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Environmental Economy Office  
Industrial Science and Technology Policy and Environment Bureau  
Ministry of Economy, Trade and Industry (METI)

Comments on the Carbon Credit Report (Draft)

The International Swaps and Derivatives Association (ISDA) <sup>1</sup> appreciate the opportunity to provide our views on the “Carbon Credit Report (Draft)” (“Draft Report”).

In this comment letter, we would like to focus mainly on “(3) To show directions of the carbon credit market in Japan” in “1.2. Purpose of This Report” in the Draft Report.

Summary

- ISDA welcomes the release of the Draft Report and the call for comments. It summarizes domestic and international trends in carbon credits and issues in Japan, and proposes basic directions and specific measures for their appropriate utilization. It is highly regarded as the first comprehensive compilation of carbon credits in Japan.
- ISDA supports the view that among initiatives for the appropriate use of carbon credits in Japan, initiatives for demands should be "Whether voluntary credits with corresponding adjustments applied in accordance with the rules of Article 6.2 of the Paris Agreement as is done so with JCM as well as whether carbon credits issued based on Article 6.4 can be utilized for Japan's NDC in the same way as JCM also are an issue to be considered" (footnote 30 in the Draft Report).
- ISDA will support the creation of a "carbon credit market" in Japan as a circulation initiative. In addition, we believe that it is important from the viewpoint of demand and circulation to develop a robust trading market for voluntary carbon credits ("VCCs"), strengthen the functions of derivative transactions that reference carbon credits, enhance the liquidity of derivative products, and enable companies to appropriately manage their own business risks.
- Derivatives play an important role in increasing transparency by providing forward-looking information on carbon credits, contributing to long-term and ambitious emission reduction targets, and providing useful signals to policy makers regarding the regulation of carbon credit prices<sup>2</sup>.

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<sup>1</sup> ISDA is a global industry association established in 1985 to make the global derivatives market safer and more efficient. As of May 2022, ISDA has over 980 members from 78 countries. These members comprise a broad range of derivative market participants, including corporations, investment management companies, government agencies, energy and commodities trading companies, financial institutions in various countries. In addition to market participants, members include key components of the derivatives market infrastructures, such as exchanges, intermediaries, clearing houses and repositories as well as law firms, accounting firms and other service providers.

<sup>2</sup> See “Role of Derivatives in Carbon Markets” published by ISDA (<https://www.isda.org/a/soigE/Role-of-Derivatives-in-Carbon-Markets.pdf>)

- Financial institutions play an important role in enhancing the functioning and liquidity of carbon credit markets. For example, financial institutions, as counterparties to operating companies, serve as intermediaries between buyers and sellers of carbon credits.
- The VCC trading market is global in nature. Therefore, it is important that the framework to be designed in Japan be consistent with global standardization efforts (e.g., by the Integrity Council for Voluntary Carbon Markets (ICVCM)<sup>3</sup>).
- To enhance the robustness of the VCC trading market, it is important to clarify the legal nature of the VCC<sup>4</sup>. As described in section 4 below of this comment letter, the legal nature of VCCs affects how VCCs are traded and what collateral can be taken, as well as the effectiveness of close-out netting at the time of bankruptcy of a party. The legal nature may also affect broader considerations, including regulatory, tax and accounting treatment of VCCs.

## Comments

### **1. Role and Importance of Derivatives**

As discussed in section "5.3. Importance of Pricing Function by Publicly Announcing the Price of Carbon Credits" of the Draft Report, providing price signals for carbon credits is important in a number of ways. Derivatives markets can also play an important role in increasing transparency through forward-looking information on the underlying asset, which can contribute to long-term reduction targets. Futures markets provide certainty about the future cost of emissions, thereby enabling firms to plan strategic investments in CO<sub>2</sub> emission reduction technologies.

Globally, pricing signals of carbon derivatives are also used in policy making to assess the effectiveness of emission reduction programs and ensure desirable outcomes, such as driving investment in renewables and use of less carbon-intensive fuels.

Investors can also use the price signals of derivatives transactions that reference carbon credits ("carbon derivatives") to assess climate transition risks, access liquidity pools to manage risks and allocate capital to benefit from energy transition opportunities. Asset managers can use carbon derivative to develop portfolios that meet the growing interest to invest in companies that are actively decarbonizing and avoid those that are carbon intensive.

