



ASIC
Australian Securities &
Investments Commission

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and Investments Commission**

Office address (inc courier deliveries):
Level 5, 100 Market Street,
Sydney NSW 2000

Mail address for Sydney office:
GPO Box 9827,
Brisbane QLD 4001

Tel: +61 1300 935 075
Fax: +61 1300 729 000

www.asic.gov.au

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waterinquiry@accc.gov.au

The Director
Murray-Darling Basin Inquiry
Australian Competition and Consumer Commission

Dear Sir/Madam,

ASIC Submission on the Murray Darling Basin water markets inquiry – interim report

ASIC appreciates the opportunity to provide this submission on certain aspects of the interim report.

ASIC's role in regulation of financial services and financial markets

ASIC is responsible for the regulation of financial services and financial markets under the Corporations Act 2001 (Com). The regime is limited to financial products and services as defined in the Corporations Act. Financial products includes a broad range of financial instruments including derivatives.

The definition of derivative in s 761D of the Corporations Act is a very broad concept. As observed by Giles JA in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 at [[66], [72]:

The definition of “derivative” is extraordinarily wide, one which could catch many arrangements not ordinarily thought of as derivatives ... Given this deliberate drafting, there is little warrant for reading down the definition in the inclsory s761D(1).It was intended to be wide, overwidth was to be controlled by subsequent exclusions, including by regulation.

As a result of the breadth of that expression and to provide current water market participants with regulatory certainty Corporations Regulation 7.1.04(8) was made to make it clear for market participants the application of the regime to the certain arrangements related to water.

Scope of this submission

The interim ACCC Report outlines three options to enhance water market regulation. The three options are:

- (1) Government initiated licensing scheme
- (2) Applying the financial regulation framework to water products
- (3) Independent market focused government regulator.

ASIC recognises that there are significant matters to be considered in determining the preferred option for the regulation of water products and that this will be a matter for the ACCC to recommend and the Government to determine what may be the best option to pursue for the regulation of water markets.

This submission only engages with the option for proposed regulation involving the application of financial regulation of water markets based on ASIC involvement in the financial regulation framework.

The application of financial regulation may be contemplated as a result of the characterisation of the water rights as a derivative. The value of water rights may be derived from the value of some other thing, that being the water that is subject to the water right and that the water rights are intangible property.

ASIC's focus on financial markets

ASIC only regulates financial markets. The ACCC draft interim report notes on page 256 that the Australian Energy Regulator (AER) is the specialised regulator for the Australian physical electricity market. Also significant in the regulation of the electricity market is the involvement of Australian Energy Market Commission which undertakes rule making and energy market development. The specialised expertise for a unique market is an important aspect of the regulatory framework for electricity, In addition the involvement of the Australian Energy Market Operator (AEMO) as the specialised market operator for physical market highlights the benefit of specialised arrangements for the operation of unique physical markets. AEMO has an exemption from the licensing requirements that apply under the Corporations Act to the operators of clearing and settlement facilities.

ASIC does not regulate the physical electricity market. The physical market is the responsibility of the AER. ASIC regulates derivatives financial products that are traded over physical electricity such as listed futures and options or swap agreements that relate to the wholesale price of electricity. This separate regulation of the physical electricity market and the financial product market associated with electricity has operated effectively for more than 15 years. It relies on the expertise of a dedicated energy market regulator to engage with the oversight of a very specialised physical market.

Water rights and derivatives

The ACCC Interim report notes in a number of places that water is a commodity. Physical commodities are generally not regulated by the Corporations Act as financial products, unless there is cash settlement associated with the activity: see s761D(3) and Corporations Regulations 7.1.04(4). One difficulty is that at law a water right does not involve tangible property and so the exception from the definition of derivative applicable to commodities was not available for a thing which has the characteristics of a commodity but is not tangible property.

The ambiguity about the characterisation of water rights as a commodity was indirectly addressed by providing the express exclusion in the legislation of water rights from the definition of derivatives in s761D of the Corporations Act.

