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RE: Call for Input

Dear Article 6.4 Supervisory Body,

This letter is to confirm our unconditional support for IETA's response to your call for input on matters of providing functionality for the treatment of financial security interests in Article 6.4 emissions reductions within the mechanism registry attached in Annex 1.

Kind regards,

LEV GANTLY
PHILIP LEE LLP

ANNEX 1

ARTICLE 6.4 SUPERVISORY BODY CALL FOR INPUT ON MATTERS OF PROVIDING FUNCTIONALITY FOR THE TREATMENT OF FINANCIAL SECURITY INTERESTS IN ARTICLE 6.4 EMISSIONS REDUCTIONS WITHIN THE MECHANISM REGISTRY

IETA Submission – 31st May 2024

The Supervisory Body (SBM), at its eleventh meeting, considered the draft procedure "A6.4 mechanism registry," and requested the secretariat to prepare an information note on the legal, technical and financial implications of providing functionality for the treatment of financial security interests in Article 6.4 emissions reductions (A6.4ERs) within the mechanism registry for its consideration at a future meeting. The SBM requested the secretariat to launch a call for public input on this matter and requested the secretariat to take these inputs into account when preparing the information note (see SB011 meeting report, para. 30).

A. EXECUTIVE SUMMARY

The Article 6.4 Mechanism is intended to move beyond the Clean Development Mechanism and drive innovative climate finance towards projects and programmes of activities ("**PoAs**") at scale. Providing targeted procedural mechanisms that can be used by account holders and financiers will have significant positive implications for the success of the Article 6.4 Mechanism. Optimising registry procedures as set out in this submission will facilitate the capacity of public and private financial market participants to cost-effectively and securely contribute towards the scaling of climate solutions under the Article 6.4 Mechanism.

In Section B we set out some background on the expectations of financiers in other markets and the tools available to recognise security interests. Recognising the challenges of implementing a comprehensive solution, in Section C to D we set out the specific and practical changes that could be implemented and in Section E we set out near term procedural steps that can be implemented to:

- enable a financier to be designated by an account holder as having consent rights before certain actions (such as transferring A6.4 units or changing the Focal Point) will be actioned by the administrator; and
- allowing for documentation to be submitted by the account holder that sets out the circumstances where specific additional rights may be exercised by the designated financier (such as changing the authorised representative for an account or the Focal Point for a project).

In the longer term, we are of the view that a comprehensive means of registering security interests will be useful and, when appropriate, can draw from international precedents discussed in Section F of this submission.

The legal nature of carbon credits generally (including A6.4 units) is subject to ongoing consideration and development (including by the work being carried out by UNIDROIT). Whilst this continues, it is

appropriate for the SBM to assess whether implementing a solution may create legal implications. However, the SBM can take practical steps under registry and other Article 6.4 Mechanism procedures to enhance climate finance *without having to resolve the legal nature of such units and the means by which security can be taken*. In this sense, material positive benefits can be accessed without causing uncertain legal implications.

For clarity, where this submission refers to "taking security" or "security interests", essentially, we mean methods to ensure that investors can realize, enforce, and recover their investment in a predictable manner. These methods normally take the form of contractual instruments such as mortgages, charges, pledges etc. By "security" we do not mean to refer to a commodity of any kind (such as shares in a company) – we use it strictly to describe means of securing investments or financings.

B. BACKGROUND

1. *Background 1: importance of the ability to take security in a financing transaction*

To enable the Article 6.4 Mechanism to successfully facilitate the financing of projects and PoAs, and to scale carbon markets at the pace required to achieve the Paris Agreement goal of limiting global warming to well below 2°C above pre-industrial levels, it is critically important that (i) financiers that contribute funding towards carbon projects and PoAs registered under the Article 6.4 Mechanism, and (ii) 'forward' buyers of the reductions and removals resulting from such projects and PoAs, as "**6.4 Financiers**" can realize, enforce, and recover their investment in a predictable manner by taking 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*.

2. *Background 2: overview of how security is typically taken in other (non-carbon) sectors: Project Finance or Structured Finance*

To mitigate the financiers' potential losses upon the default of a borrower (typically the project sponsor), it is a 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 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 that has legal and/or beneficial title to such underlying assets (usually, the project developer/sponsor, which may be a special purpose company established specifically for such project or transaction).

