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Via email: SustainableFinanceConsultation@treasury.gov.au

**Sustainable Finance Strategy – Consultation Paper**

We welcome the release of the government's sustainable finance strategy consultation paper as an important next step and important part of achieving Australia's emissions reduction target. We particularly welcome the government's recognition that investors have an important role to play in the transition to a net zero economy.

We encourage the government to take a holistic approach to its sustainable finance strategy and consider barriers for the Australian economy in meeting the government's sustainability goals and Australia's net zero target. Policymakers have an important role in incentivising investment with clear economy wide decarbonisation strategies and funding that de-risks innovative sustainable solutions.

Managed funds and superannuation funds may have different ESG or sustainability-related investment objectives, strategies, styles and risk appetites along a spectrum. As fiduciaries, all fund managers and superannuation funds have a duty to millions of Australians as trustees of their savings to act in their best financial interest. While investment plays an important facilitative role in the transition and can be supported by a good climate-related financial disclosure regime and sustainability-related information framework, funds ultimately respond to activity in the real economy, with investors' decision making occurring as fiduciaries under the primary consideration of acting in the financial interests of their members.

Our members seek to maximize returns for Australians for any level of investment risk. Better climate-related financial disclosures will enable funds to identify companies well positioned for the climate transition, and therefore positioned to offer long-term risk adjusted returns in the long-term financial interests of a funds' members. Government can play an important role in enhancing the usability, quality and comparability of sustainability related data to enhance disclosures.

We also recognise the importance for consumers that financial system participants' disclosures are reliable, that their ESG or sustainability-related claims have a reasonable basis and are true to label, and that they do not engage in misleading and deceptive conduct in fund product labelling and in making sustainability-related claims. However, while the government is rightly seeking to take a high ambition approach, the regulatory environment can work against the government's objective of mobilising private sector capital to support the net zero transition and other sustainability goals. Where uncertain and retrospective regulatory application of the law creates high regulatory risk and uncertainty, then funds may choose to minimise regulatory risk by investing with minimal sustainability considerations, other than engaging in the ordinary risk management of integrating ESG/sustainability-related risks as financial risks.

We urge the government and regulators to work with industry to develop consensus around sustainable/responsible investment product labelling. We propose that an industry produced and owned product labelling standard could be developed by the industry, in consultation with the regulator and enforced by the regulator. This will provide confidence to funds seeking to introduce innovative sustainability


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strategies and products into the market, while also providing flexibility as understanding and expectations evolve.

We believe that an Australian sustainable finance taxonomy has an important role to help mobilise capital toward sustainable economic activities. We look forward to continuing to support the development of an Australian sustainable finance taxonomy. It is important that an Australian taxonomy allows for sustainability themed investment products to invest in 'transition' investments, recognising that investment in high emissions sectors in the short to medium term will be vital for Australia's success in transitioning to net zero. An Australian taxonomy can work together with sector transition pathways in helping investors understand where capital can be directed to support decarbonization. Government should also learn lessons from the EU experience and allow more flexibility, not stringently tying a highly technical taxonomy to sustainable investment product disclosure, which may create perverse incentives directing capital to activities that are easier to measure under a taxonomy rather than activities that have a bigger real world sustainability impact. An Australian taxonomy should also be interoperable and internationally recognised, so that global firms can meet their obligations globally with respect to investments in Australia by complying with the Australian sustainable finance taxonomy.

Importantly, Australian sustainable finance disclosures and frameworks should be interoperable with the International Sustainability Standards Board (ISSB) IFRS S1 and IFRS S2 and emerging international disclosure and product labelling regimes. Consistency in terminology and reporting frameworks will help facilitate overseas capital investing into Australian sustainable assets and the provision of greater options for consumers seeking products that align with their values and sustainability concerns. While this does not necessarily mean completely replicating overseas regimes, interoperability should mean the ability to export and import sustainable investment strategies with less friction.

We look forward to continuing to engage closely with the government on many of the important streams outlined in the strategy, to set Australia up for a strong, financially sustainable future.

Sincerely,

**Chaneg Torres**
Policy Director
Investments & Funds Management

## Summary of FSC Recommendations

### Pillar 1: Improve transparency on climate and sustainability

**Priority 1: Establish a framework for sustainability-related financial disclosures**

Government can support companies developing the required skills, resources and capabilities to make climate disclosures through the following:

**Recommendation 1.2: Comply and explain obligation**

Government should take a flexible approach to liability and regulator enforcement that allows for continual improvement. We recommend that legislation clearly spell out that reporting entities should do everything reasonably possible to comply with the reporting regime or explain the reasons why they are unable to meet certain obligations (such as lack of data availability or reliable estimates).

**Recommendation 1.3: Timing of regime**

Government should consider the timing of the regime's proposed phased obligations to allow appropriate preparation. We recommend the first phase a year after the AASB standards are finalised (i.e mid 2025).

**Recommendation 1.4: Need for industry specific guidance on reporting requirements**

Government should provide industry specific guidance, developed in collaboration with industry, on what good reporting looks like (such as minimum requirements for specific industries) to create greater comparability and reduce barriers to reporting, including guidance for managed funds and superannuation funds. Guidance can include:

- guidance on reporting scope 3 (for asset managers, financed emissions) for specific industries (including boundaries and estimates),
- guidance on how disclosures should be undertaken for funds with complex corporate structures and allowance for consolidated reporting,
- guidance on industry metrics, creating clearly defined and consistent metrics for strategic sectors, and
- guidance on scenario analysis.

**Recommendation 1.5: Phasing in audit requirements**

Recognising that it will take time to build expertise and capability across the industry for audit and assurance, audit requirements should be phased over a longer time horizon. We recommend that audit requirements could be focussed at first instance on companies with material emissions and for other reporting entities the first phase of reporting should require board sign off of reports.

**Recommendation 1.6: Data utilisation**

The reporting regime should allow for the easier utilisation of data via downloadable data formats.

**Recommendation 1.7: Focus on climate-related financial disclosures**
Given the large volume of regulatory change, mandatory disclosures should focus on climate-related financial disclosures, with the allowance for other sustainability-related voluntary disclosures within the framework.

**Priority 2: Develop a Sustainable Finance Taxonomy**
An Australian sustainable finance taxonomy has an important role to play in mobilising capital toward sustainable economic activities. We recommend the following with respect to an Australian sustainable finance taxonomy.

**Recommendation 2.1: Taxonomy should be voluntary and interoperable with overseas taxonomies**
We would caution against embedding the Australian taxonomy within the sustainability disclosure framework at this stage, given investor experience with the complexity of the EU Taxonomy. The Australian taxonomy should avoid excessive complexity, begin as voluntary best practice guidance and be interoperable and internationally recognised, so that global firms can meet their obligations globally with respect to investments in Australia by complying with the Australian sustainable finance taxonomy.

**Recommendation 2.2: Transition category needed**
An Australian taxonomy should include a transition category and not limit investment by sustainable/responsible investment themed funds in 'green' only investments, given the need for capital in a large part of the Australian economy to transition.

**Recommendation 2.3: Do no significant harm criteria**
We support the development of 'do no significant harm' criteria in recognition of the interconnectedness of sustainability objectives.

**Recommendation 2.4: Periodic review of transitional activities**
There should be periodic review of transitional activities to ensure credibility.

**Recommendation 2.5: Independent Taxonomy Technical Expert Group**
Government should support an independent Taxonomy Technical Expert Group to review the taxonomy periodically. The Technical Expert Group should have a transparent decision-making process.

**Recommendation 2.6: Guidance on calculating alignment with the taxonomy**
Government should eventually provide guidance on how companies and different asset classes can calculate revenue and expenditure alignment with the taxonomy.

**Recommendation 2.7: Initial taxonomy focus on climate**
We support an initial focus on climate mitigation and climate adaptation objectives.

**Priority 3: Support credible net zero transition planning**
Government should provide clear policy direction around transition, having regard to trade-offs in pursuit of emissions reduction and the way emissions reduction intersects with other sustainability concerns.

**Recommendation 3.2: Transition roadmap guidance and best financial interests**
Government can endorse transition roadmap guidelines for industry but should not direct investment contrary to investors' best financial interests.

**Recommendation 3.3: Transition plan scenario, metrics and data guidance**
Government can enhance transition plan disclosure by requiring that transition plans include a scenario involving current global policy settings and by providing guidance on metrics and data to be used in sector transition plans.

**Priority 4: Develop a labelling system for investment products marketed as sustainable**
Current regulatory uncertainty underscores the need for greater consensus around sustainable/responsible investment labelling.

**Recommendation 4.1: Industry-led product labelling regime**
We recommend an industry led code or standard. The FSC and the Responsible Investment Association of Australasia (RIAA) have undertaken extensive work on product labelling, accounting for the current legal and regulatory framework and the spectrum of legitimate sustainable/responsible investment strategies undertaken by a variety of funds with a variety of sustainability or responsible investment related objectives. The government should consider the information note produced by the FSC for its members as it reflects broad Australian industry consensus.

**Recommendation 4.2: Lessons from overseas, interoperability and passporting of sustainable investment strategies**

- Overseas regime categories do not necessarily account for the broad range of sustainable/responsible investment strategies or objectives.
- Interoperability and minimising fragmentation of understanding is very important to enable the scaling of investment solutions across borders. This does not necessarily involve complete duplication, but rather allowing global funds to passport strategies that meet the criteria of overseas labels.

## Pillar 2: Financial system capabilities

**Priority 5: Enhancing market supervision and enforcement**

**Recommendation 5.1: General law can be strengthened by product labelling consensus**

Current general law around misleading and deceptive conduct is good and can be strengthened by greater consensus in product labelling and the use of terms.

**Recommendation 5.2: Regulator should be more collaborative with industry around product labelling and disclosure**
Government and regulators should take a collaborative approach with industry in creating consensus around product labelling and disclosure in order to encourage industry ambition and empower investors to meaningfully compare products.

**Priority 7: Addressing data and analytical challenges**

**Recommendation 7.1: Government support of greater data quality**

Government can support the provision of robust, comparable and consistent data thorough the provision of sector specific metrics, guidance on industry specific scope 3 emissions calculation methodologies, data on climate change risks, providing for digital and downloadable reporting, and guidance on data estimation. Government should cooperate with international regulators to develop metrics, data and scenarios.

