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SUMMARY REPORT

OF THE FOURTH SESSION

(15 – 17 January 2025)

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1. The fourth session of the Working Group on the Legal Nature of Verified Carbon Credits (the "Working Group" or "Group") was held in hybrid format from 15 to 17 January 2025 at the seat of UNIDROIT in Rome. The Working Group was attended by a total of 59 participants, including ten members and 30 observers, with representatives from governmental, intergovernmental and non-governmental organisations, as well as industry associations and private practitioners (the list of participants is available in Annexe II).

Item 1: Opening of the session and welcome

2. *The Deputy Secretary-General* opened the session on behalf of Secretary-General Professor Ignacio Tirado who was on an institutional mission abroad and would be connecting remotely. She welcomed all participants to the fourth session of the Working Group, acknowledging the presence of in-person and remote attendees across various time zones. She thanked the participants for having dedicated so much time to the project and for all the work that went into the intersessional period.

3. In particular, the *Deputy Secretary-General* thanked the Working Group Chair, Professor Hideki Kanda. She also thanked the members of the Drafting Committee for their work drafting and revising a number of Principles to be discussed by the Working Group. Finally, she thanked all participants, including the observers who had actively participated in the Working Group's discussions in the same way as members and provided essential input on how things worked in practice.

Item 2: Adoption of the agenda and organisation of the session

4. *The Chair* introduced the Annotated Draft Agenda and the organisation of the session.

5. *The Working Group adopted the Agenda (Study LXXXVI – W.G.4 – Doc.1, available in Annexe I) and agreed with the organisation of the session as proposed.*

Item 3: Consideration of the revised draft Principles and Commentary, and, where applicable, matters identified in the Issues Paper

(a) Preliminary matters

6. *The Chair* introduced the documents and outlined the session's agenda, emphasising three primary topics for the first day: (i) registry (Principle 9); (ii) custody (Principle 10); and (iii) security (Principle 11). The latter two topics were new to the Working Group and would be discussed with input from practitioners. Although initial drafts on custody and security had been prepared by the Drafting Committee, *the Chair* clarified that detailed discussions would take place in future sessions.

7. On the second day discussions would focus on revised Principles 2, 4, 5, 6, 7, and 8. On the third and last day, the Group would briefly address three matters: (i) insolvency in general (excluding insolvency of registry operators and custodians, which would be covered separately), (ii) enforcement in general; and (iii) private international law (PIL). Two new topics (tokenisation and interoperability) would not be discussed in this session but would be taken up in April.

8. *The Chair* also welcomed new participants to the Working Group and encouraged their contributions.

(b) Content of the future instrument

i. Principle 9 (Registry)

9. *The Chair* introduced the discussion on the registry. He explained that the Drafting Committee had held an intersessional meeting to gather additional input from practitioners, leading to slight revisions of Principle 9. He divided the discussion into three main parts: (i) definitions (paragraphs 1-6); (ii) duties (paragraph 7); and (iii) paragraphs 8-10.

<u>Definitions (paragraphs 1-6)</u>

10. *A Drafting Committee member* introduced draft Principle 9. She explained that the Commentary needed to describe how things worked in a way that reflected how the market was likely to continue to work in the future. If the Commentary focused too heavily on how the market worked presently, the instrument risked becoming outdated very quickly. The first six paragraphs of draft Principle 9 were definitions, which could eventually be moved into Principle 2 but were important to understand how Principle 9 worked.

11. She referred to the concept of there being an entity called the 'registry operator' that operated a registry. While currently the registry operator was often the same legal entity as the issuer of the credits, she explained that the Principles were drafted to accommodate the possibility of these being separate entities.

<u>*Publicity*</u>

12. With respect to the definition of a VCC registry, the *Drafting Committee member* explained that this did not presently include the word 'public' and thus did not provide a requirement of publicity. The draft Principle just referred to 'an electronic database', with the Commentary then noting that it was desirable for a VCC registry to be a public database. She urged the Working Group to discuss whether publicity should stay in the Commentary or be part of the definition of a VCC registry. If publicity was made a requirement, then the Group would also have to define publicity, which could prove challenging.

13. The Working Group appeared split on the question of publicity. *Several participants* took the view that publicity of the registry should not be mandated in the Principles and, while acknowledging the desirability of disclosure for market integrity, questioned whether publicity was necessary to a VCC's legal existence.

14. It was observed that requiring simple holdings in accounts to be disclosed would be unhelpful to market transparency, as it would encourage holders of carbon credits to use third party intermediaries to shield their position from the market. *Participants* also agreed with the difficulty in defining what was meant by 'public' and thus cautioned against including this as a requirement in the Principles. The difference with public registers of title was stressed, where public statements had to be made to ensure that title was perfected. In the context of VCCs, it was noted that the underlying data behind the project was useful information to have, but that it was up to the registries and the crediting programmes to determine how much of that they disclosed. For example, the issuance of anonymised market volumes was common as it provided an idea of what was happening in a market. Yet, *participants* emphasised the need to protect commercially sensitive information and urged striking a balance between transparency of useful market data and protection of confidential information.

15. *Others* recalled that the proposed 'public' requirement in the regulated Paris Agreement Crediting Mechanism (PACM) provided for minimum stipulated disclosures as opposed to a blanket

'public' requirement. Such minimum stipulated disclosures would include: (i) issuance, i.e., the existence of the units; and (ii) the cancellation or retirement of those units.

16. *Drafting Committee members* acknowledged market participants' concerns with commercially sensitive information becoming publicly available. They nevertheless recalled that, in the scheme being built by the Principles, the VCC registry performed a crucial function in relation to the coming into existence of the VCC. If the Principles did not address the question of publicity and it were thus possible for a VCC registry to not be publicly accessible at all, it could give rise to a problematic scenario in which VCCs existed as an object of property because they were registered without, however, there being any visibility into their existence. It was therefore suggested that the existence of a VCC, rather than who owned the VCC, should be public.

17. In response, it was observed that the question of publicity did not need be addressed in the Principles but could be resolved as a commercial matter—if a registry decided to make everything completely hidden, then it would not have any buyers. The comparison was made to securities registries which were generally not public and were instead just ways of providing evidence. It was noted that, as the market evolved, it was likely that big banks rather than certification bodies would be the ones maintaining VCC registries and would adopt the same mechanisms they presently used to provide evidence of holdings.

18. *The ICVCM representative* agreed that it was very difficult to recommend that a registry be public without outlining which data points should be public. As a solution, it was proposed that the Commentary factually reference the fact that most major meta standards—such as the ICVCM, ICROA, CORSIA and Article 6—considered the public availability of information on the registry to be a feature of higher integrity credits and provided specific requirements for what information should be visible.

19. *The Verra representative* agreed that the existence of a VCC should be visible and that public availability of information was a key feature of integrity. She explained that, while a lot of information was public on the Verra registry, information that was designated as commercially sensitive by the relevant account holder was not visible. It was suggested that, rather than taking a prescriptive approach, the fact that publicly available information was a feature of market integrity could be mentioned in the Commentary. A distinction was made between information relating to the fact that certain events (such as, for example, retirement) occurred, and the reasons for those events having occurred. She explained that the former was information that was available on the Verra registry. If a party needed to know whether VCCs existed, or what had happened to them and why, bilateral arrangements could be put in place with representations around delivery that covered the disclosure of information and confidentiality.

20. *The Verra representative* further explained that Verra published certain facts and when they occurred: for example, the issuance date, the vintage dates, the name of the project, the ID, the project type, and more importantly, the methodology and any retirements. She indicated that the inherent key components of the creation of a VCC were the serial number and perhaps the date on which that happened. It was suggested that those elements be used to inform what the minimum disclosure requirements might be.

21. *A Drafting Committee member* noted the need to distinguish between private law and regulation and acknowledged that, since the Principles dealt with private law, it would be inappropriate to mandate publicity. She observed, however, that it would likely be useful to have information about the issuance, cancellation, and retirement be available on the registry since it would be more easily accessible than through transactional means.

22. With respect to retirement, it was clarified that a buyer would first and foremost get representations from the counterparty that the credits that were being transferred were not retired.

In addition, it was noted that it would not be possible to effect the transfer or move the VCC to the buyer's account if the carbon credit in question was retired, because it would have been cancelled in the registry.

23. However, another *participant* noted that imposing publicity regarding the existence, the cancellation, and the retirement of VCCs would appeal to national policy makers. He stressed that, because the Principles would have to be implemented by States, addressing these issues could make the instrument more marketable.

24. With respect to the comparison to land and securities registries, *Drafting Committee members* noted that this was not particularly useful when it concerned the VCC as property. Land or securities were clearly property under various legal systems. Indeed, securities were property because they were rights against an identifiable issuer. On the other hand, the Principles were trying to establish that VCCs could be the subject of proprietary rights even if they did not necessarily represent any rights against an identifiable person. One of the hooks that had been chosen for doing so was the existence of the unique identifying number. If the unique identifying number was not public, it was queried whether it could be said that a VCC was property. The suggestion was made to move away from the broad concept of 'publicity' and start instead refining language on 'minimum disclosures' or 'minimum levels of information' as for example required in the Paris Agreement, since some minimum level of information disclosure was likely to be necessary to buttress VCCs as objects of property.

25. *The Drafting Committee* proposed that the Group consider two interrelated issues. First, what the requirements should be from a private law point of view, as opposed to what would be an extremely good idea from a regulatory or market point of view. Second, the fact that the proprietary rights analysis placed considerable weight on the registries since it essentially provided that the way the registries were set up enabled VCCs to be the subject of proprietary rights. Indeed registries: (i) provided the individuation and the identification of a VCC with the serial number; and (ii) enabled the account holder to control what happened to the VCC, since only the account holder could provide instructions related to that VCC. Thus, the registry was the key to VCCs being able to be rivalrous, controlled and individuated. While it was acknowledged that the Principles could not mandate that registries be regulated entities, it was queried whether a certain minimum level of publicity, even though not absolutely critical to make a VCC subject to proprietary rights, could strengthen the registries and therefore support the argument that registration was what allowed VCCs to be the subject of proprietary rights.

26. *The Chair* acknowledged that whether any minimum publicity should be required as a matter of property law was a complex question. He asked the Drafting Committee to consider language either for the Principles or the Commentary keeping in mind whether minimum disclosures should be required for this type of intangible property as a matter of recognising proprietary rights.

<u>*Other issues*</u>

27. *A Drafting Committee member* raised the issue of blocks of VCCs in relation to draft Principle 9(1). It was recalled that VCCs were at times issued in blocks, with a single serial number for an entire block. Even if there was a single serial number for a block, as long as serial numbers for each VCC were issued each time the block was split, the principle that a VCC could be the subject of propriety rights was not undermined, because the VCCs were individualised. The Commentary to draft Principle 2 explained this in paragraph 2.8. A drafting decision was however needed on whether to repeatedly reference 'blocks' throughout the text or to specify early on that the singular included the plural, as had been done for the UNIDROIT Principles on Digital Assets and Private Law (the "DAPL Principles").

28. A drafting issue was raised in relation to whether the term 'credited' or 'debited' should be used when describing a VCC in the registry in draft Principle 9(1)(b). The current draft identified the person to whose account the VCC was credited, and did not say 'debited', because if the VCC was debited then the VCC was no longer there—there was no person to whose account the VCC was debited. Subparagraph (3) instead provided a definition of the account to which VCCs could be credited or debited. The words credited or debited were consistent with terminology used in the Geneva Convention in relation to integrated securities and referred to the fact that it could either be said that VCCs were added to the account—i.e., 'credited'—or they were removed—i.e., 'debited'.

29. With respect to the use of the term 'registered holder' in draft Principle 9(6), it was explained that: (i) this was a drafting practicality, in order to avoid having to specify "the registry account holder to whose registry account the VCC is credited" each time; and (ii) this was necessary because, in the context of custody and transfers, it was possible that the registered holder was not always the 'owner' of the VCCs, thus a term was needed to refer to the person to whose account the VCCs were credited.

<u>Duties of the registry operator (paragraph 7)</u>

30. The Working Group addressed draft Principle 9(7) concerning the duties owed by a registry operator to a registered holder in relation to a VCC credited to the registered holder's account.

31. It was explained that this was an attempt to set out certain duties that were fundamental to the function of the registry operator; if an entity did not owe these duties, they would not be a registry operator under the Principles. It was acknowledged that there would be a contract between the registry operator and the registered holder that could address issues not included in the draft Principle. However, the purpose of draft Principle 9(7) was to formulate certain duties that could not be excluded by contract.

32. It was stressed by *the Drafting Committee* that these were private law duties, meaning the duties that would normally arise as a result of the agreement between the registry and the account holder, and so would usually be contractual duties. It was further specified that these were not the only duties that a registry operator could owe; the parties could agree to additional duties. However, they were the bare minimum private law duties that a registry operator should owe to the registered holder and which a State should ensure were not excludable by contract.

33. Draft Principle 9(7)(a) started with the obligation to comply with the registry rules and the rules of the relevant issuer; the registry had its rules and the operator needed to abide by them. Draft Principle 9(7)(b) addressed unique identifiers and was critical in conceptualising VCCs as objects of proprietary rights.

34. Draft Principle 9(7)(c) referred to an obligation to comply with an instruction given by a registered holder. The current drafting referred to any instructions; however it was noted that the instructions that the Group wanted to include were the instruction to move the VCC from one account to another and the instruction to retire the VCC. The draft Principle provided that the registry operator had a duty to comply with instructions except in two circumstances: (i) if prohibited from complying with the instructions by another law, including for example regulatory law, or by the rules of the relevant entity who approved the verification report; and (ii) where a registry operator was not obliged to follow the instructions, for example in the case of suspected money laundering.

35. *The Chair* emphasised that these were private law duties that would serve to provide guidance to States legislating in this area.

36. *A participant* queried whether, for the provisions to be broad enough, they should also refer to registries established under legislation and instances in which the relationship between an account

holder and the registry was mandated by law rather than defined through a contractual agreement. In response, it was noted that even in the situation where the registries were mandated by law, users would still generally enter into a contractual agreement with the registry.