The form of such security interests depends on (i) the nature of the assets used as collateral, (ii) the jurisdiction in which the secured assets are located and (iii) 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 and bank accounts can be charged, pledged or be hypothecated.

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 law in relation to the financing of an infrastructure project, would typically grant security by (i) entering into a deed, pursuant to which the borrower grants in favour of the financier(s) a fixed or floating charge ("**Charge**") over the bank account into which the proceeds of the investment are deposited and (ii) an assignment by way of security of the borrower's rights against the bank at which such account is held ("**Assigned Rights**"). On the occurrence of a termination event or event of default under the applicable financing agreement, the financier (or a security trustee on its behalf) may enforce such Charge, and exercise the Assigned Rights including by taking ownership and control of the bank account subject to such security interest.

3. ***Background 3: perfection of security interests and the role of "facilitators"***

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). It is also a common requirement under applicable law, or otherwise good practice to ensure enforceability, that such security interests must be *perfected*. Such perfection requirements can include, the need (i) to notify any persons whose collaboration and/or permission may be required in the event of enforcement of such security interest (for example the bank at which the borrower maintains the bank account in relation to which it has granted security (the "**Account Bank**")) 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.

By way of example, in renewable energy project finance transactions, it is common for the Account Bank, the financier and the project owner/developer to enter into a, *tripartite* arrangement (an "**Account Control Deed**") pursuant to which the Account Bank:

- acknowledges the existence of the 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 respect of 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.

C. WHAT IS NEEDED: THE OPTIMAL AND THE REALISTIC

As noted in B1 above, it is critically important that (i) financiers that contribute funding towards carbon projects and PoAs registered under the Article 6.4 Mechanism, and (ii) 'forward' buyers of the reductions and removals resulting from such projects and PoAs, ("**6.4 Financiers**") can realize, enforce, and recover their investment in a predictable manner by taking 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.*

In simple terms, what is needed in the Article 6.4 Mechanism rules and procedures is an ability for financiers/secured parties to have their security interests recognised by the Mechanism registry administrator and for the Mechanism registry administrator to be a "facilitator" (similar to that of an Account Bank, as more particularly described in paragraph B.3 above) in giving the financier/secured party control over the applicable registry account on the occurrence of certain pre-defined trigger events.

We therefore have analysed specific procedures that could be implemented which would support financing solutions for A6.4 projects and PoAs. Those do not pre-judge how security can be granted in respect of A6.4 units. Instead, they focus on what procedural rights a third party may be granted in respect of an account and how those may be exercised.

D. THE CURRENT STATE OF THE ARTICLE 6.4 MECHANISM REGISTRY PROCEDURES AND DRAFT PROCEDURES AS THEY RELATE TO THE ISSUES THAT ARE THE SUBJECT OF THIS SUBMISSION

We refer to the:

- A6.4-SB008-A06 document titled "Procedure: Article 6.4 activity cycle procedure for projects, Version 01.0" adopted during the 8th meeting of the Supervisory Body and effective as of 1 January 2024 (the "**Adopted Projects Procedure**");
- A6.4-SB011-A04 document titled "Draft Procedure: Article 6.4 activity cycle procedure for programmes of activities, Version 02.0" considered during the 11th meeting of the Supervisory Body and subject to further consideration during the upcoming 13th meeting of the Supervisory Body (the "**Draft PoA Procedure**"); and

- A6.4-SB011-AA-A11 document titled "Draft Procedure: Article 6.4 mechanism registry, Version 01.0" considered during the 11th meeting of the Supervisory Body and subject to further consideration during the upcoming 12th or 13th meeting of the Supervisory Body (the "**Draft Registry Procedure**").

It is clear from paragraph 27 of the Adopted Projects Procedure and paragraph 30 of the Draft PoA Procedure that the role of a focal point is key in terms of primary responsibility for communication on behalf of activity participants with the Supervisory Body and the secretariat in relation to the scopes of authority described in paragraphs 29 and 32 of the Adopted Projects Procedure and the Draft PoA Procedure, respectively.