**Priority 8: Ensuring fit for purpose regulatory frameworks**

**Recommendation 8.1: Current government priorities the right focus in ensuring regulatory framework fit for purpose**

The current proposals around enhanced climate-related financial disclosures, the development of a sustainable finance taxonomy and a greater focus on consensus around sustainable fund labelling and the use of sustainability-related terms strikes the right balance in meeting the government's goal of encouraging the allocation of capital toward more sustainable investments, while also giving superannuation funds and managed funds the necessary freedom to determine what is in the best financial interests of their members.

**Recommendation 8.2: Your Future Your Super performance benchmarks**

On Your Future Your Super performance benchmarks, the FSC supports stable policy settings in superannuation, including with respect of the performance test. Government should act where there is strong evidence of unintended consequences.

**Recommendation 8.3: Government should draw on existing industry work on stewardship standards**

Industry has already undertaken extensive work in lifting investor stewardship standards. Government should consider work already done by the FSC with its Standard 13 and Standard 23.

## Pillar 3: Australian Government leadership and engagement

**Priority 9: Issuing Australian sovereign green bonds**

**Recommendation 9.1: Importance of credibility of sovereign green bonds**

Government should ensure that sovereign green bonds are credible in order to be attractive to investors.

**Recommendation 9.2: Biodiversity and nature repair**

We are supportive of the government developing the biodiversity and nature repair market.

**Priority 12: Reducing barriers to sustainable investment**

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Government can play an important role in de-risking innovative sustainable solutions where these are aligned with national priorities, making these investments more attractive for co-investment and shortening the timeframes for transition.

## Pillar 1: Improve transparency on climate and sustainability

### Priority 1: Establish a framework for sustainability-related financial disclosures

**What are the opportunities for Government, regulators and industry to support companies to develop the required skills, resources and capabilities to make climate disclosures under the proposed new obligations?**

**Priority 1 recommendations**

Government can support companies developing the required skills, resources and capabilities to make climate disclosures through the following:

**Recommendation 1.2: Comply and explain obligation**
Government should take a flexible approach to liability and regulator enforcement that allows for continual improvement. We recommend that legislation clearly spell out that reporting entities should do everything reasonably possible to comply with the reporting regime or explain the reasons why they are unable to meet certain obligations (such as lack of data availability or reliable estimates).

**Recommendation 1.3: Timing of regime**
Government should consider the timing of the regime's proposed phased obligations to allow appropriate preparation. We recommend the first phase a year after the AASB standards are finalised (i.e mid 2024).

**Recommendation 1.4: Need for industry specific guidance on reporting requirements**
Government should provide industry specific guidance, developed in collaboration with industry, on what good reporting looks like (such as minimum requirements for specific industries) to create greater comparability and reduce barriers to reporting, including guidance for managed funds and superannuation funds. Guidance can include:

- guidance on reporting scope 3 (for asset managers, financed emissions) for specific industries (including boundaries and estimates),
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**Recommendation 1.5: Phasing in audit requirements**
Recognising that it will take time to build expertise and capability across the industry for audit and assurance, audit requirements should be phased over a longer time horizon. We recommend that audit requirements could be focussed at first instance on companies with material emissions and for other reporting entities the first phase of reporting should require board sign off of reports.

**Recommendation 1.6: Data utilisation**
The reporting regime should allow for the easier utilisation of data via downloadable data formats.

**Recommendation 1.7: Focus on climate-related financial disclosures**
Given the large volume of regulatory change, mandatory disclosures should focus on climate-related financial disclosures, with the allowance for other sustainability-related voluntary disclosures within the framework.

Taking a flexible approach to liability

A key way government and regulators can support companies is by allowing for regulatory flexibility that provides confidence to report and encourages continual improvement, while also encouraging companies to be reporting usable data as early as possible. We have previously argued that it is in the interest of investors that companies and their directors are encouraged to disclose their climate risk and develop best practice disclosure without the fear of vexatious litigation when they have acted in good faith to produce disclosures with the best information available to them.

We do not think that Treasury's current proposal to introduce modified liability relief for forward looking statements through limiting action against misleading and deceptive conduct to regulator-only actions for a fixed period of three years is sufficient. There is concern that the current requirement of 'reasonable grounds' under section 769C of the *Corporations Act 2001*, while providing some confidence that future looking statements are made on a reliable basis, would undermine confidence that business needs to make statements about climate risks and opportunities given the difficulty in relying on the current state of data to make forward looking statements.

Climate disclosures are an evolving area, and we expect that experience will lead to improvement and greater quality disclosures over time. There must be a recognition by government and regulators that what constitutes best practice climate-related financial disclosures will continue to evolve for several years, especially with regard to scope 3 emissions. As investors, our members consider scope 3 to be very important in assessing the economic viability of a business model via assessing exposure to carbon-intensive activities or supply chains. However, it is important to acknowledge the practical difficulties involved in building capability across the economy to report scope 3. For instance, data in emerging markets will continue to be sparce. While asset managers can undertake estimations of unreported values, the methods of estimation can vary depending on data providers and methodology. In time, we do expect to see a shift from emissions being estimated to actual emissions and this should be recognised as an improvement, not as a misrepresentation by the company.

We recommend that Treasury reflect the principle of flexibility in the law via a comply or explain obligation, where investors and businesses can help users understand the limitations of the estimates used by disclosing assumptions and the sources of information for any estimates. Penalties should be limited to conduct where there is a deliberate failure to produce a report, or a neglect to produce after warnings, or the submission of false statements and a failure to address the mandatory reporting criteria.

Commencement of the reporting regime

We encourage Treasury to reconsider whether the proposed timing of the regime's phases will allow adequate time for preparation and capability build across the economy. Currently, first phase entities will have under a year to prepare. Our previous submission has recommended that reporting start one year after the AASB standards are finalized. With the current timeframe for completion of the AASB standards, commencement should be mid-2025.

Provision of industry specific guidance

The government and regulators can support climate disclosure capability across the economy by providing clear guidance on the minimum requirements for specific industries, developed in collaboration with industry, while allowing for innovation and development in industry specific metrics. This will help provide greater consistency and comparability across industry and reduce barriers to reporting for companies. Guidance should include expectations for scope 3 disclosures for major industries/sectors and how scope 3 disclosures can be assured. We also submit there is a role for government and regulators to provide industry specific guidance for scenario analysis (see Priority 3).

The government should follow the lead of the the Financial Stability Board (FSB) and the ISSB, who released specific guidance for different industries including asset managers.[1] The ISSB has sought to harmonise developed industry metrics through the *Industry-based Guidance on Implementing IFRS S2*. We outline areas where guidance can be provided below.

It is important to recognise that asset managers are at the end of the disclosure chain. Ideally, reporting would be phased to involve corporates first, then asset managers, then asset owners. European experience shows the challenge that asset managers have in meeting the requirements under the Sustainable Finance Disclosure Regulations (SFDR), which imposed disclosure obligations on asset managers before wider disclosure requirements were introduced under the Corporate Sustainability Reporting Directive (CSDR). The European Commission is currently undertaking a review of the implementation of the SFDR, and stakeholders are being asked to consider whether 'data gaps make it challenging for market participants to disclose fully in line with the legal requirements under the SFDR.'[2] While we note the government's current planned phased approach (with material scope 3 emissions reported from the second reporting year onward), we reiterate

[1] TCFD (2001), Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures (https://www.fsb.org/wp-content/uploads/P141021-4.pdf), IFRS (2003), IFRS S2 Industry Based Guidance on Implementing Climate-related Disclosures (https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards-issb/english/2023/issued/part-b/ifrs-s2-ibg.pdf?bypass=on)

[2] European Commission (2023), Target Consultation Document Implementation of the Sustainable Finance Disclosures Regulation (SFDR), pg 6 (https://finance.ec.europa.eu/system/files/2023-09/2023-sfdr-implementation-targeted-consultation-document_en.pdf)

the need to recognise that asset managers, reliant on the disclosures of underlying investee companies, will still be required to report without the data from underlying investee companies that fall under a later reporting phase. Under the proposed regime phasing, large asset managers will be required to report before many of its underlying companies have reported and so will need to rely on estimates.

For scope 3, the risk is that there will be divergent interpretations of the requirement to disclose scope 3 emissions leading to a lack of consistency. For funds, we consider scope 1, 2 and 3 as follows:

- Scope 1 and Scope 2 – the operational emissions of the financial institution
- Scope 3 – investment emissions, otherwise called financed emissions or portfolio emissions (category 15 in the Greenhouse Gas Emissions (GHG) protocol). As defined by the GHG protocol, this represents the scope 1 and 2 emissions of investee companies.

Given the need to rely on estimates. we recommend that government and regulators can support industry through providing guidance on how to report on scope 3 emissions, including boundaries and estimates.

As raised previously, clarity is needed on reporting requirements, particularly for group financial firms who have multiple managed investment schemes, investment options and complex corporate structures. Managed funds and superannuation funds have multiple (for many, hundreds of) reporting entities within the one corporate structure (such as each managed investment scheme or superannuation option). Currently, our understanding is that the regime will allow for consolidated reporting at a group level and that the entity can make a judgement as to how to report its scope 3 obligations depending on what it considers to be material to its business. We submit that regulators can support asset managers and provide greater confidence under the new reporting regime by providing guidance on where disclosure would be appropriate at the consolidated corporate level and at the separate fund level. We have previously provided the following suggestion as to how consolidated and separate fund reporting could occur, and we submit that the relevant regulators consider this as a starting point for industry guidance:

- Certain disclosures could be disclosed at the responsible entity/RSE licensee level with respect for all funds where those disclosures would be consistent across all funds, such as the scenario analysis applied, transition plan, governance, risks and opportunities. This may take the form of booklets in the Annual Report.
- Fund level disclosures could focus on portfolio metrics, for example, reporting on the scope 1, and 2 emissions of portfolio companies.
- For firms that operate internationally, local non-listed subsidiaries should be able to rely on group reporting that is publicly available. This will limit unnecessary and costly duplication of reporting. We note that the existing regime in Hong Kong and proposals in Singapore allow for this.

