

10 February 2023

International Organization of Securities Commissions
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By email, facsimile and post

Dear Sirs

Re: GFMA response to Compliance Carbon Markets – Consultation Report

The Global Financial Markets Association (**GFMA**)^[1] welcomes the opportunity to comment on the International Organization of Securities Commissions (**IOSCO**) “Compliance Carbon Markets – Consultation Report” (**Report**).

We agree that compliance carbon^[2] markets (**Compliance Markets**) have an important role to play in the transition to a carbon-neutral world and the ability of countries around the globe to meet their greenhouse gas emissions reduction targets pursuant to the Paris Agreement.^[3]

In the absence of mandatory, regulated carbon markets that enforce consistent standards that catalyse and drive the permanent reduction of greenhouse gas emissions, our ability to limit global warming to below 2 degrees Celsius (whilst still aiming for 1.5 degrees Celsius) and avoid the worst effects of climate change is near impossible.

Compliance Markets must be underpinned by the same core principles that underpin any sound and robust regulated market: (i) transparency; (ii) integrity; (iii) stability; and (iv) accountability. Without a set of core principles that promote consistency and interoperability of standards and price discovery, Compliance Markets are vulnerable to instability and misuse and will also be less effective in realising their ultimate goal of reducing global carbon emissions.

In preparing this response, we recognise that some jurisdictions have well-established Compliance Markets, whilst others are exploring the possibility of establishing Compliance Markets. For this reason, maintaining flexibility in the implementation and enforcement of core principles and market protective measures is critical to the collective success, strength and longevity of global Compliance Markets.

Effective carbon markets, whether regulated or voluntary, should adhere to science-based decarbonisation principles. Their successful expansion, in line with global emissions reduction targets, is reliant upon collaboration between policymakers, regulators, market participants and other stakeholders across all jurisdictions to promote best practice and neutralise the risk of

¹ GFMA represents the common interests of the world’s leading financial and capital market participants to provide a collective voice on matters that support global capital markets. It also advocates on policies to address risks that have no borders, regional market developments that impact global capital markets, and policies that promote efficient cross-border capital flows to end users. GFMA efficiently connects savers and borrowers, thereby benefiting broader global economic growth. The Association for Financial Markets in Europe (**AFME**) located in London, Brussels, and Frankfurt; the Asia Securities Industry & Financial Markets Association (**ASIFMA**) in Hong Kong; and the Securities Industry and Financial Markets Association (**SIFMA**) in New York and Washington are, respectively, the European, Asian, and North American members of GFMA. This submission reflects the views of a majority of the GFMA board members rather than those of any one member. Individual GFMA members may have views that differ from those expressed in this document.

² In this letter, references to ‘carbon’, ‘emissions’ and ‘greenhouse gases’ are references to those gases that become trapped in the Earth’s atmosphere and contribute to the increase of surface temperatures, including: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, chlorofluorocarbons, sulphur hexafluoride and nitrogen trifluoride.

³ The Paris Agreement is a legally binding international treaty on climate change. It was adopted by 196 parties at the United Nations Climate Change Conference in Paris, on 12 December 2015 and entered into force on 4 November 2016.



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greenwashing,^[4] carbon leakage^[5] and (to the extent relevant because of linking carbon markets) double-counting^[6] or double-claiming^[7]. Globally consistent approaches are key to avoiding fragmentation, reducing costs and complexity, increasing usability and bolstering stability.

We support IOSCO's efforts to:

- (a) generate an open and meaningful, cross-industry dialogue with a view to maximising the potential of Compliance Markets;
- (b) promote the establishment of a global baseline for the orderly functioning and operation of Compliance Markets;
- (c) identify the vulnerabilities associated with upscaling Compliance Markets to mitigate the risk of market abuse and instability;
- (d) promote transparent and comprehensive oversight of Compliance Markets, similar to the principles that underpin the integrity and stability of other regulated markets;
- (e) strive for certainty as to the legal classification and treatment of carbon allowances; and
- (f) propose recommendations to relevant authorities (e.g. regulators as well as public policy governmental institutions) to allow for flexibility in the establishment of Compliance Markets and that support meaningful cross-market and cross-border connections in both primary and secondary markets to upscale and accelerate global decarbonisation efforts.

Our responses to the questions raised in the Report are set out in the schedule to this letter. We very much appreciate the opportunity to comment on the Report and we look forward to engaging with IOSCO further as may be helpful.

If you have any questions, or you would like to discuss the points raised in this letter, please feel free to contact us or our counsel, Richard Mazzochi (richard.mazzochi@hk.kwm.com; +852 3443 1046) and Claire Potter (claire.potter@hk.kwm.com; +852 3443 1093) at King & Wood Mallesons.

Yours faithfully

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⁴ Greenwashing refers to the act of providing misleading or false information about the environmental impact of an entity's products and operations.

⁵ Carbon leakage occurs when carbon generating activities are relocated to a jurisdiction which has a more lenient regime in respect of carbon emissions.

⁶ In this letter 'double-counting' refers to where the benefit of a particular carbon allowance is claimed by more than one country as part of their respective emissions reduction commitments under the Paris Agreement.

⁷ In this letter 'double-claiming' refers to where the benefit of a particular carbon allowance is claimed by: (i) a country; and (ii) a natural or a legal person, as part of their respective emissions reduction commitments under the Paris Agreement.

