

Commentary - draft amendments to the Corporations and ASIC Regulations relating to eligible emissions units as financial products

Introduction

1. The Government decided that eligible emissions units under the Carbon Pollution Reduction Scheme (the CPRS) will be financial products for the purposes of the *Corporations Act 2001* (the Corporations Act) and the *Australian Securities and Investments Commission Act 2001* (ASIC Act). This amendment is included in the Carbon Pollution Reduction Scheme (Consequential Amendments) Bill 2009 (No. 2) (the Consequential Amendments Bill). It also committed to consult interested parties about adjustments to that regime so that it fits the characteristics of the relevant units and does not involve unnecessary compliance costs.
2. An issues paper was released in April 2009 with the aim of exploring with stakeholders the variations of the Chapter 7 regime which should be considered in order to fit the regulatory regime to the product and to ensure no unnecessary compliance costs. It is available at:
<http://www.climatechange.gov.au/en/publications/cprs/cprs-eligible-emissions-units.aspx>
3. The draft Corporations Regulations modify the application of the Chapter 7 regime. In addition, draft ASIC Regulations are being exposed for public comment. This commentary provides an explanation of the two sets of draft Regulations.

Background

General

4. The CPRS legislative package comprises 11 Bills which were introduced into the House of Representatives in May 2009 and passed by the House on 4 June 2009. The introduction of these Bills followed the release of the Green Paper on the CPRS in July 2008, the White Paper in December 2008, and the exposure draft legislation on 10 March 2009. On 13 August 2009, the Senate voted against the Bills. The Government reintroduced the Bills on 22 October 2009.
5. Items 1 and 4-6 of Division 1, Part 1, Schedule 1 of the Consequential Amendments Bill will make Australian emissions units and eligible international emissions units financial products. Item 2 of the same Division makes a related amendment.
6. Eligible emissions units are units that can be surrendered to meet a person's liability under the scheme. In brief, this means Australian emissions units and eligible international emissions units. The phrase 'eligible international emissions units' encompasses the possibility of prescribing additional international emissions units (units issued in accordance with the Kyoto rules or non-Kyoto international emissions units) in the future.
7. Eligible emissions units include Australian emissions units issued by the Australian Climate Change Regulatory Authority (ACCRA). Current eligible international emissions units (certain certified emission reductions, emission reduction units and removal units – all issued under the Kyoto Protocol) are variously issued by the Australian and foreign governments, and the Clean Development Mechanism Executive Board. Thus the units will be issued overseas or by the Australian Government.
8. The Regulations propose modifications to the Chapter 7 regime in the following areas:

- the need for an Australian Financial Services licence;
 - financial product disclosure.
9. The Regulations also include draft amendments in the following areas:
- the definition of clearing and settlement facilities (for the purpose of Chapter 7 and the ASIC Act); and
 - the provision of compliance assessments (Parts 7.2 and 7.3) and investigation reports (ASIC Act).

Commencement

10. The Regulations commence at the same time as sections 3 to 387 of the *Carbon Pollution Reduction Scheme Act 2009* (when enacted) [item 2]. Sections 3 to 387 of that Act commence on the 28th day after the Act receives Royal Assent.
11. The Consequential Amendments Bill, which will make Australian emissions units and eligible international emissions units financial products, will commence at the same time as section 3 of the *Carbon Pollution Reduction Scheme Act 2009*. This means the modifications, proposed in the regulations, would commence at the same time as the regulation of eligible emissions units as financial products under the Corporations Act and ASIC Act.