37. In addition, *a Drafting Committee member* recalled the private law nature of the Principles; they did not address regulation or public law. She noted that, to some extent, recommendations for regulation could be included in the Commentary. However, the agreement in question was a private law document and all that the Principles could do was identify what should be owed as a matter of private law. She identified two possible approaches. First, the Principles could mandate an agreement and the private law duties within that agreement. Alternatively, the Principles could provide that the duties were inherent to the registry scheme and that they could derive from either private law or public law, but that they could not be excluded by agreement as a matter of private law.

38. *A Working Group participant* suggested the inclusion of one additional obligation—that the registry operator have the duty to be legally independent from its account holders, and act at arm's length to them. *Another Working Group participant* agreed with the suggestion and added three potential areas of discussion: (i) any record keeping duties of the registry in relation to evidence of the verification of the VCC and the underlying benefit; (ii) any record keeping duties in relation to retirements and cancellations of VCCs; and (iii) any duties upon the insolvency or the disappearance of the electronic database, or the registry itself, including duties to maintain the property rights of the account holder as the registry converted to another registry.

39. *A member of the Drafting Committee* agreed that it was not controversial to include a duty to keep adequate records. In terms of the question of insolvency of a registry and maintaining the property rights, it was pointed out that, while not yet final, draft Principle 9(11) required the registry to have a recovery and orderly dissolution plan in place providing for preservation of all entries. However, it was noted that, in practice, it could be that the plan was provided by statute or by a regulatory or oversight body. It was thus suggested that the language be loosened to avoid implying that the recovery and orderly dissolution plan was something that had to be developed by the registry operators themselves.

40. *Another participant* added that the Group should consider having such a plan also for non-insolvency related proceedings. Others cautioned against including such a requirement and suggested that the provision simply state that registry operators should ensure that, were they to become insolvent, they would take all available steps to ensure that the VCCs they held were not affected, whether that be through a recovery and orderly dissolution plan or through other means.

41. *Participants* clarified that such requirements were likely to come from CORSIA and the ICVCM, which required such fallback provisions. It was noted that these were important provisions to include since the existence and availability of a recovery and orderly dissolution plan was meant to protect proprietary rights, the point being that it bolstered the concept that the unit in an account existed independently of the registry operator.

42. *Members of the Drafting Committee* agreed on the importance of the provision, though how to include it in the Principles remained challenging. They recalled the significance of the registry in the proprietary rights analysis, particularly in terms of providing for individuation and control. If the registry was just a database which could suddenly disappear and could not be replaced or continued, then it would be much harder to argue that VCCs could be the subject of proprietary rights. It was acknowledged that the usual way of addressing this issue was through regulation. However, it was also noted that the focus of the Working Group was private law rights and duties, and that the registries were unregulated private bodies rather than governmentally established entities. Private law duties were owed to specific people, and most of the duties in draft Principle 9(7) were duties owed to account holders.

43. One proposed option was to provide in the Principles that to be classified as a VCC, a VCC had to be recorded in a registry and that, from a private law perspective, an entity was a registry only if it had this kind of plan. However, this was not an ideal approach, as it entailed an attempt at achieving a regulatory objective by way of private law. Another option was to treat this as an insolvency issue, or perhaps have an instrument accompanying the Principles noting best practices in this area.

44. *A Working Group participant* observed that, before answering the question as to whether this provision should be included in the Principles, the Working Group should consider the complexities of what a recovery and orderly dissolution plan would entail. If the registry operator were to become insolvent, it would not necessarily be dissolved or liquidated. It may rather be reorganised, and in any event, the registry would not disappear, it would simply be an asset of the insolvency estate. It was noted that these were very complicated questions that became even more complicated if it was assumed that the registry operator was a bank which would be subject to resolution procedures.

45. It was suggested that, once the VCC existed in a registry, the registry owed a 'duty of stewardship' to keep the proprietary rights alive. Such a duty would not just be relevant in the insolvency context, but would also entail, for example, a duty to maintain the records of the VCCs that were important for the preservation of the proprietary right.

46. *The Chair* intervened to underline that Principle 9(11) would be discussed at the next Working Group session together with interoperability. He explained that, from a private law perspective, the bigger topic concerned whether and how one registry operator could transfer its positions to another operator, both outside insolvency as well as in insolvency and in resolution.

47. Concerns were raised in relation to a potential requirement that the registry operator be independent of the account holders since the registry operator could be a holder of VCCs. It was observed that, while currently the registries were generally maintained by the certification bodies, registry functions could move in the future to some of the big banks that performed similar functions in other contexts. Such entities would most likely require in their contracts a clause saying that they may, in their capacity, hold VCCs. It was also noted that Principle 9(7)(c)(ii) was going to be absolutely essential to them, because they were likely to have a list of disclaimers indicating that they were not obliged to follow instructions if, for example, the instructions were unclear or if they had an opinion of counsel saying there was a problem with the instructions.

48. In response, it was clarified that independence referred to freedom from conflicts of interest. It was noted that the registry operator had timing control over when VCCs were issued into accounts. Thus if the registry operator was trading on its own behalf, making a profit in relation to what was in its own account and controlling the issuance and timing of what went into other accounts, there was at least an appearance of conflicts of interest. It was recounted that a situation had occurred in the marketplace involving a registry account holder—who had since been charged with fraudulent activity—sitting on the board of directors of a registry and making decisions on issues that affected its own accounts. It was noted that this was a governance issue, but at an operational level. If a registry operator had access to market information that no other account holder had, and could manipulate how VCCs were issued into those accounts while at the same time trading on its own behalf, this raised a potential conflict of interest.

49. *Other participants* noted that such a situation, while problematic, lay outside the scope of the draft Principles. It was observed that in similar contexts this would usually be addressed as a regulatory matter. Although at the moment such regulations in relation to VCCs did not exist, it was suggested that the solution was not to include an independence requirement in the Principles, but rather that the appropriate regulatory schemes be put in place. *A Drafting Committee member* agreed and responded that it would likely be possible to state in the Commentary that there were certain risks that could be dealt with by regulation rather than by private law.

50. *A Working Group participant* queried whether it was possible to provide a practical example or illustration of the "*agreement between the registry operator and a third party, to which the registered holder is a party, or has consented*" referenced in Principle 9(7)(c)(ii) and whether such an agreement could relate to achieving third party effectiveness of a security right. It was asked whether this would allow the operator to exercise powers with respect to the VCC upon instructions of a third party that was a secured creditor. *The Chair* noted that it was an important point to be considered in the security context.

51. In response, *a Drafting Committee member* confirmed that that was one possibility that was envisaged and encouraged the Group to review DAPL Principle 11(1)(b)(i) and (ii) and the DAPL Commentary in paragraph 11.3, because the wording was almost identical to that proposed in draft Principle 9(7)(c)(i) and (ii). If the Group agreed with the structure of the draft Principle, the Commentary could be supplemented and some examples could be provided.

<u>Paragraphs 8-10</u>

52. Draft Principle 9(8) provided the statement of law that a registry operator had no proprietary right in a VCC registered in the registry.

53. It was observed that there were exceptions to the rule—i.e., instances in which registries held VCCs on their own behalf or took a lien or security interest over the assets that were registered on that registry. The draft Principle therefore needed to be redrafted to make it clear that what was being addressed was the proprietary right in a VCC credited to an account holder. The point would have to be made in Principle 9(8) that the registry had no proprietary right in anything that was not in an account credited to the registry or over which the registry had a security interest.

54. Two ways of addressing this situation were suggested. One proposal was to provide a specific exception to draft Principle 9(8). This exception would be explained in the Commentary and would provide that there was no proprietary right except for VCCs in an account credited to the registry or a security interest taken in the assets, whose validity would be dependent on the applicable law. An alternative approach was to instead merely mention in the Commentary that, although a registry operator generally had no proprietary right, in certain circumstances they might have a proprietary right, noting that it would not affect the generality of the Principle which dealt with the registry operator's nature as a registry.

55. While agreeing that registry operators had no proprietary right in the VCC, *a Working Group participant* noted that they maintained a certain degree of control, predominantly for the protection of the users, as seen in the registry operators' ability to suspend transactions in the units when there was an element of suspected fraud or extraordinary impropriety.

56. *The Chair* acknowledged the point but noted that it was different from the registry operator having a proprietary interest in a VCC. *The Verra representative* supported the distinction, stating that when the registry intervened on the basis of specific grounds that were set out in the agreement between the account holder and the registry, this did not impact on proprietary rights.

57. *A member of the Drafting Committee* agreed. He stressed that recognising control over a VCC by the registry operator would risk raising a number of complexities because even if, from a practical perspective, the registry exercised some degree of control, that was not ownership. And if it was said that the registry had control over a VCC, then it would be implied that the registry had some kind of *quasi* proprietary relationship with the object of property. That would not reflect the approach adopted in the Principles, nor would it work from an insolvency perspective. Thus, he stressed that the Principle should be built in private law from the perspective of the relationship between the registry and the account holder, and in terms of accepting or refusing instructions.

58. It was also noted that these were instances addressed by Principle 9(7)(c) which provided that the registry had to comply with instructions from the registered holder, or someone authorised by them, unless: (i) the registry was either prohibited from doing so, including on the basis of the agreement with the registered holder; or (ii) the registry was not obliged to comply with instructions, meaning the registry had the power under the agreement to refuse to comply.

59. It was clarified, however, that the concern was raised not from the perspective of permissive allowance of interference with the holder's proprietary rights, but rather with restrictive indication of how the registry operator or the registry itself could interfere with those property rights. It was noted that, in recent situations involving external allegations, the contractual arrangement between the account holder and the registry had been silent on this point and neither the applicable law nor the rules of the registry addressed the situation. Nonetheless, the registry suspended the full exercise of the proprietary rights. The need was thus stressed for very clear indications in the terms of use in the contractual agreement with the registry user of the very limited and restricted conditions under which the registry operator could exercise the rights set out in Principle 9(7)(c).

60. In response, it was noted that the Drafting Committee would amend the Commentary to reflect the points that had been made in relation to the need for clarity and the right to refuse to comply with instructions in certain situations.

61. Paragraph 9(9) related to enforcement outside insolvency and provided that claims against the registry operator could not be enforced against the VCCs registered in the registry. Paragraph 9(10) made the same point but in relation to insolvency. In insolvency, the registered VCC was not part of the registry operator's assets and not available for distribution to its creditors.

62. *A participant* noted that if a registry operator held their own VCCs in their own registry, then the VCCs would be available for the satisfaction of the claims of the registry operator's creditors. In response, *the Chair* clarified that the assumption was that the registry operator and the account holder were separate, but acknowledged that the registry operator was permitted to have its own VCCs, just like a company could own its shares. He agreed that there should be an exception and asked that the Drafting Committee consider such a situation.

<u>Paragraphs 12 and 13</u>

63. It was noted that draft Principle 9(12) and 9(13) were dependent on draft Principle 5 (Cancellation) and draft Principle 6 (Revocation). Principle 9(12) simply provided that the registry operator had to comply with instructions to cancel and revoke a VCC. Principle 9(13) provided that, if a VCC was cancelled, revoked or retired, then the registry operator could not do anything with it; they could not move the VCC to another account, nor could they retire it.

64. The neutral word 'move' rather than the word 'transfer' was used to denote the debiting of one account and the crediting of another. It was explained that the word 'transfer' could refer to either: (i) moving from one account to another; or (ii) to a transfer of proprietary rights. Movement from one account to another and the transfer of proprietary rights were not always the same thing; there could for example be a movement without the transfer of proprietary rights if the transfer was unauthorised or if the person moving the VCC was a custodian.

<u>Conclusions</u>

65. *Rather than focusing on the broad concept of 'publicity', the Drafting Committee would explore refining language in either the Principles or Commentary on the minimum disclosures needed to support VCCs as the objects of proprietary rights.*

66. *The Drafting Committee was to consider adding a 'duty of stewardship' of the registry operator to keep the proprietary rights alive, including a duty to maintain records that were important for the preservation of proprietary rights.*

67. *The question of the recovery and orderly dissolution plan referenced in draft Principle 9(11) would be discussed in greater detail at the next Working Group session.*

68. *The proposed duty of independence was likely something that had to be addressed via regulation and the Commentary could be amended to note that certain risks existed that could be dealt with by regulation rather than private law.*

69. *Principle 9(8) was to be redrafted to make it clear that what was being addressed was the proprietary right in a VCC credited to an account holder (rather than instances in which registries held VCCs on their own behalf or took security interests over the assets).*

70. *The Drafting Committee was to amend the Commentary in relation to Principle 9(7)(c) to clarify the instances where a registry operator could refuse to comply with instructions.*

ii. Principle 10 (Custody)

71. *A member of the Drafting Committee* introduced the draft Principle on custody explaining that it addressed situations where a registered holder held a VCC on behalf of someone else. The Principle was drafted to cover both custody and sub-custody, the latter referring to cases where a custodian who was the registered holder held for a client who in turn held for someone else. It was explained that, usually, sub-custody arrangements would not be recorded in the registry, though some registries may be notified of such arrangements. The draft Principle also provided that the VCCs held by a custodian for its clients were not available if the custodian became insolvent.

72. The Working Group was asked to confirm: (i) whether custody arrangements did in fact occur in the market and whether this was something that was likely to develop and have more than one layer in the future; and (ii) whether it was the case that VCCs were held in undivided pools for a number of clients, because that would require including provisions addressing shortfalls.

73. *Working Group participants* observed that the draft Principle was likely too long in that it addressed substantive issues that were likely covered by existing private law provisions on power of attorney or custodianship, or by regulatory laws governing custodians. It was also noted that it would be challenging to implement any principles relating to a custodian's insolvency in certain jurisdictions, for example the United States, where principles of property law were governed by state law but bankruptcy issues would fall under federal law; likewise in Europe it would be a mix of European Union and national law. It was suggested that perhaps the draft Principle simply state that a VCC could be held in custody, without then describing all of the features of custody which would be subject to different applicable laws and likely be very jurisdiction-specific.

74. In response, *a Drafting Committee member* pointed out that it should not be assumed that the Principles were only to be adopted by sophisticated legal systems. Rather, they could be adopted by a developing country where the custody principles were not terribly clear, and therefore draft Principle 10 as currently drafted would be very helpful.

75. As to the provisions addressing shortfalls, it was questioned why VCC clients should have higher priority than other creditors of the custodian with respect to the VCC pool rather than everybody just being an unsecured creditor with respect to the shortfall. In response, it was specified that the provisions were only meant to address VCCs held in an omnibus account and did not concern unsecured creditors.

