Climate Finance, Spring 2024
Caroline Bradley[1]
Documentation for Climate Finance and Climate Bonds: Materials for Class on Tuesday April 16

In this class session I want to focus on some issues relating to documentation for climate finance. I am assigning an article that shows how the documentation for green bonds does not contain the normal provisions we would expect to see in bond documentation with respect to binding obligations. For lawyers, this raises some questions, as the authors discuss.[2]

In addition to green bonds and loans and sustainability linked bonds and loans, market participants have developed derivatives as part of the climate finance landscape. In the introductory document I provided on data issues I cited the CFTC's recent request for comments about proposed guidance with respect to voluntary carbon credit derivative contracts.[3] Carbon credits represent a reduction in carbon emissions, and carbon credit derivative contracts are often futures whereby market participants agree to buy or sell the carbon credits at a specific future date for a specific price.[4]

Establishing a standardized global carbon price is seen as a goal to incorporate the cost of carbon emissions into business decision-making, but so far this goal has not yet been reached.[5] ISDA, an international trade association for the derivatives markets, has been arguing that derivatives can play an important role in facilitating the transition to net zero.[6] We have already learned about some of the concerns relating to the quality of voluntary carbon credits, for

2 Quinn Curtis, Mark C.Weidemaier, & Mitu Gulati, *Green Bonds, Empty Promises*, 102 N. CAROLINA L. REV. 131 (2023).

3 CFTC, Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts; Request for Comment, 88 Fed Reg 89410 (Dec. 27, 2023). As well as voluntary carbon credits, whch involve privately governed certification schemes, there are also compliance carbon markets which are created through official policy or regulation. *See*, *e.g.*, https://climatepromise.undp.org/news-and-stories/what-are-carbon-markets-and-why-are-they-important.

4 There are also indices which track tradable carbon credit futures markets, and products based on indices, such as the S&P Global Carbon Credit Index, and ICE Global Carbon Index Futures.

5 *See*, *e.g.*, Ross Kerber, Simon Jessop & Peter Henderson, *No Global Carbon Price? Some Companies Set Their Own*, Reuters (Dec. 11, 2023).

6 *See*, *e.g.*, ISDA Future Leaders in Derivatives, Energy Security and the Road to Net Zero: the Role of the Derivatives Market (May 2023), at 7 ("The voluntary carbon credit market has the potential to generate significant private investment in green projects in the medium term, and the derivatives market can facilitate the scaling of that market.")

example, do they represent reductions in emissions that would not otherwise have occurred (additionality), and ISDA argues that standardization is important in the development of these markets, both in terms of the quality of voluntary carbon credits and also in terms of legal standardization. Here is the description of the legal standardization issues:

> "Another obstacle to scaling the VCC market is the lack of legal certainty around the creation, transfer and taking security over VCCs, particularly for insolvency and netting analysis purposes. Establishing a cross-jurisdictional consensus on the legal treatment of VCCs would provide market participants with greater certainty around the legal risks relating to trading of these products, which in turn would encourage the standardization of trading terms and deepen liquidity in the voluntary carbon markets.
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> Trade organizations have taken important steps to facilitate trading in the voluntary carbon markets. For example, ISDA recently published the 2022 ISDA Verified Carbon Credit Transaction Definitions, which provide a standardized set of terms for derivatives transactions in verified VCCs and are compatible with governing laws in multiple jurisdictions. While this is a step in the right direction for legal standardization, reaching a cross-jurisdictional consensus on outstanding legal issues will take time. To encourage and potentially expedite this process, policymakers and market participants should lobby for the creation of a globally accessible 'metaregistry' for the recording of holdings and transfers in VCCs.
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> As the use of VCCs is not governed or required by any strict regulatory or legal mandate, there has been significant divergence across platforms and registries. A meta-registry should impose a topdown set of rules on individual registries, requiring adherence to a minimum set of VCC quality criteria and transfer terms.
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> To reduce the legal uncertainty surrounding VCCs, a meta-registry should be:
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> (i) accompanied by a statement on the legal nature of VCCs by global legal standard setters, such as the United Nations Commission on International Trade Law or the International Institute for the Unification of Private Law; and
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> (ii) established in a jurisdiction where there is currently greater certainty as to the legal classification of VCCs.
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> A meta-registry would also need to be supplemented by a single verification and validation arm imposing minimum quality criteria for VCCs...
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> The success of a meta-registry will depend upon consistent and comparable rules and processes across member registries. The Common Domain Model (CDM) has been used to enhance interoperability between historically incompatible IT systems in the derivatives market. Technological innovations such as the CDM could facilitate the development of a meta-registry by providing a standard operational framework for financial products (including derivatives) referencing VCCs, or otherwise serve as a model for resolving the lack of legal standardization in the voluntary carbon markets."[7]

[7] *Id.* at 9-10.

