TheCityUK

IOSCO Consultation Report on Voluntary Carbon Markets: TheCityUK Response

About TheCityUK

TheCityUK is the industry-led body representing UK-based financial and related professional services. We champion and support the success of the ecosystem, and thereby our members, promoting policies in the UK, across Europe and internationally that drive competitiveness, support job creation and enable long-term economic growth. The industry contributes over 12% of the UK's total economic output and employs nearly 2.5 million people, with two thirds of these jobs outside London, across the country's regions and nations. It is the UK's largest net exporting industry and generates a trade surplus exceeding that of all other net exporting industries combined. It is also the largest taxpayer and makes a real difference to people in their daily lives, helping them save for the future, buy a home, invest in a business, and protect and manage risk.

Executive Summary

- IOSCO should focus on guidance for voluntary carbon markets (VCMs) that brings best practice from financial and commodity markets.
- For carbon markets to operate in a similar way to other primary markets, carbon credits should be based on outturn data which evidences verified carbon impact.
- Regulatory frameworks and market tools that exist in financial market infrastructure are well-established and should be used to effectively manage carbon markets in a way that maintains participant and regulator confidence.
- IOSCO should prioritise issues that relate to the secondary market and to the integrity of primary issuers, which could have an adverse effect on the secondary market.
- Carbon markets are global in nature. International alignment and consistency in regulatory frameworks and standards will be crucial to ensure they function effectively.
- We support existing initiatives and frameworks that have emerged to add greater standardisation and integrity to the market at an international level.
- IOSCO should help coordinate current market initiatives and convene relevant stakeholders to ensure international alignment and consistency in the development of regulatory frameworks and standards for VCMs.
- Regulators need to establish reliable frameworks and infrastructure for the settlement of carbon credits to build and maintain market confidence.
- Registries must be held to a similar level of protection as the regulated financial market. They are a critical part of the value chain and should be subject to standard operating principles.
- IOSCO should consider further work on the custody of carbon credits and addressing the reliability and security of registries.
- TheCityUK considers the Good Practices set out in the Consultation Report to be broadly appropriate. We encourage IOSCO to consider and follow financial markets best practice and regulation where possible.

Role of IOSCO

With regards to voluntary carbon markets (VCMs), TheCityUK considers that IOSCO should focus on bringing best practice from financial and commodity markets. We recommend that IOSCO prioritise issues that relate to the secondary market and to the integrity of primary issuers, which could have an adverse effect on the secondary market.

International initiatives such as the Integrity Council for the Voluntary Carbon Market (IC-VCM) and the Voluntary Carbon Markets Integrity Initiative (VCMI) have emerged to address primary market integrity and add greater standardisation to the market. The IC-VCM has taken steps to improve supply-side integrity to the market through establishing a standard for high-quality carbon credits through the Core Carbon Principles and associated Assessment Framework. Similarly, the VCMI has done much work to address integrity on the buy side through the development of its Claims Code of Practice which sets guidance on how carbon credits can be voluntarily used and claimed by buyers as part of credible net zero strategies. It is important to also recognise the work of the California Air Resources Board (CARB), the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), and the Oxford Offsetting Principles. IOSCO should take steps to support the work of such international initiatives. For example, by defining what is required for the secondary market to operate effectively and engaging with international standard setters and supervisors who will enable the primary market.

TheCityUK also considers that IOSCO should play an important role in the overall coordination of current market initiatives to address potential vulnerabilities. IOSCO could convene relevant stakeholders to drive the development of appropriate regulatory frameworks and infrastructure to support the effective functioning of VCMs, given its interface with financial markets and regulators across the globe.

Existing regulatory frameworks and market tools

TheCityUK considers that the regulatory frameworks and market discipline tools that exist in financial market infrastructure are well-established and should be used to effectively manage carbon markets in a way that maintains participant and regulator confidence.

Existing regulatory frameworks for derivatives and commodities should apply to derivatives where the carbon credit is the underlying asset. Robust regulation of derivatives already exists in major jurisdictions and any regulation of carbon credits as an asset class should not duplicate or undermine this regulation. Furthermore, we encourage IOSCO to leverage existing initiatives for issuance and claiming to create standards for quality and integrity of carbon credits, for example CORSIA and the IC-VCM.

Many of the issues raised by IOSCO in Chapter 3 of the report that relate to issuance and conflict of interest in secondary markets are not unique to VCMs. We consider that these issues should be dealt with using similar tools and systems currently available in financial markets. For example, IOSCO should look to respond to conflicts of interest in the secondary market that arise from traders being on both sides of the market through existing regulation that covers commodity markets.