Audit and assurance

Noting the requirement under the proposed regime for phased in assurance, we remain concerned that the market does not have sufficient numbers of auditors with the skills and expertise to meet the large demand that will arise. Regulators should be aware of this and undertake monitoring and enforcement with the understanding that climate related financial disclosures will require a different standard to ordinary financial disclosures. Phasing in auditing requirements over a longer time horizon allows for more evenly spread use of auditing resources.

Capacity in the market will need to be built over time, whether at the board level, among investment and legal professionals, auditors, product managers, government and regulators. For instance, in the financial services sector, most professionals would not be trained in carbon accounting or interpreting transition plans. The sector also needs to develop capability to engage in robust stewardship. We note the work of the International Auditing and Assurance Standards Board (IAASB) to develop common standards for assurance on sustainability reporting, which will be finalised in late 2024-early 2025. Treasury, regulators and the Auditing and Assurance Standards Board (AUASB) should be engaged with this process so that it can be introduced and adapted into Australia.

Therefore we reiterate our previous position that in the first phase, external assurance should not be mandatory but there should be board sign off of reports. A company's internal audit committee should suffice as the regime commences. While assurance is preferred and desirable, investors do not want reporting to become so complex that companies are dissuaded from providing more data and information because of hesitancy caused by a lack of robust assurance able to be sought at this stage. This will be especially important for small to medium enterprises for who the cost of external assurance may be prohibitive. Companies should be required to disclose the approach taken including whether internal or external assurance has been conducted. We expect third-party assurance to become the norm over time as capacity develops across the economy, with an increasing number of companies providing limited or reasonable assurance for parts or all of their climate disclosures. We support assurance being required for scope 1 and 2 in the first phase of required assurance, with scope 3 not auditable in that phase.

There could be a recognition that given the supply constraints, audit requirements could be focused at first instance on companies with material emissions, for instance those that fall under the safeguard mechanism, with limited assurance for other industries.

While we do not believe there are any quick solutions to the capacity issue, one way the government or regulators can help enhance capability is through encouraging industry professionals and boards having as part of their continuing education and skills requirements a level of competency in sustainability reporting.

Downloadable data format

For easier utilization of data by investors and other users, the government could consider issuing a template for reporting to ensure consistency and make data downloadable for easy access and in an easily accessible place. This would save industry costs and increase efficiency, so industry does not need to undertake their own manual data build.

**How should the Government, regulators and industry prepare for global developments in sustainability-related financial disclosure frameworks and standards, including the TNFD?**

There is a large volume of regulatory change and the industry is currently responding to a large volume of consultations and implementing a number of initiatives. At this stage, mandatory disclosures should be limited to those that align with the national priority of emissions reduction. We note that many companies and fund managers are voluntarily reporting and considering a range of material sustainability risks to their companies and investment portfolios.

As noted before, sustainability metrics will develop overtime, and the Australian reporting regime should allow for flexibility and innovation in this space as industry practice develops, with the regime allowing for voluntary sustainability disclosures, including nature related financial disclosures. The data challenges are currently significant in nature and biodiversity considerations.

We support globally consistent reporting frameworks aligned with the work of the ISSB and the Taskforce on Nature-related Financial Disclosures (TNFD). The government and regulators should continue to participate at global forums with global policy makers and be across global developments to ensure Australian policy is aligned. As the government looks to build out sustainability disclosures, deviations from the ISSB and other global standards such as the TFND should be as limited as possible to allow for maximum interoperability and usefulness, and to reduce compliance cost for global companies. We encourage the government and regulators to continue to work collaboratively with industry to build capacity over time, including specific guidance on sustainability-related financial disclosure frameworks for asset owners and managers in line with global guidance[3]

[3] See TCFD (2001), Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures (https://www.fsb.org/wp-content/uploads/P141021-4.pdf), IFRS (2003), IFRS S2 Industry Based Guidance on Implementing Climate-related Disclosures (https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards-issb/english/2023/issued/part-b/ifrs-s2-ibg.pdf?bypass=on), Principles for Responsible Investment (2018), Guide for Asset Owners on Implementing TCFD recommendations (https://www.unpri.org/download?ac=4652)

## Priority 2: Develop a Sustainable Finance Taxonomy

**What are the most important policy priorities and use cases for an Australian sustainable finance taxonomy? What are the key insights from international experience to date?**

**Priority 2 recommendations**

An Australian sustainable finance taxonomy has an important role to play in mobilising capital toward sustainable economic activities. We recommend the following with respect to an Australian sustainable finance taxonomy.

**Recommendation 2.1: Taxonomy should be voluntary and interoperable with overseas taxonomies**
We would caution against embedding the Australian taxonomy within the sustainability disclosure framework at this stage, given investor experience with the complexity of the EU Taxonomy. The Australian taxonomy should avoid excessive complexity, begin as voluntary best practice guidance and be interoperable and internationally recognized, so that global firms can meet their obligations globally with respect to investments in Australia by complying with the Australian sustainable finance taxonomy.

**Recommendation 2.2: Transition category needed**
An Australian taxonomy should include a transition category and not limit investment by sustainable/responsible investment themed funds in 'green' only investments, given the need for capital in a large part of the Australian economy to transition.

**Recommendation 2.3: Do no significant harm criteria**
We support the development of ‘do no significant harm’ criteria in recognition of the interconnectedness of sustainability objectives.

**Recommendation 2.4: Periodic review of transitional activities**
There should be periodic review of transitional activities to ensure credibility.

**Recommendation 2.5: Independent Taxonomy Technical Expert Group**
Government should support an independent Taxonomy Technical Expert Group to review the taxonomy periodically. The Technical Expert Group should have a transparent decision-making process.

**Recommendation 2.6: Guidance on calculating alignment with the taxonomy**
Government should eventually provide guidance on how companies and different asset classes can calculate revenue and expenditure alignment with the taxonomy.

**Recommendation 2.7: Initial taxonomy focus on climate**
We support an initial focus on climate mitigation and adaptation objectives.

We believe that an Australian sustainable finance taxonomy has an important role to help mobilise capital toward sustainable economic activities. It will help to have a common language across the economy on what constitutes a sustainable economic activity. It can reduce friction and create efficiencies by providing greater certainty for capital allocators, creating a signal for investors as they assess climate-related financial risk to their portfolio and activities that bear transition risk and opportunity. It can also help to attract climate aware and sustainability aware capital to Australia where Australian economic activities can demonstrate alignment, aligning international and domestic capital. It can help to support investment in economic activities that are genuinely sustainable and contribute to sustainability objectives or support the net zero economic transition.

Some stakeholders have also expressed that a taxonomy has the potential to be useful in lowering the risk of greenwashing by providing clear and widely agreed to criteria to report alignment of a climate-themed or environmental sustainability themed fund with the taxonomy. Our members' experience in Europe suggests that the usefulness of a taxonomy for preventing greenwashing with responsible investment/sustainable investment themed funds could be limited. In the EU for instance, given the EU taxonomy only covers climate change, its objectives are limited to environmental related objectives, and it is very technical, its use to demonstrate broader sustainability concerns under the EU Sustainable Finance Disclosure Regulation (SFDR) is limited. Managed funds may have other sustainability objectives, including social or ethical objectives that are wider than what a taxonomy may be able to cover in the near to medium term. There is a risk that requiring funds with sustainability or responsible investment objectives to strictly align with a taxonomy may unnecessarily limit the variety of strategies and choice available to investors in the market. Indeed, for global investors, companies outside the EU generally do not report EU taxonomy alignment, so stringent requirements to report against taxonomy alignment would not be appropriate for globally diversified funds.

As much as possible, the Australian taxonomy should be aligned with global taxonomies, including the EU taxonomy and ASEAN taxonomy. But it is important that an Australian taxonomy learns from the EU experience and adapts it to Australian needs. Drawing on our members' experience using the EU taxonomy, they have observed that it is highly technical and in only covering climate change, may not recognise that sustainability factors involve tradeoffs, with arbitrary lines necessarily drawn when demarcating activities. A credible taxonomy is important, however we would caution against a complex and overly technical taxonomy that may create perverse incentives that undermine the goals of the strategy to enable investors to direct capital, as investors may direct capital to activities that are easiest to measure rather than those that may have a bigger impact.

Economic activities under a taxonomy should account for their applicability across the life cycle in addressing sustainability objectives. For instance, the EU taxonomy does not include pre-construction activities associated with development of taxonomy-eligible activities such as renewable energy generation. As a result, pre-construction development expenditure cannot be categorised as taxonomy-aligned capital, creating a barrier to deployment of green capital allocations into development of sustainable infrastructure. It should also make it clear when taxonomy alignment should be assessed (for instance at construction or operational stage), including any milestones that should be met.

The EU taxonomy also does not account for particular asset classes adequately. In the EU, disclosures under the SFDR require the reporting of taxonomy alignment using turnover, capital expenditure and operational expenditure for portfolios including and excluding sovereign bonds. However, these metrics are not applicable to sovereign bonds and so the proportions are difficult to calculate.

There should be an allowance for nuance in the Australian taxonomy. Companies may be diversified in their activities and should be able to attribute part of their revenues or capital expenditure to green activities. Companies have diverse operations with varying emissions intensities along different points of the value chain. Related to this, the metrics used to measure alignment should be carefully considered (e.g. turnover, capital expenditure, operational expenditure) for certain asset classes, particularly debt. When it comes to green bonds, for instance, reporting the percentage of taxonomy alignment for green bonds using revenue, capital expenditure and operational expenditure does not make sense as the proceeds of these bonds are expected to be directed for specific purposes rather than the business of the company as a whole.

Nuance should also be addressed through the inclusion of transitional activities being covered under a taxonomy, recognizing their importance to achieving the goal of net zero. The ASEAN taxonomy includes an 'amber' transition category. Eligibility criteria for economic activities should consider the Australian context, recognising there are enabling activities that are essential to achieving sustainability objectives.

