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**UNIDROIT Working Group on the  
Legal Nature of Verified Carbon Credits  
Third session (hybrid)  
Rome, 4-6 September 2024**

UNIDROIT 2024  
Study LXXXVI – W.G.3 – Doc. 2  
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## **ISSUES PAPER<sup>1</sup>**

1. The International Institute for the Unification of Private Law ("UNIDROIT" or "the Institute"), in collaboration with the World Bank Group (WBG), has undertaken a project to analyse the Legal Nature of Verified Carbon Credits.<sup>2</sup>

2. This document provides a discussion of issues that the UNIDROIT Working Group on the Legal Nature of Verified Carbon Credits (the "VCCs Working Group" or "Working Group") may wish to consider at its third session, to be held in Rome and online from 4 to 6 September 2024.

3. This Issues Paper has the following structure:

Part I (Preliminary matters) contains a revised version of the sections of the Issues Paper prepared for the second session of the VCCs Working Group ([Study LXXXVI – W.G.2 – Doc. 2](#)) relating to Preliminary Matters.

Part II (Structure of the instrument) recalls the proposed scope of the project and suggests a possible structure for the future instrument to be considered by the Working Group.

Part III (Content) provides the draft content of the future instrument as developed up to this third session. This draft content is based on the discussions of the Working Group's first and second sessions, as well as the intersessional work carried out by the core drafting group during the months of May-August 2024.

Part IV (Next steps) lays out a proposed action plan and timeline for the project. As the rest of the document, this part is subject to discussion by the Working Group.

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<sup>1</sup> The Secretariat is grateful to Ms Başak BAŞOĞLU KAPANCI (Roy Goode Scholar) for her assistance in the preparation of this document.

<sup>2</sup> At its 103<sup>rd</sup> session, the UNIDROIT Governing Council approved changing the project title from "Voluntary Carbon Credits" to "Verified Carbon Credits". For clarity, the term "verified carbon credits" will be used in place of "voluntary carbon credits" throughout this paper. The use of the acronym "VCC" in this paper thus refers to "verified carbon credit" rather than "voluntary carbon credit". For more information, see the document on the VCC project prepared for the Governing Council ([C.D. \(103\) 11](#)) and the Summary Conclusions ([C.D. \(103\) Misc. 2](#)).

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## **I. PRELIMINARY MATTERS**

### **A. Background to the Project**

4. On 24 January 2022, the International Swaps and Derivatives Association (ISDA) submitted a proposal to UNIDROIT recommending that UNIDROIT consider a project to analyse the legal nature of voluntary carbon credits. ISDA's proposal was expressly supported by the Government of Paraguay in a letter received by the UNIDROIT Secretariat on 9 May 2022.<sup>3</sup>

5. At its 101<sup>st</sup> session (Rome, 8-10 June 2022), the UNIDROIT Governing Council unanimously recommended the inclusion of a project to analyse the legal nature and other private law aspects of voluntary carbon credits in UNIDROIT's 2023-2025 Work Programme, with high priority.<sup>4</sup> The Governing Council's recommendation was unanimously endorsed by the UNIDROIT General Assembly at its 81<sup>st</sup> session (Rome, 15 December 2022).<sup>5</sup>

6. Following receipt of the mandate, the UNIDROIT Secretariat organised an exploratory consultative workshop in collaboration with the WBG and ISDA, held at ISDA's headquarters in London on 27 March 2023. The purpose of this first exploratory consultative workshop was to identify relevant private law issues in the field of voluntary carbon credits with a view to begin delineating, albeit preliminarily, the scope of the project. A discussion paper was prepared by the Secretariat to guide the deliberations. The workshop was attended by 24 participants, including representatives from international organisations, industry associations and academic institutions, as well as private practitioners and members of the UNIDROIT Secretariat.

7. An update on the preparatory work of the project, drawing on the conclusions of the first exploratory consultative workshop as well as on the Secretariat's own research, was presented to the UNIDROIT Governing Council at its 102<sup>nd</sup> session (Rome, 10-12 May 2023). On this occasion, the Governing Council confirmed the authorisation to establish a Working Group in collaboration with the WBG. The Council also encouraged further coordination in this area with other international organisations, such as UNCITRAL.

8. A second exploratory consultative workshop was held at the WBG's office in Vienna on 11 July 2023. The second workshop was attended by 28 participants, including experts from international organisations, development banks, academic institutions and the private sector, as well as representatives from the UNIDROIT Secretariat. The second exploratory consultative workshop closed with the participants noting that next steps would be delineated in coordination with UNCITRAL in light of UNCITRAL's 56<sup>th</sup> Commission Session held in Vienna on 3-21 July 2023 and the Colloquium on Climate Change and the Law of International Trade organised by the UNCITRAL secretariat in Vienna on 12-13 July 2023.

9. Following its 56<sup>th</sup> Session, UNCITRAL's Commission gave its secretariat a mandate to conduct exploratory work in the area of VCCs in cooperation with UNIDROIT and other organisations. In this context, UNCITRAL and UNCITRAL-nominated experts were invited to participate in the first session of the Working Group. See section G below for more information on the Working Group sessions and intersessional work developed to date.

### **B. Purpose of the Project**

10. The legal nature of VCCs determines issues such as the registration, issuance, transfer, and retirement of the credits and impacts broader considerations such as collateralisation and insolvency.

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<sup>3</sup> For more information on the content of ISDA's proposal, see document UNIDROIT 2022 [C.D. \(101\) 4 rev.](#)

<sup>4</sup> UNIDROIT 2022, [C.D. \(101\) 4 rev.](#), paras 50-60.

<sup>5</sup> UNIDROIT 2022, [A.G. \(81\) 3](#), paras 75-78.

Greater clarity on the legal nature of VCCs would reduce legal uncertainty and significantly contribute to the development of an efficient and more robust global VCM.

11. The main objective of the UNIDROIT project is to provide guidance on private law issues so as to enhance confidence in VCC transactions and support the development of a well-functioning VCM. A strong VCM could play a central role in fighting climate change, help achieve the goals of the Paris Agreement, and facilitate the fulfilment of the United Nations Sustainable Development Goals (UNSDGs). Given that a significant share of the projects that generate VCCs are located in developing economies, a reliable VCM also provides an opportunity to increase capital flow to emerging markets and provide funding to climate mitigation projects.<sup>6</sup>

12. While regulation *per se* is outside the scope of the project, it touches upon certain aspects which border on regulatory issues. The Working Group may thus wish to take these into account to ensure coherence between the recommendations for private law and any regulatory approaches.

### C. Format and Title

13. UNIDROIT's fundamental statutory objective is to prepare modern and, where appropriate, harmonised uniform rules of private law.

14. The uniform rules drawn up by UNIDROIT may take the form of various types of international law instruments, depending on the characteristics of the particular project. For example, in keeping with the Institute's intergovernmental structure, legal instruments developed by UNIDROIT may take the form of international conventions, designed to apply automatically in preference to a State's domestic law once all the formal requirements of that State's domestic law for their entry into force have been completed.<sup>7</sup>

15. At the same time, however, alternative forms of harmonisation or modernisation have become increasingly popular in areas where a binding instrument is not felt to be essential. Such alternatives may include model laws, which States may take into consideration when drafting domestic legislation,<sup>8</sup> or general principles, which legislators, judges, arbitrators and contracting parties may decide whether to adopt.<sup>9</sup> Where a subject is not judged ripe for uniform rules, another alternative consists in legal guides, typically addressing new business techniques or types of transactions, or the framework for the organisation of markets both at the domestic and the international level.<sup>10</sup>

16. Given the lack of a mandate to work on a hard-law instrument such as an international convention or treaty, the Working Group considered soft-law options. A model law was not considered suitable in light of the state of the market and the need to explain the nature of VCCs with reference to existing domestic frameworks. The Working Group instead focused on principles with commentary or a legal guide with recommendations. It was observed that these types of instruments were likely to be the most appropriate considering the need for flexibility and guidance, as well as the desirability to offer greater clarity to the market through the use of commentary. The Working Group thus tentatively agreed to proceed with the drafting of a set of principles and commentary. The Governing Council agreed with the proposed next steps; the Chair and the Secretariat would coordinate

<sup>6</sup> See, e.g., UNCITRAL/UNIDROIT Joint Study, para. 50.

<sup>7</sup> See, e.g., [2001 Convention on International Interests in Mobile Equipment](#) (the "Cape Town Convention"); [1995 UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects](#).

<sup>8</sup> See, e.g., [UNIDROIT Model Law on Factoring](#).

<sup>9</sup> See, e.g., [UNIDROIT Principles on Digital Assets and Private Law](#).

<sup>10</sup> See, e.g., [UNIDROIT | FAO | IFAD Legal Guide on Contract Farming](#).

intersessional meetings with members of the Working Group to advance on the drafting of preliminary principles and commentary.

17. As mentioned above, following the discussion held during the UNCITRAL/UNIDROIT joint meeting and the second session of the Working Group, the UNIDROIT Governing Council approved the change in the title of the future instrument to “the Legal Nature of Verified Carbon Credits”.<sup>11</sup> This change was mainly agreed upon to reflect the discussions of the experts who had noted that what distinguished these instruments from other types of climate financing tools was the fact that the project-based emission reductions or removals represented by the carbon credit had been independently recognised and verified by a third party. It was observed that what the unit was called and how it was defined in the instrument were two different things. Regarding what it was called, “verified” carbon credit seemed like an adequate term supported by the industry.

#### **D. Target Audience**

18. As consistent with all UNIDROIT instruments, the prospective international instrument should be relevant to all jurisdictions irrespective of the legal tradition (*e.g.*, both common law and civil law jurisdictions) and should aim to reduce the legal uncertainty which practitioners, judges, legislators and market participants face in relation to VCCs, including issues pertaining to the issuance, ownership and transfer of VCCs.

19. In particular, the Working Group is encouraged to consider the potential use of any future instrument by developing countries, including in aiding jurisdictions with limited resources develop relevant international law frameworks to better participate in the VCM.

#### **E. Composition of the Working Group**

20. Consistent with UNIDROIT’s established working methodologies, the VCCs Working Group is composed of experts selected for their expertise in the fields of carbon credit trading, environmental law, property law, contract law, secured transactions, and digital technology. Experts participate in a personal capacity and represent the world’s different legal systems and geographic regions. Due to the specific nature of the project, particular focus is placed on ensuring representation from developing economies, especially from the African, Latin American, and Asia-Pacific regions, where many of the climate mitigation projects giving rise to VCCs are situated.

21. UNIDROIT Secretary-General Professor Ignacio Tirado chaired the first two sessions of the Working Group. Professor Hideki Kanda, UNIDROIT Governing Council Member and Emeritus Professor at the University of Tokyo, Japan, has since been appointed as Chair of the Working Group.<sup>12</sup>

22. To date, the Working Group is composed of the following members:

- Filippo Annunziata, Professor of Financial Markets and Banking Law, Università Bocconi Milano (Italy);
- Ipshita Chaturvedi, Partner, Dentons Rodyk (Singapore) (nominated by UNCITRAL);
- Luca Enriques, Professor of Corporate Law, University of Oxford (United Kingdom/Italy);
- Megumi Hara, Professor of Law, Chuo University (Japan);
- Caroline Kleiner, Professor of Law, University Paris Cité (France);

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<sup>11</sup> See UNIDROIT 2024 C.D. (103) Misc. 2, para 16.

<sup>12</sup> See UNIDROIT 2024 C.D. (103) 11, para 10.

- Géraud de Lassus St-Geniès, Professor of Law, Laval University (Canada) (nominated by UNCITRAL);
- Matthias Lehmann, Professor of Private Law, University of Vienna (Austria);
- Ludovino Lopes, Founding Partner, Ludovino Lopes Sociedade de Advogados (Brazil/Portugal);
- Kelvin Low, Professor of Private Law, University of Hong Kong (People's Republic of China/Singapore);
- Andrea Tosato, Associate Professor of Commercial Law, University of Nottingham (United Kingdom) and Visiting Associate Professor in Law, University of Pennsylvania (United States of America);
- Rolf H. Weber, Professor of International Business Law, University of Zurich (Switzerland); and
- Zhang Xiaoping, Associate Professor of Law, Central University of Finance and Economics (People's Republic of China) (nominated by UNCITRAL).

23. Organisations, industry associations, legal practitioners, financial sector representatives and members of academic institutions with expertise in the field of VCCs and private law have been invited to participate as observers in the Working Group. It is expected that, in addition to contributing to the discussions of the Working Group, participation of these stakeholders will assist in the promotion, dissemination and implementation of any international instrument that is ultimately developed and adopted.

24. The below organisations have joined the Working Group as institutional observers:

- United Nations Commission on International Trade Law (UNCITRAL);
- Hague Conference on Private International Law (HCCH);
- American Carbon Registry (ACR);
- Asian Development Bank (ADB);
- Asia-Pacific Financial Forum (APFF);
- Environmental Defense Fund (EDF);
- European Law Institute (ELI);
- Frank J. Guarini Center on Environmental, Energy and Land Use Law at New York University School of Law;
- Inter-American Development Bank (IADB);
- Integrity Council for the Voluntary Carbon Market (ICVCM);
- International Bar Association (IBA);
- International Emissions Trading Association (IETA);
- International Law Institute (ILI);
- International Organization of Securities Commissions (IOSCO);
- International Swaps and Derivatives Association (ISDA);
- Ministère de l'Environnement et des Ressources Forestières, République Togolaise;
- Nigerian Securities and Exchange Commission;
- Pollination;

- Puro.earth;
- Scotia Group;
- Stock Exchange of Thailand;
- TOSCA Research Group, Centre for Responsible Digitalization;
- Uniform Law Commission (ULC);
- United Nations Framework Convention on Climate Change (UNFCCC) (nominated by UNCITRAL);
- Verra; and
- West African Alliance on Carbon Markets and Climate Finance.

25. The following individuals have joined the Working Group as observers, in a personal capacity:

- Dessanin Ewèdew Thierry Awesso, Teaching Assistant, Université Côte d’Azur (France/Togo);
- Malik R. Dahlan, Emeritus Professor of International Law and Public Policy, Queen Mary University of London (United Kingdom);
- Lisa Demarco, Senior Partner and CEO, Resilient LLP (Canada);
- Reginald Karawusa, Immediate Past Executive Commissioner, Legal and Enforcement, Nigerian Securities and Exchange Commission;
- Blanca López Bassa, Chief Legal Officer, Paskay (Peru);
- Gabriela Melgarejo, Researcher, Centro de Educación de Derecho, Economía y Política (CEDEP) (Paraguay);
- Jason Norman Lee, Managing Director, Legal & Regulatory, Temasek International Pte. Ltd (Singapore);
- Rodrigo Jesús Rodríguez Tornquist, Professor, Universidad Nacional de San Martín (Argentina);
- Sergey Sitnikov, Ph.D., Expert in international carbon policies and markets (Russian Federation);
- Munkh-Orgil Tseng, Member of the State Great Hural (Parliament) (Mongolia);
- Ingrid York, Partner, White & Case LLP (United Kingdom); and
- Peter Zaman, Partner, Holman Fenwick Willan LLP (Singapore).

26. José Antonio Moreno Rodriguez, Member of UNIDROIT’s Governing Council, as well as Suzanne Howarth and Antenor Madruga, respectively UNIDROIT Correspondents for Australia and Brazil, participate in the Working Group as observers. Professor Louise Gullifer (University of Cambridge) acts as a Senior Advisor to the UNIDROIT Secretariat for this project.

## **F. Methodology and Timeline**

27. The Working Group will undertake its work in an open, inclusive, and collaborative manner. As consistent with UNIDROIT practice, the Working Group will not adopt any formal rules of procedure and will seek to make decisions through consensus.

28. The Working Group will meet at least twice a year for three days in Rome, Italy. Meetings will be held in English without translation. Remote participation will be possible, although experts will

be expected to attend in person. In the context of the support provided by the WBG, other meetings may take place in different locations.

29. The documents for the Working Group meetings will generally be distributed at least ten days in advance of each session. After each session of the Working Group, the UNIDROIT Secretariat will share a high-level summary of the meeting with all participants. Such documents will also be published on the UNIDROIT website.

30. The present project is a high-priority project on the current UNIDROIT Work Programme for the period 2023-2025. The following would be a tentative work plan:

- Development of an international instrument on the Legal Nature of VCCs over five Working Group sessions:<sup>13</sup>
  - a. *First session*: 10-12 October 2023,
  - b. *Second session*: 22-24 April 2024,
  - c. *Third session*: 4-6 September 2024,
  - d. *Fourth session*: 15-17 January 2025,
  - e. *Fifth session*: 2-4 April 2025;
- Consultations and finalisation: second half of 2025;
- Adoption by the Governing Council of the complete draft in 2026.

## **G. Working Group sessions and Intersessional Work**

### *First session of the Working Group*

31. The first session of the Working Group was held between 10 and 12 October 2023 at the seat of UNIDROIT in Rome and online and was guided by the Issues Paper prepared by the Secretariat.<sup>14</sup> The session was attended by representatives of the World Bank and UNCITRAL, as well as by ten Working Group members and 15 institutional and individual observers, comprising representatives from international organisations, industry associations, the private sector and academia. The Working Group focused on clarifying the life cycle of a verified carbon credit, discussing the role played by independent carbon crediting programmes and registries, and identifying possible routes to concluding that verified carbon credits can be the subject of proprietary rights, whether on the basis of their substance or their form.<sup>15</sup>

### *First intersessional period*

32. The intersessional work carried out following the Working Group's first session included a subgroup meeting in December 2023 to advance in the consideration of the legal nature of VCCs and, more specifically, whether VCCs could be the subject of proprietary rights. In addition, close collaboration with the UNCITRAL secretariat also continued and a joint UNCITRAL/UNIDROIT meeting was held in Vienna in February 2024. The two organisations co-authored a Study on the Legal Nature of Verified Carbon Credits Issued by Independent Carbon Standard Setters (the "UNCITRAL/UNIDROIT Joint Study"). The Joint Study sets out a mapping exercise in the area of VCCs to help States assess the options available to them in addressing relevant legal issues, in particular

<sup>13</sup> Intersessional subgroup meetings may be conducted remotely when deemed necessary.

<sup>14</sup> For additional details on the first session of the Working Group, see the Issues Paper ([Study LXXXVI – W.G.1 – Doc. 2](#)) and Summary Report ([Study LXXXVI – W.G.1 – Doc. 3](#)) prepared by the Secretariat.

<sup>15</sup> See Summary Report of the first session of the Working Group, [Study LXXXVI – W.G.1 – Doc. 3](#).



as regards the legal nature of VCCs.<sup>16</sup> Following the UNCITRAL/UNIDROIT joint meeting, the UNIDROIT Working Group met on 2 February 2024 at the WBG premises in Vienna and online. The Working Group primarily discussed the type of instrument to be developed.<sup>17</sup>

### Second session of the Working Group

33. Between 22 and 24 April 2024, the second session of the Working Group was held at the seat of UNIDROIT in Rome and online. The session was attended by 50 participants, including representatives from the World Bank and the Hague Conference on Private International Law (HCCH), as well as legal experts and observers from international, regional and intergovernmental organisations, the private sector and academia. The deliberations focused on the Revised Issues Paper prepared by the Secretariat based on the outcomes of the first session and the intersessional work carried out in the interim. The Working Group's discussion centred on the content of the future instrument to be developed.<sup>18</sup> In particular, the Working Group analysed the main steps in the life cycle of VCCs through a property law perspective in order to ascertain the proprietary nature of VCCs and the effect of transfers and dispositions in VCCs on a holder's proprietary rights. Among other things, the Working Group discussed the definitions of key terms to be included in the instrument and addressed issues pertaining to the registration, transfer, retirement, reversal and cancellation of VCCs. Of particular relevance was consideration of the role played by independent carbon crediting programmes and registries, including in relation to the issuance and registration of VCCs. To that end, representatives from Verra and Puro Earth, two leading independent carbon crediting programmes, delivered presentations to the Working Group, addressing, *inter alia*, how VCCs are issued, evidenced, individualised, transferred, encumbered, retired or otherwise cancelled. In addition, with input from the HCCH, the Working Group discussed relevant conflicts of law issues to be addressed in the instrument.