Corporations Regulations

The need for an Australian Financial Services licence

12. Under the Corporations Act, a person must hold an Australian financial services licence or be exempt if they carry on a financial services business (section 911A). (Such a business may be carried on in conjunction with another business.) A person provides a financial service (section 766A) if they:
- provide financial product advice (section 766B);
 - deal in a financial product (section 766C) (unless an exemption applies, dealing in a financial product involves such activities as applying for or acquiring a financial product and disposing of a financial product);
 - make a market for a financial product (section 766D);
 - operate a registered managed investment scheme;
 - provide a custodial or depository service (section 766E); and
 - engage in other conduct prescribed by regulation.
13. Entities which are liable to surrender eligible emissions units under the Carbon Pollution Reduction Scheme (and those who receive free Australian emissions units) are likely to be dealing in eligible emissions units, dealing in derivatives over eligible emissions units, making a market in eligible emissions units and making a market in derivatives over eligible emissions units.

Dealing on own behalf and other members of the corporate group

14. The term ‘dealing’ includes acquiring and disposing. However, a person does not ‘deal’ in a financial product if the person deals in the product on their own behalf (either directly or through a representative) (subsection 766C(3)).
15. This means that a liable entity acquiring and disposing of eligible emissions units on its own behalf will not, by this conduct, be dealing, and therefore need an Australian financial services licence.
16. However, an amendment is proposed to ensure that the ‘dealing on your own behalf’ exemption is extended to dealing in eligible emissions units on behalf of liable entities which are related or associated [draft Regulation 7.1.35C, Schedule 1, item 3].
17. Related bodies corporate and associated entities are explained in sections 50 and 50AAA of the Corporations Act.
18. A liable entity for this purpose is an entity listed in the information database in accordance with section 262 of the Carbon Pollution Reduction Scheme Bill 2009 (No. 2) (the CPRS Bill).

Trustees acting on behalf of liable entities

19. It is not proposed to extend the ‘dealing on own behalf’ exemption to trustees acting on behalf of liable entities, as there does not appear to be a particular basis to treat eligible emissions units different from other financial products, in these circumstances. ASIC could, if appropriate, grant relief based on individual circumstances as they arise.

Dealing in derivatives over eligible emissions units

20. A liable entity which regularly enters into derivatives over eligible emissions units is more likely to be regarded as dealing in financial products (and therefore need an Australian financial services licence).
21. This is so because:
 - issuing a financial product is specifically one type of dealing (paragraph 766C(1)(b)); and
 - a derivative is issued when a person enters into the legal relationship that constitutes the financial product (subsection 761E(3)) i.e. generally, each transaction in a derivative is viewed as an issue.
22. Existing regulation 7.6.01(1)(m) provides a relevant exemption. A new regulation 7.6.01(1)(ma) is proposed to address this situation in relation to eligible emissions units and derivatives over those units. It would have the effect that an Australian financial services licence would not be required if:
 - the service consists only of dealing in either or both of derivatives over eligible emissions units and eligible emissions units;
 - the service does not involve the making of a market for those derivatives or eligible emissions units;
 - the dealing is entered into for the purpose of managing a financial risk of adverse variations in the cost of eligible emissions units that are expected to be surrendered to the Australian Climate Change Regulatory Authority by the person, a related or associated entity;

- the person does not deal in those derivatives or eligible emissions units as the principal purpose of the person's business;
 - the dealing is entered into on the person's own behalf or on behalf of related or associated entity.
23. Draft regulation 7.6.01(1) (ma) [Schedule 1, item 7] applies to eligible emissions units and derivatives over those units. The provision does not entirely mirror the criteria for the exemption in existing 7.6.01(1)(m), to the extent that the existing provision requires that 'the person does not deal in derivatives as a significant part of the person's business'. This part of the test was not adopted in draft regulation 7.6.01(1)(ma) because it is possible that this element of the test may not operate appropriately for liable entities. Given the size of the liability, for some entities, it may be viewed as a significant part of the business and therefore the exemption may not apply. Instead the test requires that a person does not deal in derivatives (over eligible emissions units) or eligible emissions units as the principal purpose of the person's business.
24. Draft regulation 7.6.01(1)(ma) is designed to cover the conduct of entering into derivatives over eligible emissions units in preparation for surrender.