76. It was also suggested that, to the extent the insolvency provisions remained in the Principle, they be supplemented to reflect that the custodians could be banks subject to resolution proceedings rather than ordinary insolvency proceedings. It was also noted that the custody section had to be reconciled with the innocent acquirer section since the Principles currently provided that one was an innocent acquirer only if the VCC was transferred to their own account within the registry. The *Drafting Committee* agreed and noted that relevant language would be added to the draft provision.

77. *Another participant* suggested that the definition of intermediary was too general and should at least refer to 'holding services' or 'services to hold VCCs for another person'. In response, it was recalled that the definitions in the Principles were just for the purpose of the instrument—the Principles did not purport to define custody in general.

78. *Participants* generally confirmed that custody arrangements did in fact take place in the market and that they often involved pooled rather than segregated accounts with none of the intermediaries being sophisticated banks. Indeed it was noted that the current lack of legal certainty in the market was encouraging smaller entities not subject to regulatory oversight to perform custodial services. However, the hope was that by clarifying issues of title, larger regulated financial entities with better infrastructure would be encouraged to become custodians.

79. *The Drafting Committee* reiterated that the Principles covered private law rather than regulation and acknowledged that the private law concerning custody varied greatly across jurisdictions. Nonetheless it was noted that the Principles were drafted in a functional manner, meaning that it would be up to each State to determine the way in which the Principles would be implemented within national law—the goal of the instrument was to indicate to States what the basis of their relevant private law in relation to VCCs should look like. The importance of making it clear in the Principles that a custody situation existed where the custodian was the registered holder of the VCC but they were holding it for someone else was stressed. In custody situations the registered holder was not the beneficial owner of the VCC. Rather, in common law, the registered holder would likely be the legal owner holding it on trust for a client or for a customer. In non-common law jurisdictions there may be other relationships and the custodian may not have any proprietary right in the VCC. It was thus critical to make it clear that, in custody arrangements, a custodian was a registered holder but not necessarily the full owner of the VCC.

80. *The Verra representative* clarified that, at the moment, Verra did have omnibus accounts, which could have sub-accounts. However, those sub-accounts were simply an organising mechanism and the sub-custodians were not considered account holders. Only the main account holder was recognised as the entity entitled to issue instructions to Verra.

81. In response to a question raised by a Working Group participant, *the Drafting Committee* clarified that the VCC registry was not a custodian of the assets, it was rather simply maintaining the database and recording the existence of the VCC against a person. That person was the registered holder, and could either be a complete and absolute owner or a custodian. The registry was thus just a record of the VCC, whereas the custodian was the person in whose account the VCC was registered.

82. *A Drafting Committee member* explained the sequence of questions presently before the Working Group:

- First, once it was established that a VCC could be the object of property, the relevant question was whether it could be given in custody to someone else to hold it on behalf of the owner.
- Second, if the answer was yes, then a framework needed to be built in which the person who was giving the VCC in custody retained ownership and the custodian obtained something else.

- Third, it had to be established whether the creditors of the custodian could attack the VCCs that the custodian held for the benefit of someone else. It was explained that the natural position of custody was that the answer should be no; the custodian had no ownership, and so the creditor of a custodian could not attack the assets in custody.
- Finally, if the commingling of assets was allowed, then the question to be addressed was how to deal with shortfalls; i.e., how to allocate from a private law perspective the rights of those who have the assets in custody and the assets held in an omnibus account.

83. *Working Group participants* expressed certain concerns with respect to sub-custody and pooled accounts. One participant referenced the problems raised by a potential delegation of a registry operator's governance responsibilities (for example, in relation to cancellation or suspension of accounts) to the custodian. If omnibus accounts and custodianship were to be recognised, then he queried what would be the responsibilities of the registry operator to the custodians and the custodians to the registry operator, recognising, however, that this could be a regulatory rather than a private law issue. Another *participant* identified several risks with the use of undivided pools, including (i) a risk of incorrect allocation of VCCs, for example if the custodian's recording system malfunctioned and led to deviations in the quantity or ownership of the client's VCCs; (ii) a risk of distribution in case of insolvency, where the handling of the undivided pool may be very complicated and could delay the distribution process; and (iii) the impact on a security interest, since if the custodian of the client had set security rights on the VCCs in the pool, the existence of the undivided pool may complicate the realisation process of the security interest and may affect the expected interests of the clients.

84. With respect to the commingling of VCCs, *a Working Group participant* noted that the operational risks would depend on the applicable private law to the relevant contract. It was noted that draft Principle 10 simply stated that unless it was prohibited, it was possible for a custodian to hold a pool. It was suggested that the provision was clear and did not need to elaborate on how that happened, since that was going to be different across jurisdictions.

85. *Drafting Committee members* further clarified that draft Principle 10 reflected a policy choice providing that a custodian could commingle assets and the custody relationship would survive (as opposed to the historical approach to custody whereby commingling would break the custodial relationship which would be transformed into a creditor-debtor relationship). It was noted that commingling was necessary for scaling and that the provision as currently drafted was protective of the clients: if, for example, there were regulations prohibiting pooled accounts, the custodian would be in breach of regulatory rules but the client would still be protected because the custody relationship would survive and the client would not become an unsecured creditor.

86. *A participant* observed that, because VCCs were individuated, they could not actually be commingled—an undivided pool would not come into existence. It was observed, however, that this depended on how the assets were treated under relevant law or by the parties themselves; whether they were recognised as non-fungible or whether a custodian could satisfy its obligations by delivering a fundamentally identical VCC. It was noted that the Commentary addressed these situations at paragraph 10.8 which provided that "*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. Fungibility is not a technical characteristic of a VCC, but a matter of market practice*."

87. It was further explained that, although the record of any VCC in a registry was individualised because it was uniquely identified, as a matter of market practice the VCCs could be treated as fungible such that any VCC would satisfy a delivery obligation. In other words, if the client and the custodian agreed that the custodian could deliver any VCCs out of the pool, then the VCCs would be treated as fungible. The language in Principle 10 as currently drafted did not make it compulsory to

keep VCCs in pools; the custody agreement could provide that it was a segregated account, although that would likely be more expensive. Thus, this was a question on which the parties could agree and take on their preferred amount of risk. It was also stressed that draft Principle 10(10) accounted for potential regulatory restrictions by providing "*unless prohibited by other law*".

88. In relation to the language at paragraph 10.8 of the Commentary, *the Deputy Secretary-General* asked what would 'of the same description' mean for a VCC. She observed that the language in the Commentary referred to the market rather than the parties to the individual custody agreement making this determination. She thus inquired whether this was an existing market practice and whether there were examples that could be provided in the Commentary to help clarify how VCCs differed from securities in this context.

89. Others suggested removing the words 'of the same description' since they could give rise to complications. The market seemed split on what actually constituted VCCs of the same description (for example, whether this related to removal or reduction units, or to VCCs resulting from the same project, or VCCs eligible to be delivered into a compliance program such as CORSIA). It was noted that the 'same description' was what parties said it was when entering into a transaction.

90. *The Drafting Committee* agreed with the concerns raised and noted the importance of clarifying in the Principles that, to the extent an undivided pool was allowed, it had to be treated as such since there were many different views in the market as to what was interchangeable.

91. *A participant* queried whether the nature of the custody relationship would be altered if a registry as defined by the Principles were to issue a VCC as a digital asset, i.e., what would happen if the VCC was tokenised. He also asked whether, in such a scenario, the VCC would just be a record or whether it would be actually held in that digital form. *The Chair* reminded the Group that tokenisation would be discussed at the next Working Group session.

92. *The Chair* wrapped up the discussion on custody summarising the key points as follows: (i) an intermediary could be a custodian; (ii) when the intermediary was a custodian, the custodian was the holder of the VCCs; (iii) the custodian maintained VCCs on behalf of its clients, and therefore the clients had property rights; (iv) the Group had to address sub-custodians and sub-accounts since they were used in practice; (v) private law rules should be provided addressing fungibility and covering shortfalls; and (vi) the instrument should include an independent Principle on innocent acquisition in a custody context.

<u>Conclusions</u>

93. *The Drafting Committee would amend the Principle to reflect the existence of sub-custody agreements.*

94. *The Principle would provide guidance on fungibility and shortfalls. To the extent an undivided pool was allowed, it had to be clarified that it had to be treated as such given the differing views in the market as to what was interchangeable.*

95. *An independent Principle would be added addressing innocent acquisition in a custody context.*

iii. Principle 11 (Security)

96. *The Chair* turned the discussion to draft Principle 11 covering security rights. This was a topic that had not yet been discussed by the Working Group. He noted that security rights included rules on creation (Principle 11(2)), third party effectiveness (Principle 11(3)), priority (Principle 11(5)) and enforcement (Principle 11(6) and 11(7)). He encouraged the Working Group to consider how VCCs

were or could be collateralised in the future and how the Principles could provide guidance in this respect.

97. *A Drafting Committee member* explained that, apart from draft Principle 11(1) which provided that a VCC could be the subject of security rights (following from the fact that a VCC could be the subject of proprietary rights), everything else in the draft Principle was a matter of determining what was needed to be addressed in the context of VCCs in addition to the normal law of securities in any particular country. It was noted that laws on secured transactions differed greatly across jurisdictions. The purpose of the Principles was thus not to rewrite the law of secured transactions for VCCs but rather identify specific points that had to be addressed. One of these was how to make a security right effective against third parties in a system where the basic way of making a right effective against third parties was by registration in a secured transactions register. Another was whether there should be an additional way of making a security right effective against third parties.

98. *One participant* raised a concern with respect to draft Principle 11(3)(b) (which provided that a security right in a VCC could be made effective against third parties if "*[t]he secured creditor becomes the registered holder of the VCC*"), noting that it was rare to see an entity with a security right over a VCC becoming the presumptive *de facto* owner of the VCC.

99. In response, *a Drafting Committee member* noted that draft Principle 11(3)(b) was trying to provide a mechanism that would be close to what for tangible goods in common law jurisdictions was described as a pledge or, in civilian jurisdictions, as a *pignus* from Roman law. This was the idea that if someone wanted to use something as collateral, they would obtain the item and give it to the lender. The lender would in turn provide the money and hold on to the collateral. The debtor would then either return the loan and get back the item, or if they defaulted, the lender would obtain satisfaction from the asset.

100. The question therefore was how to adapt this mechanism to the world of VCCs. One possible adaptation was that the secured creditor had the VCC credited to their account, becoming not an owner but a secured creditor. It was noted, however, that this proposal was simply being presented to the Working Group as a source of inspiration and for discussion purposes. Another possible route was to not say anything specific about security rights; once the Principles established VCCs as property, then the relevant applicable law would address how they could be collateralised.

101. It was further suggested that the Principles could refer to existing guidance on custody and secured transactions. It was noted that there was an international instrument, the UNCITRAL Model Law on Secured Transactions, which closely followed the Uniform Commercial Code (UCC) Article 9 system. It was thus noted that one possible approach for VCCs would be to assume that the UNCITRAL Model Law on Secured Transactions was the best system and adapt it for VCCs. However, it was noted that during the discussion on the DAPL Principles there was strong resistance this approach, since many jurisdictions would resist imposition of a different secured transactions system. It was thus suggested that the Group refrain from identifying a best practice to which States should conform. Because of this, however, it was necessary for the Group to provide some guidance.

102. *The Verra representative* noted that there were certain key practical issues with respect to which it would be helpful to have clarity, including: (i) given that security rights could be very jurisdiction dependant, how a registry could determine if the right was effective; (ii) what was the scope of security and whether the security right could be in the account or in the VCCs; and (iii) how would security be perfected and who would make the determination. It was explained that Verra did not currently recognise security rights, meaning that Verra did not act as an arbiter of whether the right was effective. Because recognising a right would entail also recognising that the right was effective, thus effectively creating or perfecting that right, it could give rise to a number of complexities, particularly if there were competing claims or if perfection was disputed. It was suggested that one way of addressing this would be through the establishment of certain minimum

requirements for the effective creation or perfection of a security right that registries could look towards and rely on when making that determination.

103. *A participant* observed that the question was about administering the process of enforcement rather than recognising security rights. She explained that, at the moment, registries were not equipped to perform such services and this created an obstacle to scaling; because these kinds of securities were not being put in place in the market, financing was not being raised on the back of that collateral.

104. *The Chair* observed that many of the challenges were due to the fact that it was difficult to know what the applicable law was on a particular issue. He reiterated that the intention of the Working Group was to understand what was going on in practice and what the practice should be in the near future.

105. On the question of what made a security interest effective against third parties, *a Drafting Committee member* noted that most jurisdictions had some form of system whereby a security interest could be made effective against third parties by registration in a debtor-based registry. The conflict of laws rule was relatively straightforward, because it usually related to the location of the debtor. It was therefore suggested that, at a minimum, Principle 11(3) could state that a security right could be made effective against third parties if a registration requirement was fulfilled effectively. However, it was also stressed that, in fast-moving markets, registration was not always the best or easiest way to make a security interest effective against third parties. Thus, a number of other ways of making a security interest effective against third parties had been developed, one of these being possession in the case of tangibles. It was observed that the Working Group had to determine whether the Principles should recommend that States mandate a way of making a security interest in a VCC effective against third parties other than by data-based registration, since data-based registration was almost always going to be the default system. The reason for doing so would be to make the security interest more easily perfected. It was explained that the subparagraphs in Principle 11(3)(b)-(d) were included to reflect the development of systems that enabled a security interest in an intangible to be perfected without registering the security interest in a database registration system.

106. *A Working Group participant* noted that the current drafting was problematic because it effectively deprioritised debtor-based methods. With respect to the secured creditor becoming the registered holder, it was clarified that this occurred through a form of a prepayment forward agreement which did not have the hallmarks of a security right but rather looked like a basic contractual right. It was further explained that the better approach, which was also seen in the marketplace, was going into the jurisdiction of the *situs* of the registry and using a personal property security registrar, or another debt registrar, to register a security in both, or either, of the registry account and the VCCs. It was noted, however, that this method was imperfect since there was an inherent conflict of laws between the jurisdiction, the governing law of the private law agreement, the contract, the laws governing the *situs* of the registry, and potentially the overall governing law of the terms of use of the actual registered user agreement.