### Second intersessional period

34. Following the second Working Group session, during its 103<sup>rd</sup> session (8-10 May 2024), the UNIDROIT Governing Council approved the Working Group's request to change the project title from the "Legal Nature of Voluntary Carbon Credits" to the "Legal Nature of Verified Carbon Credits", based on the experts' advice that the legal nature of carbon credits did not depend on the use ultimately given to the said credits.<sup>19</sup> Additionally, the Council took note of the significant progress made by the Working Group and expressed a positive view of the publication of the UNCITRAL/UNIDROIT Joint Study. During the 57<sup>th</sup> UNCITRAL Commission session, held in July 2024 in New York, the Joint Study was presented and also received positive feedback from the attendees.

35. In parallel, the HCCH received the mandate from its governing body to work on private international law (PIL) issues related to voluntary carbon markets (VCM).<sup>20</sup> Subsequently, a subgroup on applicable law was established, which was followed by an online meeting on 16 July 2024. The attendees included representatives from the UNIDROIT Secretariat and the Permanent Bureau of the HCCH, as well as the legal experts appointed to sit on the subgroup to draft PIL rules for the future UNIDROIT instrument on VCCs. The meeting discussed a preliminary timeline for further collaboration and document preparation by the subgroup, and explored the potential scope of PIL rules to be developed.

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<sup>16</sup> UNCITRAL/UNIDROIT study on the legal nature of verified carbon credits issued by independent carbon standard setters, A/CN.9/1191, 14 March 2024, available at [1191\\_advance\\_copy\\_1.pdf\(un.org\)](#).

<sup>17</sup> See Study LXXXVI – W.G.1 – Doc. 2 Add.

<sup>18</sup> For further information regarding the second session of the Working Group, see the Issues Paper ([Study LXXXVI – W.G.2 – Doc. 2](#)) and Summary Report ([Study LXXXVI – W.G.2 – Doc. 3 rev.](#)) prepared by the Secretariat.

<sup>19</sup> UNIDROIT 2024, [C.D. \(103\) Misc. 2](#), para. 16.

<sup>20</sup> See [HCCH Council on General Affairs and Policy 2024](#), paras 18-19.

### Establishment of the core drafting group

36. Following the second session of the Working Group, a core drafting group was established, composed of three main drafters, two advisors, and the Chair of the Working Group. The core drafting group met remotely on 27 May 2024 to discuss (i) the structure of the future instrument and drafting assignments among members of the core drafting group, (ii) timeline for next steps of the Working Group, and (iii) whether the Principles should address tokenisation and derivatives.

37. The core drafting group held another online meeting on 17 June 2024 to develop a draft text of Principles for the Working Group's review on 1 July. The group discussed, among other topics, the definition of "VCC", the scope of "verification", and the role of independent verifiers. They also deliberated on the "accreditation process", the "project proponent", and "retirement" and "cancellation" of VCCs.

38. On 1 July 2024, an intersessional Working Group meeting was held online to review the draft black-letter Principles prepared by the core drafting group. The discussion primarily revolved around Principle 2 (Definitions) and Principle 7 (Transfer), with the group offering comments and suggestions on several key issues. These included the definition of "VCC", the necessity of incorporating "issuance of a VCC" within the definitions, distinguishing between a "project" and a "programme", and exploring the scope of "the transfer of a VCC" addressed in this instrument.

39. In another online meeting on 17 July 2024, the core drafting group discussed the format of the document prepared for discussion during the third session of the Working Group. They also further explored the definitions of several terms in Principle 2 (Definitions) and considered matters related to VCC creation, transfer, and registry. Additionally, the group discussed and agreed to: (i) commence drafting an introductory section on the VCC lifecycle and (ii) add sub-custody rules to Principle 10 (Custody).

40. On 31 July 2024, the core drafting group emphasised the importance of the VCC life cycle and the work arrangements in the introductory part. The discussion centred around Principle 6, concerning VCC retirement, reversal, and revocation. They stressed the need to clearly define retirement and differentiate among retirement, reversal, and revocation. The group considered separating these three concepts into different principles based on their stages. They also discussed the role of buffer pools in VCC registries when a reversal occurred. Additionally, the group decided to adjust the current instrument structure to better align it with the VCC life cycle.

## **H. Relationship with Existing International Instruments and Initiatives**

41. The UNIDROIT project on the Legal Nature of VCCs is included in UNIDROIT's areas of work related to Sustainable Development and Law and Technology. The project aligns with UNIDROIT's ongoing initiative to analyse the role private law plays in the achievement of the UNSDGs, in particular towards the implementation of climate action. Because VCCs are often issued in the form of digital certificates, the project is complementary to the [UNIDROIT Principles on Digital Assets and Private Law](#) (the "DAPL Principles") which establish clear rules relating to certain private law aspects of digital assets, with a focus on proprietary rights.<sup>21</sup>

42. UNIDROIT's previous work in the area of Capital Markets and Intermediated Securities, in particular the [Geneva Securities Convention](#), the [Principles on Close-Out Netting](#) and the [Legislative Guide on Intermediated Securities](#) may also be relevant to the analysis of the legal nature of VCCs. In addition, the Working Group may wish to consider the [Guide on Best Practices for Electronic](#)

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<sup>21</sup> In particular, the DAPL Principles cover digital assets which are capable of being subject to control, and they provide guidance on issues related to private international law, control and transfer, custody, secured transactions, procedural law including enforcement, and insolvency.

[Collateral Registries](#), developed by the Cape Town Convention Academic Project. Finally, the UNIDROIT [Principles for International Commercial Contracts](#) may be relevant for any contract law analysis.

43. The project may also draw on ongoing initiatives and existing instruments of UNCITRAL and HCCH, of which the following serve as examples.

44. In 2021, the UNCITRAL Commission heard a proposal to examine (i) how existing UNCITRAL texts could be aligned with climate change mitigation, adaptation and resilience goals, and (ii) whether further work could be done by UNCITRAL to facilitate such goals in the implementation of those texts or the development of new texts. The UNCITRAL secretariat commissioned two studies on the private law aspects of climate change, the results of which have been summarised in Notes issued by the UNCITRAL secretariat (together, the “UNCITRAL Studies”).<sup>22</sup>

45. Following a request by the UNCITRAL Commission, on 6 October 2023, the UNCITRAL secretariat circulated a questionnaire to all member States of the United Nations with a view to gathering information on their existing legislation on carbon trading, the state of VCMs in their country, and on the legal nature of emissions allowances/carbon credits and VCCs under their domestic law (the “UNCITRAL Questionnaire”). The results of the UNCITRAL Questionnaire are addressed in the UNCITRAL/UNIDROIT Joint Study.

46. In addition, the project may draw on the [UNCITRAL Model Law on Secured Transactions](#) as well as the [1997 UNCITRAL Model Law on Cross-Border Insolvency](#) and the 2004 UNCITRAL Legislative Guide on Insolvency Law (“UNCITRAL LGIL”). The UNCITRAL secretariat continues to explore issues related to the applicable law in insolvency proceedings in the context of the ongoing efforts of Working Group V.<sup>23</sup>

47. As previously noted, the UNIDROIT Project on the Legal Nature of VCCs is also developed in close collaboration with the HCCH and takes into account the specific mandate of the HCCH to study the relevant PIL aspects of the VCM.<sup>24</sup>

48. Several initiatives and projects of the *World Bank Group* may also be informative. In particular, the WBG has been focusing on Emission Reductions Purchase Agreements (ERPAs), as well as carbon pricing and results-based climate finance projects. It is important to note the Climate Warehouse Project, which develops digital infrastructure to foster greater transparency, trust, and integrity in carbon markets. Examples include the metadata global platform Climate Action Data Trust (“CAD Trust”).<sup>25</sup> Further, Scaling Climate Action by Lowering Emissions (SCALE) is an umbrella multi-partner trust fund within the results-based climate finance programmes of the WBG.<sup>26</sup>

49. Additional international initiatives and studies may be relevant and should be taken into account by the Working Group when developing the international instrument to avoid duplication of efforts and overlap. These include, but are not limited to, the following.

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<sup>22</sup> Specifically, the UNCITRAL Studies examine the scope for a contribution by UNCITRAL to climate change mitigation, adaptation and resilience by addressing: (i) private law issues relating to clean investments; (ii) private law and the incorporation of climate considerations into business decisions; and (iii) UNCITRAL instruments and climate action. See UNCITRAL secretariat, *Work Programme: Possible future work on climate change mitigation, adaptation and resilience*, A/CN.9/1120, 15 May 2022; UNCITRAL secretariat, *Work Programme: Possible future work on climate change mitigation, adaptation and resilience*, A/CN.9/1153, 10 May 2023. Both documents are available at <https://uncitral.un.org/en/climatechangecolloquium>.

<sup>23</sup> For additional information, see [Working Group V: Insolvency Law | United Nations Commission On International Trade Law](#).

<sup>24</sup> See [HCCH, CGAP 2024, Conclusions and Decisions, March 2024](#), paras 18-19.

<sup>25</sup> For additional information, see <https://climateactiondata.org/>.

<sup>26</sup> In addition to those mentioned above, there are also a number of initiatives aimed at providing net-zero corporate guidance, including in relation to the use of crediting and VCCs. See UNCITRAL/UNIDROIT Joint Study, para. 73.

50. The *Integrity Council for Voluntary Carbon Markets* (ICVCM), an independent governance body for the VCM, is concentrated on the supply side of the VCM. It has established the Core Carbon Principles (CCPs), which set out key principles for high-integrity carbon credits, as well as an Assessment Framework, which includes the detailed criteria the ICVCM employs to assess whether carbon crediting programmes and specific categories of carbon credits meet the CCPs.<sup>27</sup> The first carbon crediting methodologies that meet the high-integrity CCPs were announced in June 2024, which means that the high-integrity CCP label can now be used on an estimated 27 million carbon credits generated by projects that tackle potent greenhouse gases.<sup>28</sup>

51. In December 2023, the *International Chamber of Commerce* (ICC) published its third report on *Proposals for Effective Carbon Pricing*, providing recommendations concerning, in particular, issues related to carbon leakage and carbon linkage.<sup>29</sup>

52. The *International Emissions Trading Association* (IETA) has published a report addressing the evolution of the VCM.<sup>30</sup> IETA also provides standardised documentation for emission trading, including documents that address primary and secondary over-the-counter emission markets.<sup>31</sup>

53. The *International Organization of Securities Commissions* (IOSCO) published a Discussion Paper in November 2022 with the aim of advancing the discussion on VCMs and the role financial regulators may play in promoting their integrity.<sup>32</sup> In December 2023, IOSCO followed up with a Consultation Report outlining a proposed set of Good Practices to promote the integrity and orderly functioning of VCMs.<sup>33</sup>

54. The *International Swaps and Derivatives Association* (ISDA) published a white paper in December 2021 which investigated the legal treatment of voluntary carbon credits<sup>34</sup> and considered certain other aspects of transactions in voluntary carbon credits (such as when they might be regulated as derivatives).<sup>35</sup> The white paper also recommended steps to further develop legal certainty in voluntary carbon credits at both the global and jurisdictional levels. An additional paper exploring the legal nature of voluntary carbon credits under French, Japanese and Singapore law was published in November 2022.<sup>36</sup> In December of the same year, ISDA published the *Verified Carbon Credit Transactions Definitions*, a definitional booklet that provides a set of standardised terms for

<sup>27</sup> For additional information, see <https://icvcm.org/the-core-carbon-principles/>.

<sup>28</sup> For additional information, see <https://icvcm.org/integrity-council-announces-first-high-integrity-ccp-labelled-carbon-credits-as-assessments-continue/>.

<sup>29</sup> See ICC (2023), *ICC proposals for effective carbon pricing: Leakage and linkage considerations*, available at <https://iccwbo.org/news-publications/policies-reports/principles-and-proposals-for-effective-carbon-pricing/>.

<sup>30</sup> See IETA, *The Evolving Voluntary Carbon Market*, March 2023, available at <https://www.ieta.org/resources/reports/the-evolving-voluntary-carbon-market-paper/>.

<sup>31</sup> See <https://www.ieta.org/resources/trading-documents/>.

<sup>32</sup> See IOSCO, *Voluntary Carbon Markets Discussion Paper*, CR/06/22, November 2022, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD718.pdf>. IOSCO also published a *Final Report on the compliance carbon market*. See IOSCO, *Compliance Carbon Markets Final Report*, FR/09/23, July 2023, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD740.pdf>.

<sup>33</sup> IOSCO, *Voluntary Carbon Markets Consultation Report*, CR/06/2023, December 2023, available at [CR06/2023 Voluntary Carbon Markets \(iosco.org\)](https://www.iosco.org/library/pubdocs/pdf/IOSCOPD740.pdf).

<sup>34</sup> At the time of publishing, the term “voluntary carbon credits” was a commonly used term to refer to VCCs bought and sold outside of compliance trading schemes.

<sup>35</sup> ISDA, *Legal Implications of Voluntary Carbon Markets*, ISDA, December 2021, available at <https://www.isda.org/2021/12/01/legal-implications-of-voluntary-carbon-credits>.

<sup>36</sup> ISDA, *The Legal Nature of Voluntary Carbon Credits: France, Japan and Singapore*, ISDA, November 2022, available at <https://www.isda.org/a/PlcGE/Legal-Nature-of-Voluntary-Carbon-Credits-France-Japan-and-Singapore.pdf>.

the trading and retirement of VCCs in the secondary market.<sup>37</sup> Version 2.0 of the Verified Carbon Credit Transactions Definitions was released in February 2024.

55. The *Voluntary Carbon Markets Integrity Initiative* (VCMi)<sup>38</sup> is an international non-profit organisation consisting of a multi-stakeholder project bringing together representatives of civil society, businesses, local communities, and governments to establish guidance on how voluntary carbon credits can be used and claimed as part of credible net-zero decarbonisation strategies. Alongside this work, the VCMi provides support to countries in building capacity to bring high-integrity carbon credits into the carbon market. In November 2023, the VCMi released the second version of its Claims Code of Practice (first published in June 2023).

56. Six of the main carbon crediting programmes issued a joint statement at the 2023 United Nations Climate Change Conference (COP28), noting that they “are embarking on a collaboration to promote integrity throughout 2024 to create the next step-change in the dependability of carbon markets”.<sup>39</sup>

57. It should be noted that the VCC field is a rapidly evolving space; government regulatory agencies are also exploring the use and legal nature of VCCs. For example, in December 2023 the United States Commodities Futures Trading Commission (CFTC) announced that it had approved proposed guidance and a request for public comment regarding the listing for trading of VCC derivative contracts. The proposed guidance outlines factors that a CFTC-regulated exchange should consider when addressing requirements of the Commodity Exchange Act (CEA) and CFTC regulations that are relevant to the contract design and listing process.<sup>40</sup>

## II. STRUCTURE OF THE INSTRUMENT

58. At the second session of the Working Group, it was suggested that the instrument could be structured in three sections: (i) a first section addressing what a VCC is and the importance of defining its legal nature; (ii) a second section covering the minimum threshold components of the architecture required to achieve trust and transparency to become a VCC; and (iii) a third section on aspects related to, among other things, asset management, custody, and insolvency.<sup>41</sup>

59. Based on the intersessional discussions of the Working Group, it was recommended to include a comprehensive explanation of a VCC’s entire life cycle within the instrument, preceding the laid-out Principles and Commentary.

60. In light of the discussions held to date, the following list of topics is suggested for consideration by the Working Group at its third session:

- The VCC life cycle
- The scope of the instrument and a set of definitions;
- The analysis pursuant to which VCCs can be the subject of proprietary rights;
- Relevant conflicts of law aspects;

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<sup>37</sup> ISDA, 2022 *ISDA Verified Carbon Credit Transactions Definitions*, available at <https://www.isda.org/book/2022-isda-verified-carbon-credit-transaction-definitions/>.

<sup>38</sup> For additional information, see <https://vcmintegrity.org/>.

<sup>39</sup> COP 28 ICP Joint Statement, 4 December 2023, available at <https://www.ieta.org/wp-content/uploads/2023/12/COP28-ICP-joint-statement.pdf>.

<sup>40</sup> CFTC, CFTC Issues Proposed Guidance Regarding the Listing of Voluntary Carbon Credits Derivatives Contracts, 4 December 2023.

<sup>41</sup> See UNIDROIT Summary Report WG2, para. 17.

- Aspects relevant to the creation of VCCs;
- Aspects relevant to the transfer of VCCs;
- Aspects relevant to the retirement, reversal, and cancellation of VCCs;
- Aspects relevant to registry, custody and security; and
- Aspects related to insolvency.

### III. CONTENT OF THE FUTURE INSTRUMENT

#### A. Introduction

##### [Draft] Introduction

#### A. DEVELOPMENT OF CARBON MARKETS

1. Carbon markets have emerged as critical tools in the global effort to mitigate climate change, driven by the objectives set forth in the Kyoto Protocol and the Paris Agreement.
2. The Kyoto Protocol, adopted in 1997, operationalized the United Nations Framework Convention on Climate Change (UNFCCC) by committing industrialized countries and economies in transition to limit and reduce greenhouse gases (GHG) emissions in accordance with agreed individual targets.
3. The Kyoto Protocol introduced three market-based mechanisms aimed at enhancing the cost-effectiveness of emissions reductions:
  - (a) Emissions Trading (ET): This allowed Parties to the Kyoto Protocol (i.e. countries) to transfer and acquire emissions reduction units resulting from projects aimed at reducing or removing emissions at source, if such units were supplemental to their domestic actions aimed at meeting their targets under the Protocol.
  - (b) Clean Development Mechanism (**CDM**): Enabled industrialized countries to invest in emission reduction projects in developing countries, earning certified emission reduction (**CER**) credits that could be used to meet their own targets.
  - (c) Joint Implementation (**JI**): Allowed industrialized countries to earn emission reduction units (**ERUs**) by investing in projects that reduce emissions in other industrialized countries.
4. These three mechanisms collectively aimed to provide flexibility in how countries met their targets under the Kyoto Protocol.
5. The Paris Agreement, adopted in 2015, expanded the scope of climate action by requiring all countries, not just industrialized countries and economies in transition, to commit to reducing emissions. The Agreement's primary goal is to limit global warming to well below 2°C above pre-industrial levels, with efforts to limit the increase to 1.5°C.
6. Under Article 6 of the Paris Agreement, new market mechanisms were introduced:
  - (a) Article 6.2: Facilitates cooperative approaches where countries can create and trade internationally transferred mitigation outcomes (ITMOs). This mechanism builds on the Kyoto Protocol's emissions trading system but with more flexibility and broader participation.

- (b) Article 6.4: Establishes a UN centralized mechanism, similar to the CDM, where carbon credits (6.4ERs) can be generated from emission reduction activities and sold on the international market.

7. These mechanisms under the Paris Agreement aim to enhance global cooperation, ensure environmental integrity, and mobilize climate finance, paving the way for more integrated and dynamic carbon markets.

8. Together, these international frameworks have played a pivotal role in the evolution of carbon markets, transforming them into key instruments for reducing global greenhouse gas emissions and achieving long-term climate goals. The transition from the Kyoto Protocol to the Paris Agreement reflects a shift towards more inclusive and flexible market mechanisms, designed to engage a broader range of actors and promote more ambitious climate action worldwide.