Commonly traded types of carbon derivatives include futures, options and swaps. Futures and options are standardized products that are traded on exchanges and centrally cleared. Exchanges promote more liquidity, provide price transparency and act as financial intermediaries for a transaction.

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<sup>3</sup> See work on Core Carbon Principles and Assessment Framework by ICVCM <https://icvcm.org/integrity-council-announces-timetable-for-new-voluntary-carbon-market-standards/>

<sup>4</sup> See "Legal Implications of Voluntary Carbon Credits" (<https://www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf>)

OTC derivatives, on the other hand, allow market participants to customize their contracts more precisely to meet their particular risk management needs. For example, forward trading of carbon credits has the same structure as futures trading on exchanges, but it can be customized with respect to forward dates, for example, to meet the needs of individual companies. A forward transaction is a commitment to buy or sell a certain amount of carbon credits in the future and is usually settled by physical delivery of settlement of the underlying asset.

Although swaps are generally traded as OTC derivatives, they are contracts that promise the exchange of carbon credits or cash flows, etc. for a certain period of time and are usually settled by payment rather than physical delivery.

As noted above, carbon derivatives can be of many different types, but in terms of the type of underlying assets, in addition to transactions that reference a specific carbon credit, there are transactions that reference an index of the market price of the carbon credit (presumably with cash settled, if such an index is available). In other words, as the trading market for carbon credits develops and an index is constructed based on it, transactions referring to such an index will become possible. The establishment of such an index for the market price of carbon credits is essential not only for financial transactions that reference the index, but also for funds that use the index as a performance indicator, which will encourage the participation of a wider range of market participants, thereby contributing to further market liquidity and price transparency. As noted in footnote 28 of the Draft Report, "As the market matures and more consideration is given to futures contracts on carbon credits, this could lead to the issuance of longer-term price signals.", and the establishment of such an indicator would contribute to better risk management of carbon credit market price volatility.

While the Draft Report mentions consideration of futures products, we believe that consideration of spot, futures, listed and OTC products can all be interrelated and need to be comprehensive from the start-up phase.

In 5.3 of the Draft Report, the importance of the pricing function based on the price announcement of carbon credits is indicated, and 6.3.1 states the necessity of considering the price to be publicly announced. If the establishment of a futures market is to be considered, one of the options is to establish a futures market for cash settlement that qualifies for the delivery of certain carbon credits<sup>5</sup>, and to construct an index based on the futures price, assuming that the futures market is sufficiently deep.

## **2. Role of financial institutions**

Financial institutions, such as banks and securities firms, are expected to play an important role as intermediaries for transactions in the carbon credit market, transferring risk and improving liquidity and transparency.

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<sup>5</sup> Global Emissions Offset Futures (GEO, <https://www.cmegroup.com/trading/energy/cbl-global-emissions-offset-futures.html>), Nature-Based Global Emissions Offset Futures (N-GEO, <https://www.cmegroup.com/trading/energy/nature-based-global-emissions-offset-futures.html>) and Core Global Emissions Offset Futures (C-GEO, <https://www.cmegroup.com/markets/energy/emissions/cbl-core-global-emissions-offset-c-geo.html>) listed on the CME are leading examples, and its structure may be instructive.

These core functions would contribute to the transition of the market for bilateral carbon credit transactions, which is currently considered to be less transparent, to a fair and widely accessible liquid and transparent market. In particular, one of the important roles of financial institutions is to supply a wide range of risk money to the carbon credit market, which is expected to balance supply and demand in the market and form appropriate carbon pricing.

It is also expected that these financial institutions will further improve market price transparency by providing derivative trading liquidity to the market using carbon credits as reference assets and forward-looking information as price signals. As one of the demand-side initiatives to contribute to long-term sustainability goals, this would further incentivize the use of carbon credits in the market.

In addition, a well-functioning forward market with high trading liquidity provided by financial institutions will contribute to supply-side efforts by providing certainty about future emission costs, thereby contributing to strategic investments in emission reduction technologies.

