Housing Unit Manager Social Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

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## Social Impact Investment Discussion Paper

We are pleased to have this opportunity to contribute to building the impact investment market by commenting on the Social Impact Investment Discussion Paper (January 2017).

**Social Impact Legal** provides strategic, governance and legal advice to organisations intent on making a positive impact, including impact investors, corporates, social enterprises and Not-for-Profits.

Given the short time frame available for preparing submissions, we have elected to focus on Question 23 -

**"What guidance in particular would provide a desired level of clarity on the fiduciary duty of superannuation trustees on impact investing?"**

## Executive summary

The Australian government has an opportunity to assist superannuation fund trustees to make well-informed and carefully considered decisions about their attitude toward Environmental, Social and Governance (ESG) factors and impact investing, by developing detailed guidance in consultation with the superannuation industry, and drawing on a report to be published in May 2017 by the UK Law Commission.

## ESG and impact investing

It is important to be clear about what is meant by "ESG investing" and "impact investing". A variety of different definitions have been suggested. For example, according to Goldman Sachs:

**ESG investing** is the incorporation of ESG values into traditional frameworks;

**PO Box 5057 Laburnum Vic 3130**

**T** +61 3 9893 5478 **E** info@socialimpactlegal.com **W** socialimpactlegal.com

Social Impact Legal Pty Ltd

ACN 614 831 506

**Impact Investing** is actively targeting investments aimed at solving social and environmental issues.[1]

For present purposes the important distinction is that impact investment involves the *active pursuit* of positive impact by addressing societal challenges, as opposed to considering ESG factors only as a means of mitigating risk.

Bridges[2] have described three types of impact investing, such that the focus may be on addressing:

- societal challenges that generate **competitive financial returns** for investors, as in the case of impact investments made by superannuation funds;
- societal challenges where **returns are as yet unproven**, as in the case of Social Impact Bonds; or
- societal challenges that require a **below-market financial return** for investors, as in the case of some social enterprises, charities and philanthropic ventures.

It is generally accepted that only those investments capable of generating a commercial rate of return may be considered by superannuation funds in Australia.

## Legal position in Australia[3]

Superannuation fund trustees rightly take their legal obligations very seriously in relation to the investment of members' retirement savings.

Under the current law in Australia, the sole purpose of superannuation, enshrined in s62 of the *Superannuation Industry (Supervision) Act 1993* (Cth), is the provision of benefits in retirement and in certain other circumstances. Notwithstanding that the objective of superannuation is articulated differently in the Commonwealth's *Superannuation (Objective) Bill 2016*,[4] the bottom line for superannuation funds is the financial benefits they can provide for members.

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[1] Goldman Sachs 'ESG & Impact Investing: The Evolving Landscape' available at https://www.gsam.com/content/gsam/global/en/market-insights/gsam-insights/gsam-perspectives/2015/esg.html

[2] 'The Bridges Spectrum of Capital: How we define the sustainable and impact investment market' (2015) available at http://bridgesventures.com/wp-content/uploads/2015/11/Spectrum-of-Capital-online-version.pdf

[3] Our submission is in the form of general commentary and is not to be taken as legal advice. For a detailed account of the legal position in Australia see for example, see Kylie Charlton, Scott Donald, Jarrod Ormiston and Richard Seymour, 'Impact investments: Perspectives for Australian Superannuation Funds' (2013); UK Law Commission Consultation Paper No 215 'Fiduciary Duties of Investment Intermediaries' - Appendix by Clayton Utz.

[4] The Law Council of Australia submission to the Senate Inquiry into the *Superannuation (Objective) Bill 2016* outlines significant potential difficulties associated with the potential differences between the sole purpose test and the proposed separate legislative objective of superannuation.

With financial benefits as the goal, trustees must engage their investment managers to manage members' money in accordance with a carefully framed investment strategy. Increasingly, investment strategies are including consideration of ESG factors, on the basis that these are financially material.