107. Concerns were also raised in relation to the term 'services' in 'custodial services' given the trade implications of the term; the suggestion was to simply refer to 'security and custodial arrangements'.

108. A proposal was made to provide for a label indicating that a security interest existed in relation to particular VCCs. The *Verra representative* acknowledged the practicality of the proposal but queried what would happen if there was a subsequent dispute and whether by attaching the label and accepting that instruction the registry was effectively accepting the validity of that instruction and the perfection of that security. She also observed that the proposal may require the opening of an account by the security holder. The security holder would become an account holder and enter

into the same terms and arrangements with Verra, such that if the security were to be perfected and then enforced, a valid instruction could be given to the registry.

109. *A Drafting Committee member* commented that the question of the label was distinct from the Group's discussion on substantive rules for the creation, perfection, and priority of security interests. Nonetheless, he posited that one possible approach would entail the registry specifying in its account agreement with the client that, if the registry received an instruction from the client, it would label the VCC as encumbered. The registry would take no liability for it, rather, it would just be acting upon an instruction. The market would then take advantage of this flexibility: the secured creditor, when entering into a security agreement with the debtor, would include in the security agreement a promise by the debtor to instruct the registry to flag the VCCs as encumbered.

110. *Another Drafting Committee member* noted that it would be possible to indicate to States the need for good conflict of laws rules so that the relevant jurisdiction was clear, and once the relevant jurisdiction was clear, then security rights over VCCs could be made effective against third parties under the applicable law, and market-based mechanisms could be used for market-based information. However, it was also pointed out that Principle 11(3) included ways in which a State could increase the possible methods of third-party effectiveness. It was inquired whether it would be helpful to provide alternative means to data-based registration which States would have to legislate for.

111. *Another participant* suggested that draft Principle 11(3)(d) be taken out given the complexity of control agreements. He also noted instances where the draft Principle deviated from the DAPL Principles and/or the UNCITRAL Model Law on Secured Transactions, suggesting that these instances be addressed in the Commentary.

112. With respect to control agreements, it was noted by *the Drafting Committee* that, even if complex, they could be a helpful alternative to the suggested label, since everyone who was a party to the control agreement and who would have to deal with enforcement would be aware of the security interest.

113. *The Chair* provided two comments. First, he referenced the Geneva Securities Convention in relation to the book entry of intermediate securities, where a security right was perfected by moving the asset from the debtor's account to the secured creditor's account. He noted that this could be recognised as an alternative method of third-party effectiveness; it was similar to draft Principle 11(3)(b) and comparable to digital assets recorded on blockchains, where an entry would be moved from one account to another to reflect the security interest. He also observed, however, that other jurisdictions applied a special earmark or label within the debtor's account to indicate that a security interest existed. This method, called 'designating entry,' provided legal recognition of the security interest without altering the book entry. Still, he explained, other jurisdictions combined the two methods, by moving an entry to the secured creditor's account and marking the debtor's account accordingly. The Geneva Securities Convention ultimately listed all of these methods as valid ways to establish third-party effectiveness of a security interest. If VCCs followed this model, different mechanisms could be accepted depending on jurisdictional preferences and market needs.

114. Second, *the Chair* referenced the priority rules under draft Principle 11(5), which were intentionally limited to subparagraphs 11(3)(b)-(d) but not 11(3)(a) (debtor-based registration). The question he raised was whether those special methods should be given super-priority, as an exception to the first in time principle and thus beating perfection through registration even if that had occurred at an earlier time. He explained that this principle was present in the DAPL Principles, where moving the blockchain entry from data to creditor would beat the secured creditor who made perfection in the registration system. He acknowledged that this approach could be deemed controversial and noted that it appeared that, for VCCs, the market required something like a

contract-based agreement that was given the permission to make the security interest effective against third parties.

115. *A Working Group participant* considered it important to reflect on the circumstances in which a VCC would be used as security. She explained that in prepay agreements an investor in the project would prepay or lend money by way of a prepayment for a future delivery of credits. She noted, however, that this was not the only scenario in which VCCs would be used as security. Organisations with an inventory of credits may want to use that inventory as collateral for refinancing or as security against a number of potential other risks such as non-payment risk, market risk, or settlement risk. She encouraged the Principles to be broad enough to reflect these market realities.

116. In response, *a Drafting Committee member* noted that in some jurisdictions acquisition financing would be given the highest level of priority, while in certain civil law jurisdictions the financing of inventory was not allowed. He emphasised that the question for the Group was the extent to which asset-specific rules were needed for VCCs in order to support the growth of the market and provide legal certainty.

117. *The Chair* took note of the discussion and asked that the Drafting Committee try to produce a revised text for the next Working Group session.

Conclusions

118. *The purpose of the Principle on security is to identify asset-specific rules in the context of VCCs. The Drafting Committee would consider revised language for the next Working Group session.*

iv. Principle 2 (Definitions)

119. *A member of the Drafting Committee* introduced draft Principle 2. She first stressed that, as noted in paragraph 2.1 of the Commentary, the definitions were for the purposes of the Principles only, and not for the carbon market as a whole, though the definitions did attempt to use words consistently with the market. It was also emphasised that the Principles be read in conjunction with the Commentary which was an attempt to explain not only the way in which the definitions worked, but also how the definitions resulted in the conclusion in draft Principle 3 that a VCC could be the subject of proprietary rights.

VCC (Principle 2(1))

120. With respect to Principle 2(1) concerning the definition of a VCC, it was explained that the term 'issuance' was not included. Rather, the language focused on the approval of a positive verification report as one of the constituent elements of a VCC.

121. The definition provided that a VCC was a unit which represented the achievement of a reduction in or removal of one tonne of CO_2 equivalent from the atmosphere as a result of a carbon mitigation project. It was explained that use of the language 'representing the achievement' was a way of making it clear that the VCC represented a set of facts. A set of facts was information, and thus could not be the subject of proprietary rights. However, a VCC represented this set of facts with certain characteristics that enabled the VCC to be the subject of proprietary rights, as addressed in paragraph 2.5 of the Commentary.

122. The 'achievement' referenced in Principle 2(1) had to be the result of a carbon mitigation project as defined in draft Principle 2(9)[1].

[1] Providing that "'Carbon mitigation project' means a project aimed at reducing the amount of CO_2 equivalent in the atmosphere or removing CO_2 equivalent from the atmosphere".

123. Subparagraphs 2(1)(a)-(c) set out the necessary criteria for a unit that represented the achievement of a reduction or removal to be a VCC:

- Principle 2(1)(a): The achievement had to have been verified by a positive verification report or statement (as defined in Principle 2(4)), with such positive verification report or statement providing that the achievement was a result of the relevant carbon mitigation project in accordance with applicable methodology (with methodology defined in Principle 2(8)).
- Principle 2(1)(b): The verification report had been approved, with approval defined in draft Principle 2(6). The draft did not specifically address who had to approve the positive verification report. It had to be a legal person which could include an ICCP or a government body. It was suggested that the term 'carbon crediting body' (CCB) be re-introduced and defined to include either an ICCP or government body and as the entity that registered the project at the outset.
- Principle 2(1)(c): The unit was recorded in a VCC registry using a unique identifier as defined in draft Principle 2(2bis). It was recalled that the unique identifier was heavily relied upon to state that the VCC was individuated and therefore could be the object of proprietary rights. The question of an individual number being given to a block of more than one VCC was addressed in paragraph 2.8 of the Commentary, which noted that every time the block was split up, the resulting credits would have individuated numbers. Therefore, issuance in blocks did not stop the VCCs from being able to be the subject of proprietary rights. It was suggested that blocks be addressed in the draft by noting that words in the singular included the plural.

124. *A participant* suggested that the word 'project' in the term 'carbon mitigation project' in Principle 2(1) and Principle 2(9) be replaced with the more inclusive word 'activity' which aligned with language used in Article 6 of the Paris Agreement and the ICVCM assessment framework and would allow the definition to encompass various credit-generating models, including projects, programs of activities, jurisdictional crediting, and policy-based crediting.

125. The Group was also cautioned against stating that a VCC represented the achievement of the reduction or removal of one tonne of CO_2 equivalent, since what was reduced or removed was the greenhouse gas emissions and not the tonne of CO_2 equivalent. Alternative wording was proposed, in alignment with ICVCM's definition, providing that a VCC represented a greenhouse gas emission reduction or removal equivalent to one metric tonne of CO_2 equivalent.

126. Concern was also raised in relation to the word 'achievement', since a VCC represented the achievement of one tonne of removal or reduction only to a given confidence level. For example, the ICVCM Core Carbon Principles (CCP) provided that a VCC was eligible for the CCP label if there was a 66 percent chance that the quantification was not significantly overstated, and a 90 percent chance that it was not very significantly overstated. Thus, by definition, the quantification could be overstated with the risk that if a VCC did not really achieve the one tonne reduction then it would not be covered by the Principles. It was also noted that definitions already existed in the market, including the ICVCM Principles and the European Reporting Standards, that could be referred to.

127. *A Drafting Committee member* proposed that the words 'reduction' and 'removal' be pulled from the definition in draft Principle 2(1) and be included as defined terms later in the same subparagraph. It was explained that the aim was to align the definitions as much as possible with the industry and reduce the length of the document by not having to repeat what a reduction or a removal was whenever the terms were used in the instrument.

128. In response, certain *Working Group participants* observed that it was unnecessary to introduce definitions of a reduction and a removal, since these were well-established terms. It was suggested that the definition be amended to state that a VCC "*means a unit that represents the achievement of reduction or removal of greenhouse gas emissions in the amount equivalent of one*

tonne CO_2". Others noted that there was presently disagreement in the market over the definitions of reductions, removals, and avoidance and urged the drafters to make any definitions consistent with those already being used by the market, such as the ICVCM definitions or the new ISO Standards. It was however strongly recommended that the reference to one metric tonne of greenhouse gas emissions remain in the core definition of a VCC, as this was essential to the functioning of the market, including with respect to interoperability, fractionalisation, and market transaction perspectives.

129. With respect to Principle 2(1)(a), *the Verra representative* noted that the relevant ISO Standard required a verification statement as part of a verification report, so use of the term 'verification statement' was correct. Generally, a positive statement was required to ensure that the stated activity had achieved the reduction or removal for the relevant monitoring period to a specific volume of credits.

130. With respect to Principle 2(1)(b), most *Working Group participants* agreed with the suggestion that reference to a CCB be included. With respect to the role of the ICCP, *the Verra representative* clarified that Verra was a standard setter that managed specific programs, one of which was the VCS program. A project was certified by the standard setter if that project met the requirements of the program rules and the applicable methodology was initially validated by the validation and verification body (VVB). Subsequently a project was registered and issuance could happen if the VVB subsequently provided a positive verification statement that the project met the program requirements and the methodology and, importantly, had achieved the mitigation or removal for the relevant monitoring period.

131. However, *certain participants* disagreed with the suggestion. It was noted that a CCB was not a mandatory participant in the life cycle of a VCC and therefore the Principles should cover VCCs issued without the involvement of a CCB. It was also suggested that the CCB be left out of the definition of a VCC and that instead the role of the VVB be emphasised, this being vital to the inception of the property rights. On the first point, a distinction was made between the legal nature and character of the VCC and the governance of the programs. It was suggested that hardwiring the CCB into the private law Principles was outside the scope of the Principles. The fulcrum for the property rights was the program, not who ran or managed the program, which could be governments, NGOs, or even algorithms. With respect to the relevance of the VVB, it was noted that the verifier provided a role that was independent of who ran the program; thus, from a private law perspective, the inception of the private law right of the project developer or proponent was contingent upon an independent program and not on who ran the program.

132. Based on the Group's feedback, *the Drafting Committee* added a reference to the CCB in Principle 2(1)(b) and suggested that the CCB be defined as a carbon crediting body that could include an ICCP, a government body or an intergovernmental body such as the UN and that would perform one or more of a list of enumerated functions: (i) the CCB specified the methodology applicable to the relevant carbon mitigation project; (ii) the CCB approved the carbon mitigation project; and (iii) the CCB approved the VVB carrying out the verification process. It was specified that the definition was trying to capture the activities performed by a CCB in a VCC's life cycle. It was queried whether a CCB would perform all three of the above functions and whether all three of these functions should be included in the definition.

133. *A Working Group participant* noted that, as currently drafted, the definition would allow different entities to simultaneously comply with the relevant criteria. He also suggested doing away with the approval criteria, as this was something that did not actually exist in the market. It was noted that, in practice, approval was not a separate formal step and that the term 'acceptance' more closely reflected market practice.

134. *Another participant* doubted whether it was necessary to address validation and advised that the references to validation and verification in the instrument's introduction be amended to be consistent with the language used in draft Principle 2. A query was also raised as to whether any governmental or intergovernmental entities approving the VVB did so as part of their CCB role and whether it would be a CCB performing the registration or a different entity. It was also suggested that the accreditation of a VVB by a CCB was more of a regulatory matter.

135. With respect to Principle 2(1)(c), concerns were raised with the concept of blocks of VCCs, since the blocks were made up of elements which did not have the unique identifier necessary for them to be considered property. However, it was explained that a block was not always split into individual units and could instead be transferred or moved without it being split. In such cases, it should be possible for property rights to arise from a block of units as long as the block had that unique identifier.

136. A *participant* questioned why the assignment of a unique identifier was a condition of a VCC existing. He explained that, in the future, VCC programs could be created that looked more like securities with an identifier given to a series—for example, all VCCs relating to Project A would have the same identifier, each would represent one tonne, and they could be traded fungibly. He expressed a concern that reliance on a unique identifier could be a hindrance to the application of the Principles if the market evolved in the future.

137. *A member of the Drafting Committee* inquired about what would happen if the owner of a block of VCCs with an identifier assigned only to the block tried to dispose of a fraction of the block. He also distinguished the issuance of a series of securities with the same identifier from a block of VCCs. In the case of securities, there was no problem identifying each one of them as property because they represented a fractional ownership interest in something.

138. *The Verra representative* clarified that there were different elements of the serial number that was attached either to a block or to an individual credit, and that that serial number would always include the unique identifier. The serial number could change on the basis of whether it was representing the block or the individual unit, but within that number there would always be a unique identifier. In other words, if the block was split, unique identifiers would automatically be assigned to the VCCs that comprised the block. Every block and every individual VCC would have a unique serial number that would identify and individuate that particular item or unit.