As for efforts on the circulation side, it is noted that “with an expectation that ESG funds from around the world will be induced and that the market will grow as a movement to bring the information hub of the carbon-neutral era to Japan. In the future, it is recommended that both public and private sector players should consider not only the pricing effect of carbon credits, but also a broader form of carbon credit trading market that includes internationally recognized voluntary credits.” (the Draft Report 6.3.1). Financial institutions are expected to make a significant contribution to this effort by guiding ESG funds from overseas investors to Japan in the form of bond issues, loans, etc., and by mediating internationally recognized VCCs and derivative transactions that reference them with international counterparties.

### **3. Consistency with overseas VCC initiatives**

In “4.1 Issues involving demand” of the Draft Report, it is pointed out that there are many carbon credits exchanged in Japan, including J-Credit, JCM, and voluntary credits of overseas origin, and that the certifying entities and methodologies for each are also diverse. However, the trading market for VCCs is global in nature, and it is important that the framework designed in Japan be consistent with global efforts. For example, the Japanese initiative is required to ensure consistency with global standardization efforts such as the Integrity Council for Voluntary Carbon Markets (ICVCM).

In addition, guidance for market participants explaining the types of carbon credits and their appropriate use would help them better understand carbon credits and feel more comfortable using them for offsetting. Currently, there are multiple credit certification bodies, and it is unclear which one is trustworthy. In fact, there have been disputes over carbon credit certification and offsetting overseas in other countries. Some organizations are criticizing offsetting with carbon credits. This would make it difficult for market participants to use carbon credits for offsetting with confidence. The above guidance will also have important implications in the context of the disclosures proposed in the Draft Report. If carbon credits are used for offsetting in accordance with generally accepted industry guidance, market participants will be able to disclose them without any hesitation.

Consistency with efforts related to VCCs abroad could enhance market confidence in the quality of VCCs and address market participants' concerns about the environmental and reputational risks associated with voluntary carbon credit transactions. In addition, global legal standard-setters (For example, UNCITRAL or UNIDROIT) have a track record of working with other international organizations and regulators to develop legal guidance on a range of substantive law issues relating to a wide range of commercial transactions in all regions, and, given that Japan is a member of both UNCITRAL and UNIDROIT, can facilitate decision-making on environmental products in all jurisdictions together with other member jurisdictions. This allows ISDA and other industry organizations to develop legal opinions and standard documentation to support the VCCs. Market fairness, stability, and transparency are ensured as a system, and the legal certainty of transactions is ensured. This is an important premise for building a carbon credit market in which market participants can participate with confidence.

ISDA supports efforts to establish a carbon credit market in Japan, and if this initiative is implemented in accordance with the standard framework recommended by the ICVCM and others, Japanese companies and globally operating companies based in Japan will have an important tool in their corporate emission reduction efforts. In addition, legal clarity in the treatment of carbon credits under Japanese law would be an important point in establishing Japan as a hub for carbon credit trading. For example, global companies based in Japan are considered to manage GHG emission reductions based on global standards, so it is important that Japan's market and the carbon credits traded in it be consistent with international standards. In this respect, "6.1.1. Showing the roadmap for utilization considering the diversity of carbon credits" of the Draft Report lists up the four types of carbon credits, but if they are consistent with international standards and meet certain strict requirements (e.g., certification criteria, etc.), it may be possible to consider allowing them to be used in the voluntary carbon credit market, such as the GX League, regardless of which of the four types they fall under. As a result, participation of a wide range of market participants, both domestic and international, could be expected.

#### **4. Clarification of the legal nature of carbon credits and implications for regulatory, tax, and accounting treatment**

First, we believe it is important to clarify the nature of the voluntary carbon credit itself as an asset in terms of its legal, tax, and accounting treatment.

The "4. Issues to be tackled for the appropriate use of carbon credits in Japan" in the Draft Report identifies issues from three aspects: demand, supply, and circulation. While all of the issues presented here are considered to be true, we are aware that there are further issues to be considered from a practical standpoint in order to ensure that carbon credits are actually traded widely by various market participants. In the "6.3.2. Clarify legal, accounting, and tax treatment of carbon credits to ensure transaction stability" at the end of the "6. Direction and specific measures toward the appropriate use of carbon" section of the Draft Report, it is pointed out that "In order to promote the circulation of carbon credits in Japan, clarification of the legal, accounting, and tax treatment of carbon credit trading should also be considered." as an effort on the circulation side. It is very important to clarify these points at the circulation stage (Rather, it is essential to encourage financial institutions and investors to enter the market.). In addition, some of the matters that need to be considered include those that are deemed desirable to be coordinated by multiple ministries and agencies. We suggest that specific points to be considered be listed in 6.3.2 to serve as a reference for future discussions.