Legal standardization in this context involves a number of different aspects, including the development of institutions (a meta-registry), the support of bodies with credibility in transnational law (the United Nations Commission on International Trade Law or the International Institute for the Unification of Private Law), basing activities in a jurisdiction or jurisdictions with legal certainty as to the classification of voluntary carbon credits.

ISDA's earlier work on derivatives includes the development of a Model Netting Act, and efforts to persuade jurisdictions around the world to enact legislation based on the model.[8] Swap transactions, a type of derivative contract, involve the exchange of obligations between two parties. For example, in an interest rate swap, one party (A) agrees to pay a specified fixed rate of interest on a notional principal amount to another party (B). In exchange, B agrees to pay a floating rate of interest on the same notional principal amount to A. If A goes into bankruptcy, there is a risk that a bankruptcy trustee might be able to engage in cherry picking, disclaiming A's obligations to B while enforcing B's obligations to A. A statute based on ISDA's Model Netting Act provides for the validity of close-out netting as a contractual process in which obligations under the agreement are terminated, the obligations of the parties are valued at their then current mark-to-market value, and, if the net amount owed after comparing the two values is owed to the non-defaulting party, that party receives the money owed.[9] In addition, ISDA has developed a Master Agreement, which is a standard form agreement for swap transactions, designed to create more legal certainty in the swaps market and facilitate the development of the market.[10]

Regulatory scholars have focused on the idea that ISDA's work is not merely a private regulatory regime, but also has public aspects, emphasizing the enormous impact ISDA has had

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[8] *See*, *e.g.*, https://www.isda.org/2020/07/03/status-of-netting-legislation/ ; ISDA, Re: Amendments to Regulation EE Definition of "Financial Institution," (Jul. 1, 2019) ("ISDA has over 30 years of experience working with policy-makers and regulators across the globe on close-out netting legislation to ensure netting certainty. To date, we have published netting opinions for more than 70 countries to address the enforceability of the termination, bilateral close-out netting and multi-branch netting provisions in derivatives master agreements, including the 1992 and 2002 ISDA Master Agreements, which govern a majority of the world's OTC derivatives transactions. ISDA has developed and published model netting legislation and legislative guidance, including most recently the 2018 ISDA Model Netting Act and Guide.")

[9] 2018 ISDA Model Netting Act and Guide at 1. If the net amount is owed to the defaulting party this would usually be paid. *Id.*

[10] *See*, *e.g.*, John Biggins & Colin Scott, *Public-Private Relations in a Transnational Private Regulatory Regime: ISDA, the State and OTC Derivatives Market Reform*, 13 European Business Organization Law Review 309-346, 323 (2012) ("it would be fair to suggest that ISDA itself pioneered a project of contractual standardisation which arguably facilitated enhanced legal certainty for OTC derivatives transactions. This, in turn, may have mitigated risks. Of course, it may also have performed a crucial signalling or symbolic function, as important, if not more so than what the ISDA Master Agreement actually did in practice. In other words, it could be argued that the ISDA Master Agreement project was highly successful in assuring public actors that the OTC derivatives industry was in fact capable of largely self-regulating."); M. Konrad Borowicz, *Contracts as Regulation: The ISDA Master Agreement*, 16 Capital Markets Law Journal 72 (2021).

on the development of policy,[11] and arguing that ISDA's interests may diverge from those of other stakeholders.[12]

This concern may be particularly salient in the context of ISDA's work relating to climate change. ISDA is engaging in actions with respect to climate-related derivatives,[13] that resemble its earlier work on swaps, trying to encourage the development of these transactions and markets. And ISDA has developed a clause library for sustainability-linked derivatives.[14] Sustainability-linked derivatives are often swap transactions in which the payment obligations are adjusted by reference to whether the parties have met Key Performance Indicators (KPIs) (ESG targets) specified by the parties.[15] To the extent that these transactions encourage businesses to meet Key Performance Indicators that will actually contribute to the transition to a net zero carbon environment that produces real climate change mitigation, this is all good. But a skeptic would argue that ISDA's real interests are in the development of markets in which its members can make profits, rather than in climate change mitigation as an overarching goal.

In contrast to ISDA's work on documentation, the Chancery Lane Project (TCLP) is a network of lawyers who have written clauses to help decarbonize contracts, and who share their clauses through their website.[16] A small organization, incubated by CIVA, the Centre For Innovation In Voluntary Action,[17] with the equivalent of 12 full-time staff manages a community

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[11] *See*, *e.g.*, Biggins & Scott at 322 ("ISDA has been extremely successful in penetrating public legislative processes, and public actors have, in turn, been largely receptive to ISDA's advances. These public-private interactions raise both practical and normative questions in relation to public regulatory reforms and the prerogatives of the nation state in a globalising world economy.")

[12] *See*, *e.g.*, Biggins & Scott at 336.