139. *Another participant* referenced the American Carbon Registry (ACR) system and explained that in the case of block issuances the individuated units were provided with their own unique identifier upon retirement or splitting of the block.

140. On the relevance of unique identifiers to the property analysis, *a Drafting Committee member* added that the problem with drawing analogies to existing uncontroversial forms of property was that the analogy broke down. During the early Working Group sessions it had become apparent that it was not possible to say that the holders of a VCC had rights against somebody, as was the case for shareholders (rights against other members of the company and the company) or bondholders (right against whoever issues the bond). The unique identifier had thus been recognised as a compromise to be able to state that a VCC could be property. The Principles could not simply state that a VCC was property, since States would not accept this.

141. *Another Drafting Committee member* observed that VCCs represented information and information could not be property unless something was done to that information to enable it to be the subject of proprietary rights. With respect to VCCs, it was argued that VCCs had certain characteristics that were the characteristics of other objects of proprietary rights: (i) individuation, with the unique identifier given by the registry providing the 'boundary' around the VCC to indicate a particular VCC; (ii) the fact that the VCC could be controlled, since only the registered account

holder could give instructions to the registry in relation to the VCC; (iii) the fact that a VCC was rivalrous, meaning that if one person controlled it, somebody else did not; and (iv) the fact that a VCC could be transferred. Without these characteristics, property law would not work in relation to VCCs.

142. *A participant* disagreed with the idea that a VCC was information or a right against a registry. Rather, a VCC was an environmental benefit that gave its holder the right to do something, such as, for example, report that the holder had offset its carbon footprint or deliver the VCC to a compliance program that accepted the VCC. *The Drafting Committee* however clarified that a right as understood in law had to be a right against someone. The fundamental problem with the idea that the VCC was a right to do something was that there was no counterparty and thus could not fit within a traditional system of property law.

143. *A Working Group participant* noted that there were different approaches in practice with respect to how the blocks of VCCs were split and how the unique identifiers were assigned. He encouraged the Group to focus on a single VCC. If the concept of a block of VCCs were introduced, he posited that this was not a VCC and may not be comprised of VCCs but rather of something which could lead to the creation of VCCs in the future.

Verifier (Principle 2(5))

144. The term 'verifier' was replaced with the term 'VVB', meaning a validation and verification body, this being the term used by the industry.

145. For example, *the Verra representative* explained that the standard term was validation and verification body, VVB, as accredited against an ISO Standard for a specific scope which might mean that the VVB could validate and verify against specific methodologies or certain types of projects. However, a *participant* recalled that while VVBs could also perform a validation function, only the verification function was relevant to the draft Principles.

146. In addition, the Working Group discussed making two elements definitional about the VVB: (i) the VVB had to be independent of anyone involved in the project; and (ii) the VVB had to be accredited.

147. With respect to the independence requirement, it was noted that it seemed to be important and critical enough to be part of the definition of a VVB as a matter of private law. However, if the Working Group disagreed the requirement could be taken out. *Participants* raised the point that including an independence requirement would amount to regulation by definition. It was also stressed that, at least from Verra's perspective, even more important than independence was the fact that the VVB was accredited to a certain standard. Others suggested that the term VVB be defined with reference to its function rather than just the attribute of independence, since that would be overly broad.

148. With respect to accreditation, *participants* noted that the term 'accredited' was too difficult to define and was, in any event, a matter of regulation and not of private law. It was stressed that it was likely that there would eventually be regulatory requirements placed on top of the private law addressed in the Principles. It was also noted that, in practice, VVBs were not always accredited by a standard body.

149. The proposed definition of VVB was thus amended to include three criteria: (i) the VVB was approved by the relevant CCB; (ii) the VVB was independent; and (iii) the VVB produced a verification report as a result of the verification process.

150. *The Drafting Committee* recalled that the proposed definitions related to one VCC—they did not address what the named entities did in general, nor did they purport to provide definitions for regulatory purposes. Rather, the proposed definitions just referred to the activities and functions the various entities performed in relation to the VCC as an object of proprietary rights, as defined in Principle 2(1). For this reason, the proposed definitions may not always be consistent with standard definitions used for regulatory or other purposes.

151. *The Deputy Secretary-General* agreed and reiterated that each definition was drafted for the sole purpose of application within this particular instrument and within the scope of the instrument itself. She explained that this was a technique used also in other UNIDROIT instruments; the definitions were not meant to be used for a purpose other than within the scope of application of the instrument and within the principles themselves. She noted, however, that it was nonetheless good to align definitions, if possible and if useful for the instrument.

Methodology (Principle 2(8))

152. The definition of 'methodology' in draft Principle 2(8) was amended to include the word 'quantification', since it had been noted that quantification reflected the primary function of a methodology. It was explained that some of the other functions, like monitoring or reporting arrangements, might be governed at the program level. However, quantification was specific to an activity type and thus specific to a methodology.

153. Further, a technical issue in the methodology definition was identified, where the reference to 'implementation' appeared to relate to CO_2 reduction rather than the carbon mitigation project itself. It was suggested that the wording be amended to clarify that the methodology governed the implementation of the project rather than the reduction outcome.

Other law (Principle 2(15))

154. With respect to draft Principle 2(15) concerning 'other law', it was explained that the Principles were not intended to be a complete code. Rather, the Principles only addressed the parts of law which were considered special to VCCs. They were not meant to overhaul the whole of property law in a State or the whole of contract law.

155. Therefore, there was a need for (i) a concept that referred to the law in a State that was not covered by the Principles; and (ii) a concept to refer to the law in the State that was covered by, or was consistent with, the Principles. The words 'Principles law' thus referred to any part of a State's law which implemented or was consistent with the Principles and everything else was referred to as 'other law'. It was also noted that the Commentary could specify that 'other law' referred to other applicable law, meaning the law that applied according to the applicable conflict of laws rules.

Insolvency-related proceedings (Principle 2(16))

156. With respect to draft Principle 2(16) concerning insolvency-related proceedings, it was noted that the draft came from the DAPL Principles and was a fairly encompassing draft, including what some people might call restructuring proceedings, on the basis that the line between insolvency and restructuring proceedings was very porous.

Principle 2(17)

157. With respect to Principle 2(17), it was observed that this was a common drafting provision providing that words in the singular included the plural, and the plural included the singular. It was noted that this was relevant to the discussion of blocks of VCCs.

Conclusions

158. *The term 'verification statement' should be used rather than 'verification report'.*

159. *The term 'carbon crediting body' would be re-introduced in Principle 2(1)(b) and then defined.*

160. *The reference to one metric tonne of greenhouse gas emissions was to remain in the core definition of a VCC.*

161. *The term 'verifier' was to be replaced with the term 'VVB' (validation and verification body).*

162. *The proposed definition of a VVB was amended to include three criteria: (i) the VVB was approved by the relevant CCB; (ii) the VVB was independent; and (iii) the VVB produced a verification report as a result of the verification process.*

163. *The definition of 'methodology' in draft Principle 2(8) was amended to include the word 'quantification'.*

v. Principle 4 (Creation)

164. *A member of the Drafting Committee* addressed the few changes in relation to draft Principle 4. She recalled that the Working Group had identified the need for a Principle that dealt with creation, and that explained exactly when a VCC came into existence. It was clear that, before a VCC came into existence, it: (i) had to be recorded in the registry; and (ii) it had to be given a unique identifier (draft Principle 4(1)). She queried whether the Principle should address blocks of VCCs and suggested that the Drafting Committee discuss this before bringing it back to the Working Group.

165. *The Drafting Committee member* then addressed draft Principle 4(2) and 4(3). She explained that, if something was to be capable of being the subject of a proprietary right, then a rule or system was needed to indicate who held that proprietary right when it was created. When a VCC was recorded and credited to an account, the first person who had the proprietary right was either the person who was the registered holder, i.e., the account holder, or if the account holder was a custodian, then the person for whom the custodian held the VCC. Based on industry practice, that person would normally be the project proponent. After the initial credit of the VCC into the account of the registered holder, that person could transfer their proprietary right, their ownership, to someone else.

166. Once past this initial stage, the Principles did not address who owned the VCC at any one point, because that was a matter left to national property law. Thus draft Principle 4(3) provided that after the VCC had gone to the registered holder and was owned by the registered holder, the question of whether a person actually at any particular time had a proprietary right in a VCC was a matter of other law, i.e., applicable national property law. For example, a particular national property law might say that people under the age of 18 could not own VCCs. There were many things that national property law might say about ownership which were not covered by the draft Principles, the only exception being draft Principle 7, which included the potential taking free rule.

167. *A Working Group participant* opined that the only condition for the creation of a VCC should be an objective fact, this being the moment when the entry was made into the account of the registered holder. He suggested to have only one requirement in draft Principle 4(1) to reflect that the moment when the entry was made in the account of a registered holder was the moment in which the VCC came into existence. The *Verra representative* noted that the steps in draft Principle 4(1)(a) and 4(1)(b)—i.e., the allocation of a unique identifier and the recording of a VCC—generally happened simultaneously since the act of recording attached the serial number.

168. *The Chair* thus suggested that subparagraph 4(1)(a) be tentatively removed and that the practice of the registries be checked.

169. *A Working Group participant* indicated that, in a situation where an account holder was not the *prima facie* owner of the of the VCC, because, for example, they were holding it on behalf of somebody else, draft Principle 4(2) did not distinguish between whether or not the client in the example of Principle 4(2)(b) had a different proprietary right at the exclusion of the account holder. In a situation where the legal interest under Principle 4(2)(a) notionally sat with the account holder, and 4(2)(b) was an exception deviating from that, then one would have to say that the account holder in 4(2)(b) had no legal rights, and therefore all the legal rights vested in the client, or it would have to be acknowledged that there was a legal right that vested with the account holder, but that it was not at the exclusion of a legal right or a proprietary right that may be acquired by the client. This, in turn, assumed that the proprietary right in question would be capable of accommodating a split between legal and beneficial title which was a concept not commonly recognised outside of common law jurisdictions.

170. Thus, it was noted that, if Principle 4(2)(b) was allowed to sit without addressing the question of whether or not the account holder's *prima facie* right in Principle 4(2)(a) was displaced entirely or partly by the client acquiring a right, then the drafting left a level of ambiguity. Moreover, the Principle had to address the potential scenario of multiple clients, because most custodians had sub-account structures meaning that there was a single account with notional sub-groups within which it was possible to demarcate holdings for other people as distinct from the account holders' holdings. Because of the ambiguity in draft Principle 4(2)(b), questions remained as to the status of multiple clients in those circumstances, including whether they shared in the same interest in the same unit, whether they had a co-beneficiary status, whether there were multiple interest holders and, if so, how to deal with that. It was suggested that, if the Principles were to deviate from the *prima facie* rule in Principle 4(2)(a) which provided it was the account holder who had the primary proprietary interest, then the instrument needed to be able to answer the question of how this was going to work.

171. In response, the *Drafting Committee member* recalled that there was a draft custody principle for the Group's consideration, which was open to revision. The draft custody Principle did not say anything about whether the client had a proprietary right and whether the custodian had a proprietary right. It just stated that, if the custodian became insolvent, the VCCs held by the custodian for a client were not available to the custodian's creditors, either outside or within insolvency. It was explained that the normal way of achieving this under national law would be that the client would have at least some form of proprietary right that persisted in the insolvency of the custodian. Because, however, the draft Principles addressed transnational law rather than the law of any particular jurisdiction, the drafting was very general and it was not possible to go into legal and equitable interests, or whether the interest was split.

172. With respect to draft Principle 4(2), it was further added that it pertained to one second in time, or a very short period of time. It was not a general statement. It rather only related to the moment of creation; at the moment of creation, somebody had to have a proprietary right in the VCC. A proprietary right could be either the sole proprietary right or part of a split proprietary right. The drafting was very general; it did not prescribe the type of proprietary right, since this depended on the jurisdiction. Thus, if there was only the account holder and nobody else, then the account holder would have a proprietary right. If instead the account holder maintained the VCC for someone else, that other person had a proprietary right. This had to be tied into custody, because it was based on the custody principle. But it did not preclude a split right, a legal, equitable split, or however it was that the particular jurisdiction treated custody. But the point was that draft Principle 4(2) was simply the way that the right came into existence; once that happened, how the parties dealt with it between themselves, was left to other law. Past the moment of creation, whether being a registered holder amounted to *prima facie* ownership was a matter left to other law.

173. *The Chair* noted that in the DAPL Principles custody was used in the functional sense so that the doctrine might adapt to some other legal doctrine.

<u>*Conclusions*</u>

174. *Subparagraph 4(1)(a) was to be tentatively removed to address the fact that the allocation of a unique identifier and the recording of a VCC generally happened simultaneously in the market.*

vi. Principle 5 (Cancellation) and Principle 6 (Revocation)

175. *A member of the Drafting Committee* began the discussion on Principle 5 and Principle 6 by referring back to the definitions provided at Principle 2(10) and 2(11). He explained that the main difference between cancellation and revocation was timing; cancellation dealt with events that happened after issuance, whereas revocation dealt with events leading up to issuance. He explained that the Drafting Committee had offered two sets of Principle 5 and Principle 6 for discussion : (i) a primary proposal in which cancellation or revocation of a VCC extinguished proprietary rights; and (ii) an alternative proposal providing that VCCs remained the subject of proprietary rights despite being cancelled or revoked, with the market addressing the consequences of that cancellation or revocation. He indicated that the definitions in Principle 2(10) and 2(11) would have to be adjusted depending on the approach chosen by the Working Group in relation to Principle 5 and Principle 6.

176. It was further explained that the primary proposals for Principle 5 and Principle 6 were based on general property law principles. If intangible property was defined as having certain characteristics, then it had to have those characteristics. An analogy was drawn to trademarks, where there was an expectation of continued use; if the VCC no longer represented the removal of greenhouse gases equivalent to one metric tonne of CO_2 then the VCC should be cancelled, in the same way that a trademark that was no longer used would be cancelled. It was also noted that the Principles dealt with risk allocation on the basis of property law; i.e., risk followed property, meaning that the owner of the property bore the risk of that property being destroyed. It was however emphasised that the draft Principles did not dictate a risk allocation method. Market participants remained free to allocate risk differently and it remained up to the market to determine the best risk allocation mechanism.

