November 2, 2023

Voluntary Carbon Credits: Recent Legal Developments

BACKGROUND

A large number of companies globally have announced net zero greenhouse gas ("GHG") emissions targets, most of which are likely to require some form of carbon offsetting. Many consumers are also interested in offsetting their carbon footprint. The development of this market has been constrained by the absence of national mandatory emissions systems. However, the past few years have seen a sustained increase in the issuance of voluntary carbon credits ("VCCs"). The supply of VCCs has grown to 246.9 MtCO2e in 2022 from 38.6 MtCO2e in 2015, with projections for the VCC market to grow further to a global value of $250 billion by 2050. However, demand for VCCs has not kept pace with supply, and the use or retirement of VCCs actually decreased in 2022 relative to 2021. Regulators and market participants have argued that this disconnect is driven by, among other things, (i) a lack of standardized regulations pertaining to the issuance and validation of VCCs, (ii) a lack of transparency and questions regarding market integrity and (iii) market fragmentation that makes it difficult to differentiate high-quality carbon credits from low-quality ones. This memorandum highlights the divergent efforts to address these perceived deficiencies.

CALIFORNIA LEGISLATION: VOLUNTARY CARBON MARKETS DISCLOSURES ACT

On October 7, 2023, California Governor Newsom signed into law the Voluntary Carbon Markets Disclosure Act (AB 1305) ("VCMDA").[1] This bill requires that a business entity that is marketing or selling voluntary carbon offsets within the state of California must disclose on its website (i) detailed information about the applicable carbon offset project (such as location, timeline, dates, third-party validation, emissions reduced or carbon removed on an annual basis), (ii) details regarding accountability measures in case the project is not completed or does not meet the project emissions reductions, and (iii) the pertinent data and calculation methods needed to independently reproduce and verify the number of emissions reduction or removal credits issued.[2]

Further, an entity that operates within California and makes claims within California regarding the achievement of net zero emissions, claims that the entity, an affiliate, or a product is "carbon neutral", or claims that it has made significant reductions to its carbon dioxide or GHG emissions, must disclose on its website detailed information on GHG emissions associated with those claims, including (i) all information documenting how, if at all, any such claim was determined to be accurate or actually accomplished, (ii) how interim progress towards that goal is being measured, and (iii) whether there is any accompanying third-party verification of the company data and associated claims.

In addition, if an entity that makes the claims described above also purchases or uses voluntary carbon offsets, it must also disclose on its website detailed information with respect to such offsets, including the entity selling the offset and the offset registry, the offset project type and site location, the specific protocol used to estimate emissions reductions or removal benefits, and whether there is independent third-party verification of company data and associated claims.[3]

The VCMDA will become effective on January 1, 2024, and requires relevant disclosures to be updated no less than annually. Any person who violates the VCMDA will be subject to a civil penalty capped at $2,500 per day for each day that relevant disclosure is not available or is inaccurate on its website, subject to a cap for each violation of $500,000.[4]

However, on October 7, 2023, Governor Newsom vetoed the Voluntary Carbon Offsets Business Regulation Act (SB 390), which would have regulated the quality of voluntary carbon offsets. In vetoing this bill, Governor Newsom stated his support for the bill author's intent to "address the problem of so-called 'junk offsets'", but expressed concerns with imposing civil liability for "even unintentional mistakes about offset quality".

For further information regarding the Voluntary Carbon Markets Disclosure Act or either the Climate Corporate Data Accountability Act or the Climate-Related Financial Risk Act, which were enacted by California at the same time, please see our client memo here.

US FEDERAL DEVELOPMENTS

The Commodity Futures Trading Commission has regulatory authority over the derivatives markets in the United States (including, for example, voluntary carbon emissions offset futures) and anti-fraud and anti-manipulation authority over spot commodity markets (including the VCCs market), as well as the derivatives markets. In July, CFTC Chairman Rostin Behnam announced work on guidance addressing standards in the voluntary carbon markets. Given Chairman Behnam's emphasis on the CFTC's "important policy responsibility to promote product innovation, price discovery, and liquidity for high-quality carbon credits that are the underlying commodity for derivatives products listed on CFTC-registered exchanges", the guidance likely will encompass the full variety of participants in the VCCs market.

Pending the forthcoming regulatory guidance, the CFTC has recently taken other steps affecting the VCCs market. For example:

- On June 29th, the CFTC announced the formation of an Environmental Fraud Task Force within its Division of Enforcement with the goal of "combat[ing] environmental fraud and misconduct in derivatives and relevant spot markets". According to the CFTC, the task force will seek to investigate fraud, including the sale of VCCs that overstate carbon mitigation effects, manipulation of tokenized VCCs or the sale of fake VCCs. Specifically, Director Ian McGinley emphasized that the task force would "focus on addressing fraud and manipulation in carbon credit markets and other forms of greenwashing, including material misrepresentations about ESG investment strategies".
- Earlier in June, the CFTC's Whistleblower Office issued an alert calling on market participants to report information on fraudulent behavior in the VCCs market. According to the CFTC, such behavior may include, among other things, "manipulative and wash trading, 'ghost' credits, double counting, fraudulent statements relating to material terms of carbon credits".