- What is the nature of carbon credits under Japanese private law?

With regard to transactions for carbon credits in which the actual delivery is made at a future point after the conclusion of the contract and derivative transactions involving physical delivery ("derivative transactions, etc."), the nature of such transactions under private law (for example, intangible property rights or a bundle of contractual rights) is an important issue, and a similar awareness of this issue has been shown in other jurisdictions<sup>6</sup>. For example, the legal nature relates to the following points: In January 2006, the "Legal Issues in Legislating a National Registry System under the Kyoto Protocol (Report)"<sup>7</sup> examined what kind of legal nature it would be appropriate to construct the credits under consideration in this report when they are considered to exist as property rights. Whether this view should be applied to carbon credits and whether further discussion is necessary are matters deeply related to Japan's private legal system. We hope that discussions will involve not only industry but also authorities, legal practitioners, academic experts, and others.

- (1) When carbon credits are transferred from one party to another, it is essential that the transfer associated with such transfer can be held up against third parties. What procedures are necessary for this purpose depends on what the legal nature of carbon credits is.
- (2) Given the possibility that the other party to a derivative transactions, etc. may fail during the transaction period and that multiple transactions may occur between the same parties, it is conceivable that in the event of default of one party, a so-called close-out may be conducted in which all transactions are closed and the present value of the closed transactions are settled on a netting basis (It is common not only in Japan but also globally for OTC derivatives transactions to be processed), and such close-out mechanism shall be deemed effective in insolvency proceedings commenced against the parties. The effectiveness of this close-out mechanism is important not only in managing risks to counterparties, but also for financial institutions in calculating the amount of risk-weighted assets under capital regulations. The effectiveness of the close-out mechanism is essential for the widespread trading of carbon credits. However, if the legal nature of the transaction remains unclear, the effectiveness of the agreement will also be unclear.
- (3) If carbon credits are widely traded, the availability of carbon credits would be further enhanced if carbon credits can be used as collateral. To this end, it is necessary to clarify which jurisdiction's law should be used as the governing law (in the case of cross-border transactions), whether rights should be transferred or collateralized, and what procedures are necessary to provide countervailing requirements and to protect rights. The legal nature of carbon credits needs to be clarified as a basis for this clarification.

- Are Japanese financial institutions allowed to deal in carbon credits under their regulations?

As mentioned above, the involvement of financial institutions such as banks and securities companies in the carbon credit market can improve the liquidity and transparency of the market. There is a strong

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<sup>6</sup> See ISDA publication shown in footnote 4.

<sup>7</sup> See <https://www.env.go.jp/council/28kyoto-gitei/y280-kentou.pdf>

demand for financial institutions to be allowed to enter the carbon credit market. Currently, transactions related to carbon credits are not subject to regulations in Japan, but financial institutions subject to regulations in Japan may be restricted in their business activities under the relevant regulatory laws (For example, the Banking Act and the Financial Instruments and Exchange Act). Therefore, consideration of such business regulations is inevitable. For example, in the case of a bank or a Type I Financial Instruments Business Operator, etc. , if carbon credits fall under "carbon dioxide equivalent quota as defined in Article 2, Paragraph 7 of the Act on Promotion of Global Warming Countermeasures (Act No. 117 of 1998) and other equivalents)," cash-settled derivative transactions and sales and purchase transactions, as well as intermediation, agency, or representation of such transactions, are permitted<sup>8</sup>. The Financial Services Agency is of the view that individual judgment is required to determine the applicability of this rule<sup>9</sup>, but the criteria to be applied in making such judgment are not clear.

Therefore, it is desirable to either relax the above regulations or clarify the criteria for their application in order to encourage financial institutions to enter the market. In addition, even under the current system, a framework could be developed to indicate carbon credits that are allowed to be traded collectively, rather than having each financial institution confirm them individually. For example, if it is determined that high quality carbon credits to be traded on a newly established exchange in Japan fall under the above-mentioned "carbon dioxide equivalent quotas or other equivalents," this would clear regulatory concerns.

