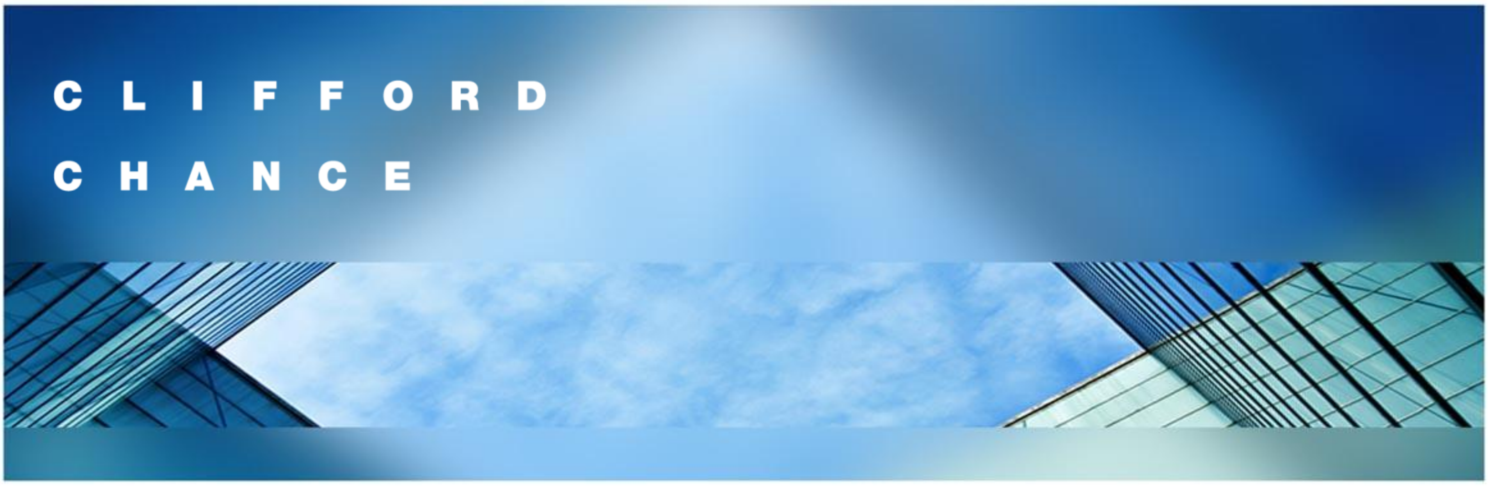

ISDA RELEASES NEW DOCUMENTATION FOR SECONDARY MARKET TRADING IN VOLUNTARY CARBON CREDITS

Voluntary carbon credits ("VCCs") play an important role and incentive for parties investing in projects that aim to reduce carbon emissions or remove carbon from the atmosphere. Market interest in VCCs has also expanded in response to an increasing demand for offsetting carbon credits by entities who have climate change goals outside of mandatory schemes. A corporate or government, for example, may wish to access the voluntary carbon markets to purchase VCCs so as to hold, trade or retire them.

Standard documentation for secondary trading in VCCs is key to increasing trading activity and building liquidity. With this aim in mind, ISDA has now published documentation to cover secondary trading in VCCs - the 2022 ISDA Verified Carbon Credit Transactions Definitions ("VCC Definitions").

ISDA initiatives and the working group

In response to growing interest in the voluntary carbon credit market, ISDA published a whitepaper on VCCs in December 2021. This paper focussed on the legal treatment of VCCs and considered challenges associated with trading VCCs and potential regulatory issues, recommending an approach to improve the legal characterisation for VCCs across a number of key jurisdictions.

The paper also recommended development of standard OTC documentation for secondary market trading, and an ISDA working group met over 2022 to develop this documentation.

