Protecting Carbon Markets From Boiler Room Activities

Overview and Recommendations for Market Participants

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The term "boiler room" is used in financial markets to refer to an organization that engages in a type of investor fraud by targeting vulnerable individuals in an attempt to sell often worthless or nonexistent investment products using high-pressure and deceptive sales tactics.

In 2010, reports of boiler rooms operating in carbon markets and selling emissions reduction credits (carbon offsets) as investments began to emerge out of the United Kingdom. By 2011, this issue had gained national media attention as well as the attention of regulators and law enforcement officials in the U.K. Reports of this activity continued to surface through 2012 and 2013, including announcements of the closing of certain firms and prosecution of their officers. There have also been reports of boiler room-type organizations, as well as new investment firms and custodians, gaining or attempting to gain access to other regional and global carbon registries, including in the United States.

In 2013, Center for Resource Solutions (CRS) began work examining what investor protections are needed in carbon markets, particularly in voluntary (over-the-counter) markets, and what practices market participants could adopt to regulate carbon investments and enhance protection against deceptive sales tactics. We reviewed the available literature and interviewed key stakeholders, experts, and regulators in carbon markets to discuss and refine our proposed recommendations. Our objectives were threefold:

1. To assess the nature, scope, and scale of boiler room activities in carbon markets
2. To describe current market oversight related to sales and investment and the current regulatory landscape affecting investment in carbon markets
3. To provide recommendations for carbon credit issuing bodies, registries, and other market regulators related to preventing and addressing deceptive or fraudulent sales and investment activity now and in the future

This research is intended to raise the visibility of sales- and investment-related risks to credit issuing bodies and market regulators. Our recommendations are aimed at increasing consumer and investor protection, with broader climate policy and market-stability benefits.

Observations and Perceptions of the Problem

Fraud and deception in selling carbon investments has involved different interactions with the market—from opening registry accounts, to buying from registry account holders or from customers of registry account holders, to selling imaginary credits or creating false registries. In fact, there are many different ways deception may occur and different risks around sales and investment to be understood and addressed in carbon markets. Sophisticated individual investors can find it difficult to resell credits even when they can demonstrate ownership. Errant or potentially fraudulent activities—including sales to individuals by non-account holders and transactions with third-parties selling outside the registry—are also not limited to boiler rooms. These observations, summarized in the table below, raise broader questions about investor expectations and disclosures and a potential lack of proper oversight for investment firms and custodians, which, to a registry, can be indistinguishable from boiler rooms.

What	Where	When	How
Boiler Rooms	U.K.	2009–2013	Deceptive sales tactics, misrepresentation, targeting of vulnerable individuals
Individual Investors	Middle East, U.K.	2012–2013	Sales to individuals as an investment, individuals attempting to sell into the secondary market
Sales by Non-Account Holders (third parties)	U.K.	2011–2013	Requests for supply from account holders by third parties with intent to resell, sales by investment firms without registry accounts
Account Applications	Voluntary Market	2011–2013	Applications for registry accounts from custodians, investment firms, and potential boiler rooms
Account Activity	Voluntary Market	2011–2013	Creation of subaccounts for individuals, holding credits on behalf of individual investors, transactions with third parties who are selling outside the registry
Subaccount Activity	Voluntary Market	2011–2013	Creation of subaccounts for third party sellers, holding credits on behalf of individual investors in subaccounts, holding credits on behalf of a third party's customers in subaccounts
False Registries and Credits	U.K.	2009–2013	Use of false registries and sales of non-existent credits by boiler rooms

The full scope and scale of these activities remains unknown. While evidence points toward a limited scale and waning frequency of incidents in the immediate term, there is also a lack of communication and coordination among organizations providing monitoring and oversight functions in the voluntary market and between carbon markets, and widespread vulnerability to new activity in the absence of coordinated action.

