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Your reference: **Our reference:**

Australian Securities and Investments Commission (**ASIC**)
Regulatory Reform and Implementation

Email: RG236.Feedback@asic.gov.au

Dear Sir/Madam

ASIC Consultation Paper 378
Submission of Norton Rose Fulbright

1 Introduction

1.1 We refer to ASIC Consultation Paper 378 'Safeguard mechanism reforms: Updates to RG 236' May 2024 (**Consultation Paper**) and the Draft Regulatory Guide 236 'Do I need an AFS licence to participate in carbon markets?' May 2024 (**Draft Reg Guide**).

1.2 We welcome the opportunity to provide feedback to ASIC in relation to the proposed updates to RG 236 to address the Safeguard Mechanism reforms and certain other changes.

1.3 Our Australian carbon market team, comprised of lawyers across multiple disciplines such as corporate, environmental, banking and financial services, has worked closely with a variety of participants in the carbon markets, including purchasers, sellers, project developers, financiers, aggregators, landholders and carbon service providers since the inception of the Australian carbon market in 2011. We have advised clients extensively in relation to trading documentation for environmental products generated from participation in the ACCU Scheme (and other voluntary emissions reduction schemes) and we also have a deep understanding of the Australian financial services licensing implications for participants that deal in and advise on transactions relating to environmental products in Australia. However the views we express in this submission are our own and should not be taken to reflect those of any client.

1.4 In this submission, we set out our comments and suggestions in relation to some of the proposals on which ASIC has sought feedback, specifically we have not commented on the proposals regarding new examples and guidance on managed investment schemes. We also make some additional points for ASIC to consider.

1.5 In this submission, unless otherwise specified:

(1) capitalised words or phrases in this submission have the same meaning given to them in the Consultation Paper and Draft Reg Guide;

(2) references to sections or regulations are to the *Corporations Act 2001* (Cth) (**Corporations Act**) and the *Corporations Regulations 2001* (Cth) (**Corporations Regulations**).

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1.6 We expect that many industry participants will make submissions to ASIC in response to the Consultation Paper. ASIC's response to these submissions, and any amendments to RG 236 that it may make as a result, will carry substantial weight when industry participants are considering how to arrange their legal and commercial affairs in relation to the trading of carbon credits and investments in carbon projects. Naturally, views among participants may differ on some points, so we would encourage ASIC to issue a further "pre-publication" draft of RG 236 to allow industry participants a final opportunity to express any views or concerns with the positions or guidance proposed by ASIC.

2 Submission

B1Q1 Do you think that any additional guidance is needed to assist financial services providers in applying for or varying an AFS licence so that they are authorised to provide financial services in relation to SMCs? If so, please detail the additional guidance required.

2.1 As ASIC notes, SMCs are financial products for the purposes of the Corporations Act. Accordingly, the previous guidance in RG 236 as it applies to ACCUs and EIEUs applies equally to dealings and conduct in relation to SMCs. In this sense, we do not consider additional guidance is specifically required to assist financial services providers in applying for or varying an AFS licence so that they are authorised to provide financial services in relation to SMCs.

2.2 That said, it has been quite some time since RG 236 was last updated in May 2015, and since then there has been considerable change in the Australian and international carbon markets. This change has involved growth in the number and types of participants in the carbon markets and, therefore, those who are potentially impacted by Australian financial services law as it applies to the trading of financial products. Some such participants have not previously engaged with the Australian financial services legal regime. Accordingly, we would encourage ASIC to take this opportunity to consider updating RG 236 more broadly to provide more specific guidance in this context, including:

(1) more specific examples of when a derivative may be considered a contract for the future provision of a service (see paragraph 2.5); and

(2) circumstances where a derivative in relation to a carbon credit can be considered to be managing a financial risk (see paragraph 2.6).

B2Q1 Is the updated example provided for derivatives practical and useful in understanding when there may be a derivative involving an emissions unit? If not, how can the example be improved or made clearer?