Schedule – Responses to Questions

Question 1: What are the benefits and risks of linking frameworks? How can these benefits be enhanced and these risks be mitigated?

Issues for consideration

The single common denominator between all Compliance Markets is that they constitute a market-based mechanism to curb carbon emissions. It is however important to recognise that, whilst Compliance Markets may share common features, the structure and priorities of each individual Compliance Market are different. In addition, they are developing at different speeds according to different standards.

Linking Compliance Market frameworks is complicated because it requires mutual recognition of domestic laws and systems as well as synergy between the domestic political and socio-economic landscapes in which such markets operate. Their individuality means that there can be no 'one size fits all' approach to linking Compliance Markets. For this reason, links between Compliance Markets may be better achieved at (micro) entity or sector level rather than (macro) market level.

In order to maintain the integrity of global Compliance Markets, it is critical that any decision to link individual Compliance Markets together is results driven (i.e. accelerating decarbonisation in each underlying market) and serves to enhance the markets that best achieve material reductions in carbon emissions.

The role of Compliance Markets is different to other regulated markets because the volume of units traded in such markets (in the form of carbon allowances) will (and must) decrease over time in alignment with global decarbonisation goals. For this reason, any integration between Compliance Markets (which aim to reduce the volume of available carbon allowances and set benchmark pricing for carbon allowances) and voluntary carbon markets (which aim to offset continued carbon production) must be very carefully controlled or risk being counterproductive. Links between Compliance Markets and voluntary carbon markets may therefore be best achieved at (micro) project level, where the attributes of a particular project (e.g. as regards 'additionality' and permanence) have been rigorously analysed and verified as representing the highest standards.

In order for Compliance Markets to be capable of being linked together (whether at entity or sector level or market level), they must:

- operate according to interoperable rules and standards (e.g. in terms of the entities and emissions covered, and overall emissions reduction targets);
- specify clear rules as to what percentage of a covered entity's^[8] annual compliance obligations may be satisfied by means other than through the acquisition of domestic carbon allowances^[9];
- have robust and compatible trading and settlement infrastructure;
- implement and enforce effective market stability reserve mechanisms to support an upwards trajectory for the price for emitting a unit of carbon (e.g. through the management of auction schedules and auctioned volumes of carbon allowances);
- operate a transparent and centralised registration system for carbon allowances that can be publicly searched and records real-time data;
- have clear and compatible rules for the use, counting, claiming and surrender of carbon allowances; and
- create opportunities and benefits that stand-up to a robust cost-risk analysis.

⁸ A "covered entity" being an entity that is mandated to participate in a Compliance Market.

⁹ For example, through carbon allowances available in a foreign Compliance Market or through carbon credits traded within a voluntary carbon market (whether domestic or foreign).

Benefits associated with linking frameworks

Where a strong case exists for linking Compliance Markets together (on a limited basis or otherwise), the potential benefits of doing so include:

- reduced fragmentation through alignment of rules and standards;
- greater transparency and collaboration through alignment of climate-related taxonomies;
- access for covered entities to a deeper, more liquid pool of instruments to trade;
- increased efficiency as a wider variety of decarbonisation pathways becomes available to market participants;
- increased trading volumes and price discovery, creating signals for investors and corporates to use in pricing climate risk into their investments and business planning;
- expansion of Compliance Market scope (e.g. in terms of the industry sectors and entities covered and the products offered);
- adherence to 'best practice' for mutual benefit of the linked markets;
- harmonised market surveillance (with the potential for cost-savings through shared infrastructure and resource);
- increased competition for carbon allowances (in turn increasing the price for emitting a unit of carbon and incentivising decarbonisation);
- the requirement for clear lines of responsibility and cross-market audit;
- the requirement for clear controls to counter the risks of carbon leakage and (to the extent relevant because of linking carbon markets) double-counting or double-claiming. Such risks will reduce as the volume of accessible data and links between systems increase; and
- developing knowhow for linking other Compliance Markets.

Risks associated with linking frameworks

In addition to the issues identified above, the risks associated with linking Compliance Markets include:

- the requirement for 'official' approvals as to the structure, eligibility criteria and rules for participation;
- increased bureaucracy and complexity (potentially resulting in higher operating costs and increased settlement delay);
- potential for carbon leakage and (to the extent relevant through because of carbon markets) double-counting or double-claiming where monitoring systems are not sufficiently robust or sophisticated;
- potential for anti-competitive behaviour;
- potential dilution of individual Compliance Market goals;
- potential for additional layers of regulation to undermine or negate market growth;
- potential for market disruption as a result of differences between linked Compliance Markets; and
- uncertainty as regards transfers between linked Compliance Markets (given the lack of certainty as regards the legal treatment of carbon allowances).

Mitigation of risks relating to linking frameworks

In order to mitigate the potential risks associated with linking Compliance Markets, governments and implementing bodies can consider (by way of example):

- formulating 'in principle' consents and 'memoranda of understanding' that allow parties to proceed by way of common understanding without all official approvals being in place at the outset;
- assessing the commonalities between and the potential benefits of linking particular Compliance Markets, and developing preconditions for their linking;
- implementing pilot schemes that leverage existing trading and settlement infrastructure to minimise and manage the bureaucracy and complexity associated with the roll out of a new framework;
- maintaining an open dialogue between regulators and market participants, establishing clear parameters for the nature and scope of the link and implementing a clear procedure for regular review, reporting of findings (including by reference to the achievement of key decarbonisation targets and the improvement of official nationally determined contributions^[10]) and making adjustments; and
- ongoing monitoring of trading positions and the 'effect' of the link on the price of carbon in order to identify and counter harmful trading practice.

