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Article 6.4 Supervisory Body
United Nations Framework
Convention on Climate Change

FAO: Chair of Article 6.4 Supervisory Body

By email: A6.4mechanism-info@unfccc.int

25 April 2024

Re: **A6.4-SB011-AA-A11 – Draft Procedure relating to the Article 6.4 Mechanism Registry**

Dear Chair and Members of the Article 6.4 Supervisory Body,

1. **Introduction – debt financers and 'forward' buyers must be able to take, and enforce, security interests**

   To enable the Article 6.4 Mechanism to successfully facilitate the financing of carbon reduction and removal projects, and to scale carbon markets at the pace required to achieve the Paris Agreement goal of limiting global warming to well below 2 degrees Celsius above pre-industrial levels, it is critically important that (i) lenders that finance carbon projects registered under the Article 6.4 Mechanism, and (ii) 'forward' buyers of the reductions and removals resulting from such projects, each be able to take security over such reductions and removals (including but not limited to the carbon credits ultimately issued in relation to such projects), *in a manner that is legally valid, binding and enforceable*.

   At the moment, the terms of the voluntary carbon market's ("**VCM**") leading standards contractually prohibit the granting of security over such reductions and removals, which in our experience is fundamentally undermining the ability of project developers in the VCM to raise debt finance and/or secure project financing through 'forward' purchase arrangements.

We, the partners of the law firms named at the bottom of this letter[1], each have market-leading legal practices in the area of carbon markets and/or carbon dioxide removal ("**CDR**"). We send you this letter:

- to emphasise the critical importance to debt financiers and to 'forward' buyers of carbon credits of being able to take valid, binding and enforceable security over the carbon reductions and removals generated through the project(s) that they finance; and
- to urge the Article 6.4 Supervisory Body to ensure that the Article 6.4 Mechanism Registry, and the wider arrangements relating to Article 6.4 Mechanism, are designed in a way that supports the valid, binding and enforceable grant of security interests in relation to carbon projects developed pursuant to Article 6.4.

Collectively, our firms have decades of experience in infrastructure finance (including renewable energy projects), structured finance and derivatives, both within and outside of the carbon market/carbon dioxide removal context.

2. Background: common practice in renewable energy project finance transactions and in structured finance transactions across all parts of wholesale financial markets, relating to the grant and enforcement of security interests

To mitigate the financiers' potential losses upon the default of a borrower, it is common and long-established practice in both domestic and international project finance transactions *outside of carbon markets,* and in structured finance transactions of all types and purposes, for financiers to take security over assets (typically, *all* assets) of the borrower. Depending on the nature of the project or structured finance transaction, such assets may range from real estate, equipment, bank accounts and/or securities to upstream/downstream contractual rights to offtake agreements, supply/distribution contracts, the benefits of insurance contracts, cash receivables and the borrower's rights against the counterparties to the various contracts into which the borrower enters in connection with such project or structured finance transaction.

Security is typically granted in favour of the finance provider by the entity (usually, the borrower, which may be a special purpose company established specifically for such project or transaction) that has legal and/or beneficial title to such underlying assets.

The form of such security interests depends on the nature of the assets used as collateral, the jurisdiction in which the secured assets are located and the law(s) pursuant to which such security interests are granted. For example, real estate, aircraft and vessels can be mortgaged or charged; rights to receivables, insurance proceeds and other contractual rights can be assigned (by way of security, rather than absolutely) and bank accounts can be charged, pledged or be hypothecated.

It is also a common requirement under applicable law, or otherwise good practice to ensure enforceability, that such security interests must be perfected.

[1] In the case of Philip Lee LLP (including its consultant, Emral Carbon).

Such perfection requirements can include, but may not be limited to, the need (i) to notify any persons whose collaboration and/or permission may be required in the event of enforcement of such security interest and (ii) to receive written acknowledgement of such notification. This is particularly necessary to establish the prior ranking of such security interests and to ensure that such security interests are enforceable in the event of a default by, or insolvency of, the borrower.

Such perfection/acknowledgement is often specified as a condition precedent to completion of the applicable financing transaction.