Making a market in eligible emissions units

25. There are two situations in which entities may be viewed as making a market in eligible emissions units. These are:
- participating in an ascending clock auction necessarily involves regularly stating the price at which the participant proposes to acquire Australian emissions units; and
 - entities which receive units free of charge from the Authority (for example, for reforestation activities, destruction of synthetic greenhouse gas, or as compensation) may decide to sell them, possibly regularly through the year, and to do so on each occasion they are received.
26. Draft regulation 7.6.02AI [Schedule 1, item 10] provides relevant exemptions from the need for an Australian financial services licence relating to participation in an ascending clock auction, on the person's own behalf, or a related or associated entity.
27. As indicated in the explanatory memorandum for the CPRS Bill, a simultaneous ascending clock auction will be the preferred auction type. In an ascending clock auction, the auctioneer announces a price for a particular quantity of each vintage and bidders reveal the amount they wish to buy at that price. The auctioneer continues to increase the price until the total demand is equal to or lower than the amount on offer. The process will be carried out simultaneously with different vintages of units.
28. Related bodies corporate and associated entities are explained in sections 50 and 50AAA of the Corporations Act.
29. A different approach is taken to address the possibility that entities which sell the free Australian emissions units which they receive will be regarded as making a market by this conduct. The conduct is proposed to be taken out of the concept of 'making a market' in section 766D [Schedule 1, item 1].

Overseas financial services providers

30. Amendments to existing regulation 7.6.02AG(2E) [Schedule 1, item 9] will extend the existing exemption from the need for an Australian financial services licence for overseas financial services providers for the provision of services to professional

investors involving dealing, providing advice and making a market, in eligible emissions units.

31. There will be a need to consider separately possible exemptions for overseas participants on overseas markets operating in Australia dealing in eligible emissions units. This may involve modification to existing regulation 7.6.02AG(2B) depending on the treatment of overseas markets operating in Australia.

Breach notifications

32. A financial services licensee is required to notify ASIC of breaches of various provisions.
33. Amendments to existing regulation 7.6.02A [Schedule 1, item 8] would require financial services licensees to notify ASIC of breaches of the *Carbon Pollution Reduction Scheme Act 2001* that relate to the provision of financial services.

Transitional arrangements

34. Further work is being undertaken on possible transitional arrangements for those who already have an Australian financial services licence but need it to extend to financial services in connection with eligible emissions units, and those who provide such services but do not have an Australian financial services licence.

Financial product disclosure

Foreign governments, Clean Development Mechanism Executive Board

35. Product disclosure requirements are triggered by, among other things, the issue of a financial product. Australian emissions units will be issued by ACCRA on behalf of the Commonwealth. There is no current intention to make regulations under subsection 5A(4) of the Corporations Act so that Chapter 7 would bind the Crown in this regard.
36. To ensure that the Chapter 7 obligations are not read as applying to the various issuers of eligible emissions units, it is proposed that issue of these units by the Australian Climate Change Regulatory Authority, the Clean Development Mechanism Executive Board and the government of a foreign country be explicitly taken out of the concept of 'dealing', one of the triggers for requiring a financial services licence [draft regulation 7.1.35B, Schedule 1, item 3].
37. Similarly, there is no requirement on Australian Climate Change Regulatory Authority, the Clean Development Mechanism Executive Board and the government of a foreign country to provide a product disclosure statement or an emissions unit statement [Schedule 1, item 17, draft 19.1].
38. However, without further amendment in at least one situation, a product disclosure statement may be required. An obligation to give a product disclosure statement arises when there is a secondary sale to a retail person within 12 months of the issue of a financial product where it was issued without a product disclosure statement and the purchaser acquired it with the purpose of transferring it (subsection 1012C(6)). This is addressed below.

