbon objectives?

Question 13: Where issuance and trading of voluntary carbon credits is not subject to comprehensive regulation, how can the accuracy of disclosures around the carbon

emissions reductions benefits of voluntary carbon credits be more transparent to regulators?

Question 14: To address risks that low-quality projects could result in voluntary carbon credits that do not represent their promised carbon emissions reductions benefits, are disclosure-based standards sufficient to mitigate against misleading investors? Are there cases where even robust disclosure as to the underlying project quality, and therefore the quality of the carbon credits based on such project, would be insufficient to protect investors?

As ISDA's focus is on derivatives markets we do not comment in detail on the section on Primary Markets.

However, as noted above in our response, there are existing standards addressing the issuance of voluntary carbon credits (e.g., the ICVCM, which has published core carbon principles[1] aimed at ensuring the integrity and environmental effectiveness of voluntary carbon credits, and VCMI, which has developed a code of practice for carbon-related claims[2]) and there is ongoing work at an international level on project level regulation and disclosures. While further international standardisation would be helpful, we consider that this work should be undertaken by bodies focussed on the carbon markets (and with expertise in issues of environmental integrity, climate policy, science and technical assessments etc) and that IOSCO should continue to focus on the interaction between VCMs and financial markets rather than seeking to develop principles governing the project level.

We also note (as discussed below in relation to the Good Practices on Secondary Markets) that while registries do act as custodians of carbon credits, they are not involved (and should not be required to be involved) in trading activities in the secondary markets beyond recording changes in ownership. They do not have access to information on trading activity or pricing of VCCs and should not be subject to requirements in relation to this information (in the same way that custodians or central securities depositories in securities markets would not have access to this information).

Question 15: Are the Good Practices set out under the section on Secondary Markets appropriate? Is there anything else IOSCO should take into account?

We agree that the proposed Good Practices under the section on Secondary Markets are appropriate in relation to VCMs, and we welcome IOSCO's focus on regulators introducing requirements where this is consistent with their respective mandates.

We have the following additional comments:

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[1] https://icvcm.org/the-core-carbon-principles/

[2] https://vcmintegrity.org/vcmi-claims-code-of-practice/

- Regulation promoting transparency of trading should be calibrated to ensure that any transparency requirements do not present increased risk for market participants in potentially illiquid markets. If IOSCO intends to apply this principle to trading in compliance carbon credits it should clarify what type and level of transparency is intended here. For example, pre-trade transparency aimed at price discovery is unlikely to be appropriate for an illiquid, primarily OTC market whereas transaction reporting for derivative transactions in compliance carbon credits may give regulators sufficient information to exercise oversight over these markets without exposing market participants to undue risk.
- With respect to Good Practice 11 (Integrity of trading), we note that IOSCO suggests promoting requirements "to ensure that only carbon credits satisfying established and recognised standards for quality and integrity are eligible for trading on regulated venues". We would welcome clarification from IOSCO that regulated venues may place reasonable reliance on assurances by a credit programme or registry that meets international standards established by an independent body.
- With respect to Good Practice 12 (public reports), IOSCO recommends that registries should provide public reports on trading activity. However, this recommendation may be based on a misunderstanding of the role of registries in secondary markets. Registries are not involved in pricing or execution of transactions and so would not have access to the information that IOSCO is proposing they should disclose (and should not be required to have access to this information as this raises concerns regarding management of conflicts of interest among other things). We would also suggest that the information to be reported publicly does not go beyond the information that is published in financial markets, in order to avoid imposing obligations on carbon market participants that are more onerous than those imposed on financial market participants, and also to avoid imposing obligations to disclose information that has not been demonstrated to be meaningful to market participants.

  However, it may be helpful to encourage registries to obtain and publish information on retirement of credits (e.g., who is retiring them and for what purpose).

Question 16: Are the Good Practices set out under the section on governance and risk management appropriate? Is there anything else IOSCO should take into account?

We would welcome a clear indication from IOSCO as to how these Good Practices would interact with other existing frameworks, including existing regulatory requirements on governance and risk management already in place for financial market participants as well as frameworks specific to VCMs such as the ICVCM/VCMI frameworks.

Question 17: Are the Good Practices set out under the section on market abuse appropriate? Is there anything else IOSCO should take into account?

While we support IOSCO's objectives in supporting orderly markets in voluntary carbon credits and preventing fraud, some of IOSCO's proposed Good Practices would be more appropriate under a more general fraud or misrepresentation regime rather than being categorised as types of market abuse.

If IOSCO does intend that financial market regulators should extend the application of market abuse regimes to cover VCMs, we would recommend that any Good Practices in relation to market abuse should also clarify that they would only apply to trading activity that either takes place on a regulated trading venue or that has the capacity to impact trading on a regulated trading venue (in line with other existing market abuse regimes).

Question 18: Are the Good Practices included in this Consultation Report appropriate? Are there any Good Practices that IOSCO should consider modifying, removing, or adding in the final report? Please provide commentary on each of the Good Practices. Please explain your rationale.

We have commented on a number of the Good Practices already in our responses to the questions above, so would refer IOSCO to those comments rather than repeat them here.

In relation to Good Practice 21, we would welcome clarification from IOSCO that any disclosure obligation regarding an entity's use of carbon credits to achieve net GHG emission targets should be imposed on the relevant entity itself, and not on financial intermediaries that arrange transactions on behalf of the relevant entity. We understand that IOSCO's intention was for this disclosure obligation to fall on the relevant entity itself, and indeed this is how the ISSB disclosure standards have been implemented in jurisdictions such as the EU.

If IOSCO intends to retain this Good Practice rather than leave it to be addressed through implementation of the ISSB disclosure standards, IOSCO should clarify that this is a disclosure obligation for entities holding and using carbon credits, and not a disclosure obligation for other entities involved in secondary market trading (but not using carbon credits). Financial intermediaries will have no insight into or control over the use that a client or counterparty may make of a carbon credit that it purchases, or responsibility for monitoring this information, and it would not be appropriate to impose such an obligation on them.