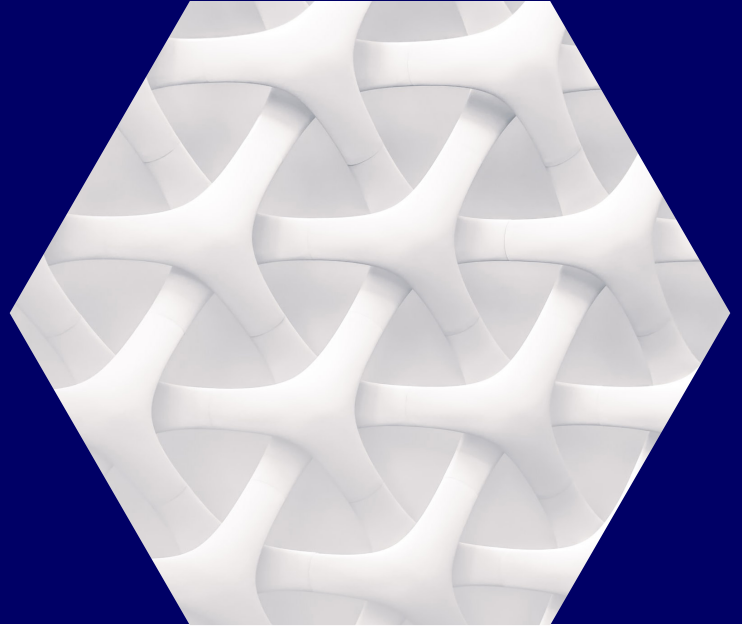


The Legal Nature of Carbon Credits



Introduction

Notwithstanding the important role of offsetting as a tool to help deliver Paris Agreement alignment and the widely anticipated surge in demand for VCCs (noting the emergence of new VCC marketplaces, exchanges, trading platforms and distribution channels to accommodate this), the precise legal nature of VCCs remains surprisingly elusive. As things currently stand, a properly issued carbon credit is likely to be a documentary intangible (i.e. a personal property right) under English law, a personal property right under the laws of other common law jurisdictions such as Hong Kong, Singapore, and Australia; may or may not be a property right in the US, depending on the laws of the state in question, or possibly a commodity; and may or may not be a financial instrument in the EU.

It matters because the legal nature of a thing is relevant to determining how it can be bought and traded, the type of security that may be granted in respect of it and how that security may be enforced, and how it will be treated in an insolvency. It will also affect regulatory, tax and accounting treatment. In the case of VCCs specifically, the legal nature of a VCC (including digital VCCs and VCC tokens that purport to grant title interests to owners) may also impact the owner's right to retire and rights in the event of the cancellation of VCCs by the registry provider for any reason including following fraud or scandal.

Context

We use the phrase voluntary carbon market (or “VCM”) in the broadest sense and are of the view that this is the proper approach. This currently means all carbon markets including associated products and participants that are not domestic compliance markets (i.e. ETS) or international compliance markets (e.g. Article 6 of the Paris Agreement and CORSIA, while recognizing that VCCs may be accepted by Article 6 and CORSIA). Many commentators tend to define the VCM by reference to the carbon offset programs and VCC design developed by the most well-known certification standard bodies and registries such as Verra and The Gold Standard. We are of the view that although these certification standard bodies and registries and their VCC design are undoubtedly important to the VCM, the VCM encompasses (and should increasingly do so as more participants with new schemes, registry solutions and VCC designs enter the market) a much broader range of carbon offset programs and VCC designs.

A voluntary carbon credit (“VCC”) represents a certification that the holder¹ either directly or indirectly has avoided, reduced, or removed from the atmosphere a specified quantity (usually one metric ton per VCC) of carbon dioxide equivalent (tCO₂e) in line with relevant rules and requirements.² Although a common definition may be applied to all VCCs, VCCs are not as homogenous as many assume and are not fungible unless they are issued from the same project and are of the same vintage. VCCs can have very different characteristics (e.g. nature-based vs technology-based; avoidance vs reduction vs removal credits) and do not all deliver the same environmental benefits.

