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**GOVERNING COUNCIL  
102<sup>nd</sup> session  
Rome, 10-12 May 2023**

UNIDROIT 2023  
C.D. (102) 14  
Original: English  
April 2023

**Item No. 7 on the agenda: Update on certain high-priority projects on the 2023-2025 Work Programme**

**(b) Legal nature of Voluntary Carbon Credits**

(prepared by the Secretariat)

<i>Summary</i>	<i>Update on the project on Legal nature of Voluntary Carbon Credits</i>
<i>Action to be taken</i>	<i>The Governing Council is invited to take note of the developments in the Project described and of the establishment of a Working Group to commence the preparation of an international instrument providing guidance on the legal nature of voluntary carbon credits</i>
<i>Mandate</i>	<i>Work Programme 2023-2025</i>
<i>Priority level</i>	<i>High</i>
<i>Related documents</i>	<a href="#">UNIDROIT 2022 - C.D. (101) 4 rev.</a> ; <a href="#">UNIDROIT 2022 - A.G. (81) 9</a> ; <a href="#">UNIDROIT 2023 - C.D. (102) 6</a>

**I. INTRODUCTION**

1. On 24 January 2022, UNIDROIT received a proposal from the International Swaps and Derivatives Association (ISDA) for a project to determine the legal nature of voluntary carbon credits (VCCs). This proposal was expressly supported by the Government of Paraguay in a letter received by the Secretariat on 9 May 2022. The content of this proposal was detailed in document [UNIDROIT 2022 - C.D. \(101\) 4 rev.](#), which was deliberated on by the UNIDROIT Governing Council at its 101<sup>st</sup> Session (Rome, 8-10 June 2022).

2. At the end of the session, the Governing Council unanimously recommended the inclusion of a project to analyse the private law aspects and determine the legal nature of VCCs in the 2023-2025 Work Programme, with high priority. While the Council recognised the similarities and linkages of this work to the UNIDROIT Project on Digital Assets and Private Law, it identified sufficient individual features to recommend that a separate Working Group be established for this new project, including experts that already form part of the Digital Assets Working Group, as well as experts in the areas of carbon credit trading and environmental law. The Governing Council's recommendation was endorsed by the UNIDROIT General Assembly at its 81<sup>st</sup> session with unanimous support ([UNIDROIT 2022 - A.G. \(81\) 9](#)).

## II. FIRST STEPS FOR THE VCC PROJECT

3. Following the mandate received, the UNIDROIT Secretariat organised a consultative workshop in collaboration with the World Bank Group and ISDA, at ISDA headquarters in London on 27 March 2023. A preliminary background paper was prepared by the Secretariat to guide the discussion. The consultative workshop was attended by 24 participants from international organisations, practitioners, industries, academia, and the UNIDROIT Secretariat.

4. The workshop sought to explore, among other matters, the following items:

- (a) Key concepts (including “voluntary carbon market”, “voluntary carbon credits”, etc.);
- (b) Key considerations regarding the legal nature of VCCs;
- (c) Ownership, creation, and transferability of VCCs;
- (d) Secured transactions involving VCCs, including collateralisation;
- (e) Custodians/intermediaries;
- (f) Applicable law issues;
- (g) Treatment in case of insolvency; and
- (h) Local market regulatory oversight.

### A. Key concepts

5. Participants at the workshop discussed working definitions for “voluntary carbon market” (VCM) and “voluntary carbon credits” (VCC). Despite some private sector-led initiatives, such as the Task Force on Scaling Voluntary Carbon Markets,<sup>1</sup> supported by the Institute of International Finance, participants generally agreed that these concepts are not uniform across marketplaces. Sometimes they refer not only to the reduction, removal, or sequestration of greenhouse gases (GHGs) from the atmosphere (so-called “carbon offsets”), but also to permits to emit GHGs (so-called “emission allowances”).

6. It was generally agreed that the development of well-functioning VCMs could have several positive effects. It could play a central role in fighting climate change, achieving the goals of the United Nations Framework Convention on Climate Change, and in particular its Paris Agreement, as well as facilitating the fulfilment of some of the Sustainable Development Goals (SDGs). Also, given that a significant share of the projects that generate VCCs are located in developing economies, VCMs also offer an opportunity to increase capital flow to emerging markets and provide funding to projects that might otherwise not receive it.

