IOSCO Consultation Report on Voluntary Carbon Markets

March 2024

On 3 December 2023, the International Organisation of Securities Commissions (IOSCO) published a Consultation Report with proposals to promote the integrity and the orderly functioning of the Voluntary Carbon Markets[1](VCMs). These recommendations are aimed at the regulators and other relevant authorities, while also to market participant, the objective being to back jurisdictions in which VCMs already exist and those intending to promote them. IOSCO's document focusses on the aspects relating to the integrity of financial markets, market infrastructures and the behaviour of the participants.

This work is part of the sustainability initiatives promoted by the IOSCO Board's Sustainable Finance Task Force. In this area, Compliance Carbon Markets (CCMs) have also been analysed, the Final Report on these being published in July 2023. Although the latter represent the greater part of the carbon market, an upward trend can be observed in VCMs with two billion dollars traded in 2021, five times that in 2017, as the commitment with long-term net zero emissions increases. However, since 2022 a fall can be observed in this market, which could be caused by the doubts regarding the quality of the carbon credits and their real contribution towards a reduction in greenhouse gas emissions.

The document describes the carbon credit ecosystem and the market structure, while proposing 21 good practices based on the proposals of the discussion paper of November 2022, the comments received, together with financial market oversight knowledge and experience of IOSCO members. The good practices take into account existing principles for markets that function correctly, such as IOSCO's Objectives and Principles of Securities Regulation. This work is aimed at the development of solid market structures, in such a way that carbon credits can be traded in an orderly and transparent manner. An efficient functioning of these markets is considered essential to progress in the ecological transition and to attain environmental objectives, such as the reduction of CO2 emissions.

The Consultation Report provides, on the one hand, a proposed set of good practices and, on the other, it notes certain relevant aspects unrelated to the integrity of financial markets and which are beyond the powers of the regulators, such as the environmental integrity or carbon credit standardization; the interoperability of VCM registries; or the legal treatment of carbon credits, describing some initiatives in these areas. The deadline for submitting comments is 3 March 2024.

[1] Market mechanism to put a price on emissions and encourage the reduction of CO2 emissions into the atmosphere or allow for emission compensation through climate change mitigation projects. In VCMs, carbon markets cover emissions in the primary market and the secondary market of carbon credits through centralized and decentralized trading (bilateral or OTC). Appendix 2. Glossary. CR06/2023 Voluntary Carbon Markets (iosco.org)

Pregunta

What are the Voluntary Carbon Markets and how do they work?

Respuesta

VCMs are markets where entities buy carbon credits for voluntary use (e.g., to offset carbon emissions or finance climate change mitigation activities). Carbon credits are usually issued regarding activities or projects that contribute towards mitigating climate change, such as renewable energies, preventing deforestation or carbon removal by planting trees[2].

For carbon credits to be traded on the market it is necessary for an accredited entity to verify that certain quality standards are fulfilled and that the credits are included in a registry.

In most cases, the process for the creation of carbon credits involves four general steps:

1. Development of a climate change mitigation project.
2. Measurement, reporting, and third-party verification (MRV) of the activity's greenhouse gas emissions and reductions or removals.
3. Certification by a carbon-crediting program[3].
4. Issuance of credits representing the activity's resulting reductions or removals in the project developer's registry account.

Credits issued may be traded either over-the-counter (OTC), through brokers, or through exchanges on secondary markets, both spot and derivatives, where the public pricing information available is limited. The holders of credits can "retire" the credit from the market and, in doing so, claim to have supported greenhouse gas emissions reductions or removals and potentially count the credit toward its own emissions target. In VCMs, investors such as investment banks, investment funds, and other financial intermediaries seeking a return from buying and selling carbon credits, can also act as purchasers.

[2] A carbon credit represents a greenhouse gas emission reduction to, or removal from, the atmosphere equivalent to one tonne of carbon dioxide equivalent, calculated as the difference in emissions from a baseline scenario to a project scenario. Page 3 final report.CR06/2023 Voluntary Carbon Markets (iosco.org)

[3] Carbon crediting program: A set of quality standards to assess carbon credits, registration of validated projects, identification or accreditation of validation and verification bodies, issuance of credit rights resulting from emission reductions or removals, allowing for the registration of verified projects and the issuance and retirement of carbon credits. Appendix 2. Glossary. CR06/2023 Voluntary Carbon Markets (iosco.org)

Pregunta

What are the vulnerabilities in these markets?