177. *The Drafting Committee member* also observed that if the position was taken that, although a VCC represented the removal of greenhouse gases equivalent to one metric tonne of CO_2, the VCC did not stop being a VCC when that gas escaped back into the atmosphere, there was a question of credibility of the entire industry at stake. Alternative Principle 5 addressed this scenario and provided that the VCC did not cease to be the subject of a proprietary interest; it was just prevented from being moved within the registry. It was, however, noted that this proposed drafting did not conform to traditional property law perspectives and was expected to make it difficult for the Principles to be adopted across legal systems. It was also observed that, if a cancelled VCC remained the subject of a proprietary interest and the only consequence of cancellation was that the VCC could not be moved within the registry, then there could conceivably be transactions off the registry.

178. *A Working Group participant* questioned the practical, operational, difference between revocation, cancellation, and retirement, noting that the net result was the same; in each instance the VCC was taken out of circulation and no longer had value. Retirement occurred upon the instruction of the holder. In the case of revocation or cancellation, the right to remove the VCC from circulation was delegated to the relevant crediting body. Yet all instances were cancellation events, regardless of the particular circumstances leading to the cancellation.

179. Concerns were also raised with respect to introduction of the concept of void *ab initio*. It was observed that this was likely a local legal issue, with differences across jurisdictions. It was also noted that it was up to the relevant crediting body to determine whether something amounted to a

cancellation event. Moreover, there were different reasons under different methodologies and crediting bodies as to why a unit might no longer be considered eligible, not just a physical leakage of the greenhouse gas.

180. *The Verra representative* differentiated between reversal and revocation on the one hand, and cancellation on the other. She explained that cancellation was the outcome of certain events, whether they occurred pre or post issuance. She described that, the way the Verra terms of use were currently drafted, cancellation was usually carried out at the request of the user, but there might be circumstances in which Verra would need to do it. Upon cancellation of a VCC, all legal and beneficial title and interest in the VCC would be extinguished, with no one having any further right to take any benefit of the VCC. She described cancellation as an outcome of possibly both reversal and revocation.

181. *A Working Group participant* pointed out that the definition of a VCC could be deemed project neutral, in that it did not specify which project the environmental benefit was achieved from. He thus queried whether it would matter that the underlying project did not represent the mitigation so long as that was made up or compensated for from another source. He warned that if proprietary rights were to nonetheless disappear in such an instance, then the market would not scale. Investors would be concerned about something happening with respect to one project, without anticipating the fact that there may have been compensatory alternatives that neutralised the damage.

182. He explained that under the CORSIA framework, for example, it did not matter what happened to the underlying project, so long as there was a compensatory action that mitigated what the loss of integrity or value of the original tonne represented. On the other hand, if the unit and all proprietary value in it was always deemed lost when there was some question about the nature of the mitigation achieved by the project, then the market would never scale because investor certainty would be destroyed. It was however noted that, at the moment, none of the voluntary standards had ensured the existence of a compensatory process, which was why the discussion focused on the loss of the underlying project mitigation benefit being a loss of the property itself. Yet, it was stressed that if the proprietary benefit was destroyed irrespective of whether or not there was a compensatory outcome provided elsewhere, then the proprietary investment, trust, and faith in the unit would also be destroyed.

183. In response, *a Drafting Committee member* noted that part of the issue was that not all of the ICCPs or CCBs were willing to provide a right against them in the event that a VCC no longer represented the environmental benefit. If they did provide such a right, then the right continued to exist under draft Principle 5(4). Questions were also raised as to how different mitigations would be tracked. It was noted that there was a global balance sheet tracking Nationally Determined Contributions (NDCs) under the Paris Agreement with national audits, which were then reported to the UN.

184. *Another participant* reiterated the concerns previously raised in relation to the scaling of the market. He agreed that this was a risk allocation question and that there was a risk that the environmental benefits either were not realised or were reversed at some point, and somebody had to bear that risk. However, he also observed that if a party in a financial market was going to bear a risk, they had to be able to conduct due diligence to examine the extent of that risk and, currently, this was not something that was available. He thus queried whether, as a legal matter, this was a risk that had to be allocated to all holders of VCCs or whether the rules and regulations applicable to a program could at least say that this risk was going to be allocated first to the VCCs held in a buffer pool, and second, to any VCCs held by the project developer who was acting for the project promoter who was at fault and, as a last resort, to the market. He emphasised that the problem was that this was not a remote risk. It was rather a risk that undoubtedly would happen and thus could pose a significant problem to the scaling of the market if it had to remain with VCC holders.

185. *The Drafting Committee member* clarified that the draft Principles did not prescribe that the risk had to go to the account holder. Instead, the draft Principles provided the basic property default rule and it was for the market to work out a solution and for ICCPs or CCBs to provide the relevant assurances that if the VCC's benefits were lost then the holders would be compensated. It was stressed that the Principles could not prescribe a way of providing that compensation; it was rather for the market to determine the most appropriate mechanism.

186. *Participants* noted that this was likely an acceptable solution to be clarified in the Commentary, but nonetheless raised concerns with the pro rata allocation.

187. *A participant* highlighted the difference between the term 'cancellation', which referred to the loss or diminishment of value of a carbon mitigation, versus the term 'revocation', which referred to instances where the benefit never existed in the first place. He noted that this was the difference between void *ab initio* and voidability. He indicated that Principle 5 seemed to address circumstances when a VCC could be avoided. If what was reflected in Principle 5 was the concept of voidability as opposed to void *ab initio*, then this was a discretionary matter, and the only question was whether it was the discretion of the standard or somebody else.

188. He explained that, as with any voidable arrangement and voidable right, there was always the opportunity for it not to be voided. The conceptual framework reflected in the draft Principle thus suggested that this was an optionality that was being created rather than a mandatory process or a mandatory principle. If that was the case, then the relevant question was, who was authorising the right of that VCC to be interfered with? If the answer was that it was a right retained by the registry or the standard, then what the Principle was saying was under what circumstances could the standard exercise its discretionary right triggered by the concern associated with the integrity or the environmental benefit of that unit. If that was the case, then it ultimately fell upon the standard to choose what kind of position it wished to adopt. If a standard provided insurance or other alternative protection such that the integrity of the original unit was not interrupted by whatever happened with the project, then the proprietary benefits of that unit should not necessarily disappear.

189. In response to the notion of voidability being a discretionary matter, a *Drafting Committee member* observed that this was not how voidability worked under property law, as opposed to voidability in contract. He explained that whether property rights were void *ab initio* or subsequently depended on how the property rights were defined. If the property right was defined by saying that at the point of inception, it must have characteristics 1, 2, and 3, and it must have as a continuing characteristic 4, then if 1, 2, or 3 disappeared, it is void *ab initio*. If 4 disappeared subsequently, it became void subsequently. There was then the very difficult question of who initiated the process of 'cancellation'. He opined that the discussion had been around 'authorisation' because currently the process of cancellation was designed as a contractual process. He noted, however, that if the discussion moved away from contract and into property, then there would be other ways property was destroyed apart from through authorisation.

190. *A member of the Drafting Committee* recalled that the Principles were being drafted to accommodate the situation where the registry operator was a different legal person and completely separate from the ICCP or the CCB, i.e., separate from the person who issued the VCC in the first place, since this was the direction the market was expected to take. She asked the Working Group to confirm where the authority of an ICCP or CCB to cancel the credit came from.

191. *A participant* clarified that reversal was never applied to or used with regards to a VCC; it was rather used with regards to the mitigation benefit and only in a specific subset of projects. Cancellation on the other hand would happen when the VCC no longer met the standards under which, or the requirements under which, that VCC was issued, and those would be very different across crediting programs. He suggested that the Principles and Commentary be agnostic as to the reasons why the VCC was cancelled and only focus on the actual cancellation and its implications.

192. *The Verra representative* agreed and suggested that 'cancellation' was thus not the proper title for Principle 5. She also clarified that, at least under Verra's terms of use, it was the account holder or user who instructed the cancellation. As an example, it was explained that, if as a result of a project review it was determined that there had been an over issuance of credits, that would be discussed with the account holder and there would then be a process for the account holder to follow to cancel the credits and be compensated. Another *participant* noted that Verra invited the choice to be made by the account holder because there was more that one way in which Verra's procedures anticipated or allowed for the compensation. If Verra did not give the account holder more than one way to provide the compensation, then the account holder would likely have no say in the matter about whether Verra would cancel or not. Thus, it was not necessarily the case that the right or choice of cancellation sat with the account holder.

193. *The S&P Global Commodity Insight representative* explained that S&P Global Commodity Insight operated as a technology provider administering the registry. She underscored the importance of addressing the question of who could provide the instruction to cancel the credits. She explained that S&P Global Commodity Insight did not have a standalone authority to take decisions with respect to the credits issued by a certain standard or program. They therefore generally followed the standards' rules in that respect and had certain additional cancellation policies. For example, if they had a reasonable grounds to suspect fraud, then they could suspend or cancel the units, though that had never happened in practice. But normally, she explained, S&P would follow the processes and instructions from the standard or the program, so that if there was a notification that the environmental benefits ceased to exist, then the VCCs would be cancelled if that was in accordance with the rules of the standard or program. She further explained that, in an instance where the registry provider was an independent software and services provider, in S&P's view, it did not have independent authority to decide. Thus, the question of who could provide the instruction apart from the standard or account holders in the future—such as exchanges or regulatory bodies—was an important one and one that was asked by customers (i.e., programs and standards) all the time.

194. *The GCMU representative* stressed that any definition of the person giving the instructions should be flexible enough to accommodate a number of different circumstances including, for example, a State or a proxy for the State providing that instruction if it had been determined that a credit was not eligible for export. She also noted that transferring a credit to a compliance market was considered cancellation, and in that case the instruction was likely to come from the user.

195. *A Working Group participant* observed that there was a very wide range of contingencies where a VCC might be cancelled by the registry, the standards, the administrative body, or the users themselves. He noted that, conceptually, the fate of a credit that was cancelled was the same as that of a credit that was retired; nothing more could be done with that credit. The difference was in the market practice that used retirement when there was a specific purpose, so either to make a claim or to comply with some obligation. He added that it was important for the definition to also give some indication of whether the provisions would apply to a credit that was retired for a particular purpose, and whether they were the same as for a credit that was being cancelled for a specific reason.

196. *A Drafting Committee member* stressed that the fundamental question to be addressed was whether VCCs were considered to be property and thus, as a matter of property law, whether the VCCs should cease to exist if certain events occurred. Who bore the risk would change significantly based on the answer to this question.

197. In response, it was observed that what was important to the market was that the risk was allocable and that it was allocated in a way that was consistent with market expectations, i.e., in the agreement reflected in the terms and conditions of the program. *Another participant* confirmed that VCCs should be an item that could contain proprietary rights, and that this was a fundamental premise of the Principles that was not currently mutable. However, she questioned whether this

meant that a VCC that had validly come into existence at a certain snapshot in time would have to be deemed to have never existed if something were to subsequently happen to it (such as the greenhouse gas mitigation having been recorded in error or through fraud, or having been incorrectly recorded or verified, or having been physically reversed). She opined that this should not be the case, because the events that would determine the VCC's 'death' would change and move and morph according to the applicable methodologies and to many other circumstances which could not be predicted. She thus queried whether it was necessary from a legal perspective for the VCC to be able to 'die' or whether it could just be said that it was 'hibernating'; i.e., not allowed to move, but still in existence.

198. In response, *the Drafting Committee member* stated that it was a question of how the industry wanted to be perceived. Apart from the legal analysis point, he posited that if the industry wanted to create a system whereby VCCs were born based on a snapshot, and nothing that was revealed thereafter would change that snapshot, then the industry was likely to face significant greenwashing criticism. He also specified that Principle 5 and Principle 6 were based on the notion that the VCC represented the achievement of a reduction in, or removal of, greenhouse gases equivalent to one metric tonne of CO_2. It was understood that this underlying fact was critical to the VCC being recognised as property. Having the VCC continue to be property despite this fact no longer being true could be done, but it would make the Principles subject to easy criticism.

199. *A Working Group participant* recalled the buffer pool and queried whether a VCC had to be extinguished if the lack of environmental benefit was compensated by having another VCC essentially 'die' in its place. She noted that this was what buffer pools insured against and this was what was happening in the market. It was also noted that buffer pools were only one form of insurance risk mitigation. The 'replacement' VCCs could come from the same project or could be credits eligible for submission in the same compliance programme, or could be credits issued by the same host country—it went back to the idea of what 'of the same description' meant.

200. In response, *a Drafting Committee member* noted that, in the realm of property, whether something was an acceptable replacement depended on whether the owner of the original property accepted it as a replacement—it was not something that could be prescribed, but rather it was a market participant choice. He noted that current market practice provided contract-based solutions as opposed to property-based solutions. He emphasised that draft Principle 5 was not dictating solutions but its objective was rather to encourage the market to determine what worked best. It was also noted that the Commentary to Principle 5 could spell out several of the options available to the market.

201. *Another Working Group participant* differentiated between revocation and cancellation. With respect to revocation, he posited that this was a responsibility on the verifier or on the standards body, or it was a mistake that the VCC never existed. Cancellation, however, was different and more akin to a rotten apple; the apple did not cease to exist because it was rotten, but could not be consumed and ceased to have any value. The point was also raised that, when discussing cancellation, it had to be noted that the events resulting in the reversal of the environmental benefit had nothing to do with the VCC and its existence unless and until they were a confirmed fact stipulated by someone who was authorised to make such a stipulation.

202. *The Group* discussed the notion that a VCC represented something less than a 100 percent 'achievement' and instead represented a 'chance of achievement'. In other words, when a VCC was issued, it was determined to a certain confidence level that there was not an over issuance and that the quantification of the environmental benefit was correct. *Participants* observed that inserting this in the definition of a VCC would be problematic and that, at law, the position had to be taken as to whether something existed or did not exist. Rather than determining its existence, considerations as to the applicable confidence level of the attainment of the environmental benefit could affect the quality and thus the price of the credit.