[13] *See*, *e.g.*, Hogan Lovells, *Sustainability-linked Derivatives: Some Practical Considerations*, (Nov. 12, 2021) ("SLDs create an ESG-linked cashflow in the context of a conventional derivative, such as an interest rate swap or cross currency swap or forward. They do this by using Key Performance Indicators (KPIs) to monitor compliance with certain ESG targets.").

[14] *See*, *e.g.*, Hogan Lovells, *Take-off for Sustainability-linked Derivatives with the New ISDA SLD Clause Library?*, (Feb. 6, 2024) ("ISDA has published the ISDA SLD Clause Library, which is a framework of standardised definitions and provisions that provide market participants with clauses with which to document their SLD transactions. There are standard form drafting options, including in relation to disruption and review events, adjusting the payment mechanics and assessing whether relevant ESG targets or SPTs have been met. In addition, it is possible to incorporate targets defined in related sustainability-linked cash instruments in order to minimise any basis risk between the SLD and related cash instrument.")

[15] ISDA, *The Way Forward For Sustainability-linked Derivatives* (Nov. 21, 2022) at 3.

[16] *See* https://chancerylaneproject.org.

[17] *See* http://civa.org.uk/.

of thousands of lawyers in 37 active working groups around the world,[18] which allows for the clauses to be adapted to different jurisdictions.[19] Use of TCLP clauses can lead to adoption by other firms:

> A single use of a climate clause in the procurement context can have a viral effect. It mandates that suppliers within the industry think about their own sustainability, and act accordingly. A single tenderer using our clauses can influence dozens of potential suppliers. This starts a conversation, and leads to industry change.[20]

And the clauses are evolving:

> Previously climate clauses might have required some form of net zero target set by the parties for their business. Nowadays, we are seeing clauses that supplement this with reporting obligations, incentive regimes and breach mechanisms. Having these in place not only increases the likelihood of compliance, but also encourages the parties to work collaboratively to achieve decarbonisation.[21]

In contrast to the findings in the article we are reading on green bonds, TCLP found that among respondents to their survey who use their clauses 48% were actively monitoring compliance and 75% had some sort of breach mechanism in place, whereas 31% had both.[22] One of the TCLP clauses, Noah's Clause,[23] allows for borrowers in syndicated lending agreements to provide that the lenders must meet conditions to be considered an environmental lender in order to be able to participate, including confirming that they meet the conditions. The "Environmental Lender Requirement means: (a) [at least [10] percent of all of the Lending Activity in the Lender's most recently ended financial year constituted Sustainable Finance; and (b) the Lender has achieved the Agreed Environmental Step Target for that financial year]."[24] There is a notes and guidance document which addresses how the clause promotes a net zero future:

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[18] The Chancery Lane Project, Impact Report (Oct. 2023) at 10.

[19] *Id.* at 11.

[20] *Id.* at 12.

[21] *Id.* at 13.

[22] *Id.*

[23] https://chancerylaneproject.org/climate-clauses/green-or-sustainability-linked-lending-requirement/. The clause is designed to be included in loans following the Loan Market Association's form documents.

[24] A drafting note states: "Select an option depending on agreed Environmental Lender Requirement. Consider whether to include an additional requirement for new lenders buying into the debt to provide confirmation that they meet the Environmental Lender Requirement."

"Forces net zero goals to be met on a macro scale
Noah's Clause places some of the burden of achieving net zero onto Lenders rather than only on Borrowers. Changing the lending behaviour of banking institutions by one percentage point will likely have a greater impact than any corporate borrower taking out an ESG-linked or green loan facility.

Knock on-effect for further climate change action
Fewer Lenders are likely to be able to offer this kind of loan owing to the obligations imposed by this clause. It is likely that Borrowers using this clause will be investment grade corporates with sufficient bargaining power to request that the Lender meets the Environmental Lender Requirement. Adding this requirement to a loan will encourage further green and sustainability-linked lending and will be an important step towards addressing environmentally inconsistent lending.

Calculation as a percentage means a reduction in climate-negative loans
As the Environmental Lender Requirement is a percentage rather than a monetary amount this should ensure that an increase in green lending doesn't lead to an increase in non-green lending elsewhere." [25]

A law firm in Portugal, PLMJ, adapted the clause to use in commercial paper programs.[26] Other examples of TCLP clauses relating to finance are Lara's clause, which provides for an ESG-linked pricing adjustment for derivatives transactions,[27] and Evie's clause, which adjusts interest payments based on a borrower's performance with respect to key performance indicators for water sustainability.[28]

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25 https://docs.google.com/document/d/1Zc9ZFwFvUQQm25V_3c9ulbiqO1jn_PNbQI3LMcUR3Nk/edit?pli=1

26 https://chancerylaneproject.org/case-studies/plmj/.

27 https://chancerylaneproject.org/climate-clauses/esg-linked-pricing-adjustment-for-derivatives-transactions/.

28 https://chancerylaneproject.org/climate-clauses/debt-finance-clauses-and-lma-facility-amendments-promoting-sustainable-water-usage/.