Respuesta

The Report indicates that many of the challenges and vulnerabilities in respect of VCMs relate to market integrity. The critical aspects at project level would be:

1. The environmental integrity of carbon credits and their issuance to a registry (primary market issuance).
2. The quality of the carbon credits and their standardization.
3. Their effectiveness in emission reduction and collateral effects.
4. Data availability and methodologies to assess carbon quality.
5. Potential conflicts of interest of market participants regarding issuance.

It is also acknowledged that there are challenges relating to *secondary market trading*:

1. Data availability and accessibility;
2. Operational resilience of registries;
3. Supply and demand imbalances;
4. Lack of market participant expertise;
5. Potential conflicts of interest of participants regarding credit trading.

Finally, certain deficiencies are noted within the regulatory framework and in the information available to purchasers on the use of credit rights.

Pregunta

What Good Practices are proposed?

Respuesta

1. Regulatory frameworks

The regulatory framework elements which could contribute to the development of safe, efficient, accessible and

transparent VCMs are explained in good practices 1, 2, 3 and 4. In the same manner as in conventional financial markets, this framework should aim at protecting investors and market integrity. To avoid the fragmentation of VCMs, stress is placed on the need to clearly define the regulatory frameworks for carbon credits, in such a way the issuance, trading and retiring of credit rights can be overseen efficiently. Meanwhile, the need to promote domestic and international cooperation, together with training and education initiatives to improve participants' skills and competences in these markets, is highlighted.

2. Primary market

Good practices 5, 6, 7, 8 and 9 focus on carbon credit standardization, information transparency and disclosure, the quality of credit registries, and due diligence. To promote standardization, IOSCO aims at the collaboration between regulators and other relevant parties, such as supervisors, spot and derivatives markets, private sector initiatives and verifiers of carbon credits. This standardization is key to increase the transparency, efficiency and traceability of climate change mitigation projects, ultimately contributing towards building trust. The need to promote the creation of accurate, complete and updated registries of the credits issued is also indicated. Finally, it is noted that the carbon crediting programs should perform adequate know-your-customer (KYC) and due diligence procedures to prevent the use of the credits for money laundering.

3. Secondary market trading

Currently most carbon credits are traded bilaterally or OTC, with little information on the prices. The objective of good practices 10, 11, 12, 13 and 14 is to ensure open and fair access to trading, while to promote high standards of integrity and fair dealing with respect to business activities relating to carbon credits. For this, it is recommended that the trading venues and registries, including those for OTC trading, make public reports which disclose relevant data regarding trading, providing access to all market participants. Likewise, it is proposed that the provision of pre- and post-trade disclosures are consistent with, those that are required in traditional, regulated financial markets. Finally, it is recommended that the credit derivatives contracts detail the standards used to certify the underlying credits, the delivery requirements, and the procedures applicable to market participants.

On the one hand, good practices 15, 16 and 17 propose that all VCM participants (such as project developers, registries, validation and verification bodies, brokers, traders, marketplaces and exchanges, or rating agencies) have in place a comprehensive governance framework with clear lines of responsibility and accountability. And, on the other, that they establish risk management frameworks and business continuity disaster recovery plans safeguarding against operational or technological risks. IOSCO proposes the inclusion of practices proven to have effectively mitigated conflicts of interest in other markets, such as transparent governance structures, disclosure requirements and compliance frameworks.

The Report points out that the problems relating to integrity and fraud regarding carbon credits have hindered VCM growth. Good practices 18, 19 and 20 on market abuse propose market surveillance measures to prevent, detect and apply enforcement actions on fraudulent practices, such as the disclosure of false and misleading statements regarding carbon credits or price distortion. These practices use as reference the market abuse regulations of traditional financial markets.

4. Use and disclosure of use of carbon credits

The Report highlights that there are doubts on whether some carbon credits represent actual emission reductions and the possibility that the credits not traded in a market or not recorded in a registry can lead to double counting. Therefore, the need is highlighted to require companies to inform **transparently on the use of carbon credits in respect of the emission objectives**. In particular, reference is made to standards IFRS S1 and IFRS S2, recently backed by IOSCO[4], on company disclosures about sustainability and published by the International Sustainability Standards[5]. In particular, IFRS 2 Climate-related Disclosures, require entities to disclose information about their planned use of carbon credits to offset emissions to achieve any net GHG emissions targets the entity has set, or any they are required to meet by law or regulation.

[4] https://www.iosco.org/news/pdf/IOSCONEWS703.pdf

[5] IFRS – Who we are

Links of interest:
CR06/2023 Voluntary Carbon Markets (iosco.org)

CR06/2022 Voluntary Carbon Markets (iosco.org)

FR09/23 Compliance Carbon Markets (iosco.org)

IOSCO Objectives and Principles of Securities Regulation