203. A question was raised as to what would happen if it subsequently was determined that something less than a tonne was removed. It was noted that, for most programs, one unit was the minimal value at which credits could be issued or cancelled.

204. *The Working Group* returned to the fundamental question of whether only the owner should be able to determine when the VCC 'died' or whether certain extraneous events—such as determination that the mitigation outcome which gave rise to the VCC never happened—could also determine the VCC's 'death'. It was queried whether it could be said that the VCC did not 'die' if there was a replacement of the mitigation outcome, since this was what was happening in the market.

205. *A Drafting Committee member* suggested that perhaps a distinction could be drawn such that the only extraneous event resulting in the VCC 'dying' would be the extreme circumstance in which the achievement never took place; i.e., death because of extraneous events by law happened only if the requirements for a VCC to exist were, in fact, never met. If, on the other hand, things went wrong afterwards, for example, the captured CO_2 escaped back into the atmosphere, then the VCC continued and the market would price it accordingly. It was nonetheless noted that, even in this scenario, challenging questions remained that had to be answered according to property rules rather than contract rules. The market would then remain free to contract around such rules by way of insurance or buffer pools, for example. It was further clarified that there could be a system whereby somebody had to replace the 'dead' VCC with something satisfactory. Whether that something satisfactory was exactly equivalent, close enough, or did not have to meet any particular requirement, was up to the parties to decide.

206. *A Working Group participant* observed that the market in VCCs had dropped 56 percent since its peak because of uncertainty about the emission reduction attached to the credits. She thus queried whether, before asking the Drafting Committee to create a very nuanced, unique set of principles for VCCs, the Group consider whether it was actually necessary and whether instead adopting a more standard property rights approach would, in fact, build the confidence necessary to scale the market.

207. *Another participant* raised the question of who was authorised to determine that the mitigation outcome was never achieved and who was authorised to provide that instruction to then trigger the consequence of cancellation. It was noted that the fact of achievement was addressed in the VCC definition through the acceptance of the positive verification report, but there was currently nothing in the draft Principles to similarly address the lack of the achievement.

208. *The Chair* thanked the Working Group for its very active participation and lively discussion. He asked that if any participant wanted to provide any written comments they do so by mid-February in order to give the Drafting Committee the opportunity to prepare a revised document for the April session.

209. Further, *the Chair* proposed that the Drafting Committee proceed on the basis of the property law approach—i.e., that in the case of revocation or cancellation the VCC was void. He noted that determination of under what circumstances the VCC was void was to be differentiated from the allocation of risk, and the Working Group might need to consider whether to also include principles on risk allocation.

<u>*Conclusions*</u>

210. *The Working Group addressed the question of whether the proprietary interest in a VCC that no longer represented a mitigation outcome should be destroyed, and by whom. The Working Group tentatively agreed that the Principles would provide the default property law rule leaving it up to the*

market to provide contract-based solutions. The Drafting Committee would clarify this approach in the Commentary.

211. *The Working Group indicated that there were many reasons why a VCC could be cancelled and it was encouraged that the Principles remain agnostic as to the reasons for cancellation and instead only focus on cancellation and its implications.*

212. *The importance of who, and under what circumstances, could provide the registry with the instruction to cancel a VCC was stressed by the Working Group.*

vii. Principle 7 (Transfer)

213. *The Chair* turned the discussion to Principle 7. *A member of the Drafting Committee* introduced the draft Principle, noting that Principle 7 enshrined the notion that an owner of a VCC could transfer their proprietary rights to someone else, with Principle 7(1) and Principle 7(2) providing basic statements about how transfers in proprietary rights worked and the shelter rule. The rest of the draft Principle dealt instead with the innocent acquisition rule, with respect to which the Working Group had to address two questions: (i) did the industry want an innocent acquisition rule; and, if yes, (ii) what were the requirements that a purchaser had to satisfy to become an innocent acquirer.

214. As to the first question, the Working Group had previously answered this in the affirmative. It was recalled that the basic rule in property law was the *nemo dat* rule—one cannot give what one does not have. However, this required a prospective buyer to carry out significant due diligence, potentially slowing down and increasing the costs of the transaction. To prevent this, in the context of tangibles the law attributed significant legal effects to the transfer of possession. In many jurisdictions and for many forms of assets, if a buyer in good faith acquired a tangible and took possession of it, the law deemed the buyer to have acquired good title.

215. When dealing with intangible property, however, the challenge was much greater because there was no possession to be transferred. Typically with intangibles in both common law and civil law jurisdictions, the *nemo dat* rule applied unexempted. However, in the ambit of VCCs, which the draft Principles defined as intangible assets, application of the *nemo dat* rule could be particularly burdensome since it entailed buyers having to investigate whether the VCC seller was actually the VCC's owner—something particularly challenging, if not impossible, to do when purchasing the VCC on the secondary market after the VCC had been traded multiple times. This was an impediment to the scaling of the market. It was thus explained that the solution proposed by draft Principle 7, while not novel in the world of intangible assets, was an exception.

216. Principle 7(6), complemented by Principle 7(7), laid out certain conditions which, if satisfied, allowed the VCC purchaser to acquire the VCC and take it free from any conflicting claim. These conditions were: (i) the seller had to appear on a registry as being the registered holder; (ii) the VCC had to be credited to the buyer's account, the reasoning being that this was analogous to possession in the case of tangibles; and (iii) being mindful of the differences across legal traditions, the transferee had to operate in good faith. In addition, draft Principle 7(7) required the purchaser to have provided value; one could not become an innocent acquirer through a gratuitous transaction. Because an innocent acquisition rule by definition had the potential of harming the original, legitimate, owner of the asset, it was only acceptable if the innocent acquirer was providing value.

217. *The Chair* noted that the *nemo dat* rule and the shelter rule were not controversial. He indicated that the discussion should therefore focus on the innocent acquisition rule. Since there had been an agreement at the prior Working Group session to include the rule in the Principles, the question to be addressed at the present session was the relevant conditions or requirements for the rule to apply.

218. *A member of the Drafting Committee* observed that Principle 7(6) was currently drafted on the basis of both the transferor and the transferee having to be registered holders with the registry. She explained, however, that it was possible to include transfers through a custody system and still have an innocent acquirer rule. If the Principles were to include a custody principle then there would have to be special rules either in the transfer principle (Principle 7) or in the custody principle (Principle 10) where the acquirer was somebody who held or owned the VCC through a custodian that was a registered holder. Other participants agreed, noting that transfers were often affected through retirement of the VCC in the account of the original owner.

219. *The Chair* agreed and requested that the Drafting Committee produce a separate principle on innocent acquisition in a custody situation.

220. In response to a comment suggesting that the mechanics of the innocent acquisition rule be left to other law, *Drafting Committee members* explained that draft Principle 7(6)(c) represented a compromise point by referring back to the good faith and take free rules of the relevant State, thus embedding a significant level of national law within Principle 7. They also reminded the Working Group that the rules being discussed were just principles, and the reason to have principles rather than leave such issues to national law was that most national laws were likely not to have an innocent acquisition rule with respect to intangibles, nor were they likely to have specific rules in relation to VCCs and taking free. Thus, unless some change in the law was made, all that would be available would be the basic *nemo dat* rule which would not support the scaling of the market.

221. A question was raised as to the final clause concerning a security right in draft Principle 7(7)[2]. It was explained that the same language was included in the DAPL Principles with the substantive point being that one could be an innocent acquirer even if they were a secured creditor. This was also implied by the fact that the definitions provided that a transferee was not just a buyer, but also a secured creditor.

222. On this last part of draft Principle 7, *the Deputy Secretary-General* queried whether it would be helpful to add some clarifications in the Commentary as had been done in the case of the DAPL Principles, since it might not be clear in some legal systems. She also inquired as to why draft Principle 7 did not provide all the details on the burden of proof which were instead provided in DAPL Principle 8.

223. *The Drafting Committee* agreed to expand on the Commentary to further explain draft Principle 7(7), including its consistency with the DAPL Principles and the UNIDROIT Geneva Securities Convention.

224. As to the question concerning burden of proof and consistency with DAPL Principle 8, *Drafting Committee members* explained that the basic approach in the DAPL Principles was reflected in draft Principle 7(6)(c) which provided that the requirements for taking free and good faith acquisition were meant to be those equivalent to the ones specified by the State. In other words, it was up to the State to use their own rules on good faith to do so. What the draft Principles provided was that there had to be an innocent acquisition rule and it had to depend on the transferor and the transferee being the registered holders.

225. It was explained that the reason for there being a more fully worked out rule in DAPL Principle 8(5) was very technical. DAPL Principle 8(5) had been drafted that way because in the DAPL Principles' conflict of laws provision there was a possibility for a State to adopt a conflict of laws rule that meant the parties could choose that Principles Law applied to that particular digital asset, rather than adopt the entire DAPL Principles. One of the problems with such a provision was that the

[2] Providing that "*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*".

innocent acquisition rule was tied to national law, and therefore did not have enough content for it to be able to apply as Principles Law. That was the reason behind DAPL Principle 8(5); it addressed a very specific situation that did not apply to the present draft instrument. As to the burden of proof rule in the DAPL Principles, that related to the identification of a person in control. It was underscored that control was a rather different concept in digital assets, where there was no registry.

226. *A Working Group participant* expressed concern with the innocent acquisition rule possibly correcting an initial defect in title. She explained that this could occur in instances where an entity claimed the right to create the unit, the right was conditional on a government concession that was never granted, and the right was nonetheless transferred to an innocent acquirer. In response, a *member of the Drafting Committee* observed that what had been described did not entail a defect in title, but rather a situation which should have resulted in the VCC being void. The innocent acquisition rule addressed instances in which, although a seller obtained the VCC through fraud or misrepresentation, a buyer that satisfied the applicable requirements would take the VCC free of any claims against the seller.

227. It was further noted by *the Working Group participant* that most of the buyers' legal diligence was currently spent on issues pertaining to the VCC's ownership upon its creation, with secondary market purchasers asking themselves whether the seller who first obtained issuance of the VCC was in a position to do so. It was clarified by the *Drafting Committee* that this was not an innocent acquisition point but rather a question of how to treat VCCs that came into existence when they should not have.

228. *A Working Group participant* observed that the way to address issues such as land grabbing (i.e., project proponents or developers pretending that they owned land which was not in fact theirs) or the issuance of completely fraudulent data in relation to a project's stated reductions or removals would be through the cancellation of the VCC. She noted that if a VCC was retired or cancelled, it 'died', and the question of who bore that risk was beyond the scope of the Principles. It could instead be addressed contractually amongst the parties and through due diligence.

229. *Another Working Group participant* differentiated the above examples from the situation where there was a Party A, who managed the project, and a Party B, who was going to implement the project, and where the contract stated that Party B was to obtain all the environmental benefits but Party A, without telling Party B, went to a registry and obtained a VCC. In such a scenario, there was an environmental benefit and the credit was validly issued. Party A however violated its contract with Party B that gave Party B the right to obtain the credit instead of Party A. A question was raised as to whether this scenario gave rise to a defective title that the innocent acquisition rule could then serve to protect subsequent buyers against. In response, the *Drafting Committee* observed that such a situation would give rise to a breach of contract claim between Party A and Party B. It did not raise issues of defective title, since there was no proprietary problem with the VCC which existed and represented an environmental benefit.

230. *Drafting Committee members* stressed that situations in which there was abuse or fraud leading to the issuance of credits were not ones that could be addressed through an innocent acquisition rule, but were rather scenarios that needed to be tackled at the outset, through rules on revocation. It was recalled that the Working Group had reached agreement that a VCC issued and not supported by any kind of mitigation outcome—for example, despite the fact that there was no land, no project—was void.

231. Attention was brought back to draft Principle 4(2) which was the one situation in which the person who owned a VCC was prescribed by the Principles. Principle 4(2) provided that the registered holder was the person with the proprietary right at the moment the VCC came into existence. The Principle was unqualified—it simply stated that the registered holder owned the VCC. It was thus

only defects in title that arose after that moment that could be solved by the innocent acquisition rule.

232. *A Working Group participant* confirmed agreement with the proposed schema, but requested that the Commentary distinguish the innocent acquisition rule from the issues that could occur upstream upon creation of the credit. It was suggested that such issues would fall within Principle 6 addressing revocation.

233. Clarification was also offered in relation to the role of registries. It was explained that, in the system envisioned by the Principles, registries were not registries of title with all the consequences at law that a registry of title would entail. At the same time, however, one of the conditions to becoming an innocent acquirer was that information be publicly available via the registries. Those were two different things; a register of title had a number of legal implications set in law, while saying that one of the criteria that had to be satisfied to be an innocent acquirer was that the VCC be credited to the purchaser's account after having been debited from the transferor's account was just an observational point as a matter of facts and evidence. *The Drafting Committee* agreed to address this in the Commentary.

234. *A Drafting Committee member* recalled that the question of whether somebody had a proprietary right or not in the VCC, whether they owned it, or whether they had a security right, was left up to applicable law in Principle 4(3). Thus, she explained, not only was the register not a register of title, but the Principles only provided that VCCs could be the subject of proprietary rights—they did not address whether in any given case somebody had a proprietary right. This was a question that was intentionally left to applicable law, because there could be many different approaches in national law, and if the Principles were to be embedded in national law, they would have to reflect those national approaches, subject to Principle 7.

235. *The Chair* observed that it was common in most jurisdictions for possession to have two functions: (i) to facilitate proof of ownership; and (ii) to provide that the innocent acquirer was required to take the asset from the registered owner, because the innocent acquirer had to obtain possession. He noted that this should be explained in the Commentary.

236. *A Working Group participant* recalled a real life example in support of the inclusion of an innocent acquisition rule to establish a smoother market for bilateral transactions. She explained that in the early days of the EU ETS, before it was as secure as it was presently, there were cases of material fraud, hacking and theft. People were going into accounts, stealing and transferring very quickly. Because of the use of electronic accounts, tens, if not hundreds, millions of pounds, dollars, or euros, worth of allowances were transferred to multiple different jurisdictions. Although the fraud was detected and the freezing of accounts went into place, what created havoc was that there was a difference from one jurisdiction to the other. The recipients in some jurisdictions received because they were innocent acquirers, and in other jurisdictions the person from whom the allowance had been stolen was instead trying to claw back. It was further explained that this was one of the reasons why an international transaction log was developed within the EU, so that there was one central registry to avoid some of these problems across different jurisdictions. However, as of yet there was no transnational international log of transactions connecting different registries.