Question 2: What should be the conditions underpinning a decision to link frameworks?

The decision to link Compliance Markets should be:

- results driven i.e. capable of accelerating decarbonisation and generating a valid and material economic benefit; and
- underpinned by the same core principles that apply to the development of other regulated markets: (i) integrity; (ii) transparency; (iii) stability; and (iv) accountability.

Compliance Markets are an essential tool for the transition to a carbon-neutral world and accordingly the 'value' of linking markets together must be carefully considered.

Linking Compliance Markets has the potential to promote greater:

- market liquidity and depth;
- interoperability of standards; and
- transparency,

which are material benefits (for governments, regulators, participants, investors and end-users) that can help to combat greenwashing and ensure that Compliance Markets work properly. But linking Compliance Markets together must not undermine the objectives, or otherwise hinder the development, of individual Compliance Markets.

At a more granular level:

- policymakers and regulators that agree to link Compliance Markets must recognise each other's carbon allowances, and permit covered entities to purchase and surrender carbon allowances in any linked Compliance Market by establishing a secure link between their respective registries;
- regulators that agree to link Compliance Markets must understand the regulatory framework of each linked Compliance Market, including their respective legislative processes and the legal principles that underpin the treatment of carbon allowances in those linked Compliance Markets;
- some alignment of design elements, including caps on carbon allowances, allocation, trading and settlement methods (including auction processes) and market protection measures

¹⁰ 'Nationally determined contributions' refer to the official carbon reduction targets submitted by individual members of the United Nations to the United Nations Climate Change Conference of the Parties.

should be considered to streamline cross-Compliance Market trading and reduce operating costs;

- there should be a centralised registry for all covered entities trading within the linked framework and a clear process for the transfer of carbon allowances between the linked Compliance Markets;
- adopting a strategic, constant and coordinated approach to:
 - control the aggregate volume of available carbon allowances (so as to avoid diluting domestic decarbonisation targets and stabilise the price of carbon); and
 - setting clear criteria for the use of carbon offsets (including volume restrictions);
- implementing robust and transparent ‘measurement, reporting and verification’ processes for the allocation and surrender of carbon allowances to prevent carbon leakage and (to the extent relevant because of linking carbon markets) double counting or double claiming;
- comprehensive and reliable data collection, monitoring and analysis, to ensure that relevant data is accessible and accurate at all times; and
- as between the jurisdictions in which the applicable Compliance Markets operate, comparable legal treatment of carbon allowances on a pre and post insolvency basis.

Question 3: Do you agree these IOSCO principles are appropriate for carbon markets? Explain your response.

“We recommend that market participants and infrastructure providers, policymakers, regulators, standard-setters [(supranational or national bodies that establish guidelines, principles, or standards (e.g., Basel Committee, IOSCO, SASB))], and climate science bodies drive standardization of carbon market products, accounting, and legal frameworks, and develop best practices for regulating both carbon markets and associated trading activities for allowances, credits, and derivatives.”^[11]

The integrity of Compliance Markets relies on comprehensive regulatory oversight, robust trading infrastructure and consistency in the enforcement of applicable rules. Fundamentally, we can only reduce global emissions to the extent that we can:

- accurately (and consistently) measure, monitor and record: (i) the volume of carbon emitted; and (ii) the volume of carbon allowances created, traded and surrendered; and
- leverage Compliance Markets effectively to enforce a permanent reduction in carbon emissions (e.g. by the Compliance Markets determining benchmark prices for carbon allowances that have a significant economic impact on entities that generate excess carbon emissions).

Whilst we recognise that principles designed to promote transparency, consistency and standardisation in other regulated markets could have application within, and support the development of, Compliance Markets, we also recognise that the classification of carbon allowances (and the classification of spot and derivative transactions relating to them) varies between jurisdictions. Accordingly, we consider that the application of principles designed to support the operation of derivatives markets are best applied to the trading and settlement mechanics (and associated infrastructure) of Compliance Markets, and should not impact the ‘individual’ aspects of such markets (such as their domestic objectives and emissions reduction targets).

IOSCO’s objectives and principles are designed to support the operation of securities and commodity derivatives markets, which are centralised, mature and highly liquid markets. By contrast, Compliance Markets are decentralised and significantly less mature. The application of securities or commodity derivatives based objectives and principles to Compliance Markets should therefore be assessed and periodically reviewed, having regard to their respective size, scale and maturity. We suggest that Compliance Markets are not currently of a size and scale to merit the cost and complexity of putting a prescriptive regulatory framework in place.

¹¹ “Unlocking the Potential of Carbon Markets to Achieve Global Net Zero”, October 2021, GFMA and Boston Consulting Group - section 4.4, “Drive standardization and maturity”.

Having regard to the foregoing, we recognise that greater consistency and standardisation can help to:

- transform carbon allowances into an at-scale investable asset class with greater liquidity;
- promote accurate measurement, reporting and verification of the use, allocation and surrender of carbon allowances between different registries;
- promote efficiency and reduce running costs by centralising trading and settlement infrastructure and removing duplication;
- disseminate know-how and promote best-practice;
- streamline and simplify expansion (e.g. to cover additional industry sectors and broaden the definition of ‘covered entity’);
- promote transparency and interoperability between markets; and
- align and support the implementation and enforcement of, market stability reserve mechanisms.

