Grantham Research Institute on Climate Change and the Environment

Response to the IOSCO consultation on voluntary carbon markets

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March 2023

Grantham Foundation for the Protection of the Environment

LSE The London School of Economics and Political Science

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About this submission

In November 2022, the Board of the International Organization of Securities Commissions (IOSCO) published a discussion paper on voluntary carbon markets (VCMs), inviting feedback on the approach that regulatory authorities and market participants could take to foster sound and well-functioning voluntary carbon markets. The discussion report can be found here: **https://www.iosco.org/library/pubdocs/pdf/IOSCOPD718.pdf**

This report consists of a submission to this consultation written by Rob Macquarie and Valentin Jahn on behalf of the Grantham Research Institute on Climate Change and the Environment at the London School of Economics and Political Science. The response was submitted on 10 February 2023. The version presented here has been lightly edited.

Authors' note

The evidence in this submission is drawn from research for the **Independent High-Level Expert Group on Climate Finance**, the **Climate Change Laws of the World database** and wider programme on litigation and governance, and the **Transition Pathway Initiative (TPI) Global Climate Transition Centre**, which is hosted by the Grantham Research Institute. The Institute works closely with the Integrity Council for the Voluntary Carbon Market (ICVCM), the UK Voluntary Carbon Markets Forum, carbon credit ratings agencies, and national and local decision-makers in many lower-income countries where carbon credits will be generated. These experiences and engagements have also informed the content of this submission.

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Acknowledgements

The authors of this submission gratefully acknowledge inputs provided by Tiffanie Chan and Bob Ward, and review of the draft by Natalie Pearson.

The views expressed in this report represent those of the authors and do not necessarily represent those of the host institutions or funders. The authors have no relevant financial or non-financial interests to disclose.

This report was first published in March 2023 by the Grantham Research Institute on Climate Change and the Environment.

Suggested citation: Macquarie R and Jahn V (2023) *Response to the IOSCO consultation on voluntary carbon markets*. London: Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science.

Summary points

- Voluntary carbon markets (VCMs) have the potential to provide important financial flows to mitigation activities that can also help to drive sustainable development. But rules, regulation and infrastructure to enable this are still emerging. The International Organization of Securities Commissions (IOSCO) has a key role to play in facilitating the development of an environment in which VCMs function well and deliver positive impacts.
- IOSCO can facilitate a 'road to regulation' to consolidate best practice in VCMs into general norms, as called for by the UN's High Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities. Guidance and principles are expected to be released in 2023 by private initiatives (chiefly the Integrity Council for the Voluntary Carbon Market, the Voluntary Carbon Markets Integrity Initiative and the Science Based Targets Initiative), which are likely to increase transparency, harmonise data templates and ensure safeguards are in place. This will in turn lead to greater integrity in the issuance of carbon credits and the claims that buyers make about their climate impact. IOSCO should collaborate with these bodies to support the broad adoption of their guidance by stakeholders and to align with any early rules from public regulators.
- New information services will also help to transform VCMs. These include ratings agencies, meta-registries and data providers tracking carbon credit transactions and retirements. Market regulators must pay attention to how these services are developed and integrated, including conditions for open and fair access, to ensure accountability and to prevent malpractice.
- Communities affected by activities in VCMs should have a seat at the table in any bodies established by IOSCO for monitoring and surveillance. Human rights abuses threaten market stability via legal and reputational risk. For example, Indigenous communities have had their rights infringed by some projects selling carbon credits. Rules for trading platforms should also include requirements to set and evaluate social and environmental safeguards for credit issuance.
- Market participants need to adopt strong practices to guard against corruption risks and market manipulation, and IOSCO members should consider how to enforce these. Corruption and fraud could undermine carbon markets via malpractice in monitoring, reporting and verification, extractive government approval processes for projects, and opaque transactions.
- Companies should disclose their use of carbon credits, including key attributes like the volume of credits used, their year of issuance (vintage), type, provenance and serial numbers for identification in registries. IOSCO members should set rules supporting sufficient and transparent disclosures, and could seek to integrate such rules into any emergent regulations on net zero transition plans.

Question 1: Is our description of the issuance of carbon credits accurate? Have we properly reflected all key market participants?

Ratings agencies are only discussed in a relatively minor clause and footnote within the consultation document (p. 10), yet they will play a key role in delivering a high integrity, well-functioning carbon market. These agencies sit between buyers and carbon brokers/retailers or exchanges. Independent ratings add legitimacy to reliable certifications. Some market observers consider carbon offset programmes to face a conflict of interest, as there is an incentive for them to certify the credits that they will receive payment from. By contrast, ratings agencies do not necessarily receive payment from credit issuance. Ratings add value to decision-making as they synthesise data from credited projects and issuing programmes, and allow market participants to view a spectrum of credit quality (rather than binaries such as certified/not certified). However, for these agencies to gather and process data reliably requires transparency at the level of issuance. They will therefore benefit from greater harmonisation of certification methodologies, which are currently highly varied and opaque (see e.g. Arcusa and Sprenkle-Hyppolite, 2022). This is one anticipated positive effect of a shift in practices to comply with the Integrity Council for the Voluntary Carbon Market (ICVCM) Core Carbon Principles (CCPs).