The exclusion of water rights from the definition of derivative reflects the approach recommended by the Companies and Markets Advisory Committee (CAMAC) in its Derivatives Report. The CAMAC report at para 4.6.4 noted that one way to deal with peripheral areas is through the powers to enact regulations declaring something not to be a derivative. This is the approach adopted in the regulation which currently exempts certain types of water rights from the definition of derivative: see Corporations Regulation 7.1.04(8)

Obligations that will apply under financial regulation

The interim report identifies a number of obligations that will apply should financial regulation under the Corporations Act be applied to water rights. In addition to the matters outlined in Parts 7.6.1 and 7.6.2 of the interim report there are significant disclosure obligations about water rights that will apply if there is an issue of a financial product to a retail client. There may also be disclosure obligations that apply in some cases where there is the sale of water right to a third party if the water rights is a derivative for the purposes of the Corporations Act.

The Corporations Act requires disclosure when a financial product is issued, in a product disclosure statement about the details of the financial product: see 1013C Corporations Act.

Each person who is a party to a financial product that is a derivative and that is not entered into or acquired on a financial market will be an issuer of the derivative: see s761E(5) Corporations Act. This means that if water rights are derivatives then the person who is issued a water right may be required to prepare a product disclosure statement where the sale of the water right occurs to a retail client, as defined in in s761G of the Corporations Act.

As the creation of water rights relies on the Crown granting the water right under the respective legislation it is possible that the Crown in issuing the water right may not be subject to the Corporations Act. This is as result of the operation of the s5A of the Corporations Act. This provision exempts the Crown from the application of, amongst other things, the product disclosure obligations in Part 7.9 of the Corporations Act. One of the key aspects of the regulation of financial products

under the financial service regulation outside the licensing obligations in Part 7.6 of the Corporations Act (which have been outlined in interim report) are obligations about product disclosure that may not be adequately accommodated if the financial regulation in Chapter 7 of the Corporations Act was adopted.

Dual regulation of statutory licences

Water licences are created by statute in the respective states and transferred in accordance with the relevant rules applicable to the transfer of those licences.

Unlike for other financial products ASIC does not regulate or oversee the initial issue of that financial product. The characteristics of a licence are determined by the relevant State government which has created types of water rights and the mechanism for the transfer of such rights is a matter for the relevant State legislation. ASIC would have limited engagement with the oversight of the licences that will be traded and the clearing and settlement arrangements for transactions involving water rights.

In addition, each state within the Murray-Darling Basin has its own legislation that creates the relevant water rights. ASIC under the financial regulation scheme has no control over the nature of those rights and the mechanisms that are used to transfer those rights.

ASIC does not currently regulate other forms of statutory licences such as mining, taxi or fishing licences.

Role of Intermediaries

As noted in the ACCC interim report at page 202 most intermediary relationships are subject to industry-specific state and Commonwealth laws, imposing obligations akin to the obligations of a fiduciary. There are mechanisms that are available under state law that could be extended to impose relevant obligations on brokers as an alternative to financial regulation regime.

Water rights although created separately from land rights have significant parallels between the transactions that occur with the holder of those rights and land transactions. The water rights are often connected with land connected to a water source. Therefore, the possibility of applying state based regimes such as the regulation of land brokers or stock and station agents is another mechanism that could be considered as way to regulate the activities of intermediaries associated with water rights rather than applying the financial regulation under the Corporations Act applicable to intermediaries.

Conclusion

The regulation of specialised commodity markets in Australia has generally been undertaken by tailored legislation overseen by specialised regulators, for example in the electricity markets. The nature of water rights and trading in those rights is more analogous to a commodity and this suggests mechanisms to regulate commodity trading may be another avenue to regulate the activity.

There are limitations in the application of financial regulation as well as other regulatory mechanisms that are available to regulate water rights that may warrant further review by the ACCC in forming their recommendations about the regulation of water rights and the markets on which those rights are traded.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Nathan Bourne', with a long horizontal line extending to the right.

Nathan Bourne
Senior Executive Leader, Financial Markets Infrastructure