Furthermore, even if a clear conclusion is not reached regarding the nature of carbon credits under Japanese private law, if the treatment and positioning of carbon credits under the regulatory law are clarified, it is likely to give a sense of security to trading participants and improve the liquidity of trading itself, as is the case with digital money and crypto-assets.

- What is the accounting treatment of carbon credits and transactions that reference carbon credits?

Accounting standards need clarification, as noted in Table 16 on page 29 of this Draft Report. For both financial institutions as intermediaries of transactions and investors as suppliers of risk money, it would be difficult to hold exposure to carbon credits without clarification of accounting standards, and as a result, the form of transactions would be limited.

The Accounting Standards Board of Japan (ASBJ) PITF No. 15, "Tentative Treatment of Accounting for Emission Trades" (last revised on June 23, 2009), prescribes a tentative accounting treatment for credits under the Kyoto Mechanisms ("emission credits") as stipulated in the Kyoto Protocol, which came into effect in February 2005. Under this treatment, investments in emission credits are considered to be

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<sup>8</sup> See Article 10, Paragraph 2, Items 14 and 15 of the Banking Act, Article 13-2-3, Paragraph 1, Item 2 (Financial Derivatives Transactions) and Article 13-2-5 (Acquisition of carbon dioxide equivalent quotas, etc.) of the Ordinance for Enforcement of the Banking Act, and Article 68, Items 16 and 17 of the Cabinet Office Ordinance on Financial Instruments Business, etc.

<sup>9</sup> See "Results of Public Comment, etc. on the Draft Cabinet Order and Cabinet Office Ordinance on Financial Instruments and Exchange Legislation, etc." dated July 31, 2007 by the Financial Services Agency (<https://www.fsa.go.jp/news/19/syouken/20070731-7.html>), page 218, No.55 and 56, and "Results of Public Comment on the Draft Cabinet Order and Cabinet Office Ordinance, etc. for Partial Revision of the Financial Instruments and Exchange Law, etc. in 2008" (<https://www.fsa.go.jp/news/20/20081202-1/00.pdf>), page 64, No. 23 and No. 24.

business investments, not financial investments, if there is no active market for trading emission credits. On the other hand, there is a guideline stating that if there is an active market in which emissions credits are traded and a firm conducts transactions as financial investment, it shall be assessed at market value as inventories held for trading purposes. If we consider the nature of VCCs by referring to the purpose of the Guidelines, it can be understood that the presence of liquidity determines whether they are financial assets. However, from the viewpoint of room for future market development, it would be desirable to clarify that VCCs themselves are financial assets for tax and accounting purposes, based on the requirement that a certain robust OTC or exchange market be established, rather than on whether they are liquid or not.

## **5. ISDA's efforts to revitalize carbon credit markets**

ISDA is currently working on industry standard documentation for the VCC trading market. Specifically, the ISDA Energy, Commodities & Developing Products Group is preparing a template for VCC spot and forward transactions based on the ISDA Master Agreement. In developing the template, ISDA has been working closely with the International Emissions Trading Association (IETA) and certain regional trade bodies.

In Japan, the ISDA Japan ESG Task Force and Working Group have been established with the following agenda.

- (1) Sharing global activities (i.e. updates on global ESG-related policy developments and activities in ISDA Working Groups)
- (2) Updates on the progress of ESG-related policy developments in Japan
- (3) Discussions of ESG-related derivatives in Japanese market, interacting with other ISDA ESG working groups by giving feedback from Japan as appropriate, and dialogues with relevant authorities as necessary

More specifically on (3) above,

- (a) Discussions of the market design of the “carbon credit market (exchange)” under METI’s GX League concept (the role played by financial institutions such as banks and securities companies) and the role to be played by carbon credit and its derivative products in the OTC market in light of the establishment of such market
- (b) Consideration of the legal nature and issues (e.g., bankruptcy legislation, netting, collateral), regulatory and accounting treatment of VCCs (and derivatives that reference VCCs) under Japanese law
- (c) Japanese regulatory considerations relating to sustainability-linked derivatives (SLDs)

End.