We consider the settlement side of the market to be the area that requires most attention from regulators. It is the aspect of the market that is new and where market participants have concerns relating to the risk of fraudulent activity and greenwashing. To build and maintain market confidence, regulators need to establish a reliable framework and infrastructure for the settlement of carbon credits. TheCityUK encourages IOSCO to focus on this aspect of the market.

Registries and custody

TheCityUK regards registries to be the key segment of the value chain that is currently lacking oversight and standard operating principles. Registries are the touchpoints between spot and derivative markets and a key part of settlement and delivery. The infrastructure in the underlying market needs to be strengthened so that exchanges can meet emerging regulatory expectations, for example the Commodity Futures Trading Commission (CFTC) proposed guidance for the listing for trading of voluntary carbon credit derivative contracts.

We encourage IOSCO to focus on addressing the reliability and security of registry providers. Registries are critical to carbon markets and should be subject to standard operating principles, including operational, privacy and cyber-security protections. This would help address the risk of fraudulent activities. Furthermore, the notional value of assets held in carbon registries is likely to increase over time. Therefore, it will be important to hold such registries to a similar level of protection as the regulated financial market.

We would welcome further work from IOSCO on custody and registries for carbon credits, drawing on experience in applying IOSCO principles for digital assets and principles for price reporting agencies (PRAs). We consider that IOSCO is best placed to develop standard operating principles for registries used for settlement in carbon credit derivative contracts.

Consultation questions

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?

We regard the terminology used in the Consultation Report to be commonly understood amongst carbon market specialists. Chapter 1.3 would benefit from being clear that it considers CORSIA and other jurisdictional offset compliance schemes to be part of Compliance Carbon Markets (CCMs) in the table.

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Carbon credits can be used by companies for offsetting purposes, to contribute to a claim, or they can be used in some compliance regimes like CORSIA, Singapore, and California. The key difference is that the use of offsets in CCMs is driven by domestic or regional legislation, whereas VCMs are not.

We also note that the term 'baseline-and-credit' is often used interchangeably with 'project-based mechanism'. Project-based mechanisms involve generating fungible carbon credits by implementing emissions-reduction or removal projects.

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

TheCityUK considers the description of issuance to be accurate. We assess that many issues that IOSCO identifies with primary market issuance should be left to bodies such as the IC-VCM. The current process for issuing carbon credits is largely the same as the process followed by each of the standard setters (as well as the planned United Nations Framework Convention on Climate Change (UNFCCC) Article 6.4). However, the process for issuance is largely paper based at present, with no data standards, and considerable supply-side bottlenecks in the market. Additionally, there is currently a lack of standardisation of the process to an agreed, high-quality benchmark and proper implementation of the rules governing the methodologies. These issues are affecting the quality and trust of buyers in the market.

TheCityUK agrees with the way in which IOSCO has described the role of insurance companies, and that they will be an important stakeholder in the future to promote investment and create greater trust in carbon markets. As the asset class matures, carbon credit projects that are insured are likely to command higher prices as they will be perceived as a safer investment. Alongside insurers, financial institutions will also play a valuable role through providing assurance of climate impact. Therefore, we assess that insurance companies and other financial guarantors (such as financial institutions) will increasingly play an important role in the market in terms of mitigating risk and signalling quality to investors.

We encourage IOSCO to note the need for involvement of the host country where the mitigation activity is taking place. This does not specifically refer to the Paris Agreement mechanism but the implementation of regulatory standards and supervision. IOSCO should encourage relevant authorities responsible for climate markets to set rules and exercise oversight to ensure market integrity. IOSCO could consider establishing principles and good practices to assist with this. More consistent oversight and governance by the host country that reduces market risk could help ensure carbon credit projects deliver carbon impact and are disclosed adequately and priced accordingly.

IOSCO should also work with other international bodies (such as the UN and the World Bank) to collectively help create the right end-to-end carbon market frameworks to incentivise investments and protect ownership of assets across different countries.

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

TheCityUK considers financial participation to be crucial for carbon markets to function effectively. Our report, *'Global carbon pricing mechanisms and their interaction with carbon markets'*, highlights the role financial intermediaries play in compliance markets and the output of this report could also be applicable to VCMs. The development of standardised products has helped increase liquidity, transparency, and price discovery. These are all key ingredients for the development of a healthy market and to increase the size and value of the primary market. It would not be possible to set up a primary market without a vibrant secondary market.

Regulated exchanges can play a significant role in the ongoing development of VCMs by working to create the infrastructure that will help carbon markets work more efficiently, assist with price formation and transparency, and increase standardisation and integration of various markets in the long-term. Key components of the exchange-trading value chain include standardisation, transparent central limit order books and/or auction markets and clearing and settlement. We consider it is also important to have robust and resilient post-trade processes, to support market integrity, mitigate risk and increase liquidity.