The VCM that exists currently was not designed for the outcomes that we now need the VCM to deliver. Born out of an accidental marriage of the evolving compliance markets and corporates’ need to price carbon into their value chain, the VCM is not well-suited to deliver the outcomes that are needed to combat climate change. With more than ten certification standard bodies and registries, hundreds of methodologies on which issuance of VCCs may be based, and confusion about the efficacy of all the above, the market is uniquely dysfunctional. Hence, when navigating the VCM and the ongoing evolutionary process, it is important to keep in mind that there are opposing views on, and alternative approaches to, offsetting and climate benefits.

¹ References to the “holder” of a VCC are loose references to the person to whose account the relevant VCC is credited from time to time in the register constituting the VCC.

² <https://www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf>.

A. The Legal Treatment of VCCs in Various Sample Jurisdictions

England & Wales

There is currently no statutory confirmation³ or judicial determination regarding the legal nature of VCCs and although English courts have frequently demonstrated a willingness to adopt a liberal and flexible approach to recognizing property rights⁴, we are unaware of any determination yet on the precise legal nature of a VCC. At this time therefore, the characterization and legal treatment of VCCs is uncertain.

In the absence of a statutory definition, the starting point for determining the legal nature of a “thing” under English law is to determine whether or not that thing constitutes property and the test for this is whether it is *“definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability”*.⁵

VCCs appear to broadly meet these requirements – they are issued in accordance with a carbon standard and the rules of the relevant registry and can be evidenced by entries in the register. Assuming a VCC falls within the definition of personal property, the next step is to determine the applicable category of personal property – such as chattels personal (for example tangible goods or choses in possession, choses in action, or other intangible property) or a form of documentary intangible.

USA

There is an added layer of complexity in the US in determining the legal nature of VCCs due to the fact that individual states may establish their own laws in respect of VCCs.⁶ For example, some say that VCCs may not be legally recognized as a property right in California⁷, whereas a court in Louisiana held that the right to report, transfer or sell carbon credits was enough to designate them as part of property’s “bundle of rights”⁸. A different legal treatment of VCCs in different states can complicate matters, such as enforcement of owner’s rights, where VCCs originating in one state are traded or retired in another state.⁹ Unresolved, this will increasingly pose a challenge to efforts to create a liquid and interconnected VCM.

As we note below, there is a view among some carbon market participants that VCCs should be categorized as commodities. In the US, commodity futures are regulated by the Commodity Futures Trading Commission

³ The UK Emissions Trading Scheme (which largely mirrors the EU ETS) came into effect on January 1, 2021. The underlying framework as detailed in the Greenhouse Gas Emissions Trading Scheme Order 2020 does not define the precise legal nature of allowances and so does not provide any potential analogy as to the potential treatment of VCCs under English law.

⁴ Examples include EU allowances, milk quotas, waste management licences, goodwill and rights in respect of a personalized car registration number.

⁵ National Provincial Bank v Ainsworth [1965] AC 1175.

⁶ This is a similar issue to the European Union, where each member state has their own set of legal classification of VCCs.

⁷ See Cal. Code Regs. tit. 17 § 95802(a)(12) (West 2012) (defining an offset credit as a compliance instrument); Cal. Code Regs. tit. 17 § 95820(c) (stating that a compliance instrument “does not constitute property or a property right”).

⁸ Roseland Plantation, LLC v. U.S. Fish & Wildlife Serv., 2006 U.S. Dist. LEXIS 29334, 9–10 (W.D. La. 2006).

⁹ Monterubio, John. “Recognition of Property Rights in Carbon Credits Under California’s New Greenhouse Gas Cap-and-Trade Program.” Sustainable Development Law & Policy 12, no. 2 (2012): 32, 64–65.

("CFTC") who, we understand, also has some limited authority over the manipulation of the price of commodities generally.