In the UK, a 2014 Law Commission report summarised the legal position in the UK as follows:

- Trustees should take environmental, social and governance (ESG) factors into account where financially material including where relevant to risk; and

- Where the impact is non-financial it can be taken into account but only if members share the concern and there is no significant risk of financial detriment.

So, to the extent that ESG factors are financially material, they must be taken into account by trustees. In that sense, "ESG" is not optional, and never was. As noted by UK Law Commission, it is more helpful to talk about financial and non-financial factors, than ESG factors.

Investment managers earn their bread and butter by identifying factors that will influence the financial value of an investment. Over time, an ESG factor may shift from being a non-financial factor, which is only of interest from a social or ethical perspective, to being financially material. For example, there is increasing recognition that risks associated with climate change are financially material.[5]

## International developments

Building on the seminal "Freshfields" reports, extensive guidance material has been issued in other jurisdictions, particularly over the last 2 years, both by regulators and industry players. Some examples are set out below.

### United Kingdom

In 2014, the UK Law Commission published *Is it always about the money?" Pension trustees' duties when setting an investment strategy.*[6] While there are some legislative differences between the UK and Australia, this 4-page summary of a more detailed 2014 report by the UK Law Commission[7] is an example of the kind of guidance which might be useful in Australia.

[5] Risks include not just physical risks but also risks associated with regulatory and other changes ("transition risks") and liability risks. See for example Sarah Barker, 'Directors' personal liability for corporate inaction on climate change' (2015) 2 *Governance Directions* 21, Clancy Yeates, 'Climate change a 'material' risk for the financial system: APRA", *The Sydney Morning Herald* (Sydney) 17 February 2017.
[6] UK Law Commission Guidance on Fiduciary Duties: "Is it always about the money?" (2014)
[7] UK Law Commission, 2014, 'Fiduciary Duties of Investment Intermediaries', which addresses the question of how far pension fund trustees may (or must) "consider interests beyond the maximisation of financial return, such as questions of environmental or social impact, and the ethical views of their beneficiaries."

The UK Law Commission continues with work in this area and is due to report in May 2017 on the question: "How far does or should the law allow pension funds to select an investment because it is thought that it would make a positive social impact?"

Other examples published in 2016 include:

- *Environmental, Social and Corporate Governance (ESG) Made Simple*, published by the UK Pensions and Lifetime Savings Association; and
- *A practical approach to ESG: A guide for pension trustees*[8], published by Sackers in the UK.

## United States

In 2015, the US Department of Labor issued guidance, in what was widely hailed as a game changer[9], to

> "acknowledge that environmental, social and governance factors may have a direct relationship to the economic and financial value of an investment, and when they do these factors are proper components of the fiduciary's analysis"; and
>
> "confirm that fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits, but may take such benefits into account as "tie-breakers" when investments are otherwise equal".[10]

In 2016, the US Center for International Environmental Law published *Trillion Dollar Transformation: Fiduciary Duty, Divestment, and Fossil Fuels in an Era of Climate Risk*[11], providing a careful analysis and practical guidance for pension fund trustees in relation to how to navigate climate change risks in keeping with their fiduciary duties to fund members.

## Global initiatives

A 2015 report *Fiduciary duty in the 21st Century*,[12] concluded that "far from being a barrier, fiduciary duty creates positive duties on investors to integrate environmental, social and governance (ESG) issues, to mitigate risk and identify investment opportunities."

[8] Available at https://www.sackers.com/publication/a-practical-approach-to-esg-a-guide-for-pension-trustees/

[9] For example, see https://www.unpri.org/page/us-department-of-labor-clarifies-erisa-fiduciaries

[10] Interpretative Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments (Interpretive Bulletin 205-01).

[11] Center for International Environmental Law, 'Trillion Dollar Transformation: Fiduciary Duty, Divestment, and Fossil Fuels in an Era of Climate Risk' (2016) includes a list of questions pension fund trustees should ask their lawyers.