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?

TheCityUK considers that where information is being used to calculate the value of a carbon credit being used on a regulated exchange or market place, carbon credit ratings and data product providers should fall within scope. Carbon credit rating providers provide a valuable service in helping buyers to understand the difference between projects and project developers. However, due to the inconsistency of their models, there needs to be standardisation and consistency of approaches in order for the ratings to be recognised by market participants.

Individual country supervisors are currently approaching the supervision of ratings and data product providers without an international framework. IOSCO should consider providing guidance in this space. However, we also recognise that there is a role for carbon crediting programs and bodies like the IC-VCM, VCMI and the Science Based Target Initiative (SBTi) to play here.

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

We consider that the Good Practices relating to regulatory frameworks are broadly appropriate. In designing regulatory frameworks, regional regulators must recognise that carbon markets are global in nature and look to existing initiatives that are already in place. Initiatives have already emerged to add greater standardisation to the market at an international level, such as the IC-VCM and VCMI. However, IOSCO has a central role to play in bringing regional regulators together with other organisations to ensure international alignment and consistency in regulatory frameworks and standards for VCMs.

Scaling carbon markets requires improving carbon credit liquidity, which in turn relies on increasing fungibility through recognised standards and aligned regulation. IOSCO should encourage regional regulators to engage with existing bodies already addressing carbon market standards at an international level. Common international standards on auditing, certification, and registration of ownership of carbon credits will help overcome some of the key challenges, such as varying levels of perceived integrity. Appropriate regulation will also encourage greater investor confidence and integrity of carbon credits.

However, TheCityUK considers that it will also be important to avoid the risk of regulatory overreach. Carbon markets are a nascent and rapidly developing market, and we must ensure regulation is proportionate so as not to stifle and undermine this growth. Care must also be taken to ensure that agility and flexibility in the market is maintained. Furthermore, many of the practices, such as having relevant skills and competence, should already be standard business practice.

Specific comments relating to Good Practices 1 and 2 are outlined below:

- **Good Practice 1: Regulatory approach and scope.** The regulatory approach should seek to achieve regulatory outcomes for investor protection and market integrity that are the same, or consistent, with those that are required in traditional financial markets.
- **Good Practice 2: Regulatory treatment.** Where possible and consistent with their respective mandates, relevant regulators and authorities should consider ways to provide clarity regarding the regulatory treatment of carbon credits.

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

We consider the Good Practices set out under the section on primary markets to be broadly appropriate. Standardisation will be crucial to the credibility and transparency of the market. Comprehensive disclosures will be an important part of this so that market participants have clarity on what they are buying.

Specific comments relating to Good Practice 5, 6 and 8 are outlined below:

- **Good Practice 5: Standardisation.** Carbon markets are international in nature. Therefore, an international approach to standardisation is preferable. Development of jurisdictional or regional taxonomies will not be beneficial to the development and scaling of VCMs. However, it will also be important to recognise that the market is, and will remain, heterogeneous because of the different approaches governments and regulators will take to the market, however it is important for IOSCO to support consistency where possible. We recognise that there are different types of carbon reductions and removals, with different costs of production, however the carbon impact should be consistent in terms of CO_2e removed or avoided.

How the market evolves in terms of "standardisation" will remain to be seen and will largely evolve through the choices made by market participants. The following areas would benefit from greater standardisation, however these areas will require involvement of different actors: (i) data on project performance, (ii) methodologies for calculating performance, (ii) verification and attestation of projects, (iv) contracts, (v) regulations, and (vi) reporting (financial and non-financial).

- **Good Practice 6: Transparency.** Transparency around the creation of a carbon credit should be facilitated between the project developer, financier, and issuer of the carbon credit. Information related to the project and carbon life cycle is made available by the crediting program through their website and the registry. Standards and methodologies which are issued by crediting program operators and the related process are already subject to a public consultation process, allowing developers, validation and verification bodies (VVBs), corporate buyers of carbon credits, scientists, market participants, rating agencies and other stakeholders to raise matters which may impact carbon credit quality and integrity. The public scrutiny of standards and methodologies is an important part of the development and maturing of the market. Given the public consultation processes already in place, we do not consider further action by financial regulators to be necessary.
- **Good Practice 8: Soundness and accuracy of registries.** Registries are critical to carbon markets. A registry operator tracks the generation, ownership, and retirement of credits. Given the integral role of registries, we consider that they should be subject to standard operating principles. To scale carbon markets with integrity, IOSCO should leverage the tools, governance, systems, and controls that exist for custodians of financial market infrastructure.

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.