Our comments on the objectives and principles listed in the Report as being applicable to Compliance Markets are set out below.

Objectives and Principles of Securities Regulation

Principles for Market Intermediaries

Market intermediaries have an important role to play in facilitating access to, and generating liquidity within, Compliance Markets, particularly in the context of any auction process for the allocation of carbon allowances.

We agree that market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters. In order to maintain the integrity of Compliance Markets, we recommend that ‘dealing in’, ‘advising on’ and ‘trading’ carbon allowances should be classified as “regulated activities” under applicable domestic laws and regulations and that market intermediaries in Compliance Markets should be licensed accordingly.

We also agree that there should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and contain systemic risk. We recognise however that the features of individual Compliance Markets should be borne in mind when considering what type of market protective measures are most appropriate in each case.

Principles for the Secondary Market

The application of securities or commodity derivatives based objectives and principles to Compliance Markets should be assessed and periodically reviewed having regard to their respective size, scale and maturity. We consider that:

- trading systems (including exchanges) should be subject to regulatory oversight;
- regulatory supervision of trading systems (including exchanges) should ensure the integrity of trading through fair and equitable rules;
- regulation should promote transparency of trading;
- regulation should be designed to detect and deter manipulation and other unfair trading practices;
- regulation should aim to ensure the proper management of large exposures, default risk and market disruption; and

- systems for clearing and settlement should be subject to regulatory oversight to ensure that they are fair, effective and efficient and reduce systemic risk.

Principles for the Regulation and Supervision of Commodity Derivatives

Monitoring, Collecting and Analysing Information

The monitoring and recording of trading activity in Compliance Markets is undertaken by domestic carbon exchanges. In order to maintain the integrity of Compliance Markets, trading data should be monitored and recorded by domestic carbon exchanges, which data should be publicly available in real time. Automated systems, similar to those used in securities or commodities trading, could be used to help detect trading anomalies.

Collection of Information on On-Exchange Transactions

We agree that market authorities should collect information on a routine and regular basis in relation to pricing and daily transactions. We also agree that the collection of data relating to day-end positions is helpful because it allows relevant authorities to identify the buyers of additional carbon allowances and the volumes of additional carbon allowances that are traded. Such data may also assist relevant authorities to identify broader issues relating to decarbonisation efforts provided that such data is reliable, transparent and representative (as far as possible) of overall trading practices within Compliance Markets so as to underpin market confidence and informed trading.

Review of Evolving Practices

We agree that market authorities should keep the perimeter of regulation relating to Compliance Markets under review and ensure that they have the power to address evolving trading practices that might result in a disorderly market.

Rules and Compliance Programs

We agree that market authorities should have rules, compliance programs, sanctioning policies and powers to prohibit, detect, prevent and deter abusive practices within Compliance Markets, including manipulation or attempted manipulation of Compliance Markets (in particular in relation to, practices that seek to distort pricing of carbon allowances on secondary Compliance Markets, creating or disseminating false or misleading information, and 'wash' or collusive trades).

Framework for Addressing Multi-Market Abusive Trading

We agree that the overall framework for Compliance Market surveillance and enforcement within a jurisdiction should be structured so as to provide for active and coordinated detection and enforcement action against manipulative or abusive practices in multiple Compliance Markets.

Disciplinary Sanctions Against Market Members

We agree that market authorities should have and use effective powers to discipline Compliance Market participants or intermediaries if abusive practices occur, and that such powers should include: warnings; fines; retraining; civil liability; restitution and criminal liability.

Question 4: Are other IOSCO principles relevant for application to these markets?

In addition to the IOSCO objectives and principles identified in the Report, we suggest that a number of IOSCO's other 'Objectives and Principles of Securities Regulation' and 'Principles for the Regulation and Supervision of Commodity Derivatives Markets' could also (in principle) be applied to any entity that regulates Compliance Markets. Such objectives and principles must be applied so as to be proportionate to each Compliance Market's size, liquidity and maturity.

Such principles should of course have regard to applicable domestic laws and regulations, for example as to data privacy and transmission.

Objectives and Principles of Securities Regulation	Principles for the Regulation and Supervision of Commodity Derivatives Markets
<p>(A) <u>Principles relating to the regulator</u></p> <ul style="list-style-type: none"> • Responsibilities of the regulator should be clear and objectively stated. • Regulator should be operationally independent and accountable in the exercise of its functions and powers. • Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. • Regulator should adopt clear and consistent regulatory processes. • Staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality. • Regulator should have or contribute to a process to identify, monitor, mitigate and manage systemic risk, appropriate to its mandate. • Regulator should have or contribute to a process to review the perimeter of regulation regularly. • Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed. <p>(B) <u>Principles for self-regulation</u></p> <ul style="list-style-type: none"> • Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities. <p>(C) <u>Principles for enforcement of regulation</u></p> <ul style="list-style-type: none"> • Regulator should have comprehensive inspection, investigation and surveillance powers. • Regulator should have comprehensive enforcement powers. • Regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. 	<ul style="list-style-type: none"> • Clear framework as to design and review criteria or procedures. • Clear and robust framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of these activities. • Market authorities should have, and use, effective powers to intervene to prevent or address disorderly markets and to ensure the efficiency of the markets. • Market authorities should have adequate powers and capacity to investigate and prosecute actual or suspected market abuse. • Market authorities should cooperate with one another, both domestically and outside the jurisdiction, to share information for surveillance and disciplinary purposes. • Members should promote reporting to trade repositories in order to improve transparency, mitigate systemic risk, and protect against market abuse.