[12] Sullivan, R., Martindale, W., Feller, E. and Bordon, A. (2015). 'Fiduciary Duty in the 21st Century'. Geneva: UN PRI. Available at http://www.unpri.org/press/new-report-aims-to-end-debate-about-esg-and-fiduciary-duty/

A three-year global project (2016-2018) is now underway to assist 8 countries including Australia with fully integrating ESG issues into investment policies and practices.[13]

## Developing guidance in Australia

In the roadmap for Australia published in December 2016 by the Fiduciary Duty in the 21st Century project[14], the following actions are recommended in order to clarify fiduciary duty in Australia:

- "APRA should clarify and update paragraph 34 of SPG 530[15] to clarify the difference between ESG integration and ethical investment options....
- APRA should clarify and update paragraph 36 of SPG 530 to clarify that investors should consider all financial factors, which include ESG factors. Redrafting paragraph 34 could make paragraph 36 unnecessary, in which it could be deleted. In clarifying paragraphs 34 and 36, APRA should continue to recognise the legitimacy of ethical and reputational considerations provided that prudential and fiduciary standards are met, for example, managing risk and acting in the best interests of members.
- Institutional investors should ensure they have adequate policies, skills, advice and systems for identifying, integrating and providing transparency on their management of long-term systemic risks, such as climate change."

We **support** those recommendations.

There is an opportunity for the Australian government to play an enabling role by going further. Possibilities include:

- APRA could issue more detailed guidance, along the lines of the international examples cited above[16]; and/or
- the Australian government could support the development of more detailed guidance by industry bodies.

Examples of the types of questions which could be addressed are:

- To what extent are superannuation fund trustees required or allowed by law to take into account ESG factors, and what are the implications

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[13] The project is under the auspices of the Principles for Responsible Investment (PRI), United Nations Environment Programme Finance Initiative (UNEP FI) and The Generation Foundation, See http://www.fiduciaryduty21.org/about.html

[14] Fiduciary Duty in the 21st Century: Australia Roadmap (2016). See also Fiduciary Duty in the 21st Century Australia Roadmap Stakeholder Discussion Paper (2016 – 2018).

[15] Australian Prudential Regulation Authority Prudential Practice Guide SPG 530 – Investment Governance.

[16] Such as UK Law Commission *Guidance on Fiduciary Duties: "Is it always about the money?"* (2014).

for investment managers?
- How does “taking ESG into account” differ from “impact investing” and what are the different legal considerations?
- How should superannuation fund trustees go about taking ESG factors into account?
- Are there any circumstances in which superannuation funds could prioritise impact over risk-adjusted returns, for example in a clearly-labeled member choice portfolio?

The questions to be addressed could be further refined through consultation with industry participants. In developing the guidance, the Australian government could also draw on the forthcoming report by the UK Law Commission and the ongoing work of the *Fiduciary Duty in the 21st Century* initiative.

In addition to formal guidance, superannuation fund trustees will need ongoing education in order to be able to:

- comply with their legal duties to take into account all relevant factors in setting and monitoring their investment strategy; and
- make a well informed decision about whether or not to engage in impact investing, based on an assessment of the potential advantages in terms of diversification and member appeal, as well as the potential for competitive returns.

## Conclusion

We would be delighted to clarify any of the matters raised in our submission and look forward to working in collaboration with others to help resolve the uncertainty in the minds of superannuation trustees regarding the law on this issue. As a result, trustees will be equipped to make well-informed and carefully considered decisions about their attitude toward ESG factors and impact investing.

We believe that careful and level-headed analysis of the legal duties of superannuation fund trustees, and an informed debate in the industry, will result in a realization that there is more scope than many assume for impact investing by superannuation fund trustees.

Yours sincerely

SOCIAL IMPACT LEGAL
Libby Klein