Risks

Primary among risks identified by stakeholders are market credibility and reputational risk for carbon offsets, as deceptive activity and a perceived lack of oversight could discourage sales and dissuade policymakers from adopting carbon offsets as instruments for use in environmental policy. Legal risks to credit issuing bodies, registries, and others were also identified—with the notable recent example of the BlueNext registry, which was held partially responsible by French authorities in 2012 for fraud perpetrated by its users. Other risks include policy responses that are too sweeping and limit liquidity, or increased external regulation of these markets that could limit operations or growth. Finally, a general lack of oversight around sales and investment activity not only leaves these markets vulnerable to boiler room activity, but also to potential market manipulation by large investment firms.

Compliance markets could also be implicated in fraudulent transactions to the extent that boiler rooms and others may misrepresent credits as eligible for early action in different compliance markets for example, particularly boiler rooms with access to voluntary offset project registries that have been approved for use in compliance markets. Compliance carbon markets are perceived to be less at risk of these activities because most have a centralized agency with broad regulatory oversight authority as well as fairly stringent registry account and trading limitations. However, the risks (as well as our recommendations) are equally relevant to regulated and voluntary markets, especially since they are interconnected in many ways.

Explanations

There are several possible explanations for why boiler-room activities have proliferated in carbon markets in recent years. One is that in new markets where there is both complexity and a general lack of public information or transparency, there is opportunity for fraud and deception. Carbon markets are especially vulnerable because the commodity is intangible and there are many emerging markets.

Another explanation is that boiler room activity in carbon markets is as much the result of lax oversight of sales and investment, particularly in the fragmented voluntary market, as it is the result of opportunistic criminal behavior. These gaps in oversight may better explain troubling account activity observed. Some stakeholders question whether carbon credits are an investable commodity at all, particularly in the voluntary market, but most agreed that investment activity is desirable because it increases liquidity, allows for risk mitigation, and allows for longer-term investments that help make projects happen. But where there is no real liquid market for individual investors, no ability for individuals to make any real assessment of value, and no oversight of investment by individuals, there is potential for boiler rooms to operate, and so restrictions on the participation of individual investors and strengthening the oversight of custodians and other sellers to individual investors should be a focus of corrective action, along with general measures to increase transparency, monitor sales tactics, and strengthen oversight of trading.

Existing Market Oversight and Regulatory Landscape

There are no consistent rules for investment in carbon markets. Regulations and laws affecting carbon markets differ between jurisdictions, and in many, trading activity is unregulated. Stakeholders in carbon markets (particularly the voluntary market) largely overstate the authority, capacity, and willingness to engage of federal financial and commodity market regulators with respect to carbon investments—and in general carbon offsets and offset markets are not well understood by these regulators.

External Oversight in the U.S., U.K, and Australia

In the U.S., carbon offsets are a cash commodity, and these transactions are addressed in the Dodd-Frank amendments to the Commodity Exchange Act. The U.S. Commodity Futures Trading Commission (CFTC) has expanded enforcement powers with respect to cash commodity transactions under Dodd-Frank, making it unlawful to intentionally defraud or mislead in order to affect the price of any commodity. But while the CFTC has broad investigative authority with respect to carbon offsets, importantly it does not have regulatory authority over cash commodities. The CFTC cannot prescribe requirements such as business conduct; trade execution; financial, recordkeeping, or reporting requirements; or other protective measures with respect to spot market transactions of carbon credits. Carbon derivative markets are a different story. Comprehensive oversight of carbon derivative products by the CFTC, whether traded on an exchange or over the counter, was largely achieved as of July 2011 when the provisions of Dodd-Frank became effective.