9. As part of the response to the commitments under the Kyoto Protocol some jurisdictions implemented domestic emissions trading schemes. Most notably the EU in 2005 (EU Emissions Trading Scheme or EU ETS), where primary emitters of emissions were allocated a cap on their emissions and a compliance obligation to submit allowances issued under the EU ETS to match their actual emissions. A party with a compliance obligation may reduce its emissions below its cap and sell its allowances to a party that has exceeded its compliance obligation, a so called a Cap-and-Trade mechanism. Such an emissions trading scheme is a Compliance Scheme as there is a legal obligation on covered entities to comply and submit allowances. It is a market mechanism as the allowances may be traded, with the price set by the market, incentivizing covered entities to reduce emissions to meet their own targets or pay for allowances. Other compliance schemes include the USA Regional GHG Initiative and the New Zealand ETS and the Kazakhstan ETS. There are currently 36 compliance schemes in force globally and a further 20 approximately under development or consideration<sup>42</sup>. Each ETS is covered by its own rules defining what sectors are covered and what is eligible for submission under that scheme to meet the compliance obligation.

10. Under the EU ETS, for example, allowances are issued by the governing body (EU Allowances or EUAs) into the market in a closed registry and may then be traded and submitted for compliance purposes. The EU ETS during its early phases, also allowed a certain amount of a covered entities' compliance obligation to be satisfied with the submission of CERs or ERUs, these were issued as a result of project activities that either remove or reduce emissions (as defined above). Thus, for compliance purposes an entity could submit EU Allowances, that are in effect permits issued by the ETS governing body and also project based emissions units CERS or ERUs. In the current phase the EU ETS does not allow any project based units to be submitted for compliance purposes but this matter is constantly under review.

11. Alongside the compliance market a market developed where entities (mostly corporates) desired to voluntarily fund project-based emissions reductions or removals. Independent **crediting programs** developed to meet this need creating frameworks for project methodologies and quality standards for the issuance of units relating to a verified reduction or removal of emissions. This market is the so-called voluntary carbon market (VCM).

12. As noted above some compliance schemes permit certain project-based units to enter that scheme and be used for compliance purposes. The eligibility criteria for entry is determined by that scheme. Of note is that across carbon markets there are two primary types of units, (1) Allowances or permits of a kind issued by a governing body, and (2) project-based units that have been issued post-verification to record that the project has achieved the stated emissions reduction or removal as a Verified Carbon Credit (VCC). [VCCs include CERs issued under the CDM]

<sup>42</sup>



mechanism, 6.4 ERs and also units issued by **independent crediting programs**. ERUs under the Kyoto Protocol JI scheme are no longer in circulation. ]

13. In addition to the regional emissions trading schemes there is also CORSIA (Carbon Offsetting and Reduction Scheme for International Aviation) a global market-based measure developed by the International Civil Aviation Organization (ICAO) to help the aviation industry manage its carbon emissions. Under the scheme Airlines must submit eligible carbon credits to meet their emissions in respect of certain flights. It is estimated that the 15 largest airlines represent approximately 300 million tonnes of emissions a year<sup>43</sup>. There are no allowances or permits issued into this market and only Verified Carbon Credits issued under specified crediting programs are eligible for submission.

14. With the onset of increased incentives (regulatory or CSR) for corporates to set their own emissions reduction targets, the implementation of CORSIA and the increase in scope and number of compliance schemes accepting VCCs, the market for VCCs has rapidly grown. Where previously the market was niche, with only a small number of voluntary buyers and a limited compliance use, now estimates are that the market could reach a value of \$50billion to \$100billion by 2028<sup>44</sup>. With that growth has arisen the requirement to ensure the global marketplace operates with integrity, on the supply side and on the demand side, but also to ensure the issues of private law are clear to enable the market to thrive and drive necessary finance towards projects that reduce or remove emissions.

15. At this juncture in the relatively new market in VCCs, there are issues of Private Law that are uncertain. Of paramount importance for providing certainty around transactions between individuals and organizations is the legal nature of VCCs. The definition of the legal nature of a VCC informs (inter alia) the ability to transfer title under contract, issues of property in an estate and the ability to take and give security. Certainty around these issues is required to enable the market to grow. These issues are separate from those of Public Law, which in this context, relate to the oversight of the market by governmental bodies and their regulators. For clarification by example, the CFTC regulates the US market in commodity-based financial instruments including derivatives based on VCCs.

16. All VCCs are issued as a consequence of activities in a project designed to avoid, reduce or remove emissions from the atmosphere. The lifecycle of a VCC has commonalities whether it is issued by a Governmental crediting program of country (a CER) the crediting program of the UN (a 6.4ER) or a private crediting program<sup>45</sup>. In summary that process entails the setting of the methodology that will be used by a project proponent, the validation and registration of the project at a carbon crediting platform, the running of the project, the independent third party verification that the project has achieved certain emissions reduction or removals, [followed by the issuance of a VCC and the recording of it in a registry] [followed by the issuance of a VCC into a registry]. Transactions in the market may then be conducted with the VCC as the underlier ending with the eventual retirement of the VCC where an environmental claim is being made, thereby removing the VCC from circulation in the market. The party retiring the unit [typically] [usually] does so for compliance purposes or to 'make a statement' either that they have contributed to the relevant emissions reduction or removal in the host country of the project or that they have offset their own emissions. These principles are concerned with, and limited to, the legal nature of a VCC post issuance and do not consider other issues relating to VCCs including: rights associated with the project, the efficacy of the methodologies, integrity of any use case of a VCC, and market

<sup>43</sup> To be added.

<sup>44</sup> To be added.

<sup>45</sup> Examples of such ICCPs include, but are not limited to, the Verified Carbon Standard (Verra),<sup>45</sup> the Gold Standard,<sup>45</sup> the American Carbon Registry,<sup>45</sup> Climate Action Reserve,<sup>45</sup> and Puro Earth.<sup>45</sup>



infrastructure and participants. It also does not consider the appropriate use case for a VCC in respect of what claim may be made by the party retiring the VCC. The issues associated with integrity of the projects and supply of VCCs and the integrity of claims being made are being addressed by various organizations associated with the market, both public and private.

17. Set out below is a more detailed description of the lifecycle of a VCC to add background and context to these Principles.

## **B. TYPICAL LIFE CYCLE OF A VCC**

### **1. The Methodology, Validation and Registration**

18. A methodology for a carbon project refers to a set of detailed boundaries, procedures and criteria used to measure, quantify, monitor, and verify the emission reductions or removals achieved by a carbon project. The crediting program that will issue the VCCs (whether a private or public entity) often both develops and determines what methodologies it will accept. Methodologies fall into two key brackets, nature-based and technology-based programs, and within each of those categories are methodologies that remove emissions and methodologies that avoid or reduce emissions. Examples include: nature based removals through reforestation and technology based removals through carbon capture and sequestration and nature based reduction through reduced methane from ruminants and tech based reduction through clean energy switching. Each crediting program publishes the details of the methodologies it has already accepted. New projects may adopt an existing methodology or develop a new methodology subject to approval of the relevant crediting program.

19. The key actors at this stage are the project proponent and the project developer who may or may not be the same entity. The project proponent is the individual or entity that possesses overall control and responsibility for the project<sup>46</sup>. The Project Developer often has a broader role in bringing the project to fruition, including sourcing finance and engaging with all stakeholders. Importantly the project proponent is usually the party into whose registry account the crediting program will first issue the VCC.

20. The project proponent creates a project design document (PDD) that describes all aspects of the project, including its boundaries, objectives, the methodologies, monitoring plan, and expected outcomes. The PDD also includes a baseline, “business as usual” emissions scenario that represents the level of emissions that would occur in the absence of the project. This is the concept of additionality. The PDD serves as the blueprint of the project and provides the basis for subsequent validation of the project and verification of the emissions reductions or removals. The project developer will also compile associated documentation including technical specifications, environmental impact assessments, financial analyses and expected environmental and social benefits.

21. Each project must be registered with a crediting program. To achieve registration the project must be validated by an approved third party validation/verification body (VVB). A VVB has three main roles, (i) assess methodologies, (ii) validates projects and monitoring plans, and (iii) verifies the achievement of claimed emission reductions and removals. Validation involves an assessment of the project to determine if it conforms to the rules of the relevant crediting program and the applicable methodology and also the likelihood that the expected environmental and social benefits will be achieved. If the project passes Validation, it may then be registered as a project by the relevant crediting program. Registered projects are generally published by the crediting programs along with key documents in accordance with crediting program rules.

<sup>46</sup>

UNIDROIT Summary Report WG1, para. 19.

## **2. Monitoring and Verification**

22. Once the project is running it must be continuously monitored, according to the monitoring plan set out in the PDD, to ensure it is running in conformance with the statements in the PDD and associated documents. Such monitoring runs through pre-stated time periods (monitoring periods) established by the crediting program that are appropriate to the project and methodology during which emissions reductions or removals and other social or environmental benefits are monitored. Throughout the project's implementation, the project developer ensures monitoring reports are periodically generated to support the verification of the project impact by the VVB in accordance with crediting program requirements.

23. The VVB is responsible for verifying the claimed achievement of emissions reductions or removals and other project impacts as being accurate, real and in accordance with the relevant methodology and rules of the crediting program. Verification occurs periodically (verification period) which may or may not coincide with the monitoring periods. [The duration of a verification period is a practical matter relating to the methodology. For example, for a carbon capture and sequestration project linked to an energy plant such verification would be largely a desktop process done through analysis of data relating to energy production and may be done monthly, whereas verification of forestry project usually requires gathering primary data on the ground and may be done only every six months or less.] The VVB creates a verification report that confirms the achievement of the claimed emission reductions or removals. The verification report is then used as the basis for crediting program's issuance of the corresponding number of VCCs claimed in respect of that verification period.

24. This process is designated as the measurement, reporting, and verification (MRV) process. All projects must undergo the MRV process and demonstrate both environmental and financial additionality. Environmental additionality is the measure of greenhouse gases (GHG) removed or reduced against the baseline in addition to those that would have occurred in a "business-as-usual" scenario. As an example, if a coal fired power plant were ready for decommissioning, then the decommissioning would not be environmentally additional. Financial additionality refers to the principle that a project would not be economically feasible without the revenue from the sale of carbon credits.

## **3. Issuance and a Registry**

25. The verification report is submitted to the crediting program in accordance with the relevant rules and protocols of that crediting program. The crediting program notifies the project proponent in accordance with the relevant rules and protocols of that crediting program that the verification report has been accepted. The project proponent may now instruct the crediting program to issue credits into its account at the relevant registry. The crediting program issues VCCs and the registry operator registers each VCC with a unique identifier in the account of the project proponent. Each VCC represents a claim to the achievement of the verified emission reductions or removals of specific greenhouse gases (GHG) measured on a one tonne of CO<sub>2</sub>-equivalent basis. The equivalence is measured using a conversion factor based on the relative global warming potential of the relevant GHG, by way of example the conversion factor for methane is approximately 30, meaning the removal of 30 tonnes of methane would be equivalent to 30tCO<sub>2</sub>e or 30 VCCs.

26. Registries are electronic record-keeping systems designed for the purpose of maintaining records and related documents of projects and the VCCs that have been issued in respect of those projects. Registries may or may not be owned and/or operated by the crediting program. The issues relating to registries and their operation are not covered in this report, only to note that as the market matures so does the development of registry infrastructure and management.

#### **4. Transactions and Trading**

27. Once issued, a VCC may be disposed of by the current holder and acquired by a new holder. The transfer between parties is recorded in the applicable registry account(s) on instruction from the transferring party to the registry operator. Such dispositions and acquisitions may occur multiple times in a secondary market.

28. In this context there is also a primary market that refers to the original purchase of the VCCs from the project proponent through bespoke spot or forward contracts. The purchasers in the primary market are often investors that generate pre-financing for the project in return for the delivery of the issued or to-be-issued VCCs. This is critical for the functioning of the market as there is a considerable time lag (sometimes years) between project initiation and issuance of VCCs when material capital is required for development and operation of the project. The investor may be a market intermediary intending to on-sell the VCCs in a secondary market or a party wanting the VCCs for their own purpose, whether for voluntary or compliance use.

29. Buyers and sellers in the secondary market may transact bilaterally or on an exchange for spot, forward or physically-settled futures delivery. There are considerable developments underway in the secondary market infrastructure with the growth in regulated exchanges offering cleared contracts and uncleared trading, some offering trading in fungible digital receipts representing the physical holding of VCCs in a registry and others offering platforms for the transfer of VCCs within registries. These developments are out of scope for these Principles. Of relevance is the settlement of any transaction for physical delivery of VCCs is completed by the seller instructing the registry where it holds the VCCs in its account to transfer the sold VCCs to the account of the buyer.

#### **5. Retirement**

30. To use a VCC for compliance under a scheme, for example CORSIA or an emissions trading scheme where the VCC is eligible for submission, the party with the compliance obligation must prove the VCC has been retired by the registry operator. Retirement refers to the process of permanently removing the VCC from the market ensuring it cannot be held or transferred again. To complete retirement the holder of the VCC instructs the registry operator to retire the VCC. It can notify the registry operator whether it is retiring on its own behalf or on behalf of another party and the purpose of retirement. The registry moves, tags, freezes, removes or otherwise encumbers the relevant VCC as retired, thereby removing the ability of that unit to circulate. In effect all that remains is the information relating to the VCC and what it was retired for and not the VCC itself.

31. As noted above a party may have bought VCCs not for the purpose of fulfilling a compliance obligation but for entirely voluntarily carbon management purposes. [The sale and purchase of VCCs for voluntary purposes is termed a voluntary carbon market.] The voluntary buyer may instruct the registry operator to retire a VCC, thereby removing it from circulation preventing any compliance buyer using the VCC and also preventing any other voluntary buyer acquiring the VCC. Typically, a voluntary buyer retires a VCC so that it may lay claim to the relevant environmental and social benefits recorded by that VCC. [In some instances the party retiring the VCC may be able to make a claim that it is offsetting its own emissions footprint or the footprint of emission along its value chain, or it may make a claim to have contributed to the environmental and social benefits of the relevant host country of the project.] The governance and guidance on what claims may be made in respect of a voluntary retirement of a VCC is in development and efficacy of any such claim is out of scope of these Principles.

## **6. Suspension, Revocation, and Reversal**

32. Suspension is used to describe a temporary measure when post issuance the VCC is frozen and may not be transferred or retired. Revocation is a permanent measure, post issuance, to remove the VCC from circulation and prevent retirement for a compliance or voluntary purpose. Suspension or revocation may be done by the relevant crediting program in accordance with its own rules and regulations, it may take such measure where for example, the crediting program (i) believes that the VCC holder has failed to comply with the applicable rules of the crediting program; (ii) believes that the VCC was issued following fraud, misrepresentation or illegality i.e. that the verification was incorrect; or (iii) withdraws approval of the project or methodology. If a VCC is suspended and the issues are then resolved and the compliance is restored, the suspension will be lifted and VCC will be resumed. Such suspension or revocation is not common.

33. Reversal may arise where after issuance of a VCC an event has occurred resulting in the GHGs that have already been verified relating to that VCC escape back into the environment. Reversal is linked to the physical nature of the underlying project and may occur due to natural disasters, project failure or other unexpected events. The illustrative example is a VCC issued in respect of forest that subsequently burns down, or GHG that has been stored in a reservoir leaks.

34. The risk of reversal varies according to the type of methodology. Crediting programs may address this tail risk in different ways and in accordance with their own rules. In some instances, the crediting program reserves a number of unissued credits in a buffer pool that may be used to replenish the VCCs relating to the reversed GHG reduction or removal, in other instances the VCC may be removed with the associated risks being born by the holder of the VCC or the party that retired the VCC at the time of reversal. Insurance and processes relating to the risks associated with reversals are in development and may vary from one crediting program to another and in respect of one methodology to another.

## **7. Summary**

35. VCCs are each transactable units that have been “issued” by a crediting program to represent a claim to one tonne of CO<sub>2</sub>-equivalent emissions that has been verified as removed or reduced by a registered and validated project in accordance with the applicable crediting program and methodology. Each crediting program has its own set of rules and terms of business and may be a government, the UN or a private entity. VCCs are an important tool for providing finance upstream to environmental projects. Their importance and the size of the potential market is growing as the use case for VCCs expands in compliance and sectoral schemes (currently CORSIA) and voluntary buyers are increasingly incentivized to purchase VCCs to make voluntary claims in respect of the environmental and social benefits associated with the VCC. To facilitate the scaling of the market in VCCs and consequently provide financing to environmental projects it is necessary to ensure the issues relating to private law are clear to enable participants in the market to have certainty around the private transactions that raise the finance. [These Principles are intended to provide guidance to market participants, their advisors (including lawyers), and the courts and others who will consider the legal effects of these transactions. In sum, these Principles aim to reduce legal uncertainty which practitioners, judges, arbitrators, legislators, and market participants would otherwise encounter in the context of transactions in VCCs and thereby to help scale the VCMs, due to the positive externalities that they bring.]

61. The Working Group at its second session largely agreed that the instrument should provide basic Principles to clarify the legal status of the asset and the prerequisites for a country to consider when trading with them, given the legal nature and the specific characteristics of the asset while

complementing the existing regulations.<sup>47</sup> To this end, it is suggested that the instrument should be compatible with all legal families and legal approaches.<sup>48</sup>

62. The Principles would then be accompanied by Commentary that would elucidate their intended meaning. The Working Group at its second session noted that while the Principles are drafted as neutral as possible, the Commentary will also address the present situation, noting that the market could develop in a different way in the future.<sup>49</sup>

63. The issues related to scope would be addressed in the Introduction part, enabling the readers to gain an understanding of VCCs and of the instrument's scope before reaching Principle 1.<sup>50</sup> Accordingly, the Introduction part also sets out the development of the CVM's and the main stages in the life cycle of a VCC.<sup>51</sup> The instrument should further set out the reasons why it is being developed.

64. As observed in the UNCITRAL/UNIDROIT Joint Study, markets require a clear understanding regarding the private law characterisation of the unit that is being traded. This is necessary in order to address a range of legal issues including the manner in which this unit may be acquired and sold, the rights its owner may assert over it, the treatment of this unit upon the insolvency of any market participant, and whether this unit may be used as security.<sup>52</sup> By providing guidance, the instrument seeks to reduce legal uncertainties that may be encountered by practitioners, judges, arbitrators, legislators, and market participants in VCC transactions. Therefore, the primary objective of the instrument is to facilitate transactions in VCCs and enhance predictability.<sup>53</sup>

65. As previously discussed and decided by the Working Group, it is important that the instrument clarify the legal nature and only private law aspects of VCCs, with a particular focus on proprietary law. Therefore, the instrument will focus on VCCs in the context of dispositions and acquisitions and how interests in VCCs can be asserted against third parties.

#### Questions for the Working Group

1. *The Working Group is invited to comment on the above proposed Introduction part, especially its technical aspects.*
2. *Do you agree with the term "typical life cycle of a VCC" which aims to accommodate variations in the life cycle, including the tokenisation?*
3. *How far should the Introduction part go in terms of the process of project development (i.e., before the issuance of a VCC)? Given that the Principles are concerned with post-issuance VCC, should the introduction of the VCC life cycle start with "project registration"?*
4. *Are there any features or characteristics specific to the VCC life cycle or to the Instrument under development that should be included?*

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<sup>47</sup> See UNIDROIT Summary Report WG2, paras 42-43.

<sup>48</sup> See UNIDROIT Summary Report WG2, para. 42.

<sup>49</sup> See UNIDROIT Summary Report WG2, para. 31.

<sup>50</sup> See UNIDROIT Summary Report WG2, para. 44.

<sup>51</sup> See generally UNCITRAL/UNIDROIT Joint Study.