Also, the US Federal Trade Commission is anticipated to update its Green Guides, having sought public comment on the issue of environmental marketing claims. The current Green Guides specifically addresses marketing claims related to VCCs, and the FTC has sought public comment on proposed modifications to the Green Guides to improve the efficiency, costs, benefits and regulatory impact of the Green Guides.

DEVELOPMENTS OUTSIDE OF THE US

Regulators outside of the US also issued guidance and directives in the past year focused on VCCs and associated issues of greenwashing. These include:

- On June 23, 2023, the U.K. Advertising Standards Authority published updated guidance helping advertisers interpret U.K. rules on environmental-related advertising. The guidance advises advertisers to avoid making unqualified "carbon neutral" or "net zero" claims, and where claims are based on offsetting, that they comply with applicable standards of evidence for objective claims and provide information about the offsetting scheme used.
- On March 22, 2023, the European Union proposed an anti-greenwashing directive that would require Member States to ensure that advertisers who make explicit environmental claims carry out an assessment about such claims. This assessment should rely on widely recognized scientific evidence and include primary information available to the trader for environmental impacts.
- In addition, on November 30, 2022, the European Union proposed a voluntary EU-wide framework for quality certification of carbon removal processes, based on a QUALITY criteria: Quantification, Additionally, Long-Term Storage and Sustainability of the carbon removal activity. The proposal also includes requirements for third-party verification and certification of carbon removals.

ISDA DEVELOPMENTS

In December of last year, the International Swaps and Derivatives Association ("ISDA") released its 2022 ISDA Verified Carbon Credit Transactions Definitions with the goal of providing standardized definitions and provisions for agreements in the VCCs market. ISDA has included definitions for, among others, each of "Verified Carbon Credit", "Carbon Standard Rules", and "Registry" with sample provisions providing for settlement, delivery and payment obligations and representations and warranties associated with the verified carbon credits. These definitions, as drafted, are intended to be agnostic to any further

developments of new climate standards. It remains to be seen whether the ISDA documentation will be adopted widely in the market.

IMPLICATIONS FOR MARKET PARTICIPANTS

The growth in the VCCs market has resulted in greater regulatory efforts to standardize and scrutinize VCCs in order to ensure that the market is efficient and fair to all market participants. As such, market participants, including project sponsors that issue voluntary carbon credits, companies that purchase carbon credits to offset emissions and registries and brokers that help facilitate the market for such carbon credits, should closely monitor regulatory developments globally.

As documentation for, and disclosure of, VCC-related transactions has not yet standardized across the market, buyers, sellers and brokers should carefully consider what contractual protections they will have for any transaction and scrutinize any corporate disclosures they make (whether in securities filings or not) on GHG and carbon-related targets, figures and calculations to assess whether the disclosures are clear, accurate and complete and in compliance with any applicable law. In particular, entities marketing or selling voluntary carbon offsets within California or operating within California should assess the applicability of California's VCMDA to their operations, and provide website disclosure meeting the requirements on or before the January 1, 2024 effectiveness date. Entities subject to U.S. federal securities laws or other securities regulatory regimes, particularly those that are listed on a national securities exchange, should ensure that they have appropriate disclosure controls and procedures in effect around their disclosures, as any statements made in response to the VCMDA may subject the entity to liability under U.S. federal or other securities laws for false and misleading statements of a material fact.

Finally, market participants should be prepared for increased enforcement activity. Among other things, we expect enforcement authorities to scrutinize carbon-related public statements (particularly in marketing materials), and to evaluate whether these public statements match up with the on-the-ground practices of the business. For issuers of VCCs, this could mean scrutiny of statements and conduct related to the offsetting activity. For purchasers, this could mean inquiries related to the feasibility of achieving certain carbon-related goals and their relationship with issuers, particularly if regulators identify concerns in those issuers' underlying activity. And regulated market participants, in particular, should be prepared for authorities to evaluate their policies and procedures to test whether they are appropriately tailored to monitor compliance with regulatory obligations and to ensure business practices are in line with public statements.

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ENDNOTES

[1] California Assembly Bill 1305, https://legiscan.com/CA/text/AB1305/id/2841701. See our publication, dated October 12, 2023, on the recently enacted California climate disclosure bills for additional information.

[2] *Id.* 44475(a).

[3] *Id.* 44475.1.

[4] *Id.* 44475.3.

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