The working group discussed a number of points, including:

- The nature of the representations regarding title to the delivered VCCs. The discussion reflected the concerns that carbon representations could imply the delivered VCC constituted a property right (which may be unclear in certain jurisdictions);

Key issues

- VCCs are generated in order to provide funding to various projects that remove carbon from the atmosphere or reduce carbon emissions.
- The VCC market differs from the mandatory carbon schemes (such as the EU Emissions Trading System ("EU ETS")). The mandatory schemes are mostly accessed by parties required by law to purchase carbon credits.
- The 2022 ISDA Verified Carbon Credit Transactions Definitions consist of a definitions booklet with a set of pro forma Confirmations, providing terms for secondary market trading of physically settled VCC spots, forwards and options.
- The VCC Definitions were initially expected to follow the ISDA EU ETS Part 7 documentation but a different approach was taken as there are a number of key differences between the two markets (and within the VCC Market itself).
- In particular, the terms may be used to govern the trading of many VCC types and the provisions are intentionally drafted widely. For example, provisions regarding delivery are registry agnostic to avoid referencing the rules of a specific Carbon Standard Organisation.
- Parties will also need to consider a number of regulatory issues including whether licensing requirements may be triggered, as well as the scope of existing netting opinions.

- the allocation of risk if a VCC is cancelled;
- whether representations regarding the quality or fitness for purpose of the delivered VCC should be given; and
- the potential for the buyer to be able to offset a VCC.

Documentation overview

The early draft VCC terms were based on the Annex for documenting EU ETS transactions (the "ETS Annex") and the original proposal was to include these as a further "part" to the Schedule of an ISDA Master Agreement. However, in the end the decision was taken to have VCC Definitions to provide more optionality and because VCC are a less established product than EUAs, allowing the documentation for the VCC market to adapt as the product develops. It is expected the VCC Definitions will facilitate the development of market standard terms.

The documents consist of a definitions booklet and a set of pro forma Confirmations providing terms for physically settled VCC spot, forward and option transactions. The VCC Definitions adopt a similar approach to other ISDA spot final option terms but enable parties to make a number of elections depending on the relevant VCC type and their desired outcomes. The VCC Definitions have now been published on ISDA's "MY Library", including in a digital format which should facilitate prompt and efficient updates as the market develops.

Key features of the VCC Definitions

Specifying the VCC

On the specified Delivery Date the Delivering Party will agree to deliver the stated number of Required VCCs to the Receiving Party's Registry Account (unless "Retirement" applies – see further below). The Required VCCs shall be VCCs conforming to the "Agreed VCC Specification", detailed in the Confirmation.

The Agreed VCC Specification can be very narrowly defined, with the Confirmation providing for specification of the Carbon Standard Organisation, Registry, Project, Host Country, VCC Type, Methodology, Co-Benefit Program and Carbon Standard Label (Co-Benefit Label, Market Eligibility Label, Vintage and Reporting Year). Any of these fields may be left blank, allowing flexibility for the Delivering Party to determine the Required VCC. However, given the range of pricing assigned to VCCs in the secondary market depending on the features of the credit in question, it is anticipated that (at least initially) parties will define the assets subject to the trade very carefully.

The parties can further specify whether the VCC is transferred with or without "environmental attributes", meaning any rights, interests or benefits attaching to or associated with the relevant underlying project (such as a claim regarding the enhancement of the environment).

Settlement Approach

Delivery

Delivery of VCCs by the Delivering Party is effected by delivery to the Receiving Party's Registry Account (or through "Retirement" – see further below) with payment due from the Receiving Party within an agreed number of business days following Delivery. Provision is made for partial settlement of trades, recognising the valid delivery of a limited quantity of the required number of VCCs, notwithstanding that the total required number is not delivered. Parties will make a number of elections to tailor the settlement provisions to their specific requirements, including in relation to:

- "Multiple Delivery Dates", in which case a Transaction will be deemed to consist of a number of Transactions;
- "Possible Early Settlement", providing the Delivering Party with the option (but not the obligation) to deliver at any point in time in advance of the specified delivery date; and
- Netting, which may be specified to be applicable between VCCs of the same Agreed VCC Specification and deliverable between the same Registry Accounts on the same day.

Retirement

The Parties may elect to apply "Retirement" to a Transaction. Where this applies, instead of requiring settlement via its Registry Account as described above, the Receiving Party may (by delivering a Retirement Instruction prior to specified Retirement Cut-off Time) direct the Delivering Party to arrange for the permanent removal of the VCC from circulation. This approach is only likely to be utilised by counterparties who wish to offset the greenhouse gas reductions represented by the VCC against its own emissions and allows such counterparties to avoid the administrative burden of establishing multiple Registry Accounts in order to take the benefit of investing in a range of VCCs.