<sup>52</sup> UNCITRAL/UNIDROIT Joint Study, para. 88.

<sup>53</sup> See UNIDROIT Summary Report WG2, para. 42.

## B. Scope

### **[Draft] Principle [1]** **Scope**

**These Principles address the private law relating to verified carbon credits.**

#### ***[Commentary]***

1.1 These Principles are meant to provide guidelines for States to align their private laws with best practice and international standards regarding verified carbon credits (VCCs) as defined in Principle 2. Their aim is to foster clarity and uniformity in the private law treatment of VCCs, which is crucial for providing legal certainty and scaling up both primary and secondary markets for these assets. The Principles cover only private law issues relating to VCCs, and, in particular, proprietary rights (in the broad sense as explained in [Commentary 3.1]). Thus, they specifically address VCCs where these are the object of dispositions and acquisitions, and where rights and interests in VCCs are to be asserted against third parties. These Principles may include some matters that may be characterised as regulatory law, but generally they do not cover rules that are to be enforced by public authorities, such as rules regarding whether a person must obtain a licence for engaging in activities that concern VCCs.

1.2 Moreover, these Principles only address a specific subset of private law issues related to VCCs, while intentionally leaving many others out of their scope. For example, they do not cover matters concerning intellectual property, consumer protection or similar subjects and national law on these and similar subjects remain unaffected by the Principles. Also, they do not address many issues of contract law or property law, see Principle 3(3) and Commentary 3.6 – 3.10 .

66. The Working Group agreed at its second session that it was essential to specify, in the first Principle, that the instrument was about private law, given that this was the scope of the mandate.<sup>54</sup> Unless it is essential, the instrument would not address regulatory questions.<sup>55</sup> This is explained in the Commentary.

67. The Working Group also agreed that the instrument should cover all manner of verified units, whether they were issued by State entities or independent third parties, but unverified, ex ante, credits should not be addressed by the instrument, which was instead meant to cover the unit after issuance.<sup>56</sup> Because ex-ante credits have not yet been verified, they may be used in facilitating investment into VCMs, but they cannot be retired.

68. The Working Group decided that the analysis of VCCs' legal nature should be independent of their specific use since VCCs are issued prior to determination of their use, which may subsequently change. VCCs can serve multiple purposes, such as mitigating emissions voluntarily, fulfilling compliance obligations,<sup>57</sup> investment or contributing mitigation efforts of a third country from which the VCC has originated.<sup>58</sup>

<sup>54</sup> See UNIDROIT Summary Report WG2, para. 43.

<sup>55</sup> See UNIDROIT Summary Report WG2, para. 45.

<sup>56</sup> See UNIDROIT Summary Report WG2, para. 47. For additional details on what is meant by "unverified, ex ante, credits", see UNIDROIT Summary Report WG1, para. 12.

<sup>57</sup> Compliance schemes are set up in a number of different ways with different units being eligible within each scheme. This is outside the scope of this paper.

<sup>58</sup> See UNCITRAL/UNIDROIT Joint Study, para. 51.

Questions for the Working Group

1. *The Working Group is invited to comment on the above proposed Principle 1.*
2. *Are there any other issues or topics that should be specifically included as being within, or outside, the scope of the Instrument?*

**C. Definitions*****[Draft] Principle [2]******Definitions****(1 to 10 – First set of definitions)***(1) VCC****Verified carbon credit (VCC) means a unit that**

- (a) represents a verified reduction in, or removal of, one tonne of CO<sub>2</sub> equivalent as a result of a carbon mitigation project;**
- (b) has been issued [by an issuer]**
- (c) has been [registered] [recorded] in a VCC registry using a unique identifier.**

**(2) Unit****'Unit' means an [individuated] intangible asset.****(3) Verified****A reduction in, or removal of, one tonne of CO<sub>2</sub> equivalent is verified when a verifier has carried out a verification process resulting in a verification report.****(4) Verification report****'Verification report', in relation to a VCC, means a statement that states that the reduction in, or removal of, one tonne of CO<sub>2</sub> equivalent represented by that VCC has taken place as a result] of the relevant carbon mitigation project in accordance with the applicable methodology.****(5) Verifier****'Verifier' means a legal person that**

- (a) [is accredited [by a recognised international accreditation standard] to carry out verifications,] and,**
- (b) in respect of a verification process, is independent of any other person or legal person involved in the relevant carbon mitigation project.**

**(6) Issuer****'Issuer' means a legal person, including an ICCP or a Governmental body, that issues a VCC.**

**(7) Issuance of a VCC**

**A VCC is issued when**

- (a) the issuer [publicly] [accepts] [ratifies] the verification report] relating to the VCC;**
- (b) The relevant [registry operator] [registrar] is instructed to record the VCC in the VCC registry mentioned in paragraph 1(c).**

**(8) ICCP**

**'ICCP' means an independent carbon crediting programme.**

**(9) Methodology**

- (a) 'Methodology' means a set of requirements for the implementation, measurement, monitoring, reporting and assessment of the CO<sub>2</sub> equivalent reduction or removal effects of a carbon mitigation project;**
- (b) The 'applicable methodology' in relation to a carbon mitigation project means that methodology specified by the issuer as the methodology to that carbon mitigation project.**

**(10) Carbon mitigation project**

**'Carbon mitigation project' means a project aimed at reducing the amount of CO<sub>2</sub> equivalent in the atmosphere or removing CO<sub>2</sub> equivalent from the atmosphere.**

**[Commentary]**

2.1 Generally, words defined in these Principles are defined in the singular, for ease of drafting. However, as Principle 2(18) points out, the singular includes the plural. The definitions in Principle 2 and Principles 9 and 10 not only facilitate the reading of the Principles but also delineate the scope of the Principles. Each definition sets out the minimum that the defined concept, thing or person needs to have to fall within the defined word or phrase, and therefore to fall within the Principles. Each defined concept, thing or person is likely to have many characteristics other those set out in the definition, but the presence or absence of these characteristics may vary, and does not affect whether the concept, thing or person falls within the relevant definition and therefore within the Principles.

VCC

2.2 The definition of a verified carbon credit in Principle 2(1) is designed to reflect the nature of a VCC as an intangible asset (see Principle 2(2) and Commentary 2.4) that comes into existence as a result of the process that is described in [the life cycle]. While the events leading up to the creation of a VCC are important, and in some cases, necessary precursors to the existence of that VCC, the VCC itself reifies the fact that they have taken place and that (as verified, see Principle 2(3) and (4) and Commentary 2.10) one tonne of CO<sub>2</sub> equivalent has thereby been removed from the atmosphere or that there has been a reduction in CO<sub>2</sub> equivalent from the atmosphere. The definition in Principle 2(1) lists only those facts and events that are necessary (as a matter of Principles Law) for a VCC to exist. Depending on the circumstances, a VCC may represent additional facts, and may confer private law rights, such as a transferable contractual rights against specific parties. However, because it is not always



the case that a VCC represents these facts or confer these rights, they are not part of the constitutive elements in the definition for something to be a VCC within these Principles.

2.3 The definition of a VCC in Principle 2(1) includes a number of terms defined in subsequent Principles, each of which refers to an element that must be present for something to be a VCC. If something is a VCC, the Principles apply to it; it therefore can be the subject of proprietary rights (as defined broadly in Commentary 3.1), and therefore can be transferred (as defined in Principle XX), used as collateral (see Principle XXX), held in custody and so on. If something falls outside the definition, then it is not covered by the Principles, even though the term 'VCC' may be used colloquially to refer to it.

2.4 A VCC is defined as a 'unit', which is itself defined as an 'intangible asset'. The term 'intangible asset' is familiar in many jurisdictions, [with roots tracing back to the Roman law concept of *res incorporales*] and makes it clear that a VCC is not a tangible or corporeal thing. The use of the term 'unit', which is a word used for an individual thing, makes it clear that a VCC is individuated. This individuation is one of the important characteristics of a VCC that enables it to be the subject of proprietary rights (see Commentary 3.2).

2.5 A crucial element of the definition of a VCC is that it 'represents' the verified reduction in, or removal of, one tonne of CO<sub>2</sub> equivalent ('a reduction or removal'). The use of the term 'represents' signifies that a VCC reifies a reduction or removal. This reification is a critical element of the definition of a VCC. The word 'represents' is carefully chosen and does not entail any legal conclusion that a person with a proprietary right to a VCC has a proprietary right to the underlying reduction or removal. A reduction or removal, on its own, lacks the determinacy and other attributes necessary for something to be the subject of proprietary rights in private law. It is precisely for this reason that the definition of a VCC includes additional constitutive elements beyond merely the occurrence of a reduction or removal.

2.6 The inclusion of the word 'verified', which is defined in Principle 2(3), is also fundamental to the definition of 'VCC'. It specifies that the reduction or removal represented by a VCC is not just any reduction or removal, but one that has undergone verification through a defined process. Moreover, the reduction or removal represented by a VCC must have occurred as a result of a carbon mitigation project. This requirement reflects the necessity for additionality and the reality that the issuance and sale of a VCC is one of the methods by which carbon mitigation projects can be financed. A reduction or removal that took place by other means would not be able to be represented by a VCC (as defined). The phrase 'carbon mitigation project' is defined in Principle 2(10).

2.7 The definition also makes it clear that a VCC must be issued. Issuance (by an issuer) is defined in Principle 2(7), and is the process by which the verification of the removal or reduction is accepted by the issuer and the registry is instructed to register the VCC. While issuance may, [and often does] take place very shortly before or even contemporaneously with registration of a VCC, it is conceptually distinct.

2.8 Lastly, the definition makes it clear that the VCC must be registered in a VCC registry using a unique identifier. The term 'VCC Registry' is defined in [Principle 9(1)]. Registration using a unique identifier means that a VCC has the characteristics of being identified and individuated: characteristics that are attributes that, in conjunction with other attributes, enable a VCC to be the subject of proprietary rights (Principle 3(1) and Commentary 3.2). Furthermore, as is made clear in Principle 9, a VCC is registered in a VCC Registry by crediting it to an account of a person (a 'registry accountholder' as defined in Principle 9(4), whereupon that person becomes a 'registered holder' of the VCC. Thus, the VCC is able to be controlled in the way described in

Commentary 3.2, which is another attribute that enables a VCC to be the subject of proprietary rights.

### Unit

2.9 'Unit' is defined in Principle 2(2) as an intangible asset. This may assist a jurisdiction in classifying a VCC in the manner discussed in Commentary 3.3, if a jurisdiction wishes to do this.

### Verified

2.10A verification process is a process carried out by a verifier (see Principle 2(5) to confirm the stated reduction or removal has in fact occurred as a result of the Project in accordance with the methodology. As a result of the process, the verifier will produce a report that concludes either (a) that a removal of, or reduction in, one tonne of CO<sub>2</sub> equivalent has taken place in the course of the project, or (b) that it has not. The report will [typically] give reasons for this conclusion. A removal or reduction is verified if the verification report reaches the first of these conclusions.

### Verifier

2.11A verifier is a legal person who carries out a verification. A legal person is a person with legal personality, such as a company, but is not a natural person (a human being). While a verifier is likely to have many characteristics (such as being an expert in a particular field), only two are required by the definition for a person to be a verifier within the Principles (and therefore for a VCC (as defined) to be able to represent a removal or reduction verified by that person). The first is that the verifier is accredited. The second is that the verifier is independent of any other legal person involved in the relevant carbon mitigation project. This independence is such a critical part of the system relating to VCCs, that it is part of the definition of VCC, so that something representing a removal or reduction that has been verified by a non-independent verifier is not a VCC within the Principles.

### Issuer

2.12 Principle 2(6) defines an issuer as a legal person who issues a VCC; issuance being defined in Principle 2(7). An issuer could, but does not have to be, an ICCP (see Principle 2(8)) or a Governmental body, which includes a national government and also a transnational institution, such as the United Nations.

### Issuance

2.13As mentioned above, issuance, as defined in Principle 2(7), is the process whereby a VCC is issued. The process consists of the [public] acceptance by the issuer of a verification report, and the instruction that the VCC be registered in a VCC registry. An issuer will only accept a verification if it confirms, to the satisfaction of the issuer, that there has been a removal of, or reduction in, one tonne of CO<sub>2</sub> equivalent in the course of the relevant carbon mitigation project. Who actually instructs the registry to register the VCC will vary. It could be the issuer, [or it could be the project proponent] [see the life cycle: I am assuming that the PP will be explained in the life cycle]: this does not matter as long as the instruction takes place. The 'instruction' could be in any form. For example, it could be an electronic conformation of a pre-programmed request or even could be by the operation of a smart contract. As mentioned above, the Principles are drafted in the singular, and refer to one single VCC, but it is likely in practice that a verification [report] [statement] will relate to the removal of, or reduction in, a number of

tonnes of CO<sub>2</sub> equivalent, and therefore that a number of VCCs will be issued by one action and at the same time.

#### ICCP

2.14 The acronym ICCP is defined as ‘independent carbon crediting programme’.

#### Methodology

2.15 [This Commentary is largely factual and will need to be fitted in with the life cycle text]

#### Carbon mitigation project

2.16 As mentioned above, it is only if the removal or reduction results from a carbon mitigation project that it can be represented by a VCC as defined in the Principles. A carbon mitigation project is described in detail in the [life cycle], and is defined broadly in Principle 2(10). [A carbon mitigation project can form part of a wider programme called a carbon mitigation programme].

#### First set of definitions

69. The Working Group agreed during its second session that the instrument would define terms used within the context of the substantive Principles, with any additional terms to be explained in accompanying Commentary.<sup>59</sup> Additionally, certain Principles contain particular definitions, such as the definition of “VCC registry” found in Principle 9 on VCC Registry. The Working Group is invited to decide whether to retain these definitions within their respective principles or to consolidate them under Principle 2.

70. The first sets of definitions were discussed by the core drafting group to the Working Group at the Intersessional Meeting on 1 July 2024 and amended according to the feedback received. It was largely agreed that the definitions needed to be drafted so as to align with private law principles, ensuring VCCs could be traded as proprietary rights and prevent legal conflicts. As agreed previously, the drafting of definitions would focus on formulating the functionality of the unit or entity rather than establishing the quality-related aspects.<sup>60</sup>

71. The first set of definitions are mostly related to the Verified Carbon Credits themselves. A VCC is defined as a unit representing a verification that has been issued and registered in a VCC registry using a unique identifier. This definition is intended to define solely the VCCs that will be subject of proprietary rights under Principle 3. Therefore, this definition aims to reflect the very basic characteristics (unique identifier and registry) that enabled a VCC to be the subject of proprietary rights, meaning that its individuation, its control, and its rivalrousness. The Working Group generally agreed during its second session that a VCC's capability of being retired was not essential to the VCC being considered rivalrous.<sup>61</sup> Additionally, the Working Group stressed the importance of a proper definition of a VCC as it would lay a solid foundation to better address Principle 7 (Transfer) and Principle 9 (Registry), as these rules were closely interconnected.

72. There are, however, certain issues left in square brackets for discussion by the Working Group: whether VCCs are “registered” or “recorded” in a VCC registry.

<sup>59</sup> UNIDROIT Summary Report WG2, para. 62.

<sup>60</sup> UNIDROIT Summary Report WG2, para. 56.

<sup>61</sup> UNIDROIT Summary Report WG2, para. 85.

73. The terms used in the definition of Verified Carbon Credits (*i.e.* “unit” and “verified”) are also defined in the proposed Principle 2. “Unit” is defined as “an [individuated] intangible asset”. During the intersessional meeting on 1 July 2024, using the term “unit” in the definition of a VCC received mixed feedback from the Working Group due to its undefined nature and lack of legal tradition. Therefore, a definition of “unit” is added here, which would be preferable for clarity and legal understanding, given the fact that the instrument will be translated into multiple languages and needs to align with various legal cultures. A question for the Working Group is whether to keep the word “individuated” in the definition of the unit.

74. At present, VCCs are not tokenised on a blockchain. Rather, the records are kept by the relevant VCC registry.<sup>62</sup> However, the Working Group should also consider a definition that would be compatible with a tokenised VCC. Regarding tokenised VCCs, it was agreed that the current drafting approach should be maintained, with the possibility of incorporating a disintermediated environment for tokenisation. In such case, certain definitions, such as that of the registry operator, might need to be adjusted to accommodate tokenisation scenarios.

75. As to minimum criteria, it was noted during the first session of the Working Group that it might suffice for the instrument to specify that third-party verifiers should be independent, and that the choice of applicable methodologies should be based on the best available scientific standards.<sup>63</sup> Therefore, two key aspects are sought from verifiers: accreditation, which is deemed important for ensuring credibility, and independence from project affiliations, which is crucial for maintaining impartiality. The Working Group is invited to comment whether to keep these two requirements and whether “accreditation” is a necessary criterion for a verifier.

76. Issuance is a component of the definition of VCC, so these definitions feed into that, central, definition. The necessity of this set of definitions was discussed and agreed upon previously. Particularly with respect to the process of issuance of a VCC, one participant explained in a drafting group meeting that once the verification report was being ratified by the issuer, the unit could then be recorded in the registry. This process usually provided public notice that the verification report had been approved or ratified, which involved a notification on the project's website. However, certain issues were left in square brackets for discussion by the Working Group for greater clarity: (i) whether the issuer “accepts” or “ratifies” the verification report relating to the VCC; (ii) whether such will be made “publicly”; and (iii) whether “registry operator” or “registrar” or both terms will be used.

77. The Working Group agreed during its second session to refer to both projects and programmes, and to differentiate both terms.<sup>64</sup> Thus, the distinction is explained in the Commentary. The Working Group is invited to decide whether to keep this distinction in the Commentary.

78. The Working Group agreed in its second session that it was critically important to distinguish between ICCPs and VCC registries since their roles differed.<sup>65</sup> ICCP is therefore defined in the Principle 2. However, the Working Group is invited to decide whether ICCP should just be explained in the Introduction part. A VCC registry is also defined in detail in the related principle (See below Principle 7) defining how these systems should operate, focusing on the kind of parameters by which the VCC could be susceptible to property rights as agreed in the second session of the Working

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<sup>62</sup> For example, the Verra Registry Terms of Use provide at Section 11.4(k) that “once project information has been uploaded or posted to the Verra Registry; such project information cannot and shall not be deleted, removed, expunged or altered, except in accordance with Verra's normal operating procedures or as required by a relevant Scheme Regulator. Any subsequent changes or additions to information previously posted shall be posted as an update/amendment, but shall not replace the original posting”.

<sup>63</sup> UNIDROIT Summary Report WG1, para. 18.

<sup>64</sup> UNIDROIT Summary Report WG2, para.38.

<sup>65</sup> UNIDROIT Summary Report WG2, para. 63.

Group.<sup>66</sup> A question for the Working Group is whether to keep the definition of VCC Registry under the Principle 9 or to move all definitions to Principle 2.

Questions for the Working Group

1. *The Working Group is invited to comment on the above proposed definitions, especially on the parts left in square brackets for policy decision on terminology.*
2. *Is the word "individuated" necessary for the definition of "unit"?*
3. *Is there a need to define "CO<sub>2</sub> equivalent" in Principle 2?*
4. *Is there a need to make "ICCP" a defined term in Principle 2, or whether it should just be explained in the VCC life cycle part of Introduction?*
5. *Should "carbon mitigation programme" be mentioned in the definition of "carbon mitigation project"?*

**[Draft] Principle [2]**

**Definitions**

*(11 to 18 – Second set of definitions)*

**(11) Reversal**

**A VCC is reversed when it is permanently removed from circulation in a VCC registry when the benefits of a carbon mitigation project are lost or diminished as a result of events following its issuance.**

**(12) Revocation**

**(a) A VCC is revoked when it is permanently removed from circulation in a VCC registry when it is demonstrated that the benefits of a carbon mitigation project were never achieved from the outset.**

**(b) A VCC that has been revoked is void from the outset and was never the subject of proprietary rights.**

**(13) Transfer**

**In relation to a transfer of a VCC:**

**(a) 'transfer' of a VCC means the change of a proprietary right in the VCC from a transferor to a transferee;**

**(b) the term 'transfer' includes the acquisition of a proprietary right in a VCC;**

**(c) 'transferor' means a person that initiates a transfer of a proprietary right in the VCC**

**(d) 'transferee' means a person to which a proprietary right in a VCC is transferred;**

**(e) the term 'transfer' includes the grant of a security right in favour of a secured creditor, and 'transferee' includes a secured creditor.**

**(14) Retirement**

<sup>66</sup>

UNIDROIT Summary Report WG2, para. 65.