A 2012 determination on the definition of swaps and security-based swaps under Dodd-Frank by the CFTC also clarified that:

1. Environmental commodities are intangible and nonfinancial commodities
2. Transactions in environmental commodities can be forward contracts
3. Forward contracts in environmental commodities are not swaps or security-based swaps
4. Swaps based on carbon offsets and other environmental commodities (including options to purchase carbon offsets) are subject to regulation under Dodd-Frank

Though the status of carbon offsets with respect to the CFTC's authority in the U.S. seems relatively clear, what is less clear is under what circumstances carbon investments and transactions therein can be considered securities, and as such would be subject to federal securities laws and oversight by the Securities and Exchange Commission (SEC). This is one of the most important unanswered questions with respect to any new actions proposed by carbon markets to prevent and address deception and fraud around carbon investments in the U.S. If certain transactions or arrangements involving carbon offsets were determined to be securities, they would be subject to anti-fraud and anti-manipulation provisions and extensive regulatory requirements.

In the U.K., regulated investment activities are set out in the Financial Services and Markets Act (Regulated Activities) Order 2001. Carbon credits are not a regulated product or activity. They are not explicitly recognized as a cash commodity or a nonfinancial commodity, there has been no legislative change that has been made to capture fraud for unregulated commodities, and there has been no broad regulatory authority that has been granted to the Financial Conduct Authority (FCA). As in the U.S., in the U.K., commodity derivatives fall largely within the scope of the Financial Services and Markets Act regardless of the underlying commodity market to which they relate.

There are circumstances, however, in which carbon credits may be sold or traded in such a way in the U.K. as to fall into other regulated activities, in which case the FCA can act. These include futures contracts (selling pre-issue carbon emissions reductions) and collective investment schemes (in which investor money is pooled together to share profit). Other U.K. agencies also have broader authority than the FCA, perhaps the most important of which is the Insolvency Service, which has general powers to investigate and shut down businesses that are not operating in the public interest.

In Australia, the situation is more complicated and changing rapidly. Before the Carbon Tax Repeal Bill, certain types of "emissions units" were recognized and regulated as financial products under the Corporations Act. A license was required for financial services in relation to these regulated emissions units and a host of other requirements was enforced by the Australian Securities and Investment Commission (ASIC). Regulated emissions units included Carbon Units, Australian Carbon Credit Units (ACCUs), and Eligible International Emissions Units (EIEUs). Now that the Australian Carbon Tax Repeal has passed, Carbon Units along with European Union Allowances (EUAs) and Australian-Issued International Units (AIIUs) (which are both considered types of EIEUs) will cease to be financial products as of February 9, 2015.

Carbon credits not recognized in the Clean Energy Legislative Package are not considered financial products and are not regulated in Australia, including voluntary carbon credits. However, provisions of the Australian Consumer Law on misleading and deceptive conduct may nevertheless apply to activities related to voluntary carbon credits and other non-regulated emissions and environmental units, providing ASIC with broad investigative authority. Two other arrangements relating to carbon credits are also regulated in Australia: derivatives and managed investment schemes. As in the U.S. and U.K., all derivatives in Australia are regulated as financial products, including those created over non-regulated emissions or environmental units. Similar to collective investment schemes in the U.K., all managed investment schemes are regulated and must be registered with ASIC.

Jurisdiction	Agency	Oversight Role	What is a Carbon Offset?	Regulated Carbon Instruments/ Transactions
U.S.	CFTC	Derivative markets, limited oversight of cash commodity transactions	A cash commodity	Carbon Derivatives, Transactions involving reckless and intentional deception
U.S.	SEC	Securities markets	Unspecified	Unknown
U.K.	FCA	Financial markets	An unregulated product/activity	Carbon Derivatives, Collective Investment Schemes
U.K.	Insolvency Service	Corporate misconduct	Unspecified	Transactions made in Violation of the Companies Act
Australia	ASIC	Company and financial services	An Emission Unit; if referenced in the Clean Energy Legislative Package, then a financial product	Carbon Units (through Feb. 9, 2015), ACCUs, EIEUs (some types only through Feb. 9, 2015), Managed Investment Schemes, Carbon Derivatives

This leaves the majority of carbon offset transactions, including spot transactions and secondary market trading, unregulated and outside the routine oversight of a federal market regulators in these three jurisdictions. General prohibitions of fraud and market manipulation, where they exist, may be used to intervene on a case-by-case basis where there is verifiable evidence of intentional misconduct.