Further, in primarily focusing on one sustainability objective such as climate mitigation, the interconnected nature of sustainability objectives should be recognised. An activity that may contribute to climate mitigation may affect other areas such as modern slavery or first nations rights. To claim taxonomy alignment, an activity should be able to evidence, to a reasonable standard, its contribution to climate change mitigation and that it does not do significant harm to other identified sustainability objectives under an Australian taxonomy. For instance, the ‘storage of electricity’ activity in the EU Taxonomy has no technical screening criteria or thresholds required to demonstrate substantial contribution to climate change mitigation – provided that 'do not significant harm' (DNSH) criteria are met, the activity is automatically deemed to be Taxonomy-aligned. In Australia, where there is a possibility of electricity storage systems being used to support or prolong the life of aging coal generation capacity, electricity storage assets should be required to evidence their contribution to climate change mitigation to claim taxonomy alignment. Therefore, we support the inclusion of a 'do not significant harm' (DNSH) criteria in an Australian taxonomy in recognition of the interconnectedness of sustainability objectives. At this early stage, we would caution the inclusion of stringent DNSH criteria within the regulatory framework without greater consultation around how to implement the concept practically. The government or relevant regulator should in time develop proportional and sector-specific application of good industry practice in applying 'do no significant harm' criteria.

To the extent n Australian taxonomy applies DNSH to social objectives, these requirements should be clear and easy to assess. The EU Taxonomy’s 'minimum safeguards' are vague, ambiguous and difficult to assess as they reference international standards such as the International Labour Organization conventions and the International Bill of Human Rights, which are hundreds of pages long and not directly applicable to corporates.

The taxonomy should also be focused on materiality, to maximise use for investors. The EU taxonomy 'generic criteria for DNSH to Climate Change Adaptation’ requires any economic activities with an expected lifespan of greater than 10 years to undertake scenario analysis for a climate risk and vulnerability assessment, regardless of the materiality of potential climate risks.

**What are priorities for expanding taxonomy coverage after the initial focus on climate mitigation objectives in key sectors?**

The EU has begun with a focus on climate mitigation and adaptation objectives and we agree that an Australian taxonomy should prioritise this. Climate mitigation and adaptation objectives will take time to embed in the reporting regime in Australia. We would support discussion occurring with government and stakeholders in determining what the next pressing national priorities are where greater finance/private sector support is needed, for instance in areas like nature/biodiversity, the circular economy, waste, modern slavery, and first nations. In the long term, a taxonomy should cover both environmental and social objectives so that investors can assess the net impact of activities and investments in alignment with global goals. Broadly, an Australian taxonomy should remain aligned as much as possible with regional and international taxonomies in the sequencing, scope, and objectives.

**What are appropriate long-term governance arrangements to ensure that the taxonomy is effectively embedded in Australia's financial and regulatory architecture?**

To begin with, the taxonomy should be voluntary best practice guidance. The need to assess taxonomy alignment with extensive technical requirements can be costly and time consuming. Voluntary best practice guidance will enable companies and investors to gradually take up and use a taxonomy. In the EU, assessing non-EU companies‘ activities against the EU taxonomy has been very difficult, and that will most likely be the case with an Australian taxonomy in assessing overseas companies. Embedding a taxonomy into the regulatory framework too soon would also create implementation problems due to the data challenge, which will continue to be a challenge in the Australian context for some time as capability and data availability from climate-related financial disclosures will take time to build. Our members' experience in the EU in seeking to demonstrate portfolio alignment with a taxonomy has been difficult where underlying investee companies have not disclosed relevant data. As such, and given the observations made above about the need for flexibility to maximise opportunities for capital allocation toward sustainable investments, we do not think the government should rush into incorporating a sustainable finance taxonomy into the Australian sustainability disclosure regime as has occurred in Europe. Indeed, in our members' EU experience, the definition of taxonomy-eligible activities is not fully aligned with the definition of a 'sustainable investment' under the Sustainable Finance Disclosure Regulation. This has led to a dual classification system that may be contradictory and inefficient.

Tying a regulatory regime to the taxonomy too early, such as a labelling regime, will cause difficulties given there may not be widespread taxonomy alignment reporting across the economy for the medium term. Therefore, the introduction of minimum taxonomy alignment thresholds for sustainable-themed investment funds such as in the EU would be unnecessarily limiting of investment strategies and products available in the market until the time that sufficient data is available and alignment can be demonstrated across the economy. We submit that the disclosure of taxonomy alignment should be optional for managed funds and superannuation funds. The FSC information sheet developed for members (see Priority 4) allows for the disclosure of taxonomy alignment but also allows for flexibility if the fund can demonstrate another way how they have aligned their investments with their stated sustainability objective.

Any eventual requirements should be phased in appropriately. Ideally, this would involve corporates reporting on alignment first, with asset managers and owners second to enable appropriate information flow through the value chain. As with climate-related financial disclosures, a requirement to report before underlying investee companies will require estimates on alignment with the taxonomy and will be costly to fund managers.

The government should undertake a periodic review process of the Australian taxonomy to ensure it remains fit for purpose, as overtime economic, technological and social changes may impact its usability. There should be a review for the inclusion of transitional activities every 3-5 years so that activities can be reassessed, and an inappropriate market signal is avoided given that these activities may not be sustainable over the longer term and may need to be phased out.

The government should support an independent Taxonomy Technical Expert Group. The group should be comprised of technical scientific, legal and industry experts, advising the government body with stewardship of the taxonomy. This body should undertake a periodic review process of the Australian taxonomy to ensure it remains fit for purpose, as overtime economic, technological and social changes may impact its usability. There should be clear standards to allow for auditability and accountability of the Technical Expert Group so stakeholders have a clear understanding of the decision making process. This will ensure a rigorous process.

Guidance should eventually be provided by government or regulators around methodologies to help relevant companies calculate alignment of revenue and expenditure, particularly with asset classes such as sovereign bonds, supranational bonds, real estate, real assets and private debt. Guidance should support banking and financial institutions in reporting on financed/funding taxonomy aligned activities.

**Priority 3: Support credible net zero transition planning**

> **What are key gaps in Australian capability and practice, including relative to 'gold standard' approaches to transition planning developed through the TPT and other frameworks?**
>
> **To what extent will ISSB-aligned corporate disclosure requirements improve the transparency and credibility of corporate transition planning? What additional transition disclosure requirements or guidance would be most useful in the medium-term?**

**Priority 3 recommendations**

Government should provide clear policy direction around transition, having regard to trade-offs in pursuit of emissions reduction and the way emissions reduction intersects with other sustainability concerns.

**Recommendation 3.2: Transition roadmap guidance and best financial interests**
Government can endorse transition roadmap guidelines for industry but should not direct investment contrary to investors' best financial interests.

**Recommendation 3.3: Transition plan scenario, metrics and data guidance**
Government can enhance transition plan disclosure by requiring that transition plans include a scenario involving current global policy settings and by providing guidance on metrics and data to be used in sector transition plans.

While the financial system will help facilitate the economic transition, the framework should not be primarily focused on directing investment, but rather facilitating investment efficiently. Investment responds primarily to activity in the real economy and companies undertaking emissions reductions that enhance their long term financial value. The real economy is affected by policy that disincentivizes high carbon activities. Policymakers are best placed to guide the transition through a framework that requires industry to turn their minds to transition risks.

Clear policy direction around the economic transition helps enable investor stewardship. It provides clear goals and targets and allows investors to interrogate a company strategy against those targets with the goal of long-term financial returns. We are supportive of the government's commitment to working with industry to develop and endorse science-based sector transition plans for sectors with emissions intensive activities. The government can help provide clear policy direction by endorsing transition roadmap guidelines for industries. The disclosure of transition plans and scenario analysis should form part of mandatory climate disclosures as discussed under priority 1. This will allow investors to assess whether companies have understood the financial and operational risks that climate change poses to their business and to assess the plans they have to address these risks. Transition plans should be science based and realistic. The transition guidance could also involve the types of sustainability impacts that should be considered besides emissions (such as biodiversity, human rights), and it should provide credible projections to support transition planning. The provision of sector transition guidance must occur with the recognition that asset managers manage money as fiduciaries on behalf of investors in order to help them meet their long-term financial goals. We would caution the government around directing capital that is not in line with the primary goal of the investors' best financial interest. Any transition planning framework around investment should be informed by the underlying investors' goals and expectations for investment, with clear legal guardrails.

We would also note that while an emissions reduction first approach is pragmatic, tradeoffs should not be ignored including potential impact on other sustainability objectives that may occur from emissions reduction activities such as biodiversity, human rights, etc. For instance, an increase in reliance on biofuels in pursuit of emissions reduction could affect food prices.

The current Treasury proposal requires the disclosure of at least two climate scenarios (one of which is alignment with the *Climate Change Act 2022*) and the disclosure of targets and a transition plan (including information about the use of offsets). Transition planning from an investor perspective could be enhanced by specifying that one of the two scenarios should be a scenario involving current global policy settings (likely at an international level to be a disorderly transition), as this scenario would be useful for investors in understanding the likely impacts of climate change on the company. We have previously submitted that companies should disclose any use of greenhouse gas emissions offsets and be transparent about how they intend to use those to meet their published targets.

The ISSB S2 does not prescribe the content of transition plans, just requiring disclosure of transition plans where they exist. We would submit that the requirement to disclose transition plans should be based on materiality, that is, in high emissions sectors, allowing for comply and explain. There should be a requirement to report against transition targets, identifying what is known and unknown. There should be an allowance for stretch targets over the medium to long term.

The ISSB focuses on inward materiality, but a focus on outward materiality, that is, on the company's external sustainability impact, may also be appropriate to understand/manage impacts from transition and enable collaboration with different stakeholders and balancing interests, again noting tradeoffs when addressing sustainability objectives.

Generally, climate disclosures including transition plan disclosures should be focused on materiality, so that unnecessary data is not produced, and investors don't have to sift through useless data. Companies and investors are best placed to judge what information is material.

We submit that the following tools and guidance from government would be beneficial to support transition planning:

- specific guidance for the asset management industry;
- reporting templates;
- examples of reporting for different industries (eg asset management, insurance etc);
- guidance that benchmark or representative data can be used where actual data is not available;
- making data and tools publicly available; and
- facilitating shared learning with global experts.

Again, we would emphasise the need for directors and senior executives to be trained in climate literacy so that transition plans can be effectively created and executed.

**Are there related priorities and opportunities for supporting enhanced target setting and transition planning for nature and other sustainability issues?**

Sustainability issues are often interconnected and should ideally be looked at holistically. For instance, sustainability objectives such as the circular economy, biodiversity, and looking at waste and plastic reduction support the net zero ambition. It should be noted that developing climate-related disclosures is a challenge and time to develop higher quality data and experience is needed before further mandatory disclosure burdens are placed on the economy. But that should not necessarily hold up consideration and development of guidance to enhance and support target setting and transition planning where other sustainability issues intersect with the primary goal of emissions reduction.