Australia

Australia's Carbon Credits (Carbon Farming Initiative) Act 2011 ("**2011 Act**") defines carbon credits created and issued under the Act (ACCUs) as personal property.¹⁰ Although the 2011 Act does not specify the type of personal property (Australia follows a similar approach to property interests as English law), ACCUs are recognized as investment instruments for the purposes of the Personal Property Securities Act 2009 and can be used as collateral for financing arrangements.¹¹ The 2011 Act does provide that ACCUs are transmissible by assignment, by will, by devolution and by operation of law.¹² It is unclear if this same definition would be applied to other VCCs.

In anticipation of a growing demand for ACCUs, we understand Australia's Clean Energy Regulator is undertaking a number of initiatives to increase the supply of ACCUs.¹³ We expect that the clarity in respect of the legal nature of ACCUs will help efforts to scale the VCM in Australia and the development of a robust legal framework under which ACCUs can be owned, traded and collateralized.

Singapore

Singapore follows a similar approach to property interests as English law. Property is defined under the Conveyancing and Law of Property Act 1886 of Singapore as "*real and personal property and any estate in any property, real or personal, and any debt and any thing in action, and any other right or interest in the nature of property, whether in possession or not*". Case law suggests that VCCs are capable of being recognized as intangible property subject to VCCs being "*definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability*".¹⁴

Singapore's Carbon Pricing (Amendment) Bill ("**CPA**")¹⁵ defines carbon credits as a fixed-price carbon credit or an eligible international carbon credit¹⁶ and refers to carbon credits as being capable of transfer and being sold, which seems to confirm that carbon credits are in the nature of property. The Inland Revenue Authority of Singapore also defines¹⁷ carbon credits but does not appear to confirm the legal nature of carbon credits under Singapore law.

¹⁰ Section 150 Carbon Credits (Carbon Farming Initiative) Act 2011 Compilation No. 17 and section 103 Clean Energy Act 2011.

¹¹ Section 3 Personal Property Securities Act 2009.

¹² Sections 150, 152 and 153 Carbon Credits (Carbon Farming Initiative) Act 2011.

¹³ <https://www.ecogeneration.com.au/initiatives-lowering-emissions-on-the-path-to-net-zero/>.

¹⁴ National Provincial Bank v Ainsworth [1965] AC 1175, cited with approval in Quoine Pte Ltd v B2C2 Ltd [2020] 2 SLR 20; [2020] SGCA(I) 2 at [34], CLM v CLN and others [2022] SGHC 46 and Janesh s/o Rajkumar v Unknown Person [2022] SGHC 264.

¹⁵ The bill had a public consultation from 8 July 2022 to 5 August 2022. It has passed two readings on 3 October 2022 and 8 November 2022 respectively and is pending notification by the Minister in the Gazette before it becomes effective.

¹⁶ <https://sso.agc.gov.sg/Bills-Supp/27-2022/Published/20221003?DocDate=20221003>.

¹⁷ [https://www.iras.gov.sg/taxes/goods-services-tax-\(gst\)/specific-business-sectors/carbon-credits](https://www.iras.gov.sg/taxes/goods-services-tax-(gst)/specific-business-sectors/carbon-credits).

Hong Kong

There is currently no regulation of VCCs or established legal position regarding the nature of VCCs in Hong Kong, and therefore, common law principles regarding the determination of a property interest apply. The starting point for determining the legal nature of VCCs under Hong Kong law is to determine whether it constitutes property, and if so, the type of property. Hong Kong follows a similar approach to property interests as English law, classifying property as immovable property (i.e. those pertaining to land) and movable property (i.e. everything, except for land).

European Union (EU)

In the European Union, carbon allowances under the EU Emissions Trading System are classified under the Markets in Financial Instruments Directive 2014 (MiFID II) as financial instruments. VCCs are not included in this classification, nor assigned a unified definition across the European Union. As things currently stand, each member state may decide how to treat VCCs at its own discretion¹⁸ although an increased regulatory interest in the VCM, including consultations and regulatory statements, may imply that some form of carbon-related EU regulation or position regarding the legal nature of VCCs may be in the works. For example, the European Union is proposing an EU-wide voluntary certification framework for carbon removals, under which carbon removal activities would need to meet four so-called Q.U.A.L.I.T.Y criteria.¹⁹

B. Standardized Contracts and the Great Commodity Debate

We note that much of the narrative around the elusive legal nature of VCCs focuses on an apparent need for clear and consistent legal treatment of VCCs across jurisdictions to facilitate trading, including exchange-style and on-platform trading, on standardized contract terms because this is on the critical path to scaling the VCM. It is our view that this narrative conflates separate issues.