Internal Oversight in California and the Voluntary Market

The California market provides a recent example of oversight of a regulated market. The California cap-and-trade regulation applies a comprehensive regulatory regime to both allowances and compliance carbon offsets and provides for routine monitoring of all trading in these instruments by the California Air Resources Board (CARB). The market uses a single, centralized registry—Compliance Instrument Tracking System Service (CITSS)—for all transactions of compliance instruments, access to which is strictly vetted by CARB. CITSS and CARB-approved offset project registries in California remain separate systems: the approved registries have their own platform, on which they can issue only an intermediary tracking instrument, not compliance instruments themselves.

The California cap-and-trade regulation prohibits trading involving any manipulative or deceptive device, attempt to corner the market, fraud or attempt to defraud any other entity, misleading or inaccurate reports, or attempts to falsify or conceal a material fact. Though there are no holding limits for offsets, as there are for allowances, entities may only hold a compliance instrument for the purpose of later transfer to members of a direct corporate association. By regulation, compliance offset credits may only be used to meet a compliance obligation or by a Voluntarily Associated Entity for voluntary retirement, which must register with the accounts administrator prior to acquiring compliance instruments that it intends to hold.

In the voluntary market for carbon offsets, the various, competing standards and registries set the requirements for participation and trading of credits in their respective systems. Though requirements may differ from registry to registry, most employ internal know-your-customer procedures for entities opening and holding registry accounts and most require that custodians and similar firms be registered with a local financial services authority equivalent (CFTC, FCA, ASIC, etc.), which effectively requires them to be registered for trading in products other than carbon. Most have also issued some public statement about buying carbon credits for investment purposes. Certain programs have taken other steps, including discontinuing or setting new requirements for certain account types (e.g. for individuals and omnibus accounts), instituting limited holding requirements, and introducing new account monitoring procedures. However, the complete internal practices of registries in the voluntary market with respect to trading restrictions, monitoring of trading, and qualifications and requirements for account holders are rarely publicly available.

Other voluntary market participants have taken measures to protect themselves, including retailers, brokers and wholesale traders that have added new language to contracts and service agreements, particularly for their European business. Industry associations have issued public statements regarding recent boiler room activity and sales of carbon credits as investments. Retail-level certification options, including CRS's own Green-e Climate program, exist in the voluntary market as well. Though these verify sales and monitor disclosure and marketing language being used by sellers in the market, they do not include requirements for sellers and sales of investment products or provide oversight of custodians and others selling carbon credits as investments.

While regulated markets appear to be well positioned to address any fraud and deception around sales and investment activity, the sufficiency of oversight for the voluntary market is less clear. Efforts to strengthen registry know-your-customer procedures and account restrictions and increase public awareness may have been at least partially responsible for the observed drop off in boiler room activity in 2013 and 2014. However, these efforts may not provide sufficient oversight over sales outside the registries, use of subaccounts, and other trading.

Solutions

Based on these findings, we recommend eight general objectives for carbon markets related to prevention of and defense against deceptive sales and investment, and 21 new potential oversight measures and tools, which may be expected to help with prevention of deception, identification and detection, and enforcement.

General Objectives

The first four objectives are market conditions that are generally considered to be those that create confidence in a market's operations and which, taken together, describe a "mature" market.

1. Price Discovery
2. Transparency
3. Participation and Liquidity
4. Security

The remaining four objectives relate to these and are more specific to prevention of and defense against deceptive sales and investment in carbon markets.

5. Centralization, Standardization, Convergence, and Cooperation
   Centralization and standardization with respect to registry account and carbon trading rules may minimize opportunity for bad actors to seek out the jurisdiction with the minimum regulatory requirements. It would also minimize complexity, enable information sharing, and to a certain extent enable price convergence.

6. Empowerment of Regulatory Institutions
   This may include strengthening existing standards and registries and also potentially building new infrastructure and mechanisms to carry out specific regulatory responsibilities.