This design feature of the Article 6.4 Mechanism Registry is based on similar design features in the Clean Development Mechanism. It is our opinion that the vast majority of focal points will be the primary project proponents or activity participants – being those entities with primary knowledge of and responsibility for the applicable project or PoA. 6.4 Financiers are unlikely to be designated as focal points at the commencement of a project or a PoA. This is reflective of the experience of many IETA members during the most active period of the Clean Development Mechanism.

It is also clear from paragraph 116 of the Adopted Projects Procedure and paragraph 159 of the Draft PoA Procedure that activity participants have the ability to change the designation of any of the focal points for any reason, and at any time, by submitting a new Modalities of Communication (MoC) statement duly signed by all activity participants. In theory, this could facilitate a 6.4 Financier with a security interest in the relevant A6.4 units becoming a focal point on the occurrence of trigger events in order to realize, enforce, and recover their investment. **However**, in practice, this will not mitigate the risk of an activity participant not following the 6.4 Financier's instruction to change the designation of the focal point to the 6.4 Financier.

Turning to the Draft Registry Procedure, we note that this document relates to, *inter alia*, procedures for differentiating between different types of registry accounts as well as procedures for opening and maintaining registry accounts, including holding accounts. We note that there is opportunity here to recognise the subsequent development of certain procedures that would enable 6.4 Financiers to exercise certain specified rights in respect of accounts in which the secured A6.4 units are held. These are important as financing solutions may also be developed which relate to A6.4 units held in holding accounts after initial forwarding by project activity participants.

Please refer to Section E below for the solutions being proposed by IETA in order to remedy the issues identified above and achieve (at least in part) the objective that is the subject of this submission.

E. NEAR-TERM PROPOSED SOLUTIONS

We propose that the following considerations be integrated into the drafting in the Draft Registry Procedure and the Draft PoA Procedure. If possible, the Adopted Projects Procedure should also be amended accordingly.

Draft Registry Procedure		
	Proposal	**Rationale**
1.	The account holder of each type of account described in paragraph 14 of the Draft Registry Rules should be permitted to nominate an authorised representative in relation to its account(s). The role of the authorised representative would essentially involve it giving its consent to any action that the account holder wishes to take in connection with the applicable account or the A6.4 units in the applicable account. If certain account-types listed in paragraph 14 of the Draft Registry Rules are not suited to this type of arrangement, then this should be made clear. The appointment of an authorised representative by an account holder over an account can be achieved in numerous ways. The key element is to have a procedural mechanism by which the account holder can submit documentation that will be recognised by the registry administrator. This could be via a variation of the MoC, a form of power of attorney or an account control deed. We can help support with drafting such template documentation, if needed. An alternative to the above requirement for the authorised representative to consent to all actions may be that the authorised representative is only required to give its consent following the occurrence of certain, predefined trigger events.	This would allow an activity participant to give a financier full visibility and control over the A6.4 units being held by an activity participant in its account. It is important that these options are available not only in respect of initial issuance and forwarding but holding accounts generally.

2.	Taking the proposal at 1 a step further, it would be better if, on the occurrence of certain trigger events, the nominated authorised representative would become the exclusive controlling entity over the applicable account in place of the original account holder. Again, the key element is to have a procedural mechanism for documentation submitted that sets out the circumstances when this may occur and that will be recognised by the registry administrator. This can be achieved through a power of attorney or an account control deed. We can help support with drafting such template documentation, if needed.	By extension of the proposal at 1 above (which is simply a right of consent), this proposal would give additional comfort to finance providers that they can take full control of the assets that they have financed on the occurrence of certain, predefined trigger events.
Draft PoA Procedure		
	Proposal	**Rationale**
3.	Section 4.6.2 of the Draft PoA Procedure should be modified to facilitate the suspension or curtailment of a focal point's authority under an MoC in certain circumstances. This could be achieved in multiple ways, but our preferred solution would be to design the MoC in a way that enables the specification of a designated third party and then amending the rules to require (where that option has been selected) the confirmation of that designated entity before the focal point can exercise any authority pursuant to paragraph 32, or only seek such secured party's consent ***following*** the occurrence of certain pre-defined trigger events (which could also be set out in the MoC). This can be achieved by a procedural mechanism for documentation to submitted that sets out the circumstances when this may occur and will be recognised by the registry administrator. This can be achieved in multiple ways, including through	Focal points have broad authority regarding communications with the Supervisory Body or the secretariat, pursuant to the three scopes of authority listed in paragraph 32. Where the PoA has been financed by a financier it is imperative to provide the financier with the tools to either consent to forwarding of A6.4 units at all times or to take over the Focal Point role in certain circumstances (e.g. following the occurrence of default, insolvency etc., in the underlying transaction documentation).