Objectives and Principles of Securities Regulation	Principles for the Regulation and Supervision of Commodity Derivatives Markets
<p>(D) <u>Principles for cooperation in regulation</u></p> <ul style="list-style-type: none"> • Regulator should have authority to share both public and non-public information with domestic and foreign counterparts. • Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts. • Regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers. <p>(E) <u>Principles for service providers</u></p> <ul style="list-style-type: none"> • Entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them. <p>(H) <u>Principles for market intermediaries</u></p> <ul style="list-style-type: none"> • There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk. 	

Question 5: Do you agree the rules currently in place across key jurisdictions are helpful for scaling of carbon markets?

Whilst we agree that the development and upscaling of Compliance Markets should have regard to best practice and key learnings across key jurisdictions, we wish to reiterate that there can be no 'one size fits all' approach. In order for Compliance Markets to be effective in reducing emissions, they must address the domestic emissions reduction objectives and 'fit' with the regulatory infrastructure of the jurisdiction in which they operate. No individual Compliance Market is perfect. The key to maximising the potential of Compliance Markets is therefore to keep them under review and make regular refinements as circumstances and resources allow.

Each Compliance Market should be driven by economics (according to science-based decarbonisation principles) and maintain at its core the fundamental principles of: (i) transparency; (ii) integrity; (iii) stability; and (iv) accountability. The definition of 'best practice' will continue to evolve over time and should be applied with pragmatism (having regard to the needs of, and the challenges faced by, individual jurisdictions).

Having regard to the foregoing, the experience gleaned from existing (and more mature) Compliance Markets is an important resource, including as regards:

- the development of a comprehensive legal framework to underpin the regulation of Compliance Markets;
- the application of a rule-based approach that follows a clear process, including as regards dispute resolution;

- the implementation of market protective measures such as a market stability reserve^[12] or a cross border adjustment mechanism^[13];
- the establishment of a common registry on a single technology platform with real time data flows and robust cybersecurity;
- setting accurate and dynamic baselines. Collecting verified annual emissions data (as close to the next compliance period as possible) to help calculate the future allocation of, and market cap on, carbon allowances;
- the design and supervision of the scheme resting with entities that have experience in Compliance Markets (noting that the demand for carbon allowances is artificially constructed by the compliance obligation, and the volume of available carbon allowances is set accordingly);
- adjusting the supply of allowances during a compliance period without altering the predetermined cap to accommodate changes in the economic environment (thereby ensuring that over-supply of carbon allowances does not drive down the price of a unit of carbon and disincentivise decarbonisation);
- achieving legal certainty as to the nature and treatment of carbon allowances;
- promoting market confidence and market integrity;
- the classification of carbon allowances as regulated instruments as a means to help safeguard Compliance Markets from abuse or misconduct (i.e. by bringing such instruments within the jurisdiction of regulators);
- transitioning away from free allocation of carbon allowances to a solely auction-based system as a means to incentivise decarbonisation and raise necessary capital to support net zero ambition;
- implementing a market stability reserve to help address surpluses (and shortages) of auctioned carbon allowances, thereby supporting a stable price for a unit of carbon; and
- regular assessment (and adjustment) of the ambition level of Compliance Markets to ensure alignment with global decarbonisation targets, including accelerating the pace of cap reductions and expanding the entity and industry sector coverage of Compliance Markets.

Question 6: Are there any other aspects of Compliance Markets that could benefit from regulatory oversight?

We consider that the following aspects of Compliance Markets could benefit from regulatory oversight:

- licensing and audit of third party verifiers that create, or verify compliance with, environmental standards;
- capital/risk weighting in relation to funding the acquisition or trade of carbon allowances;
- how carbon and associated costs or taxes (as a 'liability') and carbon allowances (as an 'asset') should be classified and presented from a balance sheet perspective, as a means of cross-checking Compliance Market registry records, promoting transparency as to the volume of carbon emitted and setting appropriate caps on emissions (as well as adjusting the volume of carbon allowances) within Compliance Markets;
- the extent to which covered entities may be permitted to participate in voluntary carbon markets (and how excess 'offsets' should be classified and presented from a balance sheet perspective);

¹² A market stability reserve is an adjustment mechanism that holds excess allowances in a compliance market and adjusts the stock of allowances in circulation in response to supply and demand or external shocks.

¹³ A cross border adjustment mechanism is a tariff applied to imported goods or services that aims to reflect their carbon intensity within the overall price paid for such goods or services. It is a mechanism designed to counter carbon-leakage i.e. the relocation of carbon intensive goods or services to 'low cost' jurisdictions.

- implementing mandatory corporate filings for scope 1, scope 2 and scope 3 emissions^[14] (and guidance as to the measurement, reporting and verification of scope 3 emissions) with a view to expanding Compliance Market coverage beyond scope 1;
- the use of derivatives to hedge environmental risk;
- combatting greenwashing;
- combatting trading activities that seek to profit from environmental degradation or disaster;
- setting rules (promulgated by an international accounting body such as the IASB or FASB) around accounting for climate-related transactions; and
- developing rules for general good conduct, including as regards avoiding conflicts of interest, fraud and market abuse.