7. Engagement, Awareness, and Utilization of Expertise Outside Carbon Markets
   Carbon markets may benefit from expertise gained in other markets, as well as resources that may be available outside the market to address criminal and deceptive conduct.

8. An Educated Buying Public, Education, and Awareness
   Centralizing and increasing the visibility and usability of public sources of information may reduce complexity, increase transparency and help thwart the ability of boiler rooms and others to use deceptive tactics to defraud investors.

New Oversight Measures

The first 15 measures below are aimed at prevention of deception and fraud around sales and investment, and include measures that create additional public information resources and institute new price transparency mechanisms, new trading limitations, and new restrictions and qualifications for participation. It is important to note that these measures are not necessarily intended to be implemented together; each may be considered individually, but also in the context of a subset of other measures.

New Public Information Resources

1. Create a centralized public information resource with information on the voluntary market, regulated markets, and credit types eligible in those markets.

Price Transparency Mechanisms

2. Institute public price reporting requirements and reporting of volume information for sellers with registry accounts.

New Trading Requirements and Limitations

3. Institute and standardize account and trading privileges for different account holder classifications among registries.
4. Institute and standardize rules for wholesale transactions to control for boiler rooms that would do business with a wholesale arm.

5. Institute and standardize limitations on the types of structured investment products that may be traded and where trading may take place.
6. Institute and standardize limitations on transactions with "unqualified" investors.
7. Institute and standardize limitations on and practices for monitoring of participant positions (with appropriate exemptions for certain account holders or transactions) to prevent potential manipulative circumstances and reduce incidence of other market disruptions.
8. Institute and standardize changes to banking rules (overall or for certain market participants) to effectively shorten the lifespan of the instrument to address concerns related to manipulation and speculative holding.
9. Require or incentivize the use of standardized contract language for certain transactions to achieve limitations on investment products and transactions.
10. Institute and standardize clearing requirements (perhaps for certain categories of transactions or with exemptions for certain transactions), to create a reliable guarantee system with a central counterparty for payments and spot delivery.

New Requirements and Qualifications for Participation

11. Standardize registry know-your-customer screening in the voluntary market.
12. Institute ethical standards and standardize eligibility qualifications (requirements for certain internal policies and business) for certain participants.
13. Institute education or training requirements for certain participants, according to which participants and even advisors must undergo training and/or licensing.
14. Institute and standardize capital requirements for certain participant types.
15. Institute and standardize new registration or special designations for certain types of participants to clarify rules, differentiate trading activity, and help implement trading limitations and eligibility qualifications.

The following three measures pertain to the identification and detection of deception, rather than prevention or enforcement, though they may also act as deterrents where implemented.

16. Institute reporting and recordkeeping requirements for sellers with registry accounts perhaps in addition to price and volume reporting (measure #2), either for reporting to registries and regulators only or publicly.
17. Strengthen and standardize transaction monitoring and communications with account holders such that there is continual monitoring and communications between registries and account holders.
18. Increase inter-registry communication in the voluntary market, involving perhaps regular meetings of registry representatives, standards, industry groups, and market experts for strategic analysis of the market and to identify the risk of criminal exploitation.

The final three measures pertain to enforcement against deception and fraud around sales and investment, including enforcement and verification of certain measures above.

19. Institute verification and auditing activities for transactions or entity qualifications to enforce any new trading rules and restrictions and eligibility requirements above, which could be carried out by

market regulators, standards or registries, or a third-party certification, perhaps involving the creation of a private standard for investment products.

20. Introduce an arbitration forum to provide support for organizations that deceive or violate requirements unwittingly.
21. Adopt stiff and standardized penalties for boiler room activities, fraud, deceptions, etc. across registries.

Many of these potential solutions face significant barriers, due in part to the lack of centralization and standardization in the voluntary market and the variety of perspectives and interests at play. These must be overcome if the risks of deception are to be properly mitigated, particularly as carbon markets continue to grow and proliferate. •