Carbon Standard Organisations

- Since the quality of VCCs can vary and be difficult to assess, certain standard-setting organisations ("Carbon Standard Organisations") have established themselves in the market to provide quality assurance in respect of the project that is issuing the carbon credits.
- Once a project is certified as meeting the relevant criteria for that Carbon Standard Organisation, it will be eligible to issue a VCC for each tonne of carbon dioxide it reduces or removes from the atmosphere. The VCCs can then be traded via the relevant Carbon Standard Organisation's registry system, with delivery taking place within the registry.
- The Carbon Standard Organisations perform a variety of roles in the origination and trading of VCCs. Each develop their own specific criteria for assessing the VCCs. Together with independent third-party verifiers they then review the projects against the criteria. They also operate the registry systems that issue the VCCs, providing their unique ID numbers, keeping record of the owners of the VCCs. The VCCs will be subject to the registry's rules on matters such as their holding, transfer, retirement, and cancellation.
- Interoperability between registries is limited, as adherence to specific carbon standards and rules means that VCCs cannot be transferred between them.
- The Carbon Standard Organisations can be international or governmental regulatory bodies, or even independent NGOs, and include names such as the American Carbon Registry, the Gold Standard and the Verified Carbon Standard Organisation.

Settlement Disruption

Existing users of the ETS Annex will recognise the "wait and see" approach of the settlement disruption provisions within the VCC Definitions, even though these have been significantly simplified. Three scenarios are envisaged by the VCC Definitions (summarised below). In each case no Event of Default, Potential Event of Default or Termination Event will occur on the basis of such event, but alternative consequences will apply.

Scenario	Events	Consequences	Remediation	Termination
VCC Settlement Disruption Event	An event or circumstance beyond the control of the affected party (an "SD Affected Party") which makes it impossible or impracticable for such party to deliver or receive the Required VCCs, e.g. disruption of the relevant registry.	Delivery and payment obligations will be deferred until the earlier of the cessation of the event, or the settlement disruption longstop date (agreed between the parties or 30 days). If the VCC Settlement Disruption Event continues beyond the settlement disruption longstop date, termination applies.	Not applicable	An Additional Termination Event (under a 1992 Master Agreement) or an Illegality (under a 2002 Master Agreement) will occur. All Transactions affected by the VCC Settlement Disruption Event will be Affected Transactions and each SD Affected Party shall be an Affected Party.
Failure to Deliver	The Delivering Party fails to deliver the Required VCCs.	Consequences depend on the cause of the failure to deliver: 1) the Receiving Party's non-performance under the ISDA Master Agreement, the existence of an Illegality or a Force Majeure, or following a Bankruptcy of the Delivering Party - the provisions of Section 6 of the ISDA shall apply. 2) An on-going VCC Settlement Disruption Event - VCC Settlement Disruption Events (as above) applies. 3) Other causes – Remediation or Termination.	Receiving Party notifies the Delivering Party and requires the failure to be remedied. If the failure is remedied within the relevant timeframe, the Delivering Party will pay default interest with respect to the delay.	If the failure to deliver is not remedied the Receiving Party may terminate the Transaction. The Receiving Party then calculates the Early Termination Value. This consists of (i) the difference between the price of the Required VCCs under the Transaction and the market price under an arms-length transaction, (ii) default interest and (iii) reasonable costs and expenses of the Receiving Party. The Delivering Party pays this if a positive number and the Receiving Party pays this if a negative number (unless "One-way RP ETV" is specified as applicable, in which case no amount shall be payable by either party).
Failure to Receive	If the Receiving Party fails to take any steps that are necessary to enable the Delivering Party to deliver the Required VCCs.	As above, but with references to the Delivering Party and Receiving Party reversed.		

Allocation of Risk

Representations

The standard representations included in the VCC Definitions, which apply on each delivery date, are relatively narrow in scope and the parties may elect that these will only be made by reference to the actual awareness of the Delivering Party. Representations include (amongst other things) a confirmation that the VCC being delivered conforms to specifications agreed in the confirmation, but do not include any assurance as to the eligibility or suitability of the VCC.

Where "Retirement" is specified, certain additional representations will apply. On the basis that a Receiving Party will be offsetting the VCCs against their carbon emissions, rather than simply holding them, these additional representations have been included to provide a further level of comfort that the relevant VCCs have been validly issued in accordance with the relevant Carbon Standard Organisation's rules and that the underlying project is not subject to any claims or allegations regarding its integrity.