**A VCC is retired when it is permanently removed from circulation in a VCC registry on the instruction of its registered holder.**

**(15) Principles law**

**'Principles law' means any part of a State's law which implements or is consistent with these Principles.**

**(16) Other law**

**'Other law' means a State's law to the extent that it is not Principles law.**

**(17) Insolvency related proceeding**

**'Insolvency-related proceeding' means a collective judicial or administrative proceeding, including an interim proceeding, in which, for the purpose of reorganisation or liquidation, at least one of the following applies to the assets and affairs of the debtor:**

- (a) they are subject to control or supervision by a court or other competent authority;**
- (b) the debtor's ability to administer or dispose of them is limited by law;**
- (c) the debtor's creditors' ability to enforce on them is limited by law.**

**(18) Words in the singular include the plural and those in the plural include the singular.**

**[Commentary]**

Reversal

2.17 Similarly to revocation (Principle 2(12)) and retirement (Principle 2(14)), a reversal of a VCC results in its being permanently removed from circulation in a VCC registry. Principle 2(11) distinguishes reversal from revocation and retirement however in that reversals are the result of post-issuance events leading to a reversal of the benefits of a carbon mitigation project. The Principle deals with reversal of a VCC rather than reversals at a project level since the Principles are intended to address the proprietary nature of VCCs. As Principle 5 clarifies, a reversal at the project level may or may not lead to a reversal of issued VCCs but it is necessary for the Principles to provide for such an eventuality.

Revocation

2.18 Similarly to reversal (Principle 2(11)) and retirement (Principle 2(14)), a reversal of a VCC results in its being permanently removed from circulation in a VCC registry. Principle 2(12) distinguishes revocation from reversal and retirement however in that revocations are the result of events leading up to issuance, typically fraud, that lead to the issuance of VCCs that would otherwise not have been issued. Principle 6 clarifies the proprietary consequences of revocation.

Transfer

2.19 A transfer, as defined in Principle 2(13), means the change of a proprietary right in a VCC from one person ("a transferor") to another ("a transferee"). This concept is functional and intentionally broad, encompassing all types of proprietary rights, whether in whole or in part.

It includes not only the transfer of full ownership rights, but also the transfer of limited proprietary rights such as usufruct or other partial rights recognized under national law.

2.20 In these Principles, the term 'transfer' is also used to denote the grant of a security right in favour of a secured creditor, and consequently, a 'transferee' includes a secured creditor. It is important to note that this broad use of 'transfer' is purely definitional within the context of these Principles. It does not imply that the grant of a security right necessarily constitutes a transfer of ownership or any other proprietary right under applicable national laws. This approach aligns with other international instruments, such as the Hague Securities Convention, which in Article 1(1)(h) defines 'disposition' to include both outright transfers of title and grants of security interests, whether possessory or non-possessory.

2.21 A transfer as defined here, i.e. a change of a proprietary right in a VCC, must be distinguished from a change in the registry account to which a VCC is credited. A change in the registry account to which a VCC is credited may or may not be associated with a transfer of proprietary rights. A custodian (as defined in Principle 10(3)), for instance, may have VCC credited to its registry account for the benefit of a client, but will typically not acquire 'ownership' (as defined under the applicable national law) of that VCC. Conversely, a transfer of proprietary rights may or may not be accompanied by a change of registry account to which the VCC is credited. A State's law, for instance, may provide that under certain circumstances a proprietary right (such as ownership) in a VCC may pass to another person while it remains credited to the same account. An example of this could be a court-ordered transfer of ownership in a divorce settlement, where the VCC remains in the original account but legal ownership changes.

2.22 These Principles do not exhaustively prescribe the conditions for a proprietary right in a VCC to be validly transferred to another person. [Although Principle 7(4) does require that a transferee must have obtained XXX to qualify as an innocent acquirer], these Principles do not dictate all the requirements for a valid transfer of a VCC. For instance, they do not specify whether an agreement in a particular form is required, or consideration is necessary for the transfer, or if authorization from any regulatory bodies is required for the transfer to be valid. These and other specific requirements for a valid transfer are left to other law, which may vary across jurisdictions.

2.23 The term 'transferor' is defined as 'a person that initiates a transfer' because [the person may have the power to transfer greater rights than the person has]. [Indeed, a person to whose account a VCC is credited may have no rights at all but has the power to transfer rights to an innocent acquirer]. [See Principle 7(1) and Commentary 7.1].

### Retirement

2.24 Similarly to reversal (Principle 2(11)) and revocation (Principle 2(12)), a retirement of a VCC results in its being permanently removed from circulation in a VCC registry. Unlike reversal and revocation, however, which result in the permanent retirement of a VCC regardless of the intent of its registered holder, retirement follows from the instruction of a registered holder and thus is dependent on its intent. Again unlike reversal and revocation, retirement marks the end of the intended normal life cycle of a VCC. The registered holder of a VCC may or may not have a proprietary right in that VCC, for example, the registered holder may be acting as a custodian (see Principle 10).

### Principles Law and Other Law

2.25 Under Principle 1, these Principles cover private law issues relating to VCCs. They include various rules such as the rule that a VCC can be the subject of proprietary rights, and rules concerning, transfer and custody of, and the taking of security in, VCCs. [[treatment on insolvency] maybe others...]. 'Principles Law' as defined by Principle 2(15) refers to all the rules in the Principles once they have become part of State law, whether by express implementation, or because State law is already consistent with them. Within the law of a State, all law that is not 'Principles law' as defined here is referred to in these Principles as 'other law' (see Principle 2(16)). 'Principles law' and 'other law' as defined here together form 'the law'. Other law includes administrative rules and judicially determined law, as well as legislation.

### Insolvency-related proceeding

2.26 The definition of 'insolvency-related proceeding' is not meant to provide a general definition of insolvency proceedings but defines the concept only for the purpose of these Principles. A general definition of 'insolvency proceedings' can be found in the UNCITRAL Legislative Guide on Insolvency Law and subsequent insolvency law texts. The definition in Principle 2(17) seeks to include all forms of collective insolvency-related procedures, which may take place in court or out of court, so long as the procedure is aimed at dealing with a debtor's current or immediate financial or economic distress and some legal effect is attached to the commencement of the procedure. This definition captures the new generation of insolvency proceedings whose legal design, often labelled as 'hybrid', features characteristics of both formal in-court proceedings and out-of-court contractual collective workouts. The term 'insolvency-related proceeding', as defined in Principle 2(17), would include full in-court proceedings; proceedings the opening of which entails a limitation in the debtor's ability to manage and/or dispose of its assets outside the ordinary course of its business; and proceedings which merely trigger a temporary stay of enforcement against the debtor's assets necessary for the continuation of the business activity. Hence, unlike other legal texts such as the 2009 UNIDROIT Convention on Substantive Rules for Intermediated Securities ('Geneva securities Convention') (Article (1)(h)), a debtor would find itself in an 'insolvency-related proceeding' for the purposes of these Principles even where its assets are not subject to the control or supervision of the court or an administrative authority.

### Second set of definitions

79. Definitions of the three distinct concepts of retirement, reversal and cancellation are included in the Principle 2.

80. Transfer is defined as the change of proprietary rights in a VCC from one person to another. Regarding the definition of "transfer", it was noted during the drafting group meetings that there was a need to differentiate between transfer of proprietary rights and transfer (or movement) from one registry account to another which did not involve the transfer of proprietary rights. To clarify this and ensure consistent use of "transfer" in the instrument, the Working Group might consider using a different term, such as ['move' and 'movement'], for the latter case.

### Question for the Working Group

1. *The Working Group is invited to comment on the above proposed definitions.*



**D. General Principles*****[Draft] Principle [3]******General Principles***

- (1) A VCC can be the subject of proprietary rights.**
- (2) Principles law takes precedence over other law to the extent that they conflict.**
- (3) Except as displaced by these Principles, other law applies to all issues, including:**
  - (a) whether a person has a proprietary right in a VCC;**
  - (b) whether a proprietary right in a VCC has been validly transferred to another person;**
  - (c) whether a security right in a VCC has been validly created;**
  - (d) the rights as between a transferor and transferee of a VCC;**
  - (e) the rights as between a grantor of a security right in a VCC and the secured creditor to whom the security right is granted;**
  - (f) the legal consequences of third-party effectiveness of a transfer of a VCC;**
  - (g) the requirements for, and legal consequences of, third-party effectiveness of a security right in a VCC.**

***[Commentary]***

3.1 Principle 3(1) makes it clear that a VCC, [an intangible asset] as defined in Principle 2, is capable of being the subject of proprietary rights. All the other rules in these Principles are built on this premise. The phrase 'proprietary rights' is deliberately used in a broad sense, reflecting the functional approach of these Principles, which intend to cater for the largest variety of jurisdictions possible. 'Proprietary rights' includes both proprietary interests and rights with proprietary effects, that is, rights (or interests) that can be asserted against third parties (persons that are not necessarily contractual parties). For example, in the context of insolvency, an insolvency representative might assert a right or interest in a VCC on behalf of the insolvency estate against third parties, or a third party might assert a right or interest in a VCC against an insolvency representative. The term 'proprietary rights' is not limited to absolute rights or interests, and includes, for example, security rights.

3.2 A VCC (as defined) has attributes that make it possible for it to be the subject of proprietary rights. First, it is individuated: a VCC is registered using a unique identifier. A VCC itself is unique, and can be identified. Second, it can be controlled in that a VCC is registered by being credited to an account of a specified registry account holder (see Principle 9(4)). That registry account holder (who becomes, on registration of a specific VCC, the 'registered holder' of that VCC, see Principle 9(6)) is the only person who can instruct the registry to transfer or retire that VCC. Third, a VCC is rivalrous in the sense that if one person 'has' it (ie controls it) another does not, and if one person 'uses' it (for example, by retiring it) another person cannot. Fourth, a VCC can be transferred from A to B by debiting A's registry account and crediting B's registry account. For these reasons, a VCC, although representing a fact (or, to put it another way, information) is susceptible to being dealt with in the same way as other types of asset which are capable of being the subject of proprietary rights, and therefore should itself be capable of being the subject of propriety rights.

3.3 [Whether VCCs can be the subject of proprietary rights (a legal consequence) must be distinguished from the classification of them in any particular jurisdiction. For example, in certain jurisdictions a VCC could be classified as 'property', 'a good', 'a thing' or a similar concept, but this would depend on the applicable law in question and is left for each State to decide. [If the law of a State includes a classification of different categories of assets that can be the subject of proprietary rights, and these different categories have different consequences, it is recommended that the law of that State should specify which category or categories of assets VCCs are. That is in order that VCCs can be the subject of proprietary rights in that State. This could mean the introduction of a new category of assets, but again, this is left for each specific State to decide.]

3.4 While Principle 3(1) states that a VCC (as defined) is capable of being the subject of proprietary rights, it does not prescribe any specific requirements for the acquisition of a proprietary right in a given VCC. Whether a person has a proprietary right in a VCC is left up to 'other law', as is whether a proprietary right in a VCC has been transferred from one person to another, see Principle 3(3).

Principle 3(2)

3.5 To give the rules of these Principles full effect, Principle 3(2) provides that they should take precedence over State laws wherever they conflict. Consequently, once they have been adopted and implemented into the law of a State, these Principles (by then 'Principles law' as defined in Principle 2(15)) must take precedence over other law (as defined in Principle 2(16)).

Principle 3(3)

3.6 Principle 3(3) makes it explicit that other law (as defined in Principle 2(16)) continues to apply to VCCs. For this purpose, Principle 3(3) lists several examples of issues of property law, but also of contract law, that may continue to be addressed by a State's other law, because these Principles do not cover those issues, nor do they intend to change or derogate from that other law. The list is not intended to be exhaustive or limitative. Although Principle 2(13) defines 'transfer' (as used in these Principles) as including the grant of a security right in favour of a secured creditor, the list in Principle 3(3) refers separately to transfers and security rights. This is for clarity of exposition, and because Principle 3(3) lists matters to which other law applies.

3.7 The examples in Principle 3(3) of issues that continue to be addressed by other law, can be categorised as follows. First, Principle 3(3)(a) concerns the static situation in which it must be determined whether a person has a proprietary right in a VCC. Pursuant to Principle 3(3)(a), the requirements for a (valid) right or interest in a VCC that can be asserted against third parties continue to be a matter of other law. Therefore, and by way of example, whether, in any given factual situation, a person holds a valid right of ownership in a certain VCC, is, as a matter of principle, not regulated by these Principles.

3.8 Second, Principles 3(3)(b) and 3(3)(c) concern dynamic situations of acquisition and disposition of a VCC from the perspective of the transferor and security right provider respectively. If the question arises whether a person has validly transferred a proprietary right, or validly created a security right, in a VCC, Principles 3(3)(b) and 3(3)(c) make it clear that the requirements for a (valid) transfer or creation of a security right continue to be, as a matter of principle, a matter of other law. However, this last statement is subject to some exceptions, where these Principles provide specific rules regarding the transfer of, and third-party effectiveness of a security right in, a VCC (Principles 5 and 9).

3.9 Principles 3(3)(d) and 3(3)(e) make explicit that the relationships between a transferor and a transferee, and between a grantor of a security right and the relevant secured creditor, respectively, continue to be a matter of other law and are not, as a matter of principle, dealt with by these Principles. In some situations and some jurisdictions, these relationships are characterised as primarily contractual in nature. Principles 3(3)(d) and 3(3)(e) provide that the rights between a transferor of a VCC and the transferee, and between a grantor of a security right in a VCC and the secured creditor, are left to be dealt with by other law, whatever the qualification of the relationships between those parties.

3.10 As explained above, Principles 3(3)(d) and 3(3)(e) concern the (contractual) relationships between a transferor and a transferee, and between a grantor of a security right and the relevant secured creditor, respectively. These provisions thus concern inter se relationships, i.e. relationships between (contracting) parties. Principles 3(3)(f) and 3(3)(g), on the other hand, concern erga omnes relationships, i.e. the relationships with third parties. Pursuant to Principles 3(3)(f) and 3(3)(g), whether a transfer and a security right, respectively, can be asserted against third parties, continues to be, as a matter of principle, a matter of other law. In some jurisdictions, the 'assertability' of a right or interest against third parties follows from the concept of 'effectiveness'. Principles 3(3)(f) and 3(3)(g) provide that, whatever the doctrinal context, the requirements for such effectiveness or assertability continue to be, as a matter of principle, a matter of other law, except where the Principles provide other rules (see Principles 7 and 11).

81. At its first session, the Working Group emphasised that, to attract the necessary scale of investment needed for VCCs to become a vehicle for raising climate finance, one had to make VCCs property.<sup>67</sup> Thus, one of the fundamental issues addressed by the instrument is whether it is possible to recommend that a national system of property law, whatever that may be, can apply to VCCs.

82. During its meetings, the Working Group addressed why it was possible for a VCC to be the object of proprietary rights and what conditions must be met for this to occur, considering possible approaches to determining that a VCC could be the subject of proprietary rights.

83. The agreed approach of the Working Group during its previous meetings was to say that if a VCC had some very basic characteristics that enabled it to be the subject of proprietary rights, meaning that it was individuated, that it could be controlled, that there was rivalrousness, and that it can be transferred, then it could be said that a VCC could be the subject of proprietary rights.<sup>68</sup> As explained in the Commentary, VCCs as defined in Principle 2 carry these characteristics. VCCs are individuated since every VCC has a unique identifier and is separately recorded in a VCC registry. VCCs can be controlled through the recording of the VCC on a registry. In its second session, the Working Group generally agreed that the control and exclusivity did not need to be exhaustive and that limitations could be imposed on this right of control as stipulated by the ICCPs themselves. The exclusive right to something was distinct from the restricted use of that item, and the instrument would refer to exclusivity from a private law perspective.<sup>69</sup> It is rivalrous since it can only be owed to one person at a time. As stressed in the second session of the Working Group, rivalrousness does not refer to the use of the VCC, but it is rather about one person having it at a time. The registration system provided by VCC registries may indicate that a VCC is likely to be rivalrous. The Working Group generally agreed that a VCC's capability of being retired was not essential to the VCC's rivalrousness.<sup>70</sup> The Working Group further agreed that reference to the corresponding adjustments

<sup>67</sup> UNIDROIT Summary Report WG1, para. 51.

<sup>68</sup> UNIDROIT Summary Report WG2, para. 72.

<sup>69</sup> UNIDROIT Summary Report WG2, para. 98.

<sup>70</sup> UNIDROIT Summary Report WG2, para. 85.

system could be useful as a drafting matter to underline the rivalrous nature of VCCs,<sup>71</sup> since a VCC has the capacity of being transferred through the recording of the VCC on a registry. In its second session, the Working Group discussed whether the ability to independently sue, irrespective of contractual privity, was an essential feature of a property right and agreed that it was not.<sup>72</sup>

84. Accordingly, the proposed Principle 3 provides clarification that a VCC as described in Principle 2 is eligible for the designation of a subject of proprietary rights. The term “proprietary rights” on the other hand is employed in a broad sense in order to accommodate the widest possible range of legal jurisdictions. Therefore, as explained in the Commentary, the term “proprietary rights” is designated to encompass both proprietary interests and rights with proprietary effects. These are rights (or interests) that may be asserted against individuals who are not necessarily contractual parties (that is to say, third parties).

#### Questions for the Working Group

1. *The Working Group is invited to comment on the above proposed principle on proprietary rights. Is there a need to be more prescriptive, for example, in relation to the type of registry in which the VCC would have to be recorded?*
2. *Are there any features or characteristics specific to VCCs that should be included?*
3. *Should the Commentary to Principle 3 touch upon a VCC not being able to be the subject of proprietary rights (in some jurisdictions) because it represents one or more private law rights against other persons?*
4. *The Working Group is invited to comment whether to include Principle 3 (2) and its related Commentary.*

### **E. Conflicts of Law**

85. The numerous cross-border actions and transactions that occur throughout a VCC’s life cycle render the question of the applicable law and jurisdiction particularly complex. This is especially true given that the different stages of the commercialisation and circulation of VCCs and their participants are multi-sited.<sup>73</sup> It is questionable whether traditional connecting factors can be applied to transactions in given VCCs. This is due to the existence of multi-sited legal agreements, the potential for the digitisation of VCCs in the secondary market, and the possibility for the application of cross-border securities laws being applied.<sup>74</sup> Indeed, the circulation of VCCs gives rise to questions regarding potential connecting factors and potential substantial links between project proponents, VCC holders, and the place where the climate mitigation project is carried out. This has implications on the applicable law.<sup>75</sup> In addition, overriding mandatory rules and public policy may restrict recourse to party autonomy rules.<sup>76</sup> Thus, the Working Group agreed in its second session that identifying the relevant objective connecting factors that could point to the applicable law for the various transactions occurring from the creation and cross-border circulation of VCCs would contribute to greater clarity and certainty in the VCM.<sup>77</sup>

86. The HCCH and UNIDROIT set up a subgroup on applicable law contributing to the Working Group on VCCs, which was followed by an online meeting on 16 July 2024.<sup>78</sup> The attendees included

<sup>71</sup> UNIDROIT Summary Report WG2, para. 100.