By way of example, a borrower wishing to grant a security interest over a bank account in favour of a project finance provider under English or Irish law in relation to the financing of an infrastructure project would typically grant security by entering into a deed, pursuant to which the borrower (typically the special purpose company that owns the applicable project and/or other related rights thereto) grants in favour of the financier(s) of the applicable project (a) a fixed or floating charge over the bank account into which the proceeds of the investment are deposited on completion of the debt financing transaction and (b) an assignment by way of security of the borrower's rights against the bank at which such account is held. Indeed, the borrower would typically go much further – by granting security over *all* of its assets and rights (an "all assets charge"). On the occurrence of a termination event or event of default under the applicable loan agreement, the financier (or a security trustee on its behalf) may enforce such security interests, including by taking ownership and control of all assets subject to such security interest.

In many jurisdictions, in order for such security interests to be valid, binding and enforceable, the creation of such security interests may be required to be notified to certain persons, for example the bank at which the borrower maintains the bank account in relation to which it has granted security (the "Account Bank").

Typically, the document through which the borrower grants the security interest(s) in favour of the financier is only entered into between the borrower and the financier (or a security trustee on behalf of the financier).

In structured finance transactions, the borrower will typically just notify the Account Bank of the creation of such security interest in order to perfect such security interest. In renewable energy project finance transactions, it is common to go a step further - the Account Bank, the financier of the project and the project owner/developer typically enter into a short-form, *tripartite*, arrangement (an "Account Control Deed") pursuant to which the Account Bank:

- acknowledges the existence of a security interest that was created under a separate document; and

- confirms, for the benefit of the financier, that on notice to the Account Bank from the financier that an event of default has occurred in relation to the project owner/developer in relation to the underlying project/transaction

documentation, the Account Bank (i) does not need to investigate or enquire about the merits of the event of default, (ii) will prohibit the withdrawal of cash from the secured bank account without consent of the financier, (iii) will treat the financier as the legal and beneficial owner of the bank account (and the monies standing to the credit of that account), and/or (iv) will transfer the monies standing to the credit of the secured account to, or to the order of, the financier.

In other words, the Account Control Deed helps to reassure the financier that there is a practical way to enforce its security interest under the document(s) that granted the security interest(s) upon the occurrence of an event of default that is not cured.

The assumption of this "facilitator" role by Account Banks and other intermediaries is one of several reasons why debt finance of renewable energy projects, and structured finance transactions more broadly, have proliferated across the world over the last several decades to finance trillions of U.S. dollars of investment in infrastructure, projects and businesses.

3. **Further Background: common practice in project finance transactions *within* carbon markets, relating to the grant and enforcement of security interests**

As is the case with project finance and structured finance *outside* of carbon markets, one of the most important considerations for financiers of *carbon* projects (whether as lenders or as 'forward' buyers in the over-the-counter carbon market) is how, where and over which assets to take security.

The key assets that are typically financed in relation to a carbon project are the carbon credits and/or other instruments (e.g. Pre-CORCs issued by puro.earth, that is subsequently exchanged for a carbon credit upon issuance) generated by the development of such carbon project. Entities providing finance for carbon projects are not looking to reinvent the wheel for carbon markets – they want to mitigate their risk through strategies that have been developed and proven over decades in other analogous contexts, e.g. project finance of renewables projects and structured finance transactions in wholesale financial markets. Accordingly, such financiers increasingly want to take security over:

- the carbon reductions and removals generated by the projects that they finance (including but not limited to the carbon credits representing such reductions or removals, as recorded in the applicable registry);
- accounts maintained by or on behalf of the borrowers (whether directly or via a custodian) with the registrar that acts for the applicable standard that has issued the carbon credits (and/or other instruments) that result from such projects; and
- the rights of the borrower against various relevant parties, including but not limited to the applicable standard, registrar and (if any) custodian standing to the credit of such accounts.

There is significant complexity around this, much of which is attributable to the lack of consensus regarding the legal nature of a carbon credit in various

jurisdictions and/or means by which legal and/or beneficial ownership of such carbon credit is established as a matter of law in such jurisdictions.