Priority 4: Develop a labelling system for investment products marketed as sustainable

**What should be the key considerations for the design of a sustainable investment product labelling regime?**

**How can an Australian model build off existing domestic approaches and reflect key developments in other markets?**

**Priority 4 recommendations**

Current regulatory uncertainty underscores the need for greater consensus around sustainable/responsible investment labelling.

**Recommendation 4.1: Industry-led product labelling regime**
We recommend an industry led code or standard. The FSC and the Responsible Investment Association of Australasia (RIAA) have undertaken extensive work on product labelling, accounting for the current legal and regulatory framework and the spectrum of legitimate sustainable/responsible investment strategies undertaken by a variety of funds with a variety of sustainability or responsible investment related objectives. The government should consider the information note produced by the FSC for its members as it reflects broad Australian industry consensus.

**Recommendation 4.2: Lessons from overseas, interoperability and passporting of sustainable investment strategies**

- Overseas regime categories do not necessarily account for the broad range of sustainable/responsible investment strategies or objectives.
- Interoperability and minimising fragmentation of understanding is very important to enable the scaling of investment solutions across borders. This does not necessarily involve complete duplication, but rather allowing global funds to passport strategies that meet the criteria of overseas labels.

Consumers are increasingly demanding investment products that align with their personal values, whether these involve ethical or religious concerns, environmental sustainability concerns and/or human rights or social concerns. This means an increase in demand for investment products that are labelled to indicate they have ESG, responsible or sustainable investment objectives and strategies (such as supporting environmental sustainability objectives and reflecting social or ethical values). We agree that there is currently a need for greater clarity and consistency in the sustainable investment product labelling market so that consumers understand products in the market and can make informed decisions on how to allocate their capital to achieve their investment goals in line with their personal or institutional sustainability preferences or goals.

It should be recognized that sustainable investment themed products can have different objectives. 'ESG', 'responsible' and 'sustainability' are broad terms that cover many themes such as climate, social issues such as modern slavery, human rights or diversity. While many funds integrate ESG considerations as part of risk-based management, not all will have primarily climate mitigation aims or broader sustainable, responsible or ethical investment aims. Funds can address varied individual preferences and values, and therefore apply different approaches or strategies to meeting any specific objective (such as divestment, positive screening, active ownership and themed investing). ESG products are on a spectrum with different objectives and therefore not all are or should be thought of as impact funds seeking to achieve a measurable sustainability-related outcome and not all should necessarily have all investments aligned with a 'green' category within a taxonomy or have investments that are 'best in class'.

We acknowledge this complexity can lead to varied understanding among retail investors as to what sits under a particular ESG or responsible/sustainable investment label. There is indeed a need to support the regulator's role in lifting industry standards and combatting greenwashing. However, it must be recognized that there are varied legitimate sustainable investment approaches to address varied investor demand and objectives. We recognise that the breadth of approaches under similar labels, without consensus as to how these labels and terms are used, increases the risk that consumers are misled, and we see an important role for government to work with industry in creating greater consensus and lifting industry standards cooperatively.

<u>Current regulatory uncertainty around having a reasonable basis for the use of terms or claims</u>

We agree with ASIC's emphasis that all labels and terms used must have a reasonable basis and products must be true to label. We acknowledge the clear ASIC view in Information Sheet 271 that absolute statements purporting the exclusion of companies involved in certain activities without qualification, for instance 'significant business activities involving fossil fuels', but only excluding producers of fossil fuels and not distributors, are misleading and deceptive. However, industry has been concerned that regulator enforcement action has led to some uncertainty around the extent to which investments cannot have remote associations with excluded/screened activities. As a result, any managed fund that wants to sell a product that has sustainability or responsible investment goals would be uncertain about whether it can have exposures to important defensive asset classes that constitute a large part of the ASX. Importantly, this uncertainty may work against the government's sustainable finance strategy goals of encouraging greater capital flow into sustainable themed investments.

A key issue around products that have certain sustainability-related objectives is that given the complex and interlinked nature of the economy, it may sometimes be difficult to determine that investments have zero relationship to an excluded activity, despite the fund acting in good faith to exclude the activity. For example, if 'fossil fuels' are screened by an ESG themed product, while it is clear the fund must exclude companies' whose activities are fossil fuel emissions intensive such as mining, gas or coal electricity generation, it is arguably unclear from the regulator's perspective whether it is able to retain holdings in companies with remote associations to the excluded activity such as a bank or fixed income asset that lends to a transportation company which in turn earns a small proportion of its income from the transportation of fossil fuels. Related to this, there is uncertainty as to extent to which the exposure to sovereign bonds and large financial institutions is allowable when avoiding making false or misleading representations about exclusions to fossil fuels or other excluded activities given they may have remote or direct financial associations with the excluded activity.

Further, many funds, as part of their ESG/sustainability/responsible investment strategy apply a negative or positive screen based on revenue or activity thresholds. We note and agree with ASIC's enforcement stance that absolute claims by a fund such as a 'no gambling fund' which then applies a threshold are likely to be misleading. However, it should be recognized that negative and positive screens based on revenue or activity thresholds are a legitimate part of an ESG strategy, particularly given the complexity of economic links along the production and value chain as noted above. Applying ASIC's understanding may be clear in a situation where a fund that makes the 'no gambling' claim invests in a company that earns a large proportion (eg 30%) of its revenue from gambling. Where uncertainty lies for the industry is where it has invested in a financial institution or a company that may have some investments in gambling or may underwrite or loan to gambling businesses or local clubs that earn revenue from gambling machines. As another example, a fund with the headline claim 'we do not invest in tobacco' should clearly not invest in tobacco producers. But the question arises as to whether they are permitted to invest in a large retailer whose revenue from tobacco is an almost negligible proportion of their total revenue, or in trucking and shipping distribution companies for who the volume of tobacco they move is a small proportion of their business.

While we acknowledge that some of the questions above can be addressed with clearer disclosure or redrafting headline claims, the uncertainty has led to some of our members advising us that they have had to withdraw or scale back ESG themed products or strategies in Australia that they have been able to market with confidence in jurisdictions such as Europe. There is great need for a more common understanding between industry, regulators and government of what sustainable/responsible/ESG products are, including the strategies they can legitimately employ.

Labelling regime principles and necessity of industry leadership

As a broad rule, we submit that if the responsible or sustainable investment objective and approach is clearly disclosed and that the investment strategy in meeting the objective can be clearly demonstrated, then a wide spectrum of sustainable investment/responsible investment themed products should be permitted. There needs to be an accepted understanding of what an ESG, responsible or sustainability-themed product is to provide greater certainty to the market. We submit that any understanding should recognise that there are a spectrum of legitimate sustainable/responsible investment strategies and methodologies.

Any labelling regime needs to capture the nuance of remoteness when it comes to deciding screening thresholds. It must be focused on whether the terminology and headline claims are creating a misleading impression overall for an investor. While this will be dependent on the facts of a specific case, a labelling regime should recognize that headline claims will not include all necessary information, but the headline claim should be clear about any qualifications. Entities should be able to consider whether the business of the companies they invest in is primarily dependent on its relationship with the headline exclusion, or a relationship that a reasonable person would think is merely incidental and minor.

The FSC has, in collaboration with RIAA, produced an information sheet for its members that use ESG, responsible investment or sustainability related terms in their investment product labelling. We have sought to draw on observations from current law, ASIC Information Sheet 271, ASIC enforcement action, labelling developments overseas and established industry practice to provide principles for the consideration of members as they seek to provide a reasonable basis in labelling their products.

The principles underlying the FSC information sheet allow for more flexible development of sustainable/responsible investment products in Australia. An important feature of the note is that it addresses the nuance between sub-categories and labels further than what covered in UK/EU and US regimes where funds are classified under three or four categories.[4]

[4]**EU SFDR**: **Article 9** funds have as their objective sustainable investment.
**Article 8** funds promote environmental and/or social characteristics, such as sustainability related policies, goals or targets.
**Article 6** funds are any other fund that isn't an Article 8 or Article 9 fund.
**UK FCA**: **Sustainability Focus:** funds that invest in assets that are environmentally or socially sustainable determined by a robust, evidence-based standard of sustainability.

We ask that the government and regulators consider the product labelling work the FSC has undertaken which we **attach** to this submission as an appendix **(Appendix A)**. Note that this is still in draft stage.

We submit that any work on ESG/sustainable/responsible investment product labelling should be industry led, particularly given industry expertise in established investment practices and the uncertainty created as outlined above where industry has not been properly consulted. Being industry led will lead to greater confidence across companies to develop and offer more investment products with sustainability or responsible investment objectives, leading to greater choice for consumers and greater capital flows toward sustainable investments in line with the government's key aim under the strategy.

An industry produced code or standard would be preferable to a legislated labelling regime, particularly given the evolving nature of this space. This code could be enforced by the regulator, with the regulator providing oversight over the creation of the code or standard and guidance on minimum requirements. It should apply to products that identify as a sustainable/responsible or ESG product. Currently, section 1013D(1)(l) of the *Corporations Act 2001* requires that investment products disclose *the extent to which* they take into account labour standards or environmental, social or ethical considerations in selecting, retaining or realising an investment. This flexibility should be maintained, and there should not be a sustainability objective required for all categories of products.

Some key principles in the FSC note include:

- Responsible investment (RI)/sustainable investment (SI) products can utilise a spectrum of RI/SI strategies. (ESG integration, negative/exclusionary screening, minimum (norms-based) screening, stewardship, positive/best in class screening, sustainability themed investing and impact investing). The strategies are not mutually exclusive. Definitions for each strategy are outlined in the information note.
- The use of certain RI/SI labels require a reasonable basis for their use, including demonstrating that certain RI/SI strategies are used.
- The central part of the note is the table in section 8.5 that maps out commonly used labels with investment strategies used to meet the label's objectives, and requirements to demonstrate a reasonable basis for the label's use. Commonly used product labels touched on in the note are ESG, Responsible, Sustainable/ sustainability/sustain/ SDG, Earth/Nature Positive/Nature, Impact, Ethical/Ethically Conscious/Labels with Religious meanings and claims(e.g. Catholic)/Socially responsible, Stewardship/Active ownership/ Transition/ Improvers, ESG leader, Low Carbon/Paris-aligned/ Net zero, Sector-specific/ RI themes claims, e.g. Healthcare, Renewable, Climate, no-tobacco, no-gambling.
- The use of an ESG integration strategy is a necessary but not sufficient condition for the use of most RI/SI labels.