Global or regional meta-registries of carbon credits are not strictly 'market participants', but they play a crucial oversight role and as such should have a regular, consistent interface with crediting programmes and exchanges alike. IOSCO should consider these as players in issuance and in the market, particularly since comparable services are being developed by different private and public organisations, and they will interact in a market-like manner. As the consultation document points out, these services are important to prevent issues related to double counting of credits and other anomalies.

National governments will also play a growing role in credit issuance, even in the voluntary market, and can take a variety of approaches in terms of overarching strategies and legal and regulatory frameworks (Clifford Chance, 2022; Gold Standard and EY, 2022). The consultation document recognises the implicitly supportive role of governments via the legal nature of carbon credits. Another crucial mechanism will be domestic laws and requirements affecting approval and/or authorisation in the context of the Paris Agreement's Article 6 and emissions accounting for Nationally Determined Contributions.

Regulation should also provide increased clarity on due diligence standards for players involved in the 'Carbon Credits Ecosystem' (p.9); for example, the due diligence required of third-party auditors, and how this may differ from the duty of credit buyers (as end users).

Question 2: Has the consultation identified the relevant vulnerabilities? Are there any others that should be considered? Please explain.

Further consideration is needed of the role of ratings, both in safeguarding credit quality and environmental integrity, and in influencing market sentiment and expectations. Measures could include:

- Sufficiently open access to the use of ratings, involving transparent fees and other conditions.
- A minimum degree of transparency around the methodologies employed by ratings agencies, just as the consultation document identifies for certification standard bodies. Clearly, methodologies cannot be fully standardised as the firms operate in a competitive market for their services, which creates beneficial incentives to refine and improve their tools.
- Clear integration of ratings into a market framework focused increasingly on trading of standardised contracts through exchanges. If market participants trade in derivative products, including options and futures, how will the carbon risk of such products be

measured? Without a tight link between credit-level risk assessments and derivatives, this could lead to a build-up of carbon risk in complex derivatives that could threaten market integrity.

All centralised trading platforms and exchanges should require all sellers of carbon credits to demonstrate environmental and social safeguards and benefit distribution systems. For instance, Indigenous Peoples must be able to grant free, prior and informed consent for any activities affecting their rights. Indeed, human rights violations by carbon credit projects have recently been reported for REDD+ projects in some countries (Greenfield, 2023). Benefits from credit-issuing projects and programmes, which include direct income from credit sales as well as co-benefits like job creation and improved climate resilience, should be shared fairly and transparently with local communities in sustainable and culturally sensitive ways (Collison, 2022). Failure to apply safeguards and distribute benefits widely represents a material risk to market functioning, including via delivery risk for projects and programmes, reputational risk for market participants and potential litigation challenges.

Corruption is a potential risk affecting credit issuance in some countries. Points of vulnerability include but are not limited to: approval processes for projects; certification of credits; credit authorisation by governments (in the case of Article 6); and trading, whereby political interests could drive preferential sales of some kinds of credits to certain clients (particularly where governments have taken an active role). Market participants must have strong protocols to guard against corruption, which could be mandated to access trading. The bureaucracy necessary for administering an effective carbon market must not lead to capture by special interests.

In relation to integrity concerns highlighted in the consultation document (Section 3.1.2.1), prosecutors will also have a role to play. For example, in the UK there have been some enforcement actions against fraudulent carbon credits (which are in the public domain).

Regulation should play a role in ensuring that transactions processed at exchanges are recorded and logged in meta-registries, and that competing services in this space are interoperable in terms of the key features required for effective market surveillance and price discovery.

Question 3: During IOSCO's roundtables, key stakeholders and industry participants expressed some concerns with respect to the lack of coordination between environmental regulators and securities markets regulators, highlighting the need for better coordination of industry-specific organizations and global standards. What kind of role could IOSCO play in coordinating the actions of industry-specific organizations and public authorities?

IOSCO is in a unique position to convene securities agencies and commodity regulators to address challenges in scaling up voluntary carbon markets in ways that preserve environmental, social and economic integrity. Convening these organisations is vital for global standardisation (or, at minimum, interoperable standards) in carbon market activity, guidance and regulation.

Question 4: How do you think IOSCO should achieve these objectives?

IOSCO can also promote work on carbon markets onto the agenda of influential international bodies (e.g. the G20, through its Sustainable Finance Working Group), to facilitate broad participation in integrity initiatives and supportive government policy.