<sup>72</sup> UNIDROIT Summary Report WG2, para. 85.

<sup>73</sup> UNCITRAL/UNIDROIT Joint Study, para. 155.

<sup>74</sup> UNCITRAL/UNIDROIT Joint Study, paras 156-157.

<sup>75</sup> UNCITRAL/UNIDROIT Joint Study, para. 159.

<sup>76</sup> UNCITRAL/UNIDROIT Joint Study, para. 158.

<sup>77</sup> UNIDROIT Summary Report WG2, para. 119.

<sup>78</sup> See UNIDROIT Summary Report WG2, para. 120.

representatives from the UNIDROIT Secretariat and the Permanent Bureau of the HCCH, as well as the legal experts appointed to sit on the subgroup to draft PIL rules for the future UNIDROIT instrument on the VCCs. The meeting discussed a preliminary timeline for further collaboration and document preparation by the subgroup, and explored the potential scope of PIL rules to be developed.

## **F. Creation of a VCC**

### ***[Draft] Principle [4]***

#### ***Creation of a VCC***

- (1) A VCC comes into existence when all of the following have taken place:**
  - (a) The VCC has been issued;**
  - (b) A unique identifier has been allocated to the VCC by a VCC Registry;**
  - (c) The VCC Registry has recorded that the VCC has been credited to an account in the VCC Registry.**
- (2) The registered holder of a VCC at the moment it comes into existence**
  - (a) has a proprietary right in that VCC, or**
  - (b) if the registered holder maintains the VCC for a client, that client has a proprietary right in that VCC.**
- (3) After that moment, [subject to Principle 7] the question of whether a person has a proprietary right in a VCC is a matter for other law.**

### ***[Commentary]***

4.1 Principle 4(1) specifies the moment at which a VCC comes into existence. While issuance (see Principle 2(7)) is a necessary precondition of the VCC coming into existence, it does not become a VCC as defined in Principle 2(1) until it has been allocated a unique identifier and has been registered in a VCC Registry. At that point, Principle 3(1) applies and it can be the subject of proprietary rights. It is a new [unit] that has not, previously, been capable of being the subject of proprietary rights. Therefore there has to be a person who is the first to have a proprietary right in the VCC. Principle 4(2) provides that that person is either the registered holder (as defined in Principle 9(6) or the person for whom the registered holder maintains the VCC (see [Principle 10]). In practice, that person is usually the project proponent (see [life cycle], who is then able to sell the VCC and can use the price to fund its financing of the carbon mitigation project.

4.2 Principle 4(3) makes it clear that after the moment discussed in the previous paragraph, when the VCC comes into existence, the question of whether a person has, at any time, a proprietary right in a VCC is a matter for other law (see Principle 3(3)). This principle is subject to Principle 7, which set out the circumstances in which a person will take a VCC free from conflicting claims, and which is a matter of Principles law.

87. In the second session of the Working Group, it was discussed (i) whether “recordation” was the correct terminology and (ii) whether the identifier that was applied to VCCs was a unique identifier. Accordingly, it was generally decided that the term “recordation” was not a term used by the market or industry.<sup>79</sup> It was noted that each unit was provided with a number that was unique within the

<sup>79</sup>

See UNIDROIT Summary Report WG2, para. 124.

registry where that unit sat. In other words, even at a future date, should the registries be interconnected, one would be able to ascertain the origin of the unit.<sup>80</sup>

88. The creation of tokenised VCCs without involving a VCC registry was raised as an issue in internal meetings, as verified carbon credits might exist before registration. It was proposed that VCCs be created upon verification, with registered VCCs becoming subject to proprietary rights.

89. Questions related to the creation of a VCC are crucial to its legal nature. The act of issuance led to the unique identifiers being applied to evidence the fact that issuance had happened. In this context, the Working Group agreed in its second session that the individualisation of the unit occurred with the provision of the unique identifier.<sup>81</sup>

#### Question for the Working Group

1. *The Working Group is invited to comment on the above proposed principle on creation of VCC.*

### **G. Reversal**

#### ***[Draft] Principle [5]***

##### ***Reversal***

- (1) The record of a VCC [Or should this simply be “A VCC”] can be reversed wholly or in part where the carbon mitigation project or programme which led to its creation is compromised so that the amount of CO<sub>2</sub> that has been verified as having been removed or reduced is diminished by events following its issue.**
- (2) A reversal is effective at the time the VCC registry updates its records to indicate it has been reversed even if the VCC registry still retains the record of its existence after reversal.**
- (3) Upon reversal, a VCC ceases to be the subject of proprietary rights even if the VCC registry still retains the record of its existence after reversal.**
- (4) Unless otherwise agreed, any reversal of the benefits of a carbon mitigation project should result in a pro rata reversal of VCCs among all registered holders.**
- (5) Should a VCC be [Or “is” if we go with “if”] reversed in error, the rights and remedies of parties affected, including the possibility of the restoration of the VCC, is a matter for other law.**

#### ***[Commentary]***

5.1 Principle 5(1) provides that a VCC can be reversed wholly or in part where there is a reversal of the benefits of a carbon mitigation project or programme has been compromised post-issuance. This distinguishes reversal from revocation (Principle 6) which deals with matters leading up to issuance.

<sup>80</sup> See UNIDROIT Summary Report WG2, para. 123.

<sup>81</sup> See UNIDROIT Summary Report WG2, para. 129.

5.2 Principle 5(2) clarifies that the time of reversal of a VCC should this come to pass is the time when the VCC registry updates its records as such. This avoids any dispute as to when a reversal of a VCC is effective.

5.3 Principle 5(3) provides that upon reversal, a VCC ceases to be the subject of proprietary rights. Where any rights arise as a result of reversal, these can be dealt with according to the laws of the relevant jurisdictions but will not be governed by these Principles.

5.4 Principle 5(4) provides for a schema for reversals of VCCs in the absence of agreement and/or the failure of such agreement to provide an adequate solution. Many carbon mitigation projects and programmes address reversals by keeping a buffer pool of VCCs which are drawn down before any project or programme level reversal affects issued VCCs. This would be an example of an agreement otherwise.

5.5 Principle 5(5) preserves such rights as a registered holder may have (whether against a VCC registry or a third party) where a VCC is reversed in error. The nature of such rights (if any) will vary across different jurisdictions. Some jurisdictions may provide relieve in tort whereas others may do so in restitution. In principle, it should be open to the parties to contractually agree to a particular solution, subject to any controls on contractual limitations of liability.

90. In its second session, the Working Group generally agreed that the three distinct concepts of retirement, reversal and revocation should be addressed separately in the instrument.<sup>82</sup> Accordingly, the Principle 5 address the concept of retirement.

91. As defined in the Principle 2, a reversal occurs when a VCC is permanently removed from circulation in a VCC registry when the benefits of a carbon mitigation project are lost or diminished as a result of events following its issuance. Principle 5 provides on how and when the reversal of VCC carried out and also provides a scheme to address potential consequences unless otherwise agreed.

#### Question for the Working Group

1. *The Working Group is invited to comment on the above proposed principle on how reversals are carried out.*

## **H. Revocation**

### ***[Draft] Principle [6]***

#### ***Revocation***

**(1) A VCC can be revoked wholly or in part where it is subsequently demonstrated that:**

**(a) the carbon mitigation project or programme had failed to abide by the methodology of an ICCP [or a Government?];**

**(b) the verifier's verification process is shown to have been compromised;**  
**or**

**(c) the methodology of an ICCP [of a Government?] is shown to be flawed.**

<sup>82</sup>

UNIDROIT Summary Report WG2, para. 172.

**(2) A VCC that has been revoked is void from the outset and never existed as the subject of proprietary rights.**

**(3) Should a VCC be [Or “is” if we go with “if”] revoked in error, the rights and remedies of parties affected, including the possibility of the restoration of the VCC, is a matter for other law.**

**[Commentary]**

6.1 Principle 6(1) provides that a VCC can be revoked wholly or in part in three circumstances that demonstrate that the benefits of a carbon mitigation project or programme were never achieved in the first place. These are (a) where the project or programme failed to abide by the methodology of an ICCP [or a Government?]; (b) where the verification process is shown to have been compromised; or (c) where the methodology of an ICCP [or Government?] is shown to be flawed. [Are there any other circumstances that need to be included in Principle 6(1)?] In each of these circumstances, the claimed benefits of a project or programme were never achieved at the outset, thus distinguishing revocation from reversal.

6.2 Principle 6(2) provides that a VCC that has been revoked is void from the outset and was never the subject of proprietary rights. This is consistent with the effects of invalidity for other categories of intangible property, such as patents. Principle 6 does not deal with the consequences of such invalidity as this would not be a matter of property but contract or restitution. For example, parties can (and often do in the case of patents) undertake the risk of a patent being invalid. In some jurisdictions, the law may also provide that a seller warrants that it has title in the subject-matter of a sale (as many common law jurisdictions do in relation to the sale of goods). However, as these are not matters relating to property, these Principles do not address them.

6.3 Principle 6(3) preserves such rights as a registered holder may have (whether against a VCC registry or a third party) where a VCC is revoked in error. The nature of such rights (if any) will vary across different jurisdictions. Some jurisdictions may provide relieve in tort whereas others may do so in restitution. In principle, it should be open to the parties to contractually agree to a particular solution, subject to any controls on contractual limitations of liability.

92. As stated above, the Working Group in its second session generally agreed that the three distinct concepts of retirement, reversal and revocation should be addressed separately in the instrument.<sup>83</sup> Therefore, the Principle 6 addresses the concept of revocation.

93. As defined in the Principle 2, a reversal occurs when a VCC is permanently removed from circulation in a VCC registry when it is demonstrated that the benefits of a carbon mitigation project have never achieved from the outset. Principle 6 provides on when the revocation of VCC occurs and its consequences, including when the revocation occurs in error, but only addresses to the matters relating to the proprietary rights.

Questions for the Working Group

1. *The Working Group is invited to comment on the above proposed principle on revocation.*

<sup>83</sup>

UNIDROIT Summary Report WG2, para. 172.



2. *The Working Group is invited to consider whether to establish a rule in respect of post-revocation of a unit.*

## **I. Transfer of a VCC**

### **[Draft] Principle [7]**

#### **Transfer of a VCC**

- (1) [Subject to paragraph (3),] a person can transfer only the proprietary rights that it has in a VCC, if any, and no greater proprietary rights.**
- (2) A transferee of proprietary rights in a VCC acquires all of the proprietary rights that its transferor had or had the power to transfer, except that the transferee acquires rights only to the extent of the rights that were transferred.**
- [(3) An innocent acquirer takes a VCC free of conflicting proprietary rights.]**
- [(4) In order to qualify as an innocent acquirer, a transferee must:**
  - (a) be a registered holder;**
  - (b) have the VCC credited to their registry account by the VCC [registry][registry operator; and**
  - (c) comply with requirements equivalent to those found in the relevant good faith acquisition and take-free rules as specified by the relevant State.]**
- [(5) No rights based on a proprietary claim relating to a VCC can be successfully asserted against an innocent acquirer of that VCC.]**
- [(6) A transferee of a VCC is not an innocent acquirer if the transfer of the VCC is made by way of gift or otherwise gratuitously and is not the grant of a security right.]**

#### **[Commentary]**

7.1 Principle 7(1) states the familiar rule of *nemo dat quod non habet*—no one can give what one does not have. [Principle 7(1) is subject to the innocent acquisition rule in Subsection 3, which operates as an exception to the consequences of the application of the *nemo dat* rule]. [The effect of Subsection 3 is not that the transferor has the rights to transfer more proprietary rights than it itself has, but that it has the power to do this. Thus, an innocent acquirer takes free of conflicting proprietary rights, and that no rights based on a proprietary claim can be asserted against an innocent acquirer.]

7.2 Principle 7(2) states the shelter principle: a transferee acquires all the rights of the transferor that were transferred or that the transferor had the power to transfer. [Principle 7(2) makes an exception for the situation in which a transferor transfers less than all of its rights in the digital asset, in which case the transferee acquires only the rights that were transferred.]

94. VCCs are currently traded Over the Counter (OTC), through private bilateral contracts, or on exchange-traded markets. Efforts are underway to promote greater standardisation of the contracts

through which VCCs are transferred.<sup>84</sup> However, market participants' ability to easily transfer VCCs and obtain proprietary rights over them upon a transfer, is essential to a well-functioning VCM. Key questions that emerge are thus how and when a transfer is completed and what rights and responsibilities VCC sellers and buyers, as well as intermediaries, have in relation to the transfer of the VCC.<sup>85</sup> Accordingly, the proposed Principle 7 provides a framework for the rules or policy objectives that should be applied when the proprietary rights over the VCC is transferred to another.

95. Issues that currently cause uncertainty in the VCM include the conditions under which a transfer of VCCs should be deemed completed and the exact moment at which proprietary rights pass from the seller to the buyer. As already noted, VCC registries are not registries of title. The VCC registries' own rules and Terms of Use normally provide for freedom of contract, specifying that the parties are free to determine how they would transfer proprietary rights or the interest in their underlying credits to each other. Where the registry acts as a facilitator of the transfer process, it is to react to a bilateral arrangement carried out between the individuals, which is in the individual's interest to then ensure it be brought to the attention of the registry, so that the registry can adjust the account record. Thus, the transfer generally occurs on the basis of bilateral contractual agreements, with the registries simply updating their records on the basis of instructions received from the parties.<sup>86</sup> However, as reflected in the Principle 3 (3) and Principle 4 (3), the passage of proprietary rights depends on the particular system and the applicable law.

96. Participants in the Working Group generally agreed that including an innocent acquisition rule, would be beneficial to facilitate trade and scale the market, even if the instrument left the question of when proprietary rights transferred to national law.<sup>87</sup> An innocent acquisition rule would provide that, if a buyer acquires a VCC and he or she has no notice that the seller did not own the VCC, the buyer nonetheless obtains proprietary rights. The reason for including such a provision in the present instrument would be to recommend, for most jurisdictions, either a change or a clarification in the law, because it would not go without saying in many jurisdictions.<sup>88</sup> Therefore, the Working Group agreed in its second session to consider a few possible innocent acquisition rules with different degrees and to present them to market participants for consideration.<sup>89</sup> The above principle is proposed according to the discussion held in the Working Group's second session.

#### Questions for the Working Group

1. *The Working Group is invited to comment on the above proposed principle on transfer of a VCC.*
2. *Should the instrument address the innocent acquirer rule?*

## **J. Retirement**

### ***[Draft] Principle [8]***

#### ***Retirement of a VCC***

- (1) The registered holder of a VCC can instruct the VCC registry [in writing? or other formality? or none?] to retire a VCC, whereupon the VCC registry must do so forthwith.**

<sup>84</sup> See, e.g., UNCITRAL/UNIDROIT Joint Study, paras 132-133.

<sup>85</sup> See UNIDROIT Study LXXXVI – W.G.1 – Doc. 2, Issues Paper, October 2023, para. 99.

<sup>86</sup> UNIDROIT Summary Report WG1, para. 95.

<sup>87</sup> UNIDROIT Summary Report WG2, para. 137.

<sup>88</sup> UNIDROIT Summary Report WG1, para. 110.

<sup>89</sup> UNIDROIT Summary Report WG2, para. 143.

- (2) A VCC is retired when the VCC registry updates its records indicating its retirement as such.**
- (3) Upon retirement, a VCC ceases to be the subject of proprietary rights even if the VCC registry still retains the record of its existence after its retirement.**
- (4) Should a VCC be [Or “is” if we go with “if”] retired in error, the rights and remedies of parties affected, including the possibility of the restoration of the VCC, is a matter for other law.**

**[Commentary]**

8.1 Principle 8(1) provides that it is the registered holder of a VCC that can instruct the VCC registry to retire a VCC. This may or may not be the beneficial owner of a VCC as a registered holder may be a custodian of the VCC for another person (see Principle 10). Principle 8(1) also provides that the VCC registry is obliged to act on such instruction in a timely manner. [The Principles currently leaves it open as to whether baseline rules should be provided as to whether the instructions should comply with some basic formalities. Formalities, such as writing, can serve important evidentiary functions should disputes arise subsequently as to whether instructions were given or not.]

8.2 Principle 8(2) specifies that the time retirement is effective is the moment that the VCC registry updates its record indicating its retirement rather than some other time, such as the time instructions for retirement are given, providing certainty to when retirement occurs.

8.3 Principle 8(3) provides that upon retirement, a VCC ceases to be the subject of proprietary rights. This follows logically from the *raisons d'être* of retirement, which is to permanently remove a VCC from circulation (see Principle 2(14)). Principle 8(3) clarifies that this is the case even if (as is commonly the case) a VCC registry retains the record of the VCC after its retirement.

8.4 Principle 8(4) preserves such rights as a registered holder may have (whether against a VCC registry or a third party) where a VCC is retired in error. The nature of such rights (if any) will vary across different jurisdictions. Some jurisdictions may provide relieve in tort whereas others may do so in restitution. In principle, it should be open to the parties to contractually agree to a particular solution, subject to any controls on contractual limitations of liability.

97. As stated above, the three distinct concepts of retirement, reversal and cancellation addressed separately in the instrument based on the general agreement of the Working Group in its second session.<sup>90</sup> Principle 8 therefore addresses the concept of retirement.

98. As defined in Principle 2, a retirement occurs when a VCC is permanently removed from circulation in a VCC registry upon the instruction of its registered holder. Accordingly, Principle 8 provides on how to retire a VCC and its consequences, including when the retirement is made in error, but only addresses to the matters relating to the proprietary rights.

Questions for the Working Group

<sup>90</sup> UNIDROIT Summary Report WG2, para. 172.

1. *The Working Group is invited to comment on the above proposed Principle on retirement.*
2. *The Working Group is invited to comment on how should the registered holder instruct the registry to retire a VCC. Should there be a form requirement?*

## **K. VCC Registry**

### ***[Draft] Principle [9]***

#### ***VCC Registry***

- (1) 'VCC registry' means an electronic [database] operated by a [registry operator] [registrar] in which the following information is recorded:
  - (a) The unique identifier of a VCC;
  - (b) The identifier of the person to whose account the VCC is credited.
- (2) '[Registry operator] [Registrar]' means a legal person who operates a registry.
- (3) 'Registry account' means an account maintained by a VCC registry to which VCCs may be credited or debited.
- (4) 'Registry accountholder' means a person who has entered into a registry account agreement with the [registry operator] [registrar] in relation to one or more accounts.
- (5) 'Registry account agreement' means the agreement governing the registry account between a registered account holder and the registrar.
- (6) 'Registered [holder]' means a registry accountholder to whose registry account a VCC is credited.
- (7) A [registry operator] [registrar] owes the following duties to a registered holder in relation to a VCC credited to the registered holder's account:
  - (a) An obligation to comply with the [registry] rules and the rules of the relevant issuer;
  - (b) An obligation to allocate a unique identifier to VCC and to maintain one, and only one, registry entry in relation to that uniquely identified VCC;
  - (c) An obligation to comply with any instruction given by a registered holder in relation to the credited VCC, including to [transfer][move] the VCC into the account of another person and to retire the VCC, unless:
    - (i) the registrar is prohibited from complying with the instruction by other law, the rules of the relevant [ICCP][issuer] or by any agreement between the registrar and a third party to which the registered holder is a party or has consented;
    - (ii) the [registry operator][registrar] is not obliged, by other law or by the registry account agreement with the registered holder, under certain circumstances, to comply with the instruction;
  - (d) [Anything further to add?]