Question 7: Are the recommendations appropriate for the Compliance Markets?

Recommendations relating to Compliance Markets should encourage:

- the development of new Compliance Markets; and
- the expansion of existing Compliance Markets beyond their current (geographic, industry sector, and emissions) scope,

in each case based on sound, science-based principles, integrity, transparency, stability and accountability.

We have considered each of the recommendations for Compliance Markets listed in the Report and we have set out our comments below.

Recommendation 1: Relevant authorities should increase predictability and transparency in primary market decisions.

We observe that certain market features^[15] are necessary to ensure a fair and safe transition to net zero. Whether, and to what extent, a particular feature is appropriate must however be determined on a case by case basis.

Ultimately, the volume (and vintage) of available carbon allowances, the method of allocation of carbon allowances, and the list of industries and entities that are designated as 'in-scope' under a particular scheme, are for governments to decide, having regard to their respective Paris Agreement commitments and applicable domestic, socio-economic factors.

We support transparency to the extent that it promotes parity and accountability. There is however a level of complexity as to how carbon-related data is used and analysed that might obscure the full picture. For example, a significant amount of manufacturing occurs in jurisdictions with a lower cost base. At a simplistic level, per capita emissions in such jurisdictions may appear high and reflect badly. However, we suggest that the pressure to reduce emissions is better aimed at those jurisdictions in which the corporates that outsource their carbon intensive activities are tax resident.

Accountability for (domestic and outsourced) carbon emissions ultimately sits with governments. Scrutiny of nationally determined contributions and national decarbonisation efforts should be focused accordingly and undertaken at supranational level (for example by the United Nations).

¹⁴ Scope 1, scope 2 and scope 3 refer to the classification of emissions pursuant to the Greenhouse Gas Protocol Corporate Standard published (as a joint initiative) by the World Resources Institute and the World Business Council for Sustainable Development to promote best practice for accounting and reporting emissions. Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions.

¹⁵ Examples of such mechanisms include: (i) free allocation of carbon allowances; (ii) market stability reserves (such as volume and distribution controls for carbon allowances, or reserve pricing for carbon allowances); and (iii) cross border adjustment mechanisms.

Recommendation 2: To foster fair, stable and competitive markets, relevant authorities in charge of primary market issuance should place greater reliance on auctions over free allocation.

Please refer to our comments in relation to Recommendation 1. We agree that Compliance Markets should aim towards all carbon allowances eventually being allocated by way of auction.

Recommendation 3: Relevant authorities should consider setting frequent auctions.

Please refer to our comments in relation to Recommendation 1 and Recommendation 2. We support staged auctions that control the volume of available carbon allowances and accordingly allows Compliance Markets to proactively manage the allocation and volume of carbon allowances.

Recommendation 4: When relevant authorities establish market stability mechanisms, any market intervention should be rule-based to allow for better predictability.

In principle, we agree that:

- market stability mechanisms and market intervention in Compliance Markets should be rule-based, with underlying rules being periodically reviewed and updated;
- market stability mechanisms and market intervention in Compliance Markets should generally be proactive rather than reactive, but there should be scope for reactionary intervention to counter or mitigate unforeseen market shocks; and
- arbitrary intervention risks destabilising and undermining the purpose of Compliance Markets.

We suggest however that the method, volume and staging of the allocation of carbon allowances should ultimately be driven by supply and demand.

Recommendation 5: Relevant authorities should consider allowing the participation of non-compliance firms in primary markets.

Our members have identified two possible interpretations of the phrase “non-compliance firms” in Recommendation 5:

- interpretation 1: “non-compliance firms” means market intermediaries (such as banks and other authorised financial institutions); or
- interpretation 2: “non-compliance firms” means entities that are not subject to a mandatory emissions reduction obligation.

Our response to Recommendation 5 responds to both possible interpretations.

1. Relevant authorities should consider allowing the participation of market intermediaries in primary markets

We consider that market intermediaries have an important role to play in facilitating access to, and generating liquidity within, Compliance Markets, particularly in the context of any auction process for the allocation of carbon allowances.

Given the importance of their role, and to ensure the integrity of Compliance Markets, we recommend that ‘dealing in’, ‘advising on’ and ‘trading’ carbon allowances should be classified as “regulated activities” under applicable domestic laws and regulations and that market intermediaries in Compliance Markets should be licensed accordingly.

2. Relevant authorities should consider allowing the participation of non-covered entities in primary markets

We have concerns with the proposition that relevant authorities should consider allowing non-covered entities to participate in primary Compliance Markets.

Compliance Markets exist to ensure that covered entities (operating within a carbon intensive industry) comply with mandated decarbonisation requirements. The volume and allocation of available carbon allowances should therefore be (as close as possible) equal to the volume of carbon anticipated to be emitted during the applicable compliance period (subject to any downward adjustments at government level to align with national emissions reduction objectives). Allowing non-covered entities to participate in primary Compliance Markets would:

- interfere with the calculation of the volume and allocation of carbon allowances available for covered entities; and
- (in the event of a shortage of carbon allowances available to covered entities) adversely impact the ability (and integrity) of Compliance Markets to deliver a fair transition to net zero.