7. The discussion regarding the concept of VCM showed some degree of preliminary consensus concerning three matters. First, participants agreed that secondary markets (official or “over-the-counter” (OTC)) and primary markets should be treated differently. Second, participants considered the fact that the asset being created on a voluntary basis (*e.g.*, through contracts) differentiated a VCM from a compliance carbon market. Third, it was acknowledged that, in the future, there should be interoperability between the VCM and the compliance carbon market once the mechanism provided by Article 6.2 of the Paris Agreement becomes operational. Further, regarding the criteria for distinguishing VCMs from compliance markets, the importance of differentiating the creation of the unit from its use (*i.e.*, circulation) was emphasised. When there is no mandate to create a unit, then it is a VCM, regardless of the reason behind the circulation of carbon credits.

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<sup>1</sup> The Taskforce on Scaling Voluntary Carbon Markets is a private sector-led initiative working to scale an efficient Voluntary Carbon Market to help meet the goals of the Paris Agreement. More information at: <https://www.iif.com/tsvcm>.

8. It was pointed out that VCMs include not only “units” that represent carbon credits after issuance, but also forms of carbon offset project financing upfront. Participants discussed whether the notion of VCCs should only cover “project-related carbon offsets” or also include “permits” or “emission allowances”. Some queried the relevance of differentiating these two types of assets to examine the legal nature of VCCs, which is the main objective of the Project. It was agreed that further reflection would be needed.

9. The role of standards (e.g., “Verra Standard” and “Gold Standard”) in the definition of VCCs was also considered. Overall, participants agreed that the Project should adopt a functional approach to define VCCs (and their markets), in line with what was done for the notion of “digital asset” in UNIDROIT’s Digital Asset Project ([C.D. \(102\) 6](#)).

## **B. Key considerations regarding the legal nature of VCCs**

10. As VCMs grow in size and complexity and VCCs become increasingly litigated in several fora, it is believed that markets trading in fungible VCCs would be significantly enhanced if steps were taken, at both national and international levels, to better understand the legal nature of VCCs. Not only the creation, transfer, and retirement of VCCs are determined by their legal nature, but also broader considerations, such as fungibility, collateralisation, and problems arising in insolvency.

11. Ultimately, greater clarity on the legal nature of VCCs would significantly contribute to the development of an efficient and more robust global VCM. Therefore, the main objective of the Project should be to provide guidance on private law issues that would offer greater confidence in VCC transactions amongst market participants. This would be fully aligned with the approach included in the proposal presented by ISDA to include the Project in the 2023-2025 Work Programme; and fully consistent with the type of analysis the World Bank deems necessary at this stage of development of the market.

12. During the workshop, participants emphasised the practical relevance of further discussing the legal nature of VCCs, as it could have an impact on, among other things, *lex situs*, security interests, and enforceability in the event of insolvency. The appropriateness and opportunity of qualifying VCCs as intangible property or as a bundle of contracts were considered, as well as whether it would be advisable to adopt a functional approach aimed at simplifying the tradability of VCCs, without dealing with different national legal definitions (e.g., intangible property).

13. Participants also discussed the fact that the legal nature of VCCs could change at different stages of their lifetime (issuance, transfer, etc.) and by the various actors involved (the issuer, the registry, the verifier, the buyer). In this regard, there was a suggestion to examine the complete life cycle of a VCC, including issuance, verification, acquisition/transfer, as well as trading and eventual retirement. All these processes could raise different private law issues which the Project could explore.

## **C. Ownership, creation, and transferability of VCCs**

14. During the workshop, participants discussed various issues relating to the ownership and transfer of VCCs. Some experts pointed out the weaknesses of the registration system and queried whether *ad hoc* registers for VCCs were necessary. Other experts emphasised the usefulness of a registration system for transferability and security. However, the main issue with existing registration systems was that different registries had their own terms and conditions of transactions, creating obstacles to an effective transaction process. There was general support for the introduction of a uniform baseline for different registries to ensure the long-term development of the VCC market.

15. Further, it was noted that a lack of uniformity and interoperability between VCC registries could lead to each registry existing within its own national governance framework, which could be detrimental to the VCC market. Secondly, it was highlighted that trading entities could not presently access the required data and information through a single system, leading to the risk of double counting. Some sort of uniform approach could solve this issue. Thirdly, there were different types of registries, serving different purposes and leading to the risk of a lack of interoperability between disparate registries. Fourthly, it was stressed that there was a need for transparency in registration, particularly concerning transfers under Article 6 of the Paris Agreement. Fifthly, concern was expressed about a potential risk of registry instability, particularly for less developed economies. Finally, the role of blockchain technology in improving the transferability of VCCs was discussed, with some participants believing that it would most likely be the primary technology used in the future, but with some uncertainty concerning tokenisation and its intersection with cryptocurrencies.