- (8) A [registry operator] [registrar] has no proprietary right in a VCC registered in the registry it operates.**
- (9) A VCC registered in a registry is not available for the satisfaction of claims of creditors of the [registry operator] [registrar].**
- (10) If a [registry operator] [registrar] of a registry enters into an insolvency-related proceeding, a VCC registered in that registry does not form part of that [registry operator] [registrar]’s assets available for distribution to its creditors.**
- (11) A [registry operator] [registrar] must have a Recovery and Orderly Dissolution Plan providing for preservation of all entries on the registry if the [registry operator] [registrar] enters into an insolvency-related proceeding.**
- (12) A [registry operator] [registrar] must comply with any instruction from [an issuer] [an ICCP] to cancel a VCC.**
- (13) A [registry operator] [registrar] must [prohibit][not permit][not carry out] any transfer, retirement or revocation of a VCC that is already retired or revoked.**

**[Commentary]**

9.1 [Principle 9 includes some definitions in relation to a VCC registry. These could stay in the registry principle or could be moved to Principle 2 eventually.] As discussed in [ life cycle/introduction], a VCC registry is, usually, established solely under private law as opposed to a registry established by, or pursuant to, legislation. The definitions in Principle 9 are therefore quite broad and minimalistic, so that most (if not all) registries that purport to be VCC Registries are covered by the Principles. This is important since under Principle 2 (1) a unit is only a VCC within the Principles if it is registered in a VCC Registry (as defined in Principle 9).

9.2 A VCC Registry is defined in Principle 9(1) as a database recording some very minimal information, namely, the unique identifier of a VCC and the identifier of the person to whose account that VCC is credited. A VCC Registry is likely to record much more information than this, but given possible variations between registries, the definition is as minimal as possible. A registry is operated by a [legal] person called the ‘registry operator’ [registrar] (see Principle 9(2). This could be the same [legal] person as the issuer of the VCC or could be a different [legal] person. The Principles take no view on this point, but treat the two different functions separately so that they apply if the functions are carried out by two different [legal] persons.

9.3 Principle 9(3) recognises that a registry will maintain accounts to which VCCs can be credited or debited. Market participants, whose relationship with the registry is governed by a contract called (in the Principles) a registry account agreement, can have one or more accounts with a registry. A person who has entered into a registry account agreement is called a registry accountholder (see Principle 9(4)). The registry account agreement is likely to include a number of rights and obligations between the parties to it. However, the only obligations that are set out in Principle 9 ((Principle 9(7)) are those that relate to a VCC credited to the account of a registry accountholder. In relation to such a VCC, the registry accountholder is called a ‘registered holder’ (Principle 9(6)). Whether a registered holder of a VCC has a proprietary right in that VCC is a matter ‘for other law’ (Principle 3(3)), with the exception of the very first registered holder who may have a proprietary right in the VCC under Principle 4(2). However,

if the first registered holder is maintaining that VCC for a client, the client will have a proprietary right in the VCC under Principle 4(2).

9.4 The obligations set out in Principle 9(7) are private law obligations arising out of the registry account agreement. They are drafted, for clarity, in relation to one, single, VCC; however, the duties apply in relation to each VCC registered in the registry and are owed to the holder of each of those VCCs. These are basic duties, and a State should not permit them to be excluded by the terms of the registry account agreement. The duty in Principle 9(7)(a) is to comply with the rules of the issuer as regards registration. [if we want to include this duty we need to explain why it is important]. The duty in Principle 9(7)(b), to allocate a unique identifier to the VCC and to maintain one, and only one, registry entry in relation to that uniquely identified VCC, is critically important to the individuation and identification of the VCC, which in turn is an important attribute enabling the VCC to be the subject of proprietary rights (see Principle 3(1) and Commentary 3.2). The duty set out in Principle 9(3) is to comply with the instructions of a registry holder. These instructions include an instruction to move the VCC into another account (which may or may not have the effect of transferring a proprietary right in the VCC to the accountholder of the receiving account: this will depend on other law, see Principle 3(3)). The instructions also include an instruction to retire the VCC.

9.5 Principles 9(8)(9) and (10) make it clear that, in relation to VCCs registered in the registry, the registered operator has no proprietary rights and the VCCs do not form part of its insolvency estate. Principle 9 also sets out some obligations of the registry operator which are needed to enable the VCC system to work well and which are likely to be part of regulatory law. These are that the registry operator must have a Recovery and Orderly Dissolution Plan, that the registry operator must comply with an instruction to cancel a VCC and that the registry operator must not enable any retired or cancelled VCC to be transferred, retired or cancelled.

99. The above draft commentary is not final but for discussion by Working Group.

100. During the second session of the Working Group, it was decided to use the term “VCC Registry” and provide minimum definitions in relation to a VCC registry.<sup>91</sup> VCC registry is therefore defined under the Principle 9.

101. Questions for discussion at this point include whether it is correct to describe the registry as a database, whether it is right to say that it is always electronic or that the possibility of a hard copy registry should be included, and whether to use the terminology “registry operator” or “registrar”.

#### Questions for the Working Group

1. *The Working Group is invited to comment on the above proposed principle on VCC registry, especially on the terminology left in square brackets.*
2. *The Working Group is invited to decide whether to keep the definition of VCC Registry under the Principle 9 or to move all definitions to the Principle 2.*
3. *The Working Group should consider the private law duties of the registrar to the registered holder in paragraph 7.*

<sup>91</sup> UNIDROIT Summary Report WG1, para. 157.

**L. Custody*****[Draft] Principle [10]******Custody***

- 1. 'Intermediary' means a person who provides services to another person in respect of a VCC.**
- 2. 'Client' means a person to whom an intermediary provides services.**
- 3. 'Custodian' means an intermediary who is a registered holder of a VCC and who provides services to another person pursuant to a custody agreement in respect of that VCC.**
- 4. 'Sub-custodian' means a custodian who provides services to another custodian pursuant to a custody agreement in respect of that VCC.**
- 5. A custodian 'maintains' a VCC for a client if:**
  - (a) That custodian is the registered holder of the VCC; or**
  - (b) That custodian enters into a custody agreement with a sub-custodian with respect to the VCC [in the circumstances set out in Principle 10(10)].**
- 6. An agreement between an intermediary and a client is a custody agreement if:**
  - (a) It relates to a VCC;**
  - (b) It is entered into in the course of the intermediary's ordinary course of business; and**
  - (c) The intermediary is obliged to:**
    - (i) maintain the VCC for the client; and**
    - (ii) instruct the [registrar][registry operator] or, in the case of sub-custody, the intermediary's own custodian, to retire the VCC if instructed by the client to do so.**
- 7. A VCC maintained by a custodian for a client is not available for the satisfaction of claims of creditors of the custodian.**
- 8. (a) If a custodian enters into an insolvency-related proceeding, a VCC maintained by a custodian for a client does not form part of that custodian's assets available for distribution to its creditors.**
  - (b) If a custodian maintains a VCC for a client with a sub-custodian, and the custodian enters into an insolvency-related proceeding, the rights it has against the sub-custodian in respect of that VCC do not form part of the custodian's assets available for distribution to its creditors.**
- 9. A custodian owes the following duties to its client in relation to a VCC that it maintains for that client:**

- (a) the custodian is not authorised to instruct the [registry operator] [registrar] to [transfer][move] the VCC to the account of another person, [or use it for its own benefit,] except to the extent permitted by the client and by other law;
  - (b) the custodian is obliged to comply with an instruction given by the client to instruct the registrar to [transfer][move] the VCC to the account of another person, unless:
    - (i) [the custodian is prohibited from complying with the instruction by other law or by any agreement between the custodian and a third party to which the client is a party or has consented;
    - (ii) the custodian is not obliged, by other law or by an agreement with the client, under certain circumstances, to comply with the instruction]
  - (c) the custodian is obliged to safeguard the VCC.
- 10. Unless prohibited by the custody agreement or by other law, a custodian may maintain VCCs [of the same description] for two or more of its clients as an undivided pool.
- 11. The duties owed by a custodian to its client may include:
  - (a) the duty to keep a record of the VCC it maintains for each client;
  - (b) the duty at all times to securely and effectively maintain VCCs in accordance with the records it keeps for its clients;
  - (c) the duty to acquire VCCs promptly if this is necessary to satisfy the duty under subparagraph (b);
  - (d) the duty to separate the VCCs maintained for clients from the VCCs maintained for its own account;
- 12. Where authorised by a client or by other law, a custodian may fulfil its duties to its client under this Principle by entering into a custody agreement with a sub-custodian if the sub-custodian is bound by the duties set out in this Principle.
- 13. A VCC maintained by a custodian for a client may be subject to a security right:
  - (a) granted to that custodian by the client;
  - (b) in favour of that custodian arising by operation of other law; or
  - (c) granted to a third party by the client.
- 14. If a custodian enters into an insolvency-related proceeding, the insolvency representative must take reasonable steps
  - (a) for a VCC registered in the account of the custodian to be [transferred] [moved] to a registry account of the client or of a custodian nominated by that client;
  - (b) for any rights the custodian has against any sub-custodian in respect of a VCC maintained for the custodian's client to be [transferred][moved] to a registry account of that client or otherwise made accessible to that



**client, including through [transfer][moving it] to the registry account of another custodian nominated by that client.**

**15. Paragraphs 16 and 17 apply if all of the following requirements are fulfilled:**

- (a) a custodian enters into an insolvency-related proceeding;**
- (b) VCCs of the same description are maintained by the custodian for two or more clients as an undivided pool; and**
- (c) the quantity of VCCs held by the insolvent custodian for those clients is less than the aggregate quantity of VCCs of the same description that it is obliged to maintain for those clients ('shortfall').**

**16. [The shortfall is met first by any VCCs of the same description maintained by the custodian for itself.]**

**17. Any [remaining] shortfall shall be borne by the clients for whom the custodian maintains the VCCs as an undivided pool, in proportion to the respective quantity of VCCs of the same description that the custodian is obliged to maintain for those clients.**

**18. If a custodian maintains a VCC for a client with a sub-custodian and the sub-custodian enters into an insolvency-related proceeding, the custodian must seek to cause that VCC to be registered in its own registry account or to maintain the VCC with another sub-custodian.**

**[Commentary]**

10.1 The purpose of Principle 10 is to set out private law principles relevant to custody of VCCs. Other law, including regulatory law, may also apply to the provision of custody services. Custody, broadly speaking, is where a person known as a 'custodian' (usually a legal person, which may be a regulated entity), maintains a VCC on behalf of and for the benefit of another person called a 'client'. The client might be another custodian. The maintain of the VCC by the custodian is in a manner that gives the client special protection against unauthorised dispositions of the VCC and against the insolvency of the custodian who maintains the VCC. Principle 10 only applies where the person providing the custody services does so in the ordinary course of its business. The special protection for the client referred to is likely to be achieved in private law by the client having a proprietary right of some sort in the VCC, although the precise technique by which this protection is achieved will vary according to the private law of the relevant jurisdiction.

10.2 Principle 10(1) defines an intermediary as a person who provides services to another person in respect of a VCC. Whether the services provided by an intermediary are custody services will depend on whether the agreement between the intermediary and its client is a custody agreement. Principle 10(6) defines a custody agreement. Principles 10(2) to (4) define the important parties in relation to custody. To be a custodian an intermediary must be the registered holder of the relevant VCC, and must provide services to a client pursuant to a custody agreement in respect of that VCC. If the client is a custodian, the intermediary is also a sub-custodian.

10.3 Sub-custody is where the registered holder of the VCC (the sub-custodian, who is a custodian) maintains the VCC for another custodian, who, in turn, maintains it for a client (who is not a custodian). In theory, there could be a chain of sub-custodians, but there will always be a client at the bottom of the chain who is not acting as a custodian. As set out in Principle 10(5), the concept of 'maintaining' a VCC includes two situations. The first is where a custodian

itself is the registered holder of a VCC and 'maintains' it for the client. The second is where a custodian 'maintains' a VCC by entering into a custody agreement with a sub-custodian (the custodian thereby becoming the sub-custodian's client). Here, the sub-custodian is the registered holder of the VCC and the custodian has rights against the sub-custodian under the custody agreement. Where a sub-custodian is used, the sub-custodian and the custodian both 'maintain' the VCC.

10.4 Custody agreement Principle 10(6) defines a custody agreement relating to a VCC (Principle 10(6)(a) and, therefore, custody of that VCC. Sub-paragraph (b) makes it clear that to be a custodian, the intermediary must be acting in the ordinary course of its business. Sub-paragraph (c) sets out the core duties of a custodian (see also Principle 10(9)). These are to maintain the VCC for the client (see Commentary 10.3) and to instruct the [registrar] [registry operator] to retire the VCC if the client instructs the intermediary to do so.

10.5 Principle 10(7) applies where the custodian has not entered into an insolvency-related proceeding. It makes it clear that VCCs maintained by a custodian for a client are not available for the satisfaction of the claims of the custodian's creditors. This result parallels the substance of Principle 10(8), which provides that VCCs maintained for clients are not part of the assets available for distribution to the custodian's creditors if it enters into an insolvency-related proceeding. These provisions reflect the baseline concept that such VCCs belong to the clients, not to the custodian.

10.6 Principle 10(8)(a) sets out the consequences of the insolvency of the custodian in a functional way rather than using legal concepts such as property or ownership. On the custodian's insolvency, VCCs it maintains for clients as custodian are not part of the assets available for distribution to its creditors. In Principle 10(8), the 'custodian' could in fact be a sub-custodian and the 'client' could be a custodian. Principle 10(8) sets out the consequences where a VCC is held through a sub-custodian (see Principle 10(12)). As explained in Commentary 10.3, where a custodian maintains a VCC through a sub-custodian, the custodian (who will be the client of the sub-custodian under a custody agreement) has rights against that sub-custodian under the custody agreement. If the custodian is insolvent, its rights against the sub-custodian are not part of the custodian's assets available for distribution to its creditors.

### Duties

10.7 Principle 10(9) sets out duties which are owed by a custodian providing custody services under an agreement with a client. The duties relate to the VCC maintained by the custodian for the client. These are basic duties and a State should not permit them to be excluded by the terms of the custody agreement. If the custodian is a sub-custodian, the client is itself a custodian. The language of Principle 10(9) is intended to be functional and neutral between legal cultures. In some jurisdictions, the relationship between custodian and client will be legally characterised as a trust while in other jurisdictions it may be characterised as a contractual or other type of legal relationship.

10.8 Principle 10(10) addresses the situation where a custodian maintains VCCs 'of the same description' for several clients. The phrase 'of the same description' is used in these Principles to refer to VCCs that are treated by market participants as fungible (see also Principles 10(15) to (17)). Fungibility is not a technical characteristic of a VCC, but a matter of market practice. The record of any VCC in a registry is individualised because it is uniquely identified. [However, as a matter of market practice, many VCCs are treated as fungible so that any such VCC or VCCs will satisfy a delivery obligation in relation to a VCC.]

10.9 Subject to other law or to the custody agreement, Principle 10(10) permits a custodian to maintain VCCs for several clients as an undivided pool. This has two consequences. First,

the custodian may maintain an undivided pool of client assets all of which are registered in the custodian's registry account, so that no specific VCC or quantity of VCCs is specifically allocated to a particular client. If the custodian maintains VCCs for several clients with a sub-custodian, maintaining them as an undivided pool means that the custodian need not have a separate sub-account with the sub-custodian for each client. As a result an undivided pool as described above includes all VCCs 'of that description' registered in the registry account of the custodian as well as all VCCs 'of that description' maintained with one or more sub-custodians. Second, when the custodian receives an instruction from a client in respect of a VCC maintained for its clients as an undivided pool, it may comply with that instruction using any VCC or quantity of such VCCs registered in its registry account or that it maintains with a sub-custodian. This is because these various VCCs 'of the same description' are treated as fungible, as explained above in Commentary 10.8. Where the custodian is not allowed to maintain an undivided pool, it must implement what is often called full segregation. The reference to 'a custodian' in Principle 10(10) also applies to a sub-custodian, whose clients are custodians.

10.10 Principle 10(11) sets out private law duties which a State may wish to ensure are owed by a custodian to its client, although it is for a State to choose whether it wishes to do so, in which case it would have to make the chosen duties mandatory and non-excludable by agreement. Separately, a State may wish to impose these duties on custodians as a matter of regulatory law, that is, by imposing duties for which there is no private law redress but breach of which may incur sanctions imposed by the State. Again, it should be recalled that if the custodian is a sub-custodian, the client is a custodian. [For the result of Principle 10(8) [insolvency] to be attained under some domestic laws, the duty under Principle 10(11)(d) must not be permitted to be excluded by the terms of the custody agreement.] A State may choose to impose a similar duty as a matter of regulatory law.

10.11 Principle 10(12) makes it clear that a sub-custody structure can be used. Under this structure, the custodian maintains the VCC by entering into a custody agreement with a sub-custodian with respect to that VCC (see Principles 10(4) and (5) and Commentary [10.3]). Such a structure can be used if the sub-custodian is bound by the duties set out in Principle 10. A custodian would, however, be in breach of its own duties to the client if the chosen sub-custodian was not subject, in the sub-custody agreement, to the mandatory and non-excludable private law duties of a custodian under the applicable law. [These duties are those set out in Principle 10(9) plus those listed in Principle 10(11) that the relevant State has chosen to make mandatory.] Other law determines the extent to which, if any, a custodian is responsible to its client with regard to the non-performance by the sub-custodian of its duties under Principle 10.

10.12 Principle 10(13) recognises that a custodian may have a security right in the VCC it maintains for a client. For example, the client may owe the custodian fees, for which the custodian wishes to be secured, or the custodian may have lent the client money to acquire the VCC.

10.13 Principles 10(14) to 10(17) give guidance as to suitable rules which should (or, in the case of Principle 10(16), could) apply in relation to VCCs (or if a sub-custodian is used, rights against the sub-custodian) if a custodian enters into an insolvency-related proceeding. These rules are not comprehensive; the applicable insolvency law governs all other issues that could arise in these circumstances. It should be noted that a custodian or sub-custodian could have a security right over, or another type of right to, VCCs maintained for its clients (see Principle 10(13)). The effect of this on the actions taken by an insolvency representative would be a matter of other law.

10.14 Principle 10(14) imposes a duty on the insolvency representative to take reasonable steps so that the client can obtain the VCCs maintained for it by the custodian. If the VCCs are maintained by the custodian by entering into a custody agreement with a sub-custodian

(Principle 10(5)(b)), the duty on the insolvency representative relates to the custodian's rights against the sub-custodian. The client may want the VCCs moved into its own registry account (or obtain the rights against the sub-custodian itself), or may want another custodian to maintain them on its behalf. The insolvency representative may need to take certain steps to achieve this result, such as instructing the registry to VCCs from one account to another.

10.15 Principles 10(15) to 10(17) apply where VCCs 'of the same description' (see Commentary 10.8) are maintained by a custodian for its clients as an undivided pool (see Principle 10(10) and Commentary 10.8). Undivided pools of VCCs 'of the same description' are explained in Commentary 10.9. A custodian can maintain VCCs as an undivided pool either by the VCCs being registered in the custodian's registry account or by entering into a custody agreement with a sub-custodian in respect of an undivided amount of VCCs. In this latter situation, its rights against the sub-custodian will be undivided. Principles 10(15) to 10(17) deal with the situation where there is a shortfall of VCCs, or rights against the sub-custodian, of a particular description. Principle 10(15) explains the situation of shortfall in an undivided pool, namely, that the custodian does not maintain sufficient VCCs to meet the number of VCCs it is obliged, under the relevant custody agreements, to maintain for the clients for whom it maintains the VCCs in the undivided pool. For example, suppose a custodian had custody agreement with four clients, each relating to 100 VCCs. If the custodian only had 300 VCCs registered in its registry account, there would be a shortfall. In the insolvency-related proceeding of a custodian, there may be potentially as many shortfalls as there are undivided pools.