We note that some Compliance Markets permit a certain volume of carbon credits (generated within voluntary carbon markets) to be used by covered entities to offset a (small) proportion of their carbon emissions so that they do not exceed the volume of carbon allowances allocated to them within the Compliance Market. We consider that this is acceptable in principle provided that the permitted threshold of carbon credits (generated within voluntary carbon markets) available to a covered entity to offset its emissions over and above the volume of carbon allowances that it has to surrender within the applicable Compliance Market is both limited and closely monitored (to ensure that the offset mechanic does not 'dilute' the compliance obligation or indicate a broader issue to be tackled within Compliance Markets).

Recommendation 6: Relevant authorities should define the legal nature of allowances in their jurisdiction.

We agree that relevant authorities should prioritise defining the legal nature of carbon allowances within their jurisdiction and determine how carbon allowances are regulated. We adopt this position because a carbon allowance's legal classification is crucial in determining, for example:

- how title (or ownership) to it is evidenced, transferred and extinguished (upon retirement);
- (subject to applicable law) whether a carbon allowance (or an interest in it) can be held on trust;
- (subject to applicable law) how security can be taken over a carbon allowance and how that security may be enforced;
- how a carbon allowance is treated in the event of the insolvency of a transferor or transferee (including with regard to close-out netting); and
- what rights of redress are available in the event of a dispute.

Recommendation 7: Relevant authorities should encourage the scrutiny of auction performances.

We agree that relevant authorities should encourage the scrutiny of auction performance in the same way that relevant authorities monitor trading patterns in other regulated markets and flag suspicious transactions. Whilst the diversity of the entities that bid for carbon allowances should theoretically guard against price-fixing and other abusive practices, we support the use of digital systems capable of analysing mass trading data to identify manipulative or abusive trading practices.

Recommendation 8: Relevant authorities should consider establishing clear and robust frameworks for conducting market surveillance, overseeing of entities' behaviour in spot and derivatives carbon markets and ensuring appropriate enforcement.

Our ability to reduce emissions relies on accurate (and consistent) measurement, reporting and analysis of emissions-related data. Transparency within Compliance Markets is critical because it underpins market confidence and price discovery. It also promotes interoperability of standards and systems.

Derivatives play an important role in carbon markets. For example:

- covered entities use carbon derivatives to meet their compliance obligations and manage climate transition risk (including volatility in the cost of carbon allowances) in a cost-effective way;
- investors and market intermediaries use the price signals from carbon derivatives to assess climate transition risk in their portfolios and allocate funds to capitalise on climate transition opportunities;
- policymakers use the price signals from carbon derivatives to assess the effectiveness of their climate related programs; and
- asset managers use carbon derivatives to build portfolios that satisfy their investors decarbonisation goals.^[16]

Based on the above, we agree that establishing clear and robust frameworks for conducting market surveillance, monitoring trading behaviour, and ensuring appropriate enforcement/redress within spot and derivative carbon markets, are important factors that underpin the integrity of Compliance Markets, encouraging transparency and promoting accountability.

However, we think that careful consideration is required as to whether measures such as position limits, position reporting or position management controls are appropriate, particularly in jurisdictions where Compliance Markets are new. Imposing requirements like these increases the compliance burden and potentially excludes smaller market participants. Market surveillance and monitoring must be proportionate to each Compliance Market's size, liquidity and maturity.

Recommendation 9: Relevant authorities should ensure that the relevant market infrastructures (e.g., trading venues, auction platforms, central counterparties, registries) are robust and properly regulated.

Compliance Markets must be underpinned by the same core principles that apply to any sound and robust regulated market: transparency; integrity; stability and accountability. In the absence of such principles, Compliance Markets are vulnerable to instability and abuse. Robust infrastructure and proper regulation are accordingly essential for the integrity and efficiency of Compliance Markets that drive decarbonisation forward.

We recognise that some jurisdictions have well-established Compliance Markets, whilst others are exploring the possibility of establishing Compliance Markets. For this reason, maintaining some flexibility towards the regulation of Compliance Markets is important. See also our response to Question 3, where we suggest that Compliance Markets are not currently of a size and scale to merit the cost and complexity of putting a prescriptive regulatory framework in place. The regulatory framework applicable to individual Compliance Markets should however be capable of growing and adapting in line with the underlying market that it regulates; which capability should, of itself, be subject to review.

In the context of trading venues, if carbon allowances are not regulated as financial instruments in the relevant jurisdiction then it may not be appropriate to seek to regulate carbon credit trading venues in the same way as securities trading venues.

Recommendation 10: Relevant authorities should encourage the development of standardised derivatives contracts.

We support the development of standardised definitions, contracts and confirmations for use in carbon derivatives transactions to promote consistency of trading and settlement procedures and greater transparency within Compliance Markets generally.

Recommendation 11: Relevant authorities should consider public disclosures about aggregate positions, as well as periodic public reporting derived from regulatory data.

The purpose of Compliance Markets is to permanently reduce carbon emissions. Transparency as to: (i) the volume of carbon emissions generated; and (ii) how carbon emissions reductions are achieved, underpins the credibility and success of Compliance Markets.

¹⁶ "Role of Derivatives in Carbon Markets" – International Swaps and Derivatives Association – September 2021.

Covered entities must prioritise carbon emissions reduction (in alignment with the volume of carbon allowances available to them to surrender) before considering the use of carbon credits (generated within voluntary carbon markets) to offset surplus emissions. We agree that public disclosure is an important tool to reinforce this expectation and require covered entities to defend their emissions reduction strategy.