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**Sustainability Improvers:** funds that invest in assets that have the potential become more sustainable over time, determined by their potential to meet a robust, evidence-based standard of sustainability over time.

**Sustainability Impact:** funds that have the objective to achieve a predefined, positive, measurable environmental and/or social impact.

**Sustainability Mixed Goals:** funds that invest in assets that meet or have the potential to meet a robust, evidence-based standard for sustainability, and/ or invest with an aim to achieve positive impact.

**US SEC**: **Integration Fund:** A fund that considers one or more ESG factors along with other, non-ESG factors in investment decisions where those ESG factors are generally no more significant than other factors in the investment selection process.

**ESG-focussed Fund:** A fund that focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments or (2) in its engagement strategy with the companies in which it invests.

**ESG Impact Fund:** A subset of ESG-Focused Funds, a fund that seeks to achieve a specific ESG impact or impacts.

- The use of the label 'impact' requires a measurable ESG-related outcome where additionality must be demonstrated. Progress in achieving the impact goal should be disclosed.
- Stewardship is an appropriate tool as part of an RI/SI strategy approach. Where stewardship forms part of the RI/SI strategy of a fund, for example to drive better sustainability outcomes, these claims should be evidenced in some fashion. The use of a 'stewardship' label or strategy requires that engagement with management be meaningful and related to the achievement of the stated objective, and updates should be provided on the progress of matters. The level of disclosure is dependent on the strength of the claim.
- The use of 'low carbon' or 'net zero' labels should have an explicit carbon reduction objective, demonstration that there are 'reasonable grounds' to make representations about meeting targets, and disclosure of any metrics used to evaluate progress.
- Screens should be defined and explained adequately, with the proportion of the portfolio to which the screen applies disclosed. This includes the extent to which its application applies to direct revenue from production or more remote associations such as distribution or the provision of finance. Exceptions and qualifications should be prominently disclosed and clearly explained. Absolute headline claims that need to be qualified with a screening threshold risk being misleading.
- For multi asset funds that use an RI/SI label responsible, RI/SI criteria should apply to at least the majority of the funds' assets (>50%) that are held directly. For balanced options and options with higher growth profiles, it is expected that the use of an RI/SI label should require the RI/SI criteria to apply to at least 70% of the funds' assets that are held directly. The remainder are assets used for liquidity and hedging purposes. Cash and Australian government bonds are not included in the calculation for determining the asset base.
- Aspirational targets should be accompanied by a strategy that has a reasonable basis for claiming the target can be achieved, without necessarily providing a guarantee. Performance against targets should be demonstrated.
- There is a place for screened index strategies, with appropriate labelling and being distinct from other ESG approaches.

<u>Sustainable funds can employ different strategies</u>

Under the FSC approach, sustainable funds have the freedom to develop and demonstrate their own approach for selecting and maintaining sustainable investments. This is also the case with Article 9 funds in Europe. There should not be prescription under a labelling regime for investments and the government should avoid mandating product features such as mandating investment strategies for ESG themed products. A labelling regime should allow for a variety of strategies such as stewardship and broader or more integrated approaches to sustainability/responsible investment concerns such as human rights, diversity, labour conditions, the circular economy, and other ethical concerns.

While managed funds may have a variety of investment strategies and sustainability/responsible investment objectives, they all have fiduciary duties. As part of ordinary risk management, funds typically incorporate ESG risk considerations into their investment decision making, such as the risk of climate change, and increasingly the financial risk of nature and biodiversity loss, to the returns of a portfolio company or sector. EST integration is strategy they should be able to indicate that they employ, though it is not enough to show that it has ESG/responsible investment/sustainability as a major feature or objective of the fund. Sustainable or responsible investment themed funds will typically undertake negative and positive screening. Positive screening involves investing only in companies assessed to perform better relative to their peers according to ESG related scores or benchmarks. Negative screening involves limiting the investable universe by excluding companies whose activities contribute negatively or don't align with the responsible/sustainable investment objectives of the fund.

In recognising that there are a variety of investment strategies, the FSC note recognizes a legitimate place for index strategies that have exclusions, as long as they are labelled and marketed appropriately. Different strategies with have different costs for consumers, and it is important that consumers have choice, including low-cost exclusionary options. There should be clear understanding on how they are different to impact funds or a fund with a transition objective.

It is also important to recognise the role of stewardship as a strategy employed by sustainable or responsible investment themed funds. We do not believe that an ESG/sustainable/responsible investment themed fund can only and should only engage in divestment or screening, and screening or divestment may not be the best way to achieve real world emissions reduction. Indeed, industries with significant exposure to climate risk or whose activities are emissions intensive need capital to enable their transition to lower emissions. Further, the Your Future Your Super performance test necessitates diversified exposure to the currently carbon intensive Australian market. As long-term investors, funds will typically, via stewardship activities, seek to engage and hold to account investee companies, their management and boards, to properly manage sustainability risks in their operations, management, strategies, products and services. Funds will typically work with the management and board of key investee companies to ensure that the company has appropriate climate risk governance and plans in place. Funds do this in fulfilment of their fiduciary duty to act in the financial interests of their members, delivering long term value. Importantly, these are ongoing relationships and so have greater potential to create greater real world emissions reduction impact. This does not rule out divestment as a course of action, but divestment is typically only taken as a last resort and in the financial interests of members. As long as the fund makes it clear that stewardship is a part of the strategy they are pursuing to advance their sustainability objective, then this should be permitted.

Funds should demonstrate alignment of their investments with their stated sustainability/responsible investment objective. This can be against a sustainable finance taxonomy, where the fund disclosures taxonomy-aligned investments as a proportion of the market value of the MIS's whole portfolio, but flexibility should be allowed. The FSC note also considers the fact that funds hold instruments such as derivatives, money market instruments, cash and other instruments for hedging and liquidity purposes which should not be included in the measurement of alignment. Further, there does remain uncertainty around different asset classes such as sovereign bond, supranational bonds, real estate, real assets and private debt, and we are open to a further discussion on how these assets can demonstrate alignment. An appropriately labelled sustainable or responsible investment themed fund should also be able to invest in assets that may have significant revenue exposure to high emissions activity but are necessary to pursue the goal of emissions reduction, such as rare earth minerals.

Any regime should be focused on retail investors, given that institutional or sophisticated investors have greater ability to scrutinize claims and requirements, and all funds should continue to be subject to general misleading and deceptive conduct obligations.

Lessons from Overseas

Overseas, there are differences between the various frameworks and a clear standard does not exist. Currently, the various overseas labelling or classification regimes do not align, noting that the SFDR is not formally labelling regime. One product may fall within one or more different categories depending on the jurisdiction. An Article 9 fund could be either a 'sustainability focus' fund or possibly a 'sustainability impact fund' in the UK. A label of 'ESG integration' in the US would have no sustainability label in the UK. We note that the EU is currently consulting on reforming the SFDR[5], looking at an option of turning the disclosure regime into a fund categorisation framework accounting for different ESG strategies with potential four categories[6] or something altogether different. As the EU Commission notes in its consultation paper: '…the product categorisation system could be based on a different approach, for instance focused on the type of investment strategy (promise of positive contribution to certain sustainability objectives, transition focus, etc.)…In such a scenario, concepts such as environmental/social characteristics or sustainable investment and the distinction between current Articles 8 and 9 of SFDR may disappear altogether from the transparency framework.'[7]

There is a need for interoperability, such that a global fund that is able to sell an ESG strategy overseas should be able to do so in Australia, in order to put the Australian market onto a level playing field. Unfortunately, we have observed that global funds are withdrawing ESG strategies domestically. A fund could meet the Article 8 or 9 criteria in the EU but not feel sufficient legal certainty to use a sustainability label in Australia. The result is the same strategy being labelled and treated differently in different jurisdictions, which is an inefficient outcome.

Under the SFDR, there are extensive prescriptive disclosure obligations. For instance, managed funds must disclose the principle adverse impacts of their portfolios but there is no requirement that all underlying companies disclose, leading to a misalignment with investee company disclosure. In Europe, given the regulatory uncertainty and burden with Article 9 funds, with Article 8 and 9 funds not sufficiently accounting for nuance in responsible investment strategies, many funds have chosen to lower their ambition by simply being Article 6 funds. Reporting requirements should be balanced so that it does not drive up the cost of sustainable investment products vis a vis other investment products in line with the sustainable finance strategy's goals.

The definition of 'sustainable investment' under the SFDR also led to interpretive uncertainty in the market and with regulators. The European Supervisory Authorities (ESAs) wrote to the European Commission seeking clarity on how the definition should be applied[8], with the Commission taking a few months to respond[9]. It is important the government work with industry in Australia to develop concepts more fully before the introduction of any regulation.

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[5] European Commission (2023), Targeted Consultation Document: Implementation of the Sustainable Finance Disclosure Regulation, pg 30 (https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2023-sfdr-implementation_en)
[6] **Product category A:** products investing in assets specifically striving to offer targeted, measurable solutions to sustainability related problems that affect people and/or planet
**Product category B**: products aiming to meet credible sustainability standards/themes
**Product category C:** products that exclude activities and/or investees involved in activities with negative sustainability effects
**Product category D:** products with a transition focus aiming to bring measurable improvements to the sustainability profile of assets they invest in.
[7] European Commission (2023), Targeted Consultation Document: Implementation of the Sustainable Finance Disclosure Regulation, pg 30 (https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2023-sfdr-implementation_en)
[8] https://www.esma.europa.eu/sites/default/files/library/jc_2021_02_letter_to_eu_commission_on_priority_issues_relating_to_sfdr_application.pdf
[9] https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf

The UK FCA proposal has a 'sustainability improvers category' which recognizes rightly that sustainable investment funds can have broader objectives and encourage transition, and where not every underlying company in its portfolio needs to be taxonomy aligned 'green'. Any regulatory regime needs to have room for funds whose investment strategies include investment in companies that may not be 'green' category aligned, but through investment and stewardship engagement can improve their sustainability outcomes, as well as funds whose strategy focusses on companies that are 'best in class'. However, we think that a weakness of the UK regime is that it does not allow for funds relying on ESG integration, negative screens or tilts to qualify for the sustainable labels. Notably under the UK proposal, a values based or ethical investment based fund would not be eligible to be labelled under the prescribed sustainability labels. We submit that the greater flexibility afforded by the FSC responsible/sustainable investment product labelling work will allow for a more accurate representation to investors and a broader product offering.