Publication of information by ACCRA

39. The Australian Climate Change Regulatory Authority will publish information relevant to the demand for units in the scheme, the issue of Australian emissions units and the characteristics of units (both Australian emissions units and eligible international emissions units). The information required to be published is specified in Part 12 of the CPRS Bill.

Requirement for emissions unit statement

40. The draft regulations:
 - omit the requirement for product disclosure statement in the situations in which it may be required, particularly in the secondary sales situation; and
 - require the regulated person to provide to the retail client in secondary sales situations a hard or electronic copy of the statement describing the characteristics of the units which is published by the Australian Climate Change Regulatory Authority (referred to as the emissions unit statement).
41. There are various changes to Part 7.9 to achieve this outcome, as well as a few other modifications to Chapter 7. This includes the insertion of a new Subdivision 4.2B. Its application is described in draft Regulation 7.9.11H [Schedule 1, item 13].
42. Draft Regulation 7.9.11I [Schedule 1, item 13] provides that certain provisions of Part 7.9 do not apply in relation to eligible emissions units. This includes provisions that require a product disclosure statement (including secondary sales situations in sections 1012A and 1012C), responsibility for preparation of a product disclosure statement (section 1013A), product disclosure statement content requirements (sections 1013D, 1013E and 1013F).
43. Modifications are made to ensure that the emissions unit statement must be given instead of a product disclosure statement. Draft Part 19.1 (which modifies Schedule 10A of the Corporations Regulations) requires that a regulated person give the client the emissions unit statement in a recommendation, issue or sale situation [draft regulation 7.9.11J, Schedule 1, item 13].
44. A revised heading for Schedule 10A is to be inserted [Schedule 1, item 16].
45. Draft Part 19 of Schedule 10A of the Corporations Regulations is at Schedule 1, item 17.
46. There are existing exemptions from the need to give a product disclosure statement in section 1012D. These are mirrored, as appropriate, in modified section 1012D [draft Schedule 10A, Part 19, clauses 19.1(2) and 19.2].
47. First, the regulated person does not need to provide the emissions unit statement, if the regulated person, believes on reasonable grounds, that the client has the current version of the emissions unit statement [Schedule 10A, Part 19, clause 19.1(2)]. Exemptions from the need to give a product disclosure statement in subsections 1012D(7) to (9A) are omitted, as these are, in particular, not relevant to eligible emissions unit [draft Schedule 10A, Part 19, clause 19.3].
48. A number of modifications are proposed to existing section 1012IA [draft Schedule 10A, Part 19, clauses 19.4 to 19.6] to require a provider to give the emissions unit statement, instead of a product disclosure statement, if a product disclosure statement were required under existing section 1012IA.
49. A modification is proposed to existing section 1017A [Schedule 10A, Part 19, clause 19.7] to ensure that specified persons can seek further information about the product from the seller of the eligible emission units.
50. A modification is proposed to existing 1017E [Schedule 10A, Part 19, clause 19.8] to ensure that the provisions about dealing with money received for financial products apply to eligible emissions units.
51. Various modifications are made to section 1018A [Schedule 10A, Part 19, clause 19.9 to 19.19] to ensure that advertising restrictions apply to eligible emissions units. This includes that such advertisements identify the issuer and seller and also refer to the

emissions unit statement, which they should consider before deciding to purchase the product.

52. Modifications are made to section 1020D [Schedule 10A, Part 19, clauses 19.20 and 19.21], so that it applies to eligible emissions units. Briefly, existing section 1020D voids contracts which waive compliance with Part 7.9 or that deems a party to have notice of contracts and matters not referred to in product disclosure statements.
53. Various modifications are made to section 1020E [Schedule 10A, Part 19, clauses 19.22 to 19.28], so that it applies to eligible emissions units. The amendments will allow ASIC to issue stop orders in relation to defective advertisements.
54. Various modifications are made to section 1021C [Schedule 10A, Part 19, clauses 19.29 to 19.32] so that it is an offence of strict liability to fail to give the emissions unit statement when required by this Part.
55. Modification is made to section 1021G [Schedule 10A, Part 19, clause 19.33] so that it is an offence for an Australian financial services licensee to fail to ensure its authorised representatives give the emissions unit statement as required.