As it relates to financial statements, disclosures are 'advancing' in this area. There has been awareness raising of the importance of risk disclosures in financial statements, and major standard setters (such as the International Accounting Standards Board and the Financial Accounting Standards Board) have taken on reporting and disclosure projects tied to the impact on climate on financial reporting (inclusive of carbon credits). However, we believe their objective/mandate should not be considered as the key litmus test, rather it is the responsibility of those designing sustainability disclosures.

More broadly, we recognise that there are various industry initiatives already taking steps to improve the integrity of the market and ensure carbon credits deliver real and additional benefits. We support the development of the IC-VCM's Core Carbon Principles, the VCMI's Claims Code of Practice, the Oxford Offsetting Principles and work from CORSIA and CARB to promote supply side and demand side integrity.

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?
Outturn performance data that evidences verified climate impact of a carbon credit, rather than forecast removal or avoidance, is central to a scalable primary market. Therefore, it is important that we move to a market that is based on outturn data going forward.

There needs to be greater standardisation and harmonisation of existing standards for certifying voluntary carbon credits, as well as general improvements in quality overall. This will help build trust in the market, which will encourage greater fungibility, trading of credits and liquidity in carbon markets. There needs to be a significant maturing of the following areas in particular: (i) the standards by which credits are issued, and a rationalisation of them; (ii) the processes for verifying against standards; (iii) consistent data standards; and (iv) clarity as to what should be measured, and a focus on carbon impact.

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?
Market participants should follow the VCMI Claims Code of Practice and the International Sustainability Standards Board (ISSB) standards as appropriate. Auditors need to provide guidance on use and disclosure of carbon credits aligned with ISSB standards. However, market participants need to recognise that there is a difference between the disclosure standards themselves, and the accuracy of the information being disclosed. We consider that the market needs to be better able to derive the data to substantiate what is being disclosed on the carbon emissions reductions benefits of carbon credits.

Capacity building within regulators is crucial in enabling greater transparency around the benefits and appropriate use of carbon credits. This is an area where regulators should engage with international counterparts and learn from best practice.

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 consider the Good Practices set out under the secondary markets section to be broadly appropriate. We encourage the guidance to follow existing financial markets best practice and regulation where possible.

Specific comments relating to Good Practice 11 are outlined below:

- **Good Practice 11: Integrity of trading.** IOSCO comments that “only carbon credits satisfying established and recognised standards for quality and integrity are eligible for trading on regulated trading venues.” We would like to highlight that the market is still waiting for the first labels of the Core Carbon Principles to be granted by the IC-VCM and this recommendation could delay trading. The IC-VCM is not the only international framework and carbon credits (for example Voluntary Carbon Offsets) which have been issued by credit programs (such as Verra and the Verified Carbon

Standard) and are compliant with one or more international (private or public) framework should be considered sufficient quality and eligible to be used as the underlying derivative.

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 consider the Good Practices set out under the governance and risk management section to be appropriate. We encourage the guidance to follow existing financial markets best practice and regulation where possible.

Specific comments relating to Good Practices 15, 16 and 17 are outlined below:

- **Good Practice 15: Governance framework.** Market participants should have in place comprehensive governance frameworks with clear lines of responsibility and accountability for the functions and activities that they are conducting.
- **Good Practice 16: Risk management.** Market participants should have effective enterprise risk management frameworks in place to address any potential operational or technological risks associated with the trading or provision of services relating to carbon credits.
- **Good Practice 17: Conflicts of interest rule.** Rules should be established to address the conflicts of interest raised by the issuance, verification, certification, transfer, and retirement of credits. This could include establishing policies and procedures to address and mitigate conflicts of interest pertaining to carbon credits, with prohibitions of the most problematic conflicts of interest. Any policies should include adequate disclosures regarding legal or beneficial relationships between project developers, validation and verification bodies, carbon crediting programs, registries, market places and exchanges, and intermediaries. This is a good example of an area where IOSCO principles for registries and custodies could make a difference.

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

We consider the Good Practices set out under the market abuse section to be appropriate. The guidance should follow existing financial markets best practice regulations where possible. We also support the development of private initiatives such as the IC-VCM and VCMI to tackle market abuse and caution against duplication of approaches globally.

Specific comments on Good Practice 21 are outlined below:

- **Good Practice 21: Disclosure of carbon credits use.** Participants should follow the VCMI Claims Code of Practice and the ISSB standards as appropriate. Auditors need to provide guidance on use and disclosure of carbon credits aligned with ISSB standards.

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.

The Good Practices set out in IOSCO's Consultation Report are broadly appropriate. We have included specific commentary on the individual Good Practices in our responses to the questions above. We would like to underscore the need for any guidance from IOSCO to follow existing financial markets best practice and regulation where possible. We would also encourage IOSCO to focus attention on specific aspects of the market infrastructure where further guidance would support the integrity of the market and build greater market confidence.

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