<u>*Conclusions*</u>

237. *The Working Group agreed on the inclusion of an innocent acquisition rule.*

238. *Special provisions needed to be added to address the situation where an acquirer was somebody who held or owned the VCC through a custodian who was a registered holder. It was agreed that a separate Principle be drafted on innocent acquisition in a custody situation.*

239. *The Drafting Committee agreed to expand on the Commentary to further explain draft Principle 7(7), including its consistency with the DAPL Principles and the UNIDROIT Geneva Securities Convention.*

240. *It was proposed that the Commentary distinguish the innocent acquisition rule from the issues that could occur upstream upon creation of the credit and which would fall under Principle 6 (revocation).*

viii. Principle 8 (Retirement)

241. *The Chair* turned to Principle 8, concerning retirement of a VCC, and gave the floor to the Drafting Committee. Similarly to the discussion concerning Principle 5 and Principle 6, the main question addressed by the Working Group was whether a retired VCC ceased to be the subject of proprietary rights.

242. *Members of the Drafting Committee* introduced the two proposed drafts of Principle 8. The first draft reflected the original understanding that retirement essentially constituted the 'natural death' of the VCC, whereby the VCC ceased to be the subject of proprietary rights. The alternative draft was instead meant to address the concern expressed at the last Working Group session that certain market participants intended to continue dealing in the proprietary interest in a VCC despite the fact that the VCC had been retired, for example to claim tax benefits. The alternative Principle 8 language thus provided for the freezing of the VCC in the registry, meaning that the registry would no longer comply with any instructions of the account holder to move the VCC or retire it; in other words, the registry's duty to comply with the instructions of the account holder disappeared. However, the VCC continued to be the subject of a proprietary interest and could theoretically be the subject of transactions outside of the registry.

243. The Working Group expressed support for the first alternative. Participants noted that the first alternative was more intuitive and provided legal certainty. It was also observed that when a VCC was retired, a certificate or electronic statement was issued which could be used, for example, by the account holder as evidence in support of statements made in their annual sustainability report. It was noted that this did not seem like a proprietary right but rather something that was done after the proprietary right had been extinguished.

244. *Members of the Drafting Committee* noted that, even if the Working Group agreed on the first alternative, the language might need to be complemented with elements from the second Principle 8 draft in order to address how retirement of the VCC affected the relationship between the account holder and the registry in relation to that VCC. It was suggested that this could be done either in Principle 8 or Principle 9 (addressing the VCC registry). It was also suggested that the issuance of the certificate upon retirement of a VCC could be spelled out in the Principles or in the Commentary in order to explain how retirement actually happened. The logical sequence was explained as the following:

- First, because the draft Principles provided that a VCC could come into existence and be the object of property and the VCC was not a tangible but rather was an intellectual construct, a statement was needed in the Principles to address the fact that an owner could destroy the VCC, i.e., a statement that an owner could retire the VCC;
- Second, the Principles needed to address how a VCC could be retired. It was suggested that a VCC could be retired by instructing the registry to do whatever it was that the registry did to signal that the VCC was retired;
- Third, the Principles needed to provide that when the owner instructed the registry to retire, the registry had a duty to comply with the instruction. This was an implied contractual duty that could not be disclaimed;

- Finally, the Working Group had to consider what the effect in property of retirement was. It was suggested that the effect of retirement was that the VCC could no longer be the object of proprietary rights. This, in turn, gave rise to a number of consequences, many of which were spelled out in alternative Principle 8(3)(a)-(e).

245. It was stressed that the VCC ceasing being an object of property would not preclude the claiming of a tax benefit or stop the registry from issuing a certificate attesting what had happened. Indeed, the fact that in law the VCC had been destroyed reinforced the tax or other kinds of claims being made.

246. It was further clarified that the concern that had been raised at the prior Working Group session was not so much whether the owner of the VCC could claim any tax benefits, but rather whether the owner could assign those tax benefits to someone else such as a sister company or subsidiary. It was suggested that there were two possible reasons why it was possible to assign such benefits: (i) either the VCC remained property; or (ii) tax laws were drafted in such a way that allowed people the right to assign the benefit to someone else. In this latter case, what was being assigned was not the VCC but rather the benefit of the tax law (if available). It was also pointed out that Principle 8(1) was drafted on the understanding that the registry only operated on the instruction of the account holder, regardless of whether the account holder was the owner of the VCC.

247. The Working Group discussed the uses and claims that could be associated with the VCC once that VCC was retired and whether these could be limited by stipulating that property rights were extinguished upon the retirement of the VCC. The Working Group agreed that a proprietary right would not be required in order to make taxation or other types of claims.

248. *A participant* proposed that the words 'in a VCC registry' be deleted from the definition of retirement, in order to underline that it was circulation in general rather than circulation in a particular environment. The participant also suggested that the language 'updates its records' in draft Principle 8(2) be replaced with 'makes an entry', to avoid too broad a reference to what records were the subject of the Principle. It was also indicated that the language in draft Principle 8(3) 'its existence after' be replaced with 'its existence before' since the reference was to the existence before the making of the entry.

249. *The Verra representative* emphasised that, from Verra's perspective, all legal and beneficial title and interest in the instruments was extinguished upon retirement. She agreed with the suggestion that the effect of retirement and cancellation was the same—they both referred to the principle that the VCC was taken out of circulation. She also noted that Verra did issue a retirement certificate. Information that the VCC was retired and when it was retired was publicly available. The entity requesting the retirement of the VCC could also choose whether to disclose the reason for retirement.

250. *A participant* observed that it should be made clear in Principle 8(1) that the seller of the VCC could be the person who retired the VCC, since many corporate buyers did not have registry accounts and simply requested in the relevant agreement that the seller retire the VCC on their behalf. It was also stressed that, once retired, the market value of the VCC would be reduced to zero and no one in the market would be interested in the instrument, regardless of whether it was deemed property or not.

251. *A member of the Drafting Committee* added that it should be specified that the right to retire was one of the irreducible rights of having a proprietary right in a VCC and that what was meant by the right to retire was the right to destroy without, for example, the risk of being sued. However, it was also observed that the Principles needed to state that the registry would only retire on the instruction of an account holder, even if the account holder was acting for someone else. It was suggested that this be addressed in the Commentary, including that the owner had the right to retire,

but may be limited in how they exercised that right by getting the account holder to act on their behalf under other law. The point was also raised that the issue of authorised representatives was an ordinary issue of agency law and could be addressed in the Commentary by noting that agency was assumed; i.e., it was assumed that when someone did something, they either did it for themselves or as an authorised representative of someone who had the right to do it. This was the approach adopted in the context of the DAPL Principles.

252. The question was raised for the Working Group's consideration of what would happen if somebody had not taken free of defects in title and therefore did not have the right to retire the VCC, but nonetheless purported to exercise such right.

253. *The Verra representative* confirmed the need for certainty in terms of who could or could not instruct the registry since, in acting on those instructions, the registry would be extinguishing proprietary rights. She agreed that the registry could receive instructions from either the account holder or their authorised representative. She also confirmed that Verra had a clear statement in its terms of use that extinguishing that proprietary right did not prevent the user, on whose behalf the VCC had been retired, from making any other claims, like offsetting claims.

254. *A participant* encouraged the Group to take into account the situation where there would not be a separate independent registry operator; i.e., where the project proponent had its own registry and recorded the VCCs in a registry which the project proponent directly operated. In that case it would instruct itself in relation to the VCCs.

255. *Another participant* urged the Drafting Committee to consider the same level of specificity provided for in Principle 8 in relation to Principle 5 (Cancellation) and Principle 6 (Revocation). It was also suggested by other participants that the net effect of cancellation and retirement was the same; the VCC was consumed and no longer carried proprietary rights. The question was then raised as to whether it was necessary for the Principles to address the reasons why a VCC was cancelled.

256. It was also suggested that the Principle include a duty for the registry to notify relevant parties, which could include previous business holders and creditors or a regulatory agency such that if there were any error, corrective measures could be swiftly taken. However, *the Verra representative* observed that the registry may not hold all of the information to fully comply with such a duty; it would be a logistical problem to notify all of the relevant holders or affected entities. She also noted that the proposed language at Principle 8(3)(a) should be drafted in such a way so as not to preclude the ability of transferring the retired VCCs to a retirement account, as was current practice. In response, it was observed that there might be a need to further explore what was meant by a retirement account and include a definition in the Principles to distinguish retirement accounts from regular accounts.

257. *The Chair* observed the differing opinions but noted the consensus on the basic rule of property law; once retired, the proprietary rights in a VCC ceased to exist. For drafting purposes, he stated that the Working Group should follow the proposal to incorporate some of the language provided in the alternative Principle 8 into the original drafting. He suggested that the following two points be included in the Principles rather than in the Commentary: (i) only the account holder could give instructions to the registry; and (ii) the owner of a VCC could provide instructions on its own behalf and on behalf of another person.

<u>*Conclusions*</u>

258. *The Working Group agreed that upon a VCC's retirement the property rights in that VCC ceased to exist and this did not affect the ability to make any available claims in relation to the retired VCC.*

259. *The Drafting Committee agreed to supplement the original language in Principle 8 with elements from the alternative proposal to address how retirement of a VCC affected the relationship between the account holder and the registry in relation to that VCC.*

260. *The Principles needed to state that the registry would only retire on the instruction of an account holder, and that the account holder could be providing instructions on its own behalf or on behalf of someone else.*

261. *The Commentary would note that agency was assumed; i.e., it was assumed that when someone did something, they either did it for themselves or as an authorised representative of someone who had the right to do it.*

ix. Insolvency and Enforcement

262. *The Chair* noted that, for the instrument to be complete, it should include general provisions on insolvency law as well as on enforcement. He urged the Working Group to review the insolvency and enforcement provisions of the DAPL Principles. He clarified that enforcement referred to procedural matters and should be taken care of by other law. Whereas with respect to insolvency or insolvency-related proceedings, there were standardised provisions that could be included in the instrument for completeness.

x. Private International Law

263. *The Chair* recalled that a special private international law (PIL) expert subgroup (the "PIL Subgroup") was established in cooperation with the Hague Conference on Private International Law (HCCH). The PIL Subgroup met in July and November 2024 remotely and discussed a preliminary report prepared by the experts sitting on behalf of the Permanent Bureau (PB) of the HCCH in their personal capacities. *The Chair* noted that the next document for the PIL Subgroup's discussion would be prepared by UNIDROIT and would likely be discussed remotely. He noted that the collaboration with the HCCH continued and that he expected to report on the substance of that collaboration during the next Working Group session.

264. *The HCCH Deputy Secretary General* echoed the collaboration with UNIDROIT and noted that the HCCH was proud of that collaboration. She explained the HCCH's purpose to work for the progressive unification of the rules of private international law and noted that, at the meeting in March 2024, the HCCH's Council on General Affairs and Policy (CGAP) mandated the HCCH PB, in partnership with relevant subject matter experts and subject to available resources, to monitor developments of private international law aspects of the carbon markets, the voluntary ones in particular. The HCCH PB was also mandated to cooperate and coordinate with the secretariats of various international organisations, including UNIDROIT. In furtherance of this cooperation, it was recalled that the HCCH had been sitting as an observer to the Working Group since September 2023. In April 2024, consultations between the secretaries of the HCCH and UNIDROIT led to an invitation from the UNIDROIT Secretariat to the HCCH PB to form a joint subgroup of experts to provide input to the applicable law provision. Thus the PIL Subgroup was formed and, as *the Chair* noted, it met twice. The HCCH experts, sitting in their personal capacities pro bono for the HCCH PB, prepared the preliminary report for the consideration of the PIL Subgroup.

265. *The HCCH Deputy Secretary General* expressed her desire for the collaboration with UNIDROIT to continue. She noted that the HCCH had asked that the Working Group's substantive discussions on private international law be deferred to the next session, in order to wait for the decision of the HCCH CGAP on further cooperation and coordination with UNIDROIT. She explained that the HCCH PB had put forward a proposal to the HCCH CGAP which entailed establishing a mechanism to allow for the multilateral consultation of this topic and coordination with UNIDROIT and to have a holistic study

for the Working Group's consideration, keeping in mind the timeline for UNIDROIT's project on the Legal Nature of Verified Carbon Credits.

266. Finally, the *HCCH Deputy Secretary General* thanked the UNIDROIT Secretariat for issuing a Revised Issues Paper incorporating the comments submitted by the HCCH's PB. She concluded her remarks thanking UNIDROIT for its cooperation and coordination and expressing hope that it would continue.

267. *The UNIDROIT Secretary-General* joined the Working Group session from Cape Town remotely. He thanked the HCCH Deputy Secretary General for her intervention, as well as the Chair for providing an overview of the cooperation between the two organisations. He stated that UNIDROIT was hopeful that the HCCH's governance would endorse future collaboration and that the Working Group would be able to have further substantive discussion at the next session. He noted that such discussion was to be informed by the dialogue of appointed experts by both organisations and thanked the HCCH PB for the good cooperation.

Item 4: Organisation of future work

268. *The Chair* noted that the next session of the Working Group would be its fifth session and would take place from 2 to 4 April 2025. He encouraged participants to share any written feedback with the UNIDROIT Secretariat by mid-February 2025 so that the Drafting Committee could take any further comments into account during the intersessional period.

Item 5: Closing of the session

269. *The Deputy Secretary-General* thanked the Working Group participants and the Drafting Committee, as well as the Chair and the Secretariat representatives, on her own behalf and on behalf of the Secretary-General. She stressed the importance of the upcoming intersessional work in advancing the project and thanked everyone for their valuable contributions.

270. *The Chair* joined the Deputy Secretary-General in thanking the Drafting Committee members as well as the Secretariat and the Working Group participants for their active engagement. He recalled the importance of developing private law principles for the growth of the market as well as for the attainment of the world's sustainability goals. The session was closed.

ANNEXE I

AGENDA

1. Opening of the session and welcome
2. Adoption of the agenda and organisation of the session
3. Consideration of the draft principles and commentary, and, where applicable, matters identified in the Issues Paper
4. Organisation of future work
5. Closing of the session

ANNEXE II

LIST OF PARTICIPANTS

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