	appropriate drafting in the form of MoC. We can support with drafting this template, if required.	
4.	In a similar vein to the proposal at 3 above, Section 6.6.3 should be modified to (i) where a third party has been designated on the original MoC, only allow the change of designation of the focal point, with that designated party's consent, and (ii) allow a designated third party require a change in designation of the focal point under paragraph 159 where certain pre-approved trigger events occur. This can be achieved in multiple ways, including through careful/appropriate drafting in the form of MoC and/or through a pre-approved form of power of attorney. We can support with drafting these templates, if required.	Where a PoA has been funded by a financier, it is important that changes to the MoC are not made without the financier both being aware of and, preferably, being involved in the changes. Further still, where the primary PoA activity participant has defaulted in the underlying financing documentation, and such activity participant has also been the nominated focal point, it is important for the financier to have the power to remove such activity participant from its role as focal point and replace it either with itself or another entity.
Adopted Projects Procedure		
5.	Any changes made to the Draft PoA Procedure for the purpose of addressing the issues set out in this submission should, for consistency, also be made in the next iteration of the Adopted Projects Procedure.	

F. Optimal Solution: *recognition of security interests on the international stage*

The legal nature of a security interest is normally driven by a combination of the legal nature of the asset against which security is taken and *lex situs* (i.e. the law of the state where the asset is located). For example, in the context of aircraft finance, although an aircraft is recognised as a form of physical or tangible property in the vast majority of jurisdictions, the security that can be take over an aircraft will vary from jurisdiction to jurisdiction. For example, a bank that is financing the acquisition of a Bombardier aircraft by Air Canada would typically be secured by a hypothec against that aircraft (as a matter of Canadian law). The same bank financing the acquisition of an Airbus aircraft by British Airways would normally take an English law mortgage over that aircraft in order to establish an appropriate security interest under English law. In both cases, the bank would try to register that security interest against the aircraft owner's title. This can sometimes be problematic for two reasons: (i) not all aviation authorities facilitate the ability for a financier to register a security interest, and (ii) aircraft are mobile assets and can in theory be located in any jurisdiction in the world at the point in time at which the debt is accelerated and the lender wishes to enforce its Canadian hypothec or English mortgage, and take physical possession or control over the aircraft.

The international community recognised that these issues posed a significant obstacle towards the availability of affordable financing solutions that were needed to enable the growth of the aviation industry to what it is today.

This resulted in the Convention on International Interests in Mobile Equipment being 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. In the example above, both the Canadian Hypothec and the English Mortgage would be registered as an "international interest" in the centralised CTC registry, in favour of the bank. This achieves two primary objectives: (i) it puts all third parties on notice that there is a security interest over the asset, and (ii) creates a legal pathway for the bank to take control of the aircraft on an event of default of the borrower **no matter where** the aircraft, or the parties to the transaction are located at the time of enforcement, provided that the countries in which the aircraft is physically located and where the transaction parties are established/incorporated, have adopted the CTC.

The precedent referred to in this paragraph is referred to as the "**CTC Precedent**".

Due to the currently high degrees of uncertainty relating to how the central Article 6.4 mechanism registry will interact with national registries, as well as other factors that may result in inconsistencies of application of the proposals set out in Section E above, it is our recommendation that a centralised registry or system for tracking and enforcing security interests is designed and adopted by the Supervisory Body for application across all Article 6.4 mechanism registries (both centralised and national). The CTC Precedent should be considered in detail in this regard with a view to replicating the highly successful roll-out of the systems underpinning the CTC international registry in the Article 6.4 mechanism procedures.

ABOUT IETA

IETA is a non-profit business organisation with a membership of over 300 leading international organisations operating in compliance and voluntary carbon markets. Since its foundation in 1999, IETA has been the leading voice of business on market-based ambitious solutions to climate change. We are a trusted adviser to governments to support them build international policy and market frameworks to reduce greenhouse gases at lowest cost, increase ambition, and build a credible path to net-zero emissions. See www.ieta.org for more information.