10.16 If there is a shortfall, a State may wish to provide that the loss is first met by any VCCs of the same description maintained by the custodian on its own account, whether these VCCs are registered in the custodian's 'house' registry account or whether the custodian uses a sub-custodian (Principle 10(16)). This approach follows that of Article 25 of the Geneva Securities Convention. However, under that Convention, a State can make a declaration that this rule is not to apply in that State. In a similar way, it is a policy decision for a State as to whether to adopt the rule set out in Principle 10(16). For this reason, Principle 10(16) is in square brackets.

10.17 Under Principle 10(17) the loss of VCCs (or rights against a sub-custodian) caused by the shortfall should be borne *pari passu* by all the clients for whom the custodian is obliged to maintain the VCCs of which there is a shortfall. The approach follows that of Article 26(2) of the Geneva Securities Convention. If a State chooses to adopt the rule in Principle 10(16), then the word 'remaining', which is in square brackets in Principle 10(17), applies. Otherwise, that word is not required.

10.18 Principle 10(18) sets out the consequences of the insolvency of a sub-custodian where a VCC is maintained through that sub-custodian (see Principle 10(12)). In these circumstances, the custodian must seek to move the VCC from the registry account of the insolvent sub-custodian either to its own registry account or to the account of another sub-custodian.

102. Custody typically refers to a custodian maintaining VCCs on behalf of a client, which may include other custodians. It is not clear from the discussion in the first Working Group whether a custody system already exists in the VCC market, or whether one is likely to develop. It is reasonably clear that a registry is not a custodian, as it merely records the information in relation to the VCC and does not have any safeguarding duties. A custodian would be a registered holder of a VCC who held it for another person. This is different from a broker who was not a registered holder, and who therefore was merely a service provider (and whose contract would be governed by the applicable law). If a custody system is already operating or is likely to develop then a custody principle would be useful.

103. The above draft has derived from the UNIDROIT Principles on Digital Assets and Private Law, with adaptations made to apply specifically to VCCs. The Working Group is invited to comment whether to include the paragraph 10 on pooled accounts, paragraphs 9 and 11 on suggested 'core' duties and 'optional' duties (for a State to make compulsory), paragraph 12 on sub-custody and the consequential drafting, paragraph 14 on actions as an insolvency representative and paragraphs on 15 - 17 on shortfall. These sections are in the preliminary stages of drafting, awaiting further discussion by the Working Group on whether their inclusion is warranted.

Questions for the Working Group:

1. *The Working Group is invited to comment on the above proposed principle on custody.*
2. *Do persons who are registered holders of VCCs for other persons (i.e. custodians) exist in the VCC market? Is a custody market likely to develop?*
3. *The Working Group should consider whether to include the private law duties of the custodian to the client in paragraphs 9 and 11.*
4. *Should the Paragraph 10 on pooled accounts, be included in the present instrument?*
5. *Is sub-custody part of the VCC custody market or likely to become part of the VCC custody market? The Working Group should consider whether to include the paragraph 12 on sub-custody.*
6. *Should the Paragraph 14, which gives guidance as to the actions of an insolvency representative upon the insolvency of a custodian, be included in the present instrument?*
7. *The Working Group should consider whether to include the paragraphs on 15 - 17 on shortfall.*

**M. Security**

***[Draft] Principle [11]***

***Security***

- (1) A VCC can be the subject of security rights.**
- (2) Whether and how a security right in a VCC is created is governed by other law.**
- (3) A security right in a VCC can be made effective against third parties if one of the following requirements is met:**
  - (a) The requirements of any method of third-party effectiveness provided by other law are fulfilled;**
  - (b) The secured creditor becomes the registered holder of the VCC; or**
  - (c) A custodian holds the VCC for the secured creditor [as set out in .....]; or**
  - (d) [The secured creditor enters into a control agreement with the grantor and the custodian who holds the VCC for the grantor of the security right.]**

- (4) [A control agreement is an agreement in relation to a VCC made between the grantor, the custodian who holds the VCC for the grantor and the secured creditor, which includes either or both of the following provisions:**
  - (a) that the custodian is not permitted to comply with any instructions given by the grantor in relation to the VCC without the consent of the secured creditor;**
  - (b) that the custodian is obliged to comply with any instructions given by the secured creditor in relation to the VCC in such circumstances and as to such matters as may be provided by the agreement, without any further consent of the grantor.]**
- (5) A security right in a VCC that is made effective against third parties by one of the methods set out in paragraph 3(b)(c) [or (d)] has priority over a security right in that VCC only by a method that is not set out in paragraph 3(b), (c) [or (d)]**
- (6) A security right in a VCC can be enforced by:**
  - (a) Selling it and applying the net proceeds of sale in or towards the discharge of the secured obligation; or**
  - (b) Appropriating the VCC as the secured creditor's own property and setting its value against, or applying its value towards the discharge of, the secured obligation, providing that the security agreement provides for realisation in this manner and specifies the basis on which the VCC is to be valued for this purpose;**
  - (c) Close-out netting under a close-out netting provision;**
  - (d) Any other method of enforcement under other law.**
- (7) If the security right is enforced under 6(a), (b) or (c), any surplus value not required for satisfaction of the secured obligation must be transferred to a subordinate competing claimant (if any) and any balance must be remitted to the grantor.**

104. The above is proposed language for a principle on security which is adopted from the UNIDROIT Principles on Digital Assets and Private Law in order to be a placeholder therefore, some of it may not apply very specifically to VCCs. The core drafting group has not yet discussed this proposed language. The below explanations are for the Working Group's consideration of the origins of the drafting.

105. The difficulty with a principle on security is that the law of secured transactions differs considerably between jurisdictions. The generic term used in international instruments such as the UNCITRAL Model Law on Secured Transactions for a security interest or right is "security right", as this is thought to work for most legal cultures.

106. The Commentary will need to explain that the meaning of "security right" will depend on the applicable secured transactions law. Some jurisdictions term everything that has a security function a "security right", while others treat devices such as retention of title or outright transfer of title according to their form and not as security rights. For this reason, it may not be advisable to define "security right" as this will not be jurisdiction neutral.

107. Many jurisdictions will accommodate a device which operates somewhat like a security device but is an outright sale and repurchase of assets (a “repo”). In certain jurisdictions this is not treated as creating a security right. The Working Group may wish to consider whether it is necessary to include a principle on repos in the instrument, which may depend on whether they are common in the VCM or likely to become so.<sup>92</sup>

108. The language proposed in paragraph 1 is derived from the fundamental Principle 3 that VCCs can be the subject of proprietary rights.

109. With respect to paragraph 2, as with the definition of “security right”, the law as to the legal framework governing the creation of a security right in an asset exhibits significant variation across jurisdictions. To illustrate, some jurisdictions mandate the use of a written instrument for the creation of a security right, whereas others do not. It would be problematic if the rules governing the creation of a security right were to differ from those that apply to the creation of a security in all other types of assets. The Working Group should discuss whether it makes sense for the present instrument to leave this matter to other law.

110. As to paragraph 3, there is a divergence of opinion among the various jurisdictions as to the precise requirements that must be satisfied in order to render a security right effective against third parties. For instance, numerous jurisdictions have a collateral registry, which allows for the registration of security rights with the objective of achieving third-party effectiveness. The collateral registry is typically established by legislative decree and may be administered by the state. It is evident that a VCC registry does not constitute a collateral registry. Consequently, registration in the VCC registry will not satisfy the prerequisite of collateral registry registration in any given state.

111. Additionally, numerous jurisdictions have alternative mechanisms for establishing third-party effectiveness, such as possession (of tangibles) and control (of some intangibles). These exist for a number of reasons, including: (i) enabling transactions on a market to take place quickly and efficiently without the need for registration; (ii) encouraging a secured creditor to take steps which will facilitate enforcement of the security right if necessary; and (iii) if a general practice of taking possession or control is established, then a potential secured creditor will discover about a previous security right (made effective against third parties by possession or control) when it attempts to take possession or control, since it will not be possible to do so given that the previous secured creditor will already have possession or control.

112. The Working Group may decide that the equivalent of “possession or control” should be an available method of third-party effectiveness for VCCs. Two equivalents to “possession or control” are suggested in sub-paragraphs 3(b) and 3(c). The first is that the secured creditor becomes the registered holder of the VCC, that is, that the VCC is transferred into the registry account of the secured creditor (the terms “registered holder” and “registry account” are defined in the registry principle above). The second is that a custodian (as defined in the custody principle above) holds the VCC for the secured creditor, so that the secured creditor becomes the client of that custodian. Both methods will facilitate enforcement and will prevent another secured creditor from enforcing upon the same unit (without the consent of the first secured creditor). Paragraph 3(d) is a possible additional method, taken from the world of intermediated securities, which was not included in the DAPL Principles. It is included at present for completeness and discussion.

113. Paragraph 4 relates to the “control agreement” route for third-party effectiveness. The idea behind a control agreement is that the grantor of the security right remains the client of the custodian but under certain restrictions. Paragraph 4(a) sets out “negative control”, that is, the custodian must not comply with any instructions of its client without the consent of the secured creditor. Paragraph 4(b) sets out “positive control”, that is, that the secured creditor is, under certain circumstances

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<sup>92</sup> See, e.g., UNIDROIT Summary Report WG1, para. 135.

(such as on default of the secured obligation by the grantor), able to instruct the custodian to transfer, sell or otherwise dispose of the asset without the consent of the grantor, its client. Jurisdictions vary as to which of these (if either) is sufficient for third-party effectiveness of a security right over various types of intangible assets. The advantage of positive control is that the secured creditor is able to enforce the security right easily. The advantage of negative control is that the asset is likely to still be there when the secured creditor wants to enforce against it. It will be for the Working Group to decide whether either type of method of third-party effectiveness is suitable for the VCC market.

114. The above draft principle on security does not address interoperability. It appears that there are no, or only a limited number of, instances in which registration in a private or title registry also has the effect of registration in a collateral registry. It is conceivable that this is the case with some IP registries that permit the registration of security rights, although further investigation would be required to confirm this. Such a system was indeed suggested for some platforms for the transfer of receivables in relation to UNIDROIT's Model Law on Factoring. However, the more typical approach for securities and other financial instruments is to incorporate the assumption of control into the methods of third-party effectiveness. This does not transform the asset registry into a collateral registry, but it establishes that registration or documentation at any point in the intermediary chain is sufficient to render the security right enforceable against third parties.

115. This mirrors the approach in DAPL Principle 16 and in many jurisdictions, where a security right over certain types of intangible assets made effective against third parties by "control" has priority over a security right in the same asset made effective against third parties by registration (or another non-control method). Instead of using the word "control", this draft sets out in detail the steps for third-party effectiveness in the context of VCCs in sub-paragraphs 3(b), (c) and (d). However, in the explanation below, for brevity, the word "control" (in inverted commas) is used.

116. There are a number of reasons for this rule in relation to assets other than VCCs. Firstly, this rule recognises that a secured creditor who takes control is relying to the greatest extent possible on the asset in question for the payment of the secured obligation. In contrast, a secured creditor that (only) registers the security right is likely to have taken security rights over a multitude of assets belonging to the grantor. Secondly, this implies that a secured creditor that assumes control is not required to search the registry, as it is aware that its security rights will be given priority (over registered security rights). Thirdly, it gives priority to the secured creditor who has put itself into the best position to enforce the security right. Fourthly, it may facilitate certain market practices, such as margin lending. Not all jurisdictions have this rule, although many do. Some have it only in relation to documentary intangibles, which can be taken into possession. Other jurisdictions (e.g., English law) do not have the rule at all. It will be for the Working Group to decide whether this type of priority rule is suitable for the VCM.

117. Paragraph 6 reflects the enforcement provision in the UNIDROIT Geneva Securities Convention (GSC) (art. 33), which is based in part on the EU Financial Collateral Directive (relating to investment securities). It is included for consideration by the Working Group on the basis that the VCM may resemble, or come to resemble, the securities market. Sub-paragraph 6(b) has the effect of vesting ownership of the asset in the secured creditor, who is then obliged to return any surplus value to the grantor or to any subordinate secured creditor. It is beneficial for financial collateral, as a sale of a significant number of securities (such as shares) may result in a decline in market value. Consequently, the approach outlined in sub-paragraph 6(a) may prove disadvantageous for the involved parties. Sub-paragraph 6(b) stipulates that the assets need not be sold immediately; they may be retained by the secured creditor. Nevertheless, sub-paragraph 6(b) necessitates the prompt valuation of the asset in order to ascertain any surplus value. Consequently, the method of valuation must be explicitly delineated within the security agreement, and is only applicable if it is explicitly stated therein. Sub-paragraph 6(c) addresses close-out netting, the relevance of which for the VCC market has yet to be determined by the Working Group.



118. In conclusion, paragraph 7 makes it clear that the secured creditor is solely entitled to the value necessary to fulfil the secured obligation, and any surplus must be distributed to a junior secured creditor (or other competing claimant) or to the grantor. Some of the wording is derived from Article 79 of the UNCITRAL Model Law on Secured Transactions, including the term “competing claimant”, which is broader than “subordinate secured creditor”. Article 79 is somewhat complex, and it will be for the Working Group to determine the level of detail required in the present instrument as to the mechanics of enforcement.

Questions for the Working Group:

1. *Should the instrument include a principle on security right or leave the creation of the security right up to other law?*
2. *Considering Principle 3, paragraph 3 where most proprietary aspects of security left up to ‘other law’, what level of detail should the security principle cover?*
3. *What are the most appropriate methods for third-party effectiveness for security over VCCs?*
4. *What level of detail is required in the present instrument as to the mechanics of enforcement?*

## **N. Insolvency**

119. The issue of Insolvency will be discussed in the future meetings of the Working Group. Therefore, at this stage, the core drafting group has not drafted any principle or commentary on the Insolvency, except in relation to the custody in Principle 10.

120. The applicable treatment in case of insolvency is closely linked to the legal nature of VCCs. In the context of insolvency, the relevant entity may be a person with a proprietary right in a VCC, who may or may not have, as a debtor, granted to his or her creditor a security right in a VCC as collateral. Alternatively, the relevant insolvency may be that of the project proponent that is still the VCC holder or who is no longer the VCC holder (depending on the stage of the climate mitigation project and the VCC’s circulation). Additionally, the ICCP, the third-party verifier or the VCC registry may be involved.

121. The insolvency of a project proponent whose project has already generated VCCs that are transacted on the secondary market could give rise to legal questions, particularly if those VCCs are the result of GHG removals. One might, for instance, inquire as to whether the disappearance of the legal entity responsible for ensuring that the carbon remain stored in the reservoirs (*e.g.*, trees, soils, subsurface) would impact the validity of the VCCs that have been generated by the climate mitigation project and which are traded on the secondary market.<sup>93</sup>

122. In the context of digital assets, DAPL Principle 19 builds on DAPL Principle 3(1) (which provides that digital assets can be the subject of proprietary rights) and confirms that a proprietary right in a digital asset that is made effective against third parties is effective against relevant parties in an insolvency-related proceeding. However, given that VCC registries are typically owned and operated by private entities, the risk of insolvency and its potential consequences for VCC holders are likely to be specific considerations with the context of VCCs. Indeed, the insolvency of a VCC registry may result in the “perishing” of the digital VCC.<sup>94</sup>

<sup>93</sup> UNCITRAL/UNIDROIT Joint Study, para. 148.

<sup>94</sup> UNIDROIT Issues Paper WG1, paras 122-123.

123. This is particularly relevant when contemplating the proprietary nature of VCCs, as they inherently entail certain rights, as previously outlined in the substantive approach (see Section III.B.3 above). If conceptualised as rights against the VCC registry, and in the event of the registry being dissolved without a successor entity assuming its functions, it follows that trading will no longer be a possibility. The creation of a new register would, however, result in the emergence of an entirely different VCC, given that liabilities could not be transferred. It should be noted that the opposite of a right is a liability, with the former belonging to the VCC holder and the latter to the registry. Such liability could be novated, but this would require a rescue, which cannot be assumed. In the absence of a rescue and in the absence of a regulated registry system, if the entity were to be wound up, the VCCs would be lost. The suggested Principle 10 of the proposed registry principle above addresses this eventuality, but it would probably need to be in tandem with regulation.

124. Similarly, insofar as some VCCs are structured according to the Verra model, which encompasses not only rights against the registry but also rights against the third-party verifier and the project proponent, the resulting warranty is rendered essentially valueless in the event of the bankruptcy of any of these entities.<sup>95</sup>

125. At the first session, concerns were raised as to whether moving to a form-based regime would solve the issue. It was explained that if the form was maintained by a bankrupt entity, and the bankrupt entity stopped maintaining the form, then there would be instances where the entire ledger would be wiped out unless one had a separate right against the registry to force the registry to re-create the register. However, this would be futile in the event of the registry being insolvent.<sup>96</sup> One potential solution to this issue would be to impose a duty on the insolvency officer of the registry to transfer the registered information to another registry.

#### Questions for the Working Group:

1. *What are the fundamental characteristics that should be included in a principle on insolvency?*
2. *Could a duty on the insolvency officer of the registry to transfer the registered information to another registry be established?*

## **IV. NEXT STEPS**

126. The following timetable has been decided for the following meetings of the Working Group:

- The Third Session of the Working Group on the Legal Nature of Verified Carbon Credits will take place at the seat of UNIDROIT in Rome on **4-6 September 2024**;
- The Fourth Session of the Working Group on the Legal Nature of Verified Carbon Credits will take place at the seat of UNIDROIT in Rome on **15-17 January 2025**;
- The Fifth Session of the Working Group on the Legal Nature of Verified Carbon Credits will take place at the seat of UNIDROIT in Rome on **2-4 April 2025**.

127. The Chair and the Secretariat will coordinate any intersessional work with members of the Working Group.

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<sup>95</sup> UNIDROIT Summary Report WG1, para. 138.

<sup>96</sup> UNIDROIT Summary Report WG1, para. 141.

**ANNEXE I****LIST OF ACRONYMS**

<b>Acronym</b>	<b>Definition</b>
ADB	Asian Development Bank
APFF	Asia-Pacific Financial Forum
CAD Trust	Climate Action Data Trust
CCPs	Core Carbon Principles developed by the ICVCM
CEA	Commodity Exchange Act
CFTC	United States Commodities Futures Trading Commission
COP28	2023 United Nations Climate Change Conference
DAPL Principles	UNIDROIT Principles on Digital Assets and Private Law
EDF	Environmental Defense Fund
ELI	European Law Institute
ERPA	Emission Reductions Purchase Agreements
GHG	Greenhouse Gases
GSC	UNIDROIT Geneva Securities Convention
HCCH	Hague Conference on Private International Law
IADB	Inter-American Development Bank
ICC	International Chamber of Commerce
ICCP	Independent Carbon Crediting Program
ICVCM	Integrity Council for Voluntary Carbon Markets
IETA	International Emissions Trading Association
ILI	International Law Institute
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
MRV	Measurement, Reporting, and Verification
OECD	Organisation for Economic Cooperation and Development
OTC	Over the Counter
PDD	Project Design Document
PIL	Private International Law
SCALE	Scaling Climate Action by Lowering Emissions
ULC	Uniform Law Commission
UNCITRAL	United Nations Commission on International Trade Law
UNCITRAL LGIL	2004 UNCITRAL Legislative Guide on Insolvency Law

Acronym	Definition
UNFCCC	United Nations Framework Convention on Climate Change
UN SDGs	United Nations Sustainable Development Goals
UNIDROIT	International Institute for the Unification of Private Law
VCC	Verified Carbon Credit
VCM	Voluntary Carbon Market
VCMI	Voluntary Carbon Markets Integrity Initiative
WBG	World Bank Group
WRI	World Resources Institute