Cancellation

The default position under the VCC Definitions is that post-Delivery, the risk of cancellation should sit with the Receiving Party. However, in light of working group discussions around this issue, the VCC Definitions include an option to switch this position. Parties may therefore specify "Delivering Party Cancellation Risk" as applicable, in which case the Delivering Party shall remain liable for any direct loss of the Receiving Party upon cancellation of the Required VCCs.

Parties will therefore have much to consider from a legal and commercial perspective when negotiating the above provisions.

Developing a trading environment

Entities using the VCC Definitions will need to take a number of key steps and consider various issues involved with the trading of VCCs. These include the following:

- **Establishing the Internal Trading Infrastructure** - setting up the trading systems, providing internal training on products and documentation, playbooks and escalation procedures, developing a house approach for Confirmations and accessing the relevant registries. There will also be compliance issues and consideration of relevant tax issues.
- **Adjustment to Settlement Conventions with respect to VCCs** - entrants to the VCC markets will have to adjust to the settlement terms for VCCs, including a payment following delivery as well as the possibility of a partial settlement and approach to delivery caused by settlement disruptions.

- **Regulatory Categorisation of VCCs** – Questions remain regarding the regulatory categorisation of VCCs and it is likely there will be some variation between jurisdictions in settling this question. This is relevant to a number of issues, including applicable licensing requirements, applicable tax regimes, the potential application of mandatory margin payments and/or risk mitigation techniques.
- **Industry Legal Opinions** – Counterparties are likely to require the expansion of existing legal opinions to address the enforceability of close-out netting arrangements for VCCs.

Regulatory Issues for Trading in VCCs

Two of the key issues raised with the voluntary carbon markets have been how to ensure the quality and integrity of carbon credits, and whether secondary trading in carbon credits needs to be regulated.

Integrity of carbon credits

There are ongoing discussions at an international level about establishing an independent governance body to oversee the integrity of the voluntary carbon market (potentially including a UN platform for trading VCCs), and also establishing international best practice for Carbon Standard Organisations.

Financial regulation and VCCs

Unlike EUAs or UKAs, spot VCCs are not a regulated financial instrument under MiFID in the EU or under the Regulated Activities Order in the UK. But that does not mean that they fall outside the scope of financial services legislation altogether – where they are traded by regulated firms, those firms will be subject to general requirements around management of conflicts of interest and prevention of mis-selling, for example, and trading in spot VCCs may be regulated in individual EU Member States.

However, derivatives on VCCs may be regulated financial instruments in both the EU and UK, meaning that entities trading in VCC derivatives would need to understand what licensing requirements may be triggered (or what exemptions may be available) and whether they need to comply with other obligations (e.g., reporting and margin under EMIR).

IOSCO also published a discussion paper in November 2022 seeking feedback on potential approaches to develop sound and well-functioning VCC markets, including the possibility of regulating spot carbon markets in the same way as securities markets.

But at the same time there is also a push to limit the participation of regulated firms in this space, with carbon credits attracting one of the highest risk weightings under the Basel III framework and EU regulators considering extending the position limit regime to cover a wider range of derivatives, potentially including VCC derivatives.

A Digital Asset?

The Law Commission of England and Wales published a Consultation Paper on Digital Assets in July this year (the "Paper"). This extends to over 500 pages of analysis on the applicability of current property law in relation to digital assets and includes recommendations to "ensure that the law recognises and protects digital assets". In the context of seeking to ensure legal certainty to support the use and development of digital assets, the paper raises the question of whether there is, or should be, a third category of personal property – Data Objects – and proposed criteria for determining how assets (such as digital assets) can be identified as these.

Although the Paper focusses its attention on digital assets it also considered if the same criteria could mean VCCs would be data objects. The Law Commission's view was that VCCs were capable of satisfying the first two criteria, that is, being represented in an electronic medium (i.e. composed of data) and capable of independent existence from persons and the legal system, but the third category proved more problematic and is likely to need to be addressed on a case by case basis. This third category is the requirement of "rivalrousness" (i.e., that only one person can use the piece of personal property at a time).

Whilst some parties responding to the Paper may question the approach, it raises an important observation. As the legal characterisation and regulatory treatment of digital assets continues to evolve it will be necessary for the VCC market to keep focus on the application of any legal or regulatory developments that impact digital assets in case these also have an impact on the development of the VCC market.

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