We support interoperability, though not necessarily duplication of overseas regimes such as in the UK, US and EU. One way to allow interoperability is to consider relief of passporting for strategies that meet the criteria under overseas labels. This would help reduce costs for global funds and allow greater choice in the Australian market for consumers. Funds could also disclose under what category they are deemed eligible under the overseas regime.

## Pillar 2: Financial system capabilities

__Priority 5: Enhancing market supervision and enforcement__

**Are Australia's existing corporations and financial services laws sufficiently flexible to address greenwashing? What are the priorities for addressing greenwashing?**

**Priority 5 recommendations**

**Recommendation 5.1: General law can be strengthened by product labelling consensus**

Current general law around misleading and deceptive conduct is good and can be strengthened by greater consensus in product labelling and the use of terms.

**Recommendation 5.2: Regulator should be more collaborative with industry around product labelling and disclosure**

Government and regulators should take a collaborative approach with industry in creating consensus around product labelling and disclosure in order to encourage industry ambition and empower investors to meaningfully compare products.

We believe current laws around misleading and deceptive conduct provisions are good and can be bolstered by greater consensus in product labelling and the use of sustainability/responsible investment related terms as outlined above. A separate greenwashing rule is unnecessary. As submitted above, we ask government and regulators to work with industry toward an industry developed enforceable code, particularly given that the environment and standards are evolving as data availability changes and investor expectations change.

The main risk the FSC sees is in enforcement action that does not seek a collaborative approach with industry. The government is rightly seeking a high ambition approach with this strategy, but there is a risk that enforcement action may lead to a cautious approach being taken by participants leading to the opposite outcome intended by government. There is a risk that enforcement action could focus on products where standard industry practice was undertaken prior to the release of Information Sheet 271, but fell short of the evolving understanding of the regulator in Information Sheet 271. This has led to increased disclosure without necessarily an increased understanding for retail investors. There are also concerns in the industry that funds are being exposed to action for product disclosures prior to the release to Information Sheet 271, despite remedying public claims and disclosures since the release of Information Sheet 271 to align with the evolving understanding of the regulator post the information sheet's release.

We also note that concerns around this approach to enforcement may be reducing ambition from industry across the economy. Businesses need confidence to set ambitious plans and targets, even if parts of the journey have not been fully mapped out. While they must do this in a way that is not misleading and their claims must be made with a reasonable basis in line with their legal obligations, the enforcement environment can swing the pendulum too far in the opposite direction, where companies are too cautious to undertaken necessary ambition.

**Is there a case for regulating ESG ratings as financial services?**

While we would be open to considering future proposals by the government, we submit that given the breadth of the sustainable finance strategy, this is not a priority. In the Australian market, ESG ratings do not tend to be central to investment approaches.

There is value to metrics provided by ESG ratings providers in helping identify risks and opportunities, but there currently exists a lack of consistency in the underlying data and methodology used to generate the ratings.

If the government were to move ahead with regulatory proposals, it could consider minimum transparency, conflict of interest requirements or an industry led code of conduct that accounts for how they are used by industry. The government could refer to voluntary codes of conduct for ESG ratings and data product providers in Japan, Singapore, UK and Hong Kong as a starting point.

**Priority 6: Identifying and responding to potential systemic financial risks**

- **Are there specific areas where the Government or regulators could further contribute to market-wide understanding of systemic sustainability related risks, including climate-related financial risks?**

See Priority 3.

**Priority 7: Addressing data and analytical challenges**

- **What are the priorities for ensuring that data-related initiatives already underway are tailored to meet the needs of firms and investors?**

- **What key sustainability data gaps or uncertainties faced by financial institutions in Australia should be prioritised by the CFR?**

> **Priority 7 recommendations**
>
> **Recommendation 7.1: Government support of greater data quality**
>
> Government can support the provision of robust, comparable and consistent data thorough the provision of sector specific metrics, guidance on industry specific scope 3 emissions calculation methodologies, data on climate change risks, providing for digital and downloadable reporting, and guidance on data estimation. Government should cooperate with international regulators to develop metrics, data and scenarios.

There is a need for greater standardization and rigour in data, so that the data is more useful for investor decision making. Fund managers need financially material risk information to inform their investment decisions. Our members have suggested several ways the government could support the provision of more robust, comparable and consistent data which also helps to reduce data use and reporting barriers for industry:

- Generally, the government should develop clearly defined, consistent metrics including industry specific and sector specific metrics.
- Currently, understanding of scope 3 emissions is inconsistent and investors will have to rely on varied understandings of scope 3 when determining their own portfolio exposure. Government could support the provision of consistent methodologies for calculating scope 3 emissions for different industries, focusing on industries with material emissions exposure.
- Consistent scenario analysis would also aid in comparability. Government could support scenario analysis disclosures being more useful for investors by providing guidance on the metrics and assumptions that should underpin scenario analysis in different industries.
- Government can help companies in undertaking scenario analysis by providing easy access and guidance around the use of the following data:
    - Historical data and future projections for acute physical climate change risks, particularly the frequency and severity of weather events, by type and location.
    - Historical data and future projections of chronic physical climate change risks by location, such as average temperature, rainfall and sea-level.
    - Historical and current carbon emissions and sequestrations data by type and location, particularly where data would facilitate the determination of Scope 3 emissions.
    - Information on higher physical risk areas for property and building development.
- Government could support the development of easy-to-use tools and calculators to reduce the financial and administration burden on smaller companies that will need to feed into larger companies' scope 3 reporting.
- Reporting in a digital format that is easily downloadable rather than just embedded in written reports would help investors as data users.
- Sector specific guidance on the use of benchmark data or representative data/estimates where actual data is not available. For instance, for globally distributed assets and operations, companies should be enabled to estimate climate related risks by statistical inference as a second-line method

before declaring an insufficiency of available data. For example, global statistical models of geospatial carbon emissions may be used by entities to estimate emissions along their supply chain or global geospatial projections of rainfall may be used to evaluate climate-risks for overseas landed assets under various emissions scenarios. This would enable entities to make more extensive climate-related disclosures in cases of data scarcity, producing less information gaps for investors. Importantly, disclosures based on data resources of lower reliability should be identified as such as part of the disclosures.

- Treasury and regulators could cooperate with international work to develop data, metrics and scenarios.

**Priority 8: Ensuring fit for purpose regulatory frameworks**

**Do you agree that existing regulatory and governance frameworks and practices have adapted well to support better integration of sustainability-related issues in financial decision making? Are there barriers or challenges that require further consideration? This may include:**

- **Corporate governance obligations, including directors' duties**
- **Prudential frameworks and oversight, including in relation to banks and insurers**
- **Regulation of the superannuation system and managed investment schemes**

**Priority 8 recommendations**

**Recommendation 8.1: Current government priorities the right focus in ensuring regulatory framework fit for purpose**

The current proposals around enhanced climate-related financial disclosures, the development of a sustainable finance taxonomy and a greater focus on consensus around sustainable fund labelling and the use of sustainability-related terms strikes the right balance in meeting the government's goal of encouraging the allocation of capital toward more sustainable investments, while also giving superannuation funds and managed funds the necessary freedom to determine what is in the best financial interests of their members.

**Recommendation 8.2: Your Future Your Super performance benchmarks**

On Your Future Your Super performance benchmarks, the FSC supports stable policy settings in superannuation, including with respect of the performance test. Government should act where there is strong evidence of unintended consequences.

**Recommendation 8.3: Government should draw on existing industry work on stewardship standards**

Industry has already undertaken extensive work in lifting investor stewardship standards. Government should consider work already done by the FSC with its Standard 13 and Standard 23.

We agree that the existing regulatory and governance frameworks, and the proposed enhancement to the framework via enhanced climate-related financial disclosures, will support the better integration of sustainability-related issues in financial decision making. Fiduciary obligations to put financial returns first is vital and should be the umbrella under which other sustainable finance objectives are aimed.

Investors as fiduciaries, with duties to their members, should not be directed to invest in assets or sectors that would be inconsistent with their duty to act in their members' best financial interests. It may be useful for government, where they see a role for institutional/private co-investment in key priorities, to provide clear guidance on how investment in that priority is consistent with the best financial interest duty, in order to provide more confidence to investors.

We consider that the current proposals around enhanced disclosures, the development of a sustainable finance taxonomy and a greater focus on sustainable fund labelling and use of sustainability-related terms strikes the right balance in meeting the government's goal of encouraging the allocation of capital toward more sustainable investments, while also giving superannuation funds and managed funds the necessary freedom to determine what is in the best financial interests of their members. Naturally, given the wide consensus that climate and other sustainability factors such as nature and biodiversity loss pose long term financial risks, then the strategy of enhanced disclosures and greater consensus created by a taxonomy and labelling framework will assist with a more efficient allocation of capital toward sustainable sectors and activities. Enhanced climate-related financial disclosures and in the future other sustainability themed disclosures will allow institutional investors as allocators of capital to identify where there are material sustainability-related risks and opportunities that impact on a business' cash flow, operations and strategy and therefore its valuation.

We note legal opinions around evolving sustainability issues that state that consideration of nature-related issues is a duty for company directors under s180 of the *Corporations Act 2001.* While this may have merit, market participants need time to develop processes and metrics around climate-related financial disclosures, and nature related risks and opportunities are still in the early stages of development. This is why an appropriate liability regime for sustainability disclosures is important, given the nascency of the sustainability space and that understandings of sustainability risks will continue to evolve for some time. Market participants need confidence about their legal obligations while being encouraged to improve and evolve in broader sustainability disclosure and risk considerations.