Advice

56. Draft regulation 7.7.10AI modifies paragraph 949A(2)(c), [Schedule 1, item 11] so that warnings which must be given in relation to the provision of general advice operate if the general advice relates to the acquisition of eligible emissions units. This includes the warning that the client should obtain the emissions unit statement before making any decisions to acquire the product.

Hawking

57. Draft regulation 7.8.21B modifies section 992A [Schedule 1, item 12] so that the prohibition on hawking operates appropriately for eligible emissions units. This includes certain obligations to give the emissions unit statement and refer to its importance in the decision to purchase the product.

Market misconduct

58. It is proposed that eligible emissions units will be prescribed as a financial product to which the short-selling provisions apply [draft regulation 7.9.80B(d), Schedule 1, items 14 and 15].

Clearing and settlement facilities

59. A clearing and settlement facility is defined in subsection 768A(1) as a facility that provides a regular mechanism for the parties to transactions relating to financial products to meet obligations to each other that arise from entering into the transactions and are of a kind prescribed by regulations made for the purpose of paragraph 768A(1)(b). Exceptions to this definition are included in subsection 768A(2).
60. Various obligations are prescribed in Corporations Regulation 7.1.09.
61. The draft amendments to the Corporations Regulations will add paragraph 7.1.09(1)(fa) [Schedule 1, item 2] which will prescribe the obligations arising from a contract to transfer an Australian emissions unit or an eligible international emissions unit.

Provision of compliance assessments (Parts 7.2 and 7.3)

62. ASIC undertakes assessments of the compliance of market licensees and CS (clearing and settlement) facility licensees with their obligations under Chapter 7 (sections 794C and 823C). Similarly, the Reserve Bank of Australia assesses compliance by CS (clearing and settlement) facility licensees with those provisions in Part 7.3 relevant to systemic risk (section 823CA).
63. If the assessment relates to a serious contravention of a law of the Commonwealth, or of a State or Territory, the regulator may give a copy of the written report of the assessment (or the relevant part) to the bodies listed in paragraphs 794C(5)(d), 823C(5)(d) and 823C(4)(d). Further bodies can be added to these lists by regulations and this has been done in Corporations Regulation 7.2.09, 7.3.07 and 7.3.08.
64. The Australian Climate Change Regulatory Authority is to be added to each of these lists [Schedule 1, Items 4, 5 and 6].

ASIC Regulations

Provision of investigation report

65. Subsection 18(2) of the ASIC Act empowers ASIC to provide a copy of the whole or a part of an investigation report to a series of named or prescribed agencies where the report or a part of a report relates to a serious contravention of a law of the Commonwealth, or of a State or Territory. A list of agencies are prescribed in ASIC Regulation 3.
66. The draft amendments to the ASIC Regulations would add the Australian Climate change Regulatory Authority to the list of agencies prescribed for this purpose [Schedule 1, Item 1].
67. This draft amendment is comparable to draft Corporations Regulation 7.2.09(a), 7.3.07(a) and 7.3.08(a).

Definition of clearing and settlement facility

68. Subsection 12BAB(17) of the ASIC Act defines clearing and settlement facility for the purpose of section 12BAB, which defines 'financial service' for the purpose of Part 2, Division 2 of the ASIC Act.
69. Various obligations are prescribed in ASIC Regulation 45.
70. The draft amendments to the ASIC Regulations will add paragraph 45(f) [Schedule 1, Item 3] which will prescribe the obligations arising from a contract to transfer an Australian emissions unit or an eligible international emissions unit.
71. This draft amendment is directly comparable to draft Corporations Regulation 7.1.09(fa) which is referred to above.