This is important because it informs the type(s) of security interest(s) that should be granted by a borrower in relation to carbon projects (whether pursuant to Article 6.4 or otherwise) and which law(s) govern the granting of the security interests that are the subject of that instrument. Our respective law firms regularly advise financier clients on this topic.

Where we can establish that a security interest over a carbon registry account and/or the carbon credits in that account is capable of being granted at law, the questions that typically follow from our clients include:

- does the entity named in the register legally and/or beneficially own the credits recorded against its name?
- how can the security interests relating to such carbon credits be successfully enforced in practice?

One major omission from the rules and procedures that govern the operation of the registries in the voluntary carbon market (including the registry operated by Verra, the voluntary carbon market's leading standard by volume of issued carbon credits) is the lack of any processes or procedures pursuant to which the registrar and/or standard acknowledges and documents the existence of security interests and agrees to treat the secured party as the beneficial owner of the applicable registry account (and the credits in that account) on notice. Verra goes further – it contractually *prohibits* project developers from granting any such security interest.

There is nothing analogous to an Account Control Deed in the voluntary carbon market, at present.

To the contrary, and by way of example, Paragraph 9.2 of the Verra Registry Terms of Use (April 2024) states that "*Verra is under no obligation to verify or otherwise enquire into the validity of, or legal title to, the Instruments or any Related Instruments and does not recognize any interest in an Instrument or any Related Instruments other than the interest of the entity named as the holder of the Instrument in the Registry or any Approved Sub-Register.*".

This position and lack of facilitative processes and procedures within the voluntary carbon market frameworks is extremely counterproductive to scaling investment in carbon projects <u>because it deprives investors from an ability to practically and smoothly enforce security interests over the very assets that they are financing</u>. To be clear, this does not stop the granting and taking of security interests at law – but it does pose a major obstacle to creating such security interests (because their creation would contractually breach Verra's Terms of Use) and/or enforcing such security interests in practice (because the register does not identify nor segregate credits that are subject to a security interest, nor does the registrar or standard acknowledge the existence of any such security interest).

4. **Comment and Request**

We refer to the document entitled "A6.4-SB011-AA-A11 – Draft Procedure relating to the Article 6.4 Mechanism Registry" published by you on this page.

We note the absence of any protocols or procedures relating to the recognition of security interests by the Article 6.4 Mechanism Registry, and the related "facilitative"/"administrative" functions described in the preceding sections of this letter.

As the Article 6.4 Mechanism Registry is, in the eyes of many in the market, being established to ultimately become the dominant registry for international carbon finance activities for decades to come, it is paramount, in our collective view, that the Article 6.4 Supervisory Body considers the content of this letter and recognises:

- the very real deficiencies that are inhibitive to scaling investment in carbon projects in the voluntary carbon market; and

- the opportunity for the Supervisory Body to establish, at the outset of the Article 6.4 Mechanism Registry's formation, protocols and procedures for recognising security interests and facilitating enforcement measures through, among other things, the publication of a form of Account Control Deed for use by registry-users or by any other means which the Supervisory Body considers appropriate and which achieve the same purpose.

With reference to the issue of recognition of security interests estbalished in private contract by tools of public international law, we are of the view that there is significant precedent for this. Specifically, we refer to the Convention on International Interests in Mobile Equipment concluded in Cape Town on 16 November 2001 ("**CTC**"). The purpose of the CTC is to provide for a mechanism that recognises security interests (and other types of "international interests") over certain classes of assets, and enable the interest holders to register their interest in a centralized, international registry. The CTC also provides for a range of measures in connection with enforcement of "international interests" by the interest holders.

We appreciate that it will take some time for the Supervisory Body to thoroughly consider and form a view on the content of this letter and, in light of the Supervisory Body's existing workload, our request at this stage is that the Supervisory Body communicates with the SBSTA/SBI on the possibility of the CMA **including a paragraph on the content of this letter for further consideration by the Supervisory Body as part of the CMA's decisions at CMA6**.

The signatories of this letter are available for further comment and consultation on the topic described herein.

Yours sincerely,

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