#### **D. Secured transactions involving VCCs, including collateralisation**

16. The workshop also focused on secured transactions and collateralisation in relation to VCCs. The participants pointed out legal uncertainties and problems which affected the market for security over VCCs, including the role of registries, lack of communication between registries, and disclaimers of responsibility related to claim rights or the quality of their methodologies. Another issue was the law applicable to secured transactions involving VCCs, which was governed by local traditions and identification of counterparties to the transaction. It was argued that developing countries at times lacked experience with such transactions, and it was noted that guidance on these matters could lower the risk of financing VCC projects and help assess to what extent the different approaches could be harmonised with the existing and future demand. Participants agreed that the UNIDROIT Principles on Digital Assets and Private Law should be the starting point for dealing with securities whenever VCCs were digital assets.

#### **E. Custodians/intermediaries**

17. The involvement of custodians and intermediaries in VCMs was also discussed, as well as whether carbon brokers and retailers could contribute to market scalability. It was noted that there were numerous intermediaries operating in VCMs with multiple roles, specially concerning their legal position vis a vis the asset (having title or merely acting as a transfer log), with all the legal consequences that such differences might entail.

18. The workshop examined the concept of a custodian of VCCs, with participants emphasising the importance of having integrity in custodian transactions and suggesting that the Project could outline the obligations of transparency and integrity that must be observed when part of a custodial relationship involving VCCs. The preliminary conclusion of the discussion was that participants agreed on the importance of ensuring the transparency and integrity of custodian transactions in VCMs and that this should be part of the Project's scope. The Secretariat reminded participants that the project ought to stay clear of elements which are purely regulatory in nature.

#### **F. Applicable law issues**

19. Concerning issues of applicable law, participants highlighted the main conflict of law issues in VCM practice. It was noted that for the determination of the applicable law, beyond party autonomy, several connecting factors, such as the location of the carbon-offset project, the location of the issuing registry (or of the server, when its location is disclosed by the register), the location of the asset (if different), and the location of the verifier, could be considered. It was noted that the right to control the asset could be an important consideration in this discussion.

20. Additionally, consideration was given to examining separately the determination of applicable law. It was noted that while conflicts of law could be explored by the Project generally, the question of jurisdiction should not be included because of the Project's focus on private law issues. Further, the Secretariat noted that applicable law in insolvency matters is already a project underway at UNCITRAL and therefore ought not to be part of the analysis.

## **G. Treatment in case of insolvency**

21. Experts also discussed what would happen if a participant in a VCM, such as an intermediary or a custodian, were to become insolvent and whether VCCs fell within the general insolvency estate or should be dealt with separately. Further, the priority of security interests in VCCs was considered. It was noted that some of the problems with insolvency treatment may be related to the fact that carbon credits are at the server level and standard-setting organisations do not disclose the location of the server. The importance of considering the issue of depositary insolvency was also pointed out.

22. Participants decided to start addressing the issue of insolvency treatment based on the work of the Digital Assets and Private Law Working Group and then examine whether it would be necessary to modify the rule on the basis of the specificities of VCCs.

## **H. Local market regulatory oversight**

23. Finally, the question of local market regulatory oversight was also considered at the consultative workshop, with participants noting that it was important to involve regulators in the Project. Considering that the Project concerns the private law aspects of VCCs, it was suggested that rather than delving into purely regulatory aspects, attention could be paid to developing guidelines on what types of regulators could be involved and how to coordinate the different regulators. Participants stressed that, with regard to types of regulators, it would be important to distinguish between creation and use of carbon credits, so that different agencies could perform their functions more effectively at different stages.

24. At the end of the consultative workshop, participants suggested several stakeholders, including international organisations, international development banks, industry-related organisations, non-governmental bodies, and academics who could be involved in the Working Group for this Project. Participants noted that additional deliberation should take place to determine the type of instrument to prepare, some suggesting moving towards a legal guide. It was recognised that there were synergies, at least in terms of the nature of the asset, between this work and UNIDROIT's work on Digital Assets and Private Law.

25. All participants stressed the pressing need for clarity in the area of VCCs and private law matters, as well as the urgency of providing transnational law guidance in the briefest period of time possible.

## **III. NEXT STEPS**

26. The Secretariat has gathered sufficient information on topics as well as on the experts and institutions to involve in the next stage of the Project. In compliance with the mandate received by the General Assembly, a Working Group will be convened, and a first session should take place within a short period of time. It is envisaged that two or three Working Group meetings will take place before the end of the calendar year. It is anticipated that the future instrument will be developed over at least five in-person sessions between 2023 and 2024.

27. Work will henceforth be conducted in collaboration with the World Bank Group.

**IV. ACTION TO BE TAKEN**

28. *The Governing Council is invited to take note of the developments in the Project described, of the establishment of a Working Group to commence the preparation of an international instrument providing guidance on the legal nature of voluntary carbon credits, and of the World Bank Group's involvement in the project.*