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(via email: watertrading@treasury.gov.au)

Dear Tim

Draft amendments on regulation of water market trading

Thank you for your time to discuss the proposed Corporations Amendment (Water Trading Exemptions) Regulation 2013 (**Proposed Amendment**) to amend the Corporations Regulations 2001 (**Regulations**) to ensure that tradeable water rights and arrangements in relation to tradeable water rights are excluded from the definition of "derivative" in Chapter 7 of the *Corporations Act* 2001 (Cth) (**Act**).

As discussed, we have advised various clients operating in various areas of the water industry including brokers and water trading exchange operators, and have considered this issue in the past.

1. Overview

We welcome the amendment to the Regulations to provide that "tradeable water rights" as defined in the Proposed Amendment (**Tradeable Water Rights**), are not derivatives. This has been a concern which we have previously discussed with clients as has the issue we mentioned when we spoke, namely the risk that holding a water right may amount to an interest in a "managed investment scheme" under the Act.

Chapter 7 of the Corporations Act is concerned with the regulation of financial services and markets, including services and markets in relation to financial products. "Financial products" include securities, contracts for insurance, derivatives, and interests in managed investment schemes.

We understand that the policy objective of the proposed changes is to ensure that, by excluding tradeable water rights from the definition of "derivative", tradeable water rights and services in relation to tradeable water rights will not be regulated as financial products.

That is, that parties would be able to trade, make a market in, advise upon and operate a market in tradeable water rights, as if the water right was a tangible commodity (such as wheat, cotton or beef) rather than a financial product.

However, if that is the policy objective, that policy objective would not be met if a tradeable water right, although excluded from the definition of derivative, was still a "financial product" by reason of it falling within another class of financial product that was not a derivative.

Particularly, there is potential for a tradeable water right to come within the definition of "financial product" by reason of it being an interest in a "managed investment scheme", even if it is excluded from the definition of "derivative".

While we think that whether or not a water right amounts to an interest in a managed investment scheme may turn on the nature of the water right, the catchment which relates to that right and whether or not and how such catchment is managed, we believe that there is sufficient complexity and uncertainty as to warrant consideration of also clarifying that Tradeable Water Rights do not amount to an interest in a managed investment scheme.

This could be achieved by the making of a regulation providing, for the purposes of paragraph (n) of the definition of "managed investment scheme" in section 9 of the Act, that a scheme is not a "managed investment scheme" by reason of paragraph (a) of its definition in section 9 of the Act where the rights acquired to benefits of the scheme are Tradeable Water Rights or arrangements in relation to them.

Without making this further amendment to the Regulations, we do not believe that Treasury's policy objective, as we understand it, to ensure that Tradeable Water Rights are not caught by the financial services regulation in the Act, would be met.

2. Detailed comments

2.1 Principal concern

As discussed, our principal concern in relation to the Proposed Amendment is not in relation to the Proposed Amendment itself but whether there should be a further amendment to address any concern that holding a Tradeable Water Right could be considered to be participation in a managed investment scheme and, as a result, be regulated under Chapter 5C of the Act.

Further, the trading of a Tradeable Water Right, were it considered to represent participation in a managed investment scheme, could be the trading of a "financial product" under the Act.

We understand that Treasury seeks to ensure that "simple" water rights such as the Tradeable Water Rights and arrangements in relation to them are not regulated under the Act as derivatives so as to make clear that an Australian Financial Services Licence in connection with:

- providing advice in relation to a Tradeable Water Right
- dealing in Tradeable Water Rights, or
- making a market for Tradeable Water Rights,

is not required, and to ensure that a market licence is not required to operate a market in Tradeable Water Rights.

However, if a Tradeable Water Right were to be found to be an interest in a managed investment scheme and the trading of that Tradeable Water Right to be the trading of a "financial product" under the Act, the regulatory obligations which Treasury states in the Explanatory Statement for the Proposed Amendment it is seeking reduce, could still apply.