We note that many markets function in the absence of a convention on the legal nature of the assets being traded across jurisdictions, including assets with varying specifications and quality grades (e.g. hydrocarbons, diamonds, a wide range of commodities, etc.). We see no particular reason why the absence of convention on the legal nature of VCCs across jurisdictions should necessarily be an impediment to our ability to scale the VCM, including via the adoption of standardized contracts. Contracts (including standardized contracts, trading rulebooks and T&Cs) should be able to adequately accommodate different types of VCCs and manage potentially different legal treatment across relevant jurisdictions.

¹⁸ https://www.ey.com/en_pl/law/voluntary-carbon-market.

¹⁹ https://ec.europa.eu/commission/presscorner/detail/en/qanda_22_7159.

Note that we do agree that establishing a defined position on the legal nature of VCCs should be a priority for regulators of each jurisdiction. Our view is simply that a defined regulatory position does not need to be harmonized across different jurisdictions and that the absence of such harmonization need not be regarded as a bottleneck to scaling the VCM.

There is a view among some carbon market participants that VCCs should be categorized as commodities in order to enhance legal certainty, deliver greater transparency, and facilitate trading of VCCs on standard terms, thereby enhancing confidence and trust in the market.²⁰ In the US, “commodity” is a defined term under the Commodity Exchange Act and VCCs that fall within the definition of commodity could potentially be subject to the jurisdiction of the CFTC. There are inevitably pros and cons of subjecting the VCM to regulatory oversight. By way of contrast, “commodity” is not expressly defined by statute under English law and must be given its “ordinary meaning” (e.g. raw materials such as crude oil, metals and agricultural products)²¹. If VCCs are to be treated as commodities under English law, the trading of VCCs would likely be subject to certain implied terms relating to title, quality and fitness. Although a determination of the legal nature of VCCs in any one jurisdiction will not necessarily influence other jurisdictions, most issuers and registries in today’s VCM are US organizations and this concentration (which may or may not be healthy or sustainable) means that we need to pay close attention to the legal nature debate in the US.

In response to the call for standardized documents for secondary market trading of VCCs, ISDA published the “2022 ISDA Verified Carbon Credit Transactions Definitions” and “Forms of Confirmation” on 13 December 2022 for use with certain VCC derivative transactions. Per ISDA’s report “Legal Implications of Voluntary Carbon Credits”, standardized documentation helps to facilitate liquidity in the VCM providing market participants with clearly defined provisions for execution and settlement which will allow participants to transact with confidence. ISDA’s definitions may be incorporated into transaction documents.

In general, we agree with the perceived benefits (such as efficiency and lower cost) for sellers and buyers trading VCCs on standardized terms. We also believe that VCM participants should leverage the powerful opportunity presented by the adoption of standardized terms to drive enhanced VCC quality and standards, deliver price discovery, and more effectively allocate responsibility in the event of fraud or misrepresentation at the project level. Integrating standardized contracts for the trading of VCCs within the contractual frameworks and account structures imposed by the certification standard bodies and registries will require further thought.

²⁰ A view taken amongst some of the panelists at the CFTC Voluntary Carbon Markets Convening.

²¹ <https://www.lexisnexis.co.uk/legal/glossary/commodities>.