We suggest that relevant authorities consider implementing public disclosure (at regular intervals which allows for: (i) peer to peer comparison; and (ii) comparison against previously disclosed information) including in relation to:

- covered entities actual and projected emissions (as a minimum covering scope 1 and scope 2 emissions);
- covered entities emissions reduction policies and targets;
- the use of carbon credits (generated within voluntary carbon markets) by covered entities (including details relating to the volume, type and standard/grade of carbon credits used); and
- the use of carbon derivatives by covered entities.

We note that bodies such as the International Sustainability Standards Board (**ISSB**) and the International Accounting Standards Board (the standard setting bodies for the IFRS Foundation) have published proposals regarding the disclosure of material information about a company's significant sustainability-related risks and opportunities, and that such proposals have been developed in response to requests from (among others) G20 leaders and IOSCO. We support the development of such proposals and welcome the finalisation of ISSB's Climate-related Disclosures Standard (IFRS S2).

As we approach 2050, we anticipate that entities that still emit (or are otherwise responsible for the emission of) carbon will start to:

- lose the licences that they require to carry on operations; and
- cease to be efficient, competitive and profitable (taking into account new (clean) technology, carbon taxes and carbon offsets).

Public disclosure of (individual or aggregate) positions may not be appropriate where Compliance Markets are illiquid and there are only small numbers of participants. The requirement for public disclosure must be proportionate to each Compliance Market's size, liquidity and maturity.

Recommendation 12: [Relevant authorities should set clear lines of responsibilities and cooperation between authorities in charge of compliance markets at primary and secondary market level, including both environmental and financial agencies as appropriate and promoting regulatory coordination between these entities.](#)

We agree that relevant authorities should strive to set clear lines of responsibility and cooperation between entities that are responsible for the operation of Compliance Markets at primary and secondary level, including environmental and financial agencies as appropriate and promoting regulatory coordination.

The appropriate lines of responsibility and cooperation will vary according to the jurisdiction in which a Compliance Market operates, and may be more complicated in jurisdictions that adhere to a decentralised regulatory framework. Governments are ultimately responsible for ensuring that national emissions reduction policies are implemented, monitored and enforced at all levels (and that emissions reduction targets achieved) and must be held accountable as such.

We suggest that decisions relating to primary Compliance Markets are best controlled by governments (having regard to the recommendations and requirements of best-in-class standard setting bodies) and that financial regulators are best placed to oversee activities in secondary Compliance Markets.

The roles of the key parties are:

Government:	Policies and legislation. Direct oversight of primary Compliance Markets.
Financial regulators:	Enforcement of government policies and legislation. Direct oversight of secondary Compliance Markets.
Market intermediaries:	Regulated entities (such as banks) through which trades are completed in secondary Compliance Markets.
Exchange:	Oversight of trading and settlement in secondary Compliance Markets.
Registry:	Real time data for all trades completed in secondary Compliance Markets.

We support IOSCO's view that market integrity^[17] and environmental integrity^[18] are separate concepts which may warrant oversight by different authorities. The vast array of standards and variations in the liquidity and maturity of Compliance Markets means that defining the role of regulators within Compliance Markets is of paramount importance.

We consider that securities and financial regulators and supervisors can play an important role in promoting market integrity, enhancing transparency and traceability, supporting the uptake of aligned standards among market participants and enforcing rule-based measures to protect against fraud and market manipulation.

We consider that IOSCO's mandate makes it well-placed to provide guidance as to how financial regulators can and should use their expertise, authority and influence to enhance market functioning, trust, and integrity in each case having regard to individual markets size, liquidity and maturity.

Question 8: Are there any other aspects that the recommendations should address? If so, please state which ones and explain your reasoning.

- The extent to which carbon credits (generated within voluntary carbon markets) may be eligible for use towards the satisfaction of a covered entity's compliance obligations within a Compliance Market. It is important to ensure that the fundamental goal of Compliance Markets (i.e. to permanently reduce carbon emissions in line with the commitments made under the Paris Agreement) is preserved and protected.
- Policymakers and regulators should expand the scope of geographic, sectoral, and activity coverage of Compliance Markets, and strive towards near-full coverage (by way of carbon pricing or alternative control mechanisms) within the next five years.
- Policymakers and regulators should strive for high-impact Compliance Markets aligned with limiting global warming to 1.5° Celsius.
- Over time, policymakers and regulators should target strategic interoperability between Compliance Markets with similar features and ambitions. The actual 'value' of linking Compliance Markets together must be carefully considered and stress tested.
- As a key enabler for carbon markets, leading climate-scientists and standard-setters should develop policies for measuring and reporting scope 1, scope 2 and scope 3 emissions across different sectors, and drive consensus on climate-related nomenclature and definitions.
- Governments must take responsibility for actively driving the decarbonisation agenda forward, including: (i) setting clearly defined and ambitious decarbonisation targets; (ii) centralised focus on achieving domestic decarbonisation targets; (iii) entering into business-to-government arrangements to deliver certainty to market participants and end-users; and (iv)

¹⁷ e.g. high-functioning infrastructure that promotes transparency and market integrity.

¹⁸ Namely the attributes and qualities that render a claimed emission reduction, removal, or avoidance as being real, additional, permanent, and verified.



prioritise resolving legal uncertainty as to the nature and treatment of carbon allowances, for example by issuing an authoritative legal statement.