2.3 In relation to Example 2 in the Draft Reg Guide, we comment as follows:

(1) the example should be expanded to make it clear that the same analysis applies to a forward sale and purchase agreement in respect of a carbon credit, as these are common transactions in the market. By not referring to forward contracts, a reader may have the false impression that they are to be distinguished from option contracts;

(2) the example should not be specific to SMCs, but refer to any carbon credits that are financial products;

(3) while the commentary in RG 236.100 to the effect that an option contract is a derivative and not a contract for the future provision of services is helpful, we are not generally aware of market participants taking the view that options (or forwards for that matter) would be excluded from being a derivative on the basis that they are a 'contract for the future provision of services'.

B2Q2 Are there any other common real-world scenarios where there may be a derivative involving an emissions unit that would further assist in understanding the application of s761D for ASIC to provide guidance on? If so, briefly describe other relevant scenarios.

2.4 As ASIC would be aware, the definition of a derivative in section 761D of the Corporations Act is very broad. The legislature sought to counteract this by including various exemptions in the Corporations

Act and Corporations Regulations. However, because carbon credits are not a form of tangible property, and because the activities and motivations of participants in the carbon markets are varied and diverse, many of the traditional exemptions may not apply (or it is at least unclear if they do so).

2.5 The Consultation Paper notes that ASIC is providing "further guidance regarding the application of s761D(3)(b), which exempts contracts for the future provision of services from falling within the definition of a 'derivative'." If that guidance is embodied in RG 236.98 – 100, we believe it does not go far enough. At present, the guidance and principles in RG 236.99 are very general, being derived from relevant case law. We believe that market participants would greatly benefit from further guidance in relation to the exemption for contracts for the future provision of services in the context of real-world examples that apply in the carbon markets. This could be achieved as follows:

(1) ASIC providing further commentary about when an arrangement provides exposure to a carbon credit, and what "exposure" means in this context. Presumably ASIC is concerned with exposures that relate to the movements in the price of carbon credits, rather than an arrangement that simply gives a party a right to access or claim the benefits associated with a carbon credit entered into by the party for the purpose of meeting its mandatory or voluntary emissions reduction targets. If this presumption is correct, it should be made clearer in RG236.99;

(2) including an example of a scenario where a landholder/project proponent engages a third party to manage the carbon project (**Carbon Services Provider**) and the Carbon Services Provider receives some or all of its remuneration in the form of a number of ACCUs generated by the carbon project (determined by reference to a fixed number or percentage of the ACCUs generated by the project); and

(3) providing examples of "intermediary" arrangements and guidance as to whether such arrangements would benefit from the exemption for contracts for future provision of services. Often, a key objective for a person to acquire an ACCU is to relinquish or surrender the ACCU to the Clean Energy Regulator. The surrender of the ACCU gives rise to a retirement certificate which a person may rely on to make a claim that it has fulfilled or achieved certain carbon emissions reductions (either on a mandatory or voluntary basis). The persons that wish to make these claims are many and varied, and include large corporate entities in Australia. However, their ability to purchase and surrender ACCUs on their own behalf is hindered by the costs of accessing the ACCU market (ie. setting up ANREU accounts, entering into legal trading documentation with multiple counterparties and possibly the need to obtain an AFSL). Arrangements are emerging in the market whereby certain entities will seek to act as intermediaries/aggregators that allow entities to pay money to the intermediary in exchange for a retirement certificate that notes the person as being entitled to claim the relevant emissions reductions (without the need to actually own the underlying ACCU) – in effect, providing a service of procuring carbon offset claims. Guidance on these arrangements would be extremely valuable to this emerging area.