2.2 "managed investment scheme"

The term "managed investment scheme" is defined in section 9 of the Act, in paragraph (a) of the definition, as:

- (a) *a scheme that has the following features:*
 - (i) *people contribute money or money's worth as consideration to acquire rights (interests) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);*
 - (ii) *any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);*
 - (iii) *the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions);*

We note that if Tradeable Water Rights were within paragraph (a) of the definition of "managed investment scheme", none of the exclusions in sub-paragraphs (c) to (n) (inclusive) of the definition (including the specific exclusion in regulation 5C.11.01 of the Regulations) would apply.

2.3 "Tradeable Water Right"

In considering whether holding a Tradeable Water Right is the participation in a managed investment scheme, we have recognised that it is conceivable that there may be occasions when a Tradeable Water Right may be regarded as a facility for making an investment, where a person makes a payment in return for the recipient managing a scheme under which benefits (in the form of water) are delivered to the recipient.

By way of illustration, the *Catchment Management Authorities Act 2003 (NSW) (CMA)* is the relevant state legislation governing the activities of authorities established under the CMA to manage natural resource issues in water catchment areas. The CMA applies to catchment authorities established in regions such as the Murray, Hawkesbury-Nepean and Murrumbidgee areas.

Sec 14(1) of the CMA provides that a water catchment authority "has the general functions of carrying out or funding catchment activities" in accordance with the CMA. The CMA defines "catchment activities" as:

"activities relating to natural resource management in an area (including the planting of trees, the removal of weeds or obstructions, the carrying out of works and education or training)."

These activities could be interpreted as amounting to managing a scheme, the scheme being the provision of water to the holders of Tradeable Water Rights.

However, in our view, in order for a Tradeable Water Right to constitute participation in a managed investment scheme, it would need to be shown that:

- (a) the holder of a Tradeable Water Right has provided consideration (a contribution) to obtain the Tradeable Water Right or the benefits flowing from the holding of that Tradeable Water Right;
- (b) the holder of the Tradeable Water Right receives a benefit from the holding of the right (such as the right to receive water, or to draw water which would otherwise be prohibited from being drawn);
- (c) the consideration (or a contribution) paid by a holder of a Tradeable Water Right has been used or pooled in common with the consideration from other holders or used in a common enterprise for the benefit of the holders of the Tradeable Water Rights; and
- (d) the holders do not have day to day control over the scheme.

The likelihood of the common scheme or enterprise element being satisfied would be increased if the recipient of the consideration pooled and used that consideration in taking steps to enhance the water resource and the benefits flowing from it, by for instance reducing wastage or improving flows or collection of the water.

However, as we state earlier, whether or not a water right amounts to an interest in a managed investment scheme may depend on the nature of the water right, the catchment which relates to that right and whether or not and how such catchment is managed.

Given this level of potential complexity, we are of the view that to meet the policy objective of removing uncertainty around whether Tradeable Water Rights and arrangements in relation to them are subject to regulation under the Act, the amendment we refer to above is necessary, namely, the making of a regulation providing, for the purposes of paragraph (n) of the definition of "managed investment scheme" in section 9 of the Act, that a scheme is not a "managed investment scheme" by reason of paragraph (a) of its definition in section 9 of the Act where the rights acquired to benefits of the scheme are Tradeable Water Rights or arrangements in relation to them.

We understand from our conversation, that seeking to extend the Proposed Amendment to include the further amendment to the Regulation referred to above, may be considered to be outside the scope of the policy approval granted in relation to the Proposed Amendment. However, if the policy objective is, as we understand it to be, clarity around Tradeable Water Rights (and arrangements in relation to them) being outside the financial services regulation of the Act, our view is that this further amendment is required to achieve that objective and could arguably be within the scope of the policy approval.

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We would be happy to discuss this letter with you. We can be contacted through the contact details below.

Yours sincerely



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