C. Regulated Voluntary Market?

Regulators around the world are looking carefully at the VCM and considering whether or the extent to which it should be a regulated market. We note CFTC's request for information, which was open for comment until October 2022, and IOSCO's carbon markets consultation which closed in February 2023. Additionally, many regulated markets are allowing for internationally certified VCCs to be used by corporates to offset their compliance liability to some extent. Perhaps unsurprisingly given the long and growing list of VCM controversies (e.g. exaggeration of baselines and over-crediting), regulators appear to be focusing their attention on whether rules can help enhance integrity, eliminate fraud and market manipulation, and foster transparency and liquidity. Questions have also been posed by regulators as to whether a specific approach to determining the legal nature of VCCs should be recommended, although the legal nature questions seem largely unrelated to the stated VCM controversies and strategies to tackle them.

We are of the view that there are inevitably pros and cons of subjecting the VCM to regulatory oversight and that it is not the role of CFTC or IOSCO's members to regulate the VCM, other than to the extent that VCCs or derivative products fall under the ambit of existing securities and futures or commodities regulations.

We do believe that regulators and smart regulation can make a very significant contribution to developing the VCM in the short time frame that climate action and the carbon markets demand. Smart regulation might include the following:

- Mandatory disclosure of transition pathways and progress against milestones
- Setting minimum standards and quality requirements (i.e. maintain a list of approved carbon standards and/or types of VCCs that regulated entities may buy and/or retire)
- Convention on VCC quality, price discovery, and conflict of law issues
- Mandatory disclosure of all VCCs purchased and/or retired, and the role that such carbon offsetting plays in an entity's decarbonization strategy
- Implementation of robust and effective anti-greenwashing rules
- Active enforcement of the above, and a robust deterrence regime

Regulators should adopt a cautionary approach by either declining to classify VCCs as regulated products (such as securities) and leave quality control to the rapidly improving carbon market infrastructure, or put in place a holistic and comprehensive approach alongside UN bodies. Half-measures taken at national levels are likely to impede market development and delay climate action.

As the international compliance market under Article 6 of the Paris Agreement takes shape, regulators would have to be mindful of the potential risk of double claiming arising as a result of the potential overlap between the Article 6 market and the VCM, and accordingly, establish a clearly defined framework as to how both markets can work together to complement each other's efforts in supporting global decarbonization.

D. Conclusion

We are of the view that consistent legal treatment of VCCs across jurisdictions could help deliver scale to the VCM but should not be regarded as a pre-condition to facilitating trading on standardized contract terms or to achieving scale. As a practical matter, we consider achieving convention on the legal treatment of VCCs across jurisdictions to be an unlikely outcome, especially in the near or medium-term, given the number of jurisdictions, legal systems and regulatory frameworks involved. In the absence of convention on the legal nature of VCCs, participants will need to understand the legal treatment of VCCs in each relevant jurisdiction and ensure that contract terms, whether standardized or bilateral, accurately reflect this and include carefully worded and enforceable choice of law and conflicts of law provisions.

Connected to the legal nature of VCCs but outside the scope of this article, VCM participants should be mindful of the different legal and contractual rights, and applicable laws relative to a VCC transaction. The legal nature of a VCC, title to the underlying environmental attributes, and the right to a VCC in the event of insolvency of a VCC owner may be subject to the laws of different jurisdictions. Understanding this will help participants resolve some of the complexity that can complicate trading on standardized contract terms.

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Founded in September 2018, the **[Hong Kong Green Finance Association \(HKGFA\)](http://www.hkgreenfinance.org)** is a platform that offers channels and opportunities to facilitate the development of green finance and sustainable investments in Hong Kong and beyond. It aims to mobilise public and private-sector resources and talents in developing green finance policies, to promote business and product innovation within financial institutions. HKGFA's main goal is to position Hong Kong as a leading international green finance hub by providing greater access and opportunities for Hong Kong's financial institutions to participate in green financing transactions locally, in mainland China, and in markets along the Belt & Road Initiative. Please visit www.hkgreenfinance.org for more information.

This is the second in our series of thought pieces on carbon markets and is a continuation of our first article: Everyone Wants to Buy Carbon Credits – Here's What You Should Know (<https://bmcquhae.com/en/2022/11/15/everyone-wants-to-buy-carbon-credits-heres-what-you-should-know/>).

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