2.6 The Australian financial services licensing implications of an arrangement being characterised as a derivative under section 761D can be ameliorated if an exemption applies. One of those is the exemption for managing financial risk in regulation 7.06.01(1)(m) which is referred to in paragraph RG 236.184 of the Draft Reg Guide. However, the example provided in this paragraph is quite simplistic. It would be helpful if ASIC could expand this guidance in relation to the application of this exemption in more complex scenarios that arise in the carbon markets. For example, large Australian corporate entities that need to surrender carbon credits to the Commonwealth Clean Energy Regulator need to implement complex long-term strategies to procure and manage the acquisition of carbon credits. This can be done by the use of forward contracts (being derivatives). These corporate entities may already be entering into derivatives to manage interest rate and foreign currency risks, but they would not need to hold an AFSL as it is relatively clear that the exemption for managing financial risk applies in this context. However, managing the procurement of carbon credits to meet anticipated future emissions reductions targets is inherently uncertain, and circumstances may arise where forward contracts for the acquisition of carbon credits may then need to be offset by opposing forward contracts if a surplus of carbon credits arises. It is clear that these are derivatives entered into for the purposes of managing a risk that arises in the ordinary course of business, given the consequences that may arise if an entity does not surrender a sufficient number

of carbon credits (or if it does not manage its exposure to holding a surplus amount of carbon credits). However, it is arguable as to whether this is a "financial risk", and it would be helpful if ASIC provided guidance on the types of risks that it considers can be taken into account under regulation 7.06.01(1)(m).

In this regard, we note other comments made by ASIC at RG 236.121 of the Draft Reg Guide in relation to environmental products that are not specifically listed as financial products:

> "We do not consider that these types of units fall within the general definition of a financial product (i.e. a facility for making a financial investment or managing a financial risk: see s763A of the Corporations Act). These types of units are ordinarily acquired to conserve or improve certain aspects of the physical environment (e.g. investing in nature repair projects through biodiversity certificates), or to offset other emissions that cannot be avoided in the short term. They are not ordinarily acquired to manage the financial consequences that may flow if a particular outcome occurs. Therefore, we do not consider that these units are ordinarily used to manage a financial risk..."

2.7 In the Consultation Paper, Proposal B2 on page 9 states as follows:

> "We propose to provide examples of types of financial products other than ACCUs and SMCs that may involve emissions units. We are providing more explanatory material about derivatives and interests in managed investment schemes involving emission units..."

2.8 In relation to Proposal B2, we would invite ASIC to provide further guidance on whether certain transactions involving emissions units (whether they relate to ACCUs, SMCs or other types of emissions units) may nonetheless constitute a facility for making a financial investment (and therefore a financial product).[1] ASIC makes some comments in relation to this at RG 236.97 of the Draft Reg Guide:

> "Products that are not derivatives or interests in a managed investment scheme may still be a financial product under the general definition of a financial product: see s763A of the Corporations Act. For example, where a contract in relation to carbon abatement (that generates regulated emissions units) is a facility to make a financial investment, it is a financial product."

2.9 We note that the definition of "makes a financial investment" in section 763B is very broad and includes a situation where a person gives money to another person and the other person uses the money to generate a financial return or "other benefit" for the investor. It is helpful that ASIC has indicated that it does not consider the environmental units listed in RG 236.119 as being a facility for making a financial investment.[2] However, it would also be helpful for ASIC to clarify why it considers these units do not give the investor an "other benefit". For example, is not the ability to use carbon credits to offset other emissions that cannot be avoided (being an example cited by ASIC in RG 236.121 of the Draft Reg Guide) a benefit? If ASIC does not consider this type of benefit to be within the ambit of "other benefits" encompassed in the definition of "makes a financial investment", it would be helpful to know why. Does ASIC consider the phrase to be limited to benefits of a financial nature? This guidance would be helpful because other products or arrangements are likely to develop in the future which are not listed in RG 236.119 and the guidance would allow market participants to more easily determine whether the arrangement is one which is intended to be captured as a financial investment.

Should you have any queries regarding the documentation above, please do not hesitate to contact myself.

Yours faithfully

Vittorio Casamento
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Norton Rose Fulbright Australia

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1 See Draft Reg Guide RG 232.33.

2 See Draft Reg Guide RG 236.120 –121.