Climate finance and carbon market-related fraud issues should become part of the mainstream practices of financial regulators and fraud authorities so that they are considered at the same level as more traditional areas of financial fraud. Sharing knowledge and best practice, and capacity building exercises (e.g. training workshops on data sources for carbon markets), are steps that IOSCO could take to benefit members in this regard.

Question 5: Should IOSCO seek to collaborate more closely with these private initiatives? How might such a collaboration function?

Collaboration with private initiatives is important to interpret market participant behaviour. It is not the role of IOSCO to develop standards for carbon credit or programme integrity. However, the VCM continues to suffer from a fragmented landscape of approaches and rival claims to superior integrity. Understanding where gaps between different approaches are most salient will be vital to then create relevant standardisation or disclosure requirements.

Private initiatives such as ICVCM and the Carbon Credit Quality Initiative can advise based on their extensive experience of reviewing different methodologies. The ICVCM benchmark is explicitly dynamic and iterative: the CCPs will have phased requirements, and compliance will be checked and updated over time. Therefore, regulation of the carbon credit market will need to adapt to changes in standards that arise in response to new evidence on the impact of credits (either direct impacts of projects and programmes or the impact of their use on buyers' decarbonisation strategies).

It is unclear why VCMI is not identified explicitly in Section 4 (iii), where "any other private-sector carbon offset standards body for demand side of the VCM" is referred to. IOSCO should support VCMI to become the de facto, highest global standard on the use of carbon credits. IOSCO members could form working groups to develop harmonised, mandatory requirements (such as company disclosure of volume, type, certification, compliance with ICVCM CCPs, and year of issuance, or vintage, of retired credits). To this end, it will be necessary to include advertising regulators and financial regulators responsible for scrutinising climate-related disclosures in IOSCO member jurisdictions, to exchange knowledge and align tools.

IOSCO could establish a forum for member organisations to regularly engage with these leading coalitions and discuss the evolution of data and best practice in relation to carbon market integrity. Crucially, any forum of this kind must include representation from stakeholder groups and communities that are directly affected by carbon credit projects or programmes. Human rights and socioeconomic impacts are material for the soundness of these markets, as identified in the response to Question 2.

Question 9: Should IOSCO recommend good practices regarding transparency on the use and impact of carbon credits by market players?

Transparency on the demand side is essential for the VCM to achieve net positive impacts. Disclosure by buyers is one important element. Here, companies or other actors publishing net zero targets and transition plans should also disclose the attributes of the carbon credits they have used. This should cover: the volume of credits retired in each reporting period; whether those credits are retired in order to offset emissions in that period – and the scope of such emissions; the vintage, type and geographic origin of all credits retired; and alignment with any certifications (including ICVCM Core Carbon Principles). IOSCO should align with the VCMI's final guidance in this regard. As in the response to Question 5, IOSCO should then seek to implement a pathway to translate this guidance into mandatory regulation.

Ongoing research by the TPI Global Climate Transition Centre on disclosures by corporates using carbon credits for offsetting indicates that disclosure around credit purchases, banking and retirement is largely absent, and where it does exist it is usually superficial. This lack of transparency is of particular concern where companies claim to already have achieved 'carbon neutrality'. Investors need to be able to establish the magnitude of the role of offsetting in companies' overall climate-related disclosures (i.e. quantity of retired credits), the serial numbers of credit transactions, and key quality indicators (such as type, certification, vintage, purchase price and origin). Without information on companies' plans to use offsetting and the quality of purchased carbon credits – in other words, whether the company is externalising its transition costs to third parties and whether such partners produce credible emissions reductions or negative

emissions – investors will not be able to properly understand the reputational risks or transition risks affecting the companies in which they invest. Requirements to disclose the retirement of carbon credits should be linked to disclosure requirements relating to companies' overall transition plans and the envisioned role of carbon credits. An example of leading practice regarding credit retirement can be found in AGL Energy's disclosure (Climate Active, 2021: p.12).

Once buyer-side disclosure becomes widespread and credible, it will become possible to incorporate downstream companies' use of legitimate, high-quality offsets for their respective scope 1 emissions in other companies' scope 3 emissions disclosures, (e.g. a credit retired by an airline could then be feasibly counted towards the scope 3 emissions of the oil and gas company that provided the fuel).

A second element of demand-side transparency concerns registries, where information on retirements is generated and stored. Currently, the standard of information on the end users of credits is poor, requiring extensive analysis to interpret it (AlliedOffsets, 2023). By contrast, there is almost no information available about how a credit changes hands between issuance and retirement, obscuring the role of intermediaries, which in many instances may retire credits on behalf of end users. This opacity complicates the task of linking market activity to companies' marketing claims using carbon credits and poses a barrier to price discovery. Standardisation of registry rules, for instance, (requiring clearer attribution of any retired credits to a beneficiary and requiring all registered accounts to be made public) would improve market monitoring by public regulators and private information providers alike.

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