On Your Future Your Super performance benchmarks, the FSC supports stable policy settings in superannuation. While benchmarks could be revisited, we agree that sustainability objectives must be aligned with the overall objective to maximise savings for a dignified retirement. Superannuation funds and fund managers subject to the performance test pursuing sustainability objectives should be seeking to maximise returns for members in the same way as all funds subject to the performance test.

We have previously canvassed the issues with the YFYS benchmarks discouraging active management which consequently may discourage forms of impact or other ESG type investments which may carry active risk and are seeking a sustainability outcome. For instance, the Australian Equities benchmark uses the ASX 300 Total Return Index, 20% of which is the minerals sector. Around 80% of a typical Australian Equities portfolio's carbon intensity can be attributed to the materials, utilities and energy sector. There may be climate-aware funds that would seek to apply a screening strategy to parts of the sector, but to reduce a portfolio's carbon exposure significantly would risk high tracking error against the index. While we do not propose a concrete solution at this stage, we just note that the performance test as it stands makes it difficult for a fund subject to the performance test to screen out investments based on sustainability considerations and tilt toward companies they assess to have better long term sustainability value, as the incentive is to look at the shorter horizon covered by the benchmark in order to avoid being penalised for tracking error.

Ultimately, the test does not assess the investment option's performance against its stated investment objective, which could be to product risk adjusted returns in line with sustainability/ethical/social concerns. Rather, it assesses how well a fund has implemented its investment strategy against its strategic asset allocation, which may not always be conducive to encouraging greater capital flows toward sustainability themed investments or delivering the best risk adjusted returns.

Regulatory settings must be stable and consistent given that investments, particularly in superannuation, are made with multi-year or multi-decade timeframes. Investment risk increases where the regulatory framework changes too frequently. The more frequent the change, the more cautious investor behaviour will become around sustainability. With sustainable investing, as the taxonomy and ESG labelling regimes develop, if investments meet the criteria set out and are consistent with the government's sustainability objectives, government should be careful that subsequent changes to the performance test do not lead to an adverse regulatory outcome.

**What steps could the Government or regulators take to support effective investor stewardship?**

Investor stewardship is an important part of achieving sustainability goals. Via their stewardship activities, asset owners engage with the management and boards of their investee companies to hold them to account with their performance around sustainability related risks and opportunities and motivate them to manage sustainability related risks and opportunities as affects their business. Stewardship is an important part of ensuring robust governance structures around sustainability risks within investee companies. The voting power of funds can enable them to work constructively with a board or to put pressure where a company is not properly considering sustainability risks that affect the company's long-term value. Stewardship is ultimately always undertaken by funds in line with their overarching fiduciary duty to investors, to maximise investment returns.

Much industry work has already been done to support effective investor stewardship, recognising the importance of asset managers having a long-term view and the desirability of good corporate governance for the long term success of companies. FSC members are required to comply with F*FSC Standard 13: Voting Policy, Voting Record and Disclosure (Standard 13)* and the *FSC Standard 23: Principles of Internal Governance and Asset Stewardship.* Standard 13 includes requirements for FSC members to:

- Set out the role of voting in the context of the scheme operator's stewardship activities such as the role of voting in its engagement processes. (8.3(a))
- Describe the governance arrangements under which the voting policy is maintained. (8.3(b))
- Disclose who has responsibility for making proxy voting decisions, that is, whether an operator exercises its voting rights directly, engages the services of proxy voting advisers (including listing the names of third party proxy advisers) or outsources it to the fund managers of the scheme. (8.3(c))
- Disclose conflicts of interest, including those that may result in the scheme choosing not to vote. (8.3 (e))
- Disclose statements of any principles used to guide voting decisions including any principles on voting preferences, voting considerations around board composition, remuneration, diversity,

climate change and ESG matters, circumstances where the scheme operator may abstain and approach to potentially contentious issues such as shareholder resolutions, instances of voting against management recommendation and resolutions contentious in the media. (8.3(h))

- Disclose to scheme members the voting policy of the scheme. (8.4)
- Disclose details of delegation of proxy voting decisions and oversight, including details of any arrangements where the scheme operator contracts with proxy voting advisers, investment managers, custodians and other intermediaries or where scheme operators authorise investment managers and other third parties to exercise their voting rights on their behalf in accordance with the scheme operator's voting policy. (8.5)
- Disclose the use of proxy voting advisers in the scheme operator's voting policy including the role played by the proxy voting advisers (including whether advice or final decisions), the extent to which the scheme operator relies on the advice and recommendations provided by the proxy adviser when deciding how to vote, and the name and other relevant details of the proxy advisers used. (8.6)
- Have disclosure on voting policy and voting record be made readily available on the scheme operator's website in a consistent and easy to understand format. (10.1)
- Publish at least annually a summary of the scheme operator's voting record for the previous financial year at the minimum of entity and resolution level including where the voting has been inconsistent with the operator's voting policy and the reason for the inconsistency. (10.2)

Standard 23 includes requirements for FSC members to:

- Clearly state the purpose, values and underlying investment philosophy or approach of their organisation. Asset Managers should be transparent about their organisation's ownership, structure, internal governance and experience and competencies of its key staff. (2.3.1)
- Publicly disclose their policies or provide a clear description of their approach to key aspects of internal governance and management of business activities which could impact client assets. (2.3.2)
- Provide a description of their approach to asset stewardship and exercise effective asset stewardship on behalf of their clients. Asset Managers should encourage the companies in which they are invested to meet the highest standards of governance, as well as ethica1 and professional practices. They should provide a description of their approach to monitoring and engaging with investee companies and the connection between monitoring, engagement, proxy voting and investment decision making. Asset Managers should endeavour to hold boards and management accountable where they fail to maintain acceptable standards. (2.3.3)

Specifically, asset managers are required to disclose their approach to the following stewardship activities:

- monitoring of company performance on financial and non-financial matters;
- engagement with company management and the board (as appropriate) and escalation of issues in instances where initial engagements have not been adequately responded to;
- approach to considering Environmental, Social and Governance factors (risks and opportunities) and whether these considerations influence investment decision making and company engagement;
- proxy voting (see FSC Standard 13);
- collaborative engagement with other investors including involvement with industry groups and associations;
- principles used for policy advocacy including participation with industry groups and associations; and

- the approach to client engagement, education and communication regarding asset stewardship.

We submit that our standards' principles-based approach to proxy voting and stewardship reporting provide a good balance between transparency and usefulness. If the government were to pursue a regulated stewardship code, it should leverage work already done by industry. We also note that the UK is undertaking a review of its stewardship code. The experience of our members operating in the UK has been that in its initial creation, the Financial Reporting Council (FRC) constructively worked closely with industry to design the code and to subsequently review it. We would encourage a similar collaborative approach.

## Pillar 3: Australian Government leadership and engagement

**Priority 9: Issuing Australian sovereign green bonds**

**What are the key expectations of the market around issuance of, and reporting against, sovereign green bonds? What lessons can be learned from comparable schemes in other jurisdictions?**

**What other measures can the Government take to support the continued development of green capital markets in Australia?**

**Priority 9 recommendations:**

**Recommendation 9.1: Importance of credibility of sovereign green bonds**

Government should ensure that sovereign green bonds are credible in order to be attractive to investors.

**Recommendation 9.2: Biodiversity and nature repair**
We are supportive of the government developing the biodiversity and nature repair market.

Green bonds can be attractive for funds, particularly funds with sustainable finance goals.
Funds would be interested to see a reasonable initial tender size and liquidity on secondary markets. The Government will need to clearly identify appropriate projects in advance to ensure sizable issuance. Clarity will also be needed on how investment in these bonds will be treated by regulators under the current framework, given current interpretation of the law. A green bonds framework could also serve as a model for domestic issuers intending to issue green debt.

We also note Australia's late adoption of green bonds globally. Additional incentives may be needed such as favourable treatment via collateral at the central bank, tax incentives, or grants for smaller companies wishing to access the green market. The Government should consider how to make the instrument the best way for issuers to access capital at a (slight) discount to market and thus the best financing programme for a green transition.

It is important that the proceeds of sovereign green bonds are clearly directed toward credible projects and are backed by credible government commitments. In assessing sovereign green bonds, one important consideration is the framework's role in the nation's decarbonisation strategy. Members have advised us that in their own internal assessment of sovereign green bonds' credibility and alignment with their sustainability objectives, a green bond framework is deemed effective only if the funds raised significantly advance the country's Nationally Determined Contributions. One example provided by a member is a central Asian country's recent issuance. The government has pledged to reduce unconditional emissions per unit of GDP by 35% by 2030. Given the country's current energy mix, substantial investments are needed to reach this target. However, the green bond recently issued by the government does not allocate meaningfully to renewable energy projects and subsequently, so the member fund did not count it as 'green'.

Generally, 'do no significant harm' is a crucial consideration for green frameworks (including clear fossil exclusions) that has increased in importance with various regulations, such as the Sustainable Finance Disclosure Regulation (SFDR) in Europe. It has been observed that sovereign frameworks have significant allocations towards 'clean transportation' but without 'Do No Significant Harm' (DNSH) considerations. A green bond from a Scandinavian country sought to include railway infrastructure opex without being able to quantify the amount of fossil fuels transported and stored through the rail transport infrastructure, which meant this could not be deemed a green bond for one of our members' portfolios. Additionally, a focus on 'building new' (or capex) rather than operational expenditures (opex) is welcomed by investors, as well as quantitative thresholds where possible.

Finally, in terms of structure, a clear adherence to the International Capital Market Association's Green Bond Principles (including allocation and impact reporting requirements) is crucial.

We would be supportive of developing the market such that large companies can buy investable assets which they can use to offset their reliance on nature/a framework for markets where biodiversity assets can be traded. Biodiversity restoration projects could include such disparate projects as repairing a farm dam, building shelterbelt windbreaks, revegetating forest, or deploying nesting boxes for native animals. We note the Australian Government's Nature Repair Market, which rewards landholders who restore and protect nature, which is a good example of the direction of travel markets should head in.

**Priority 10: Catalysing sustainable finance flows and markets**

> **What role can the CEFC play to support scaling up of sustainable investment in Australia, as part of a more comprehensive and ambitious sustainable finance agenda?**
>
> **What are the key barriers and opportunities for the CEFC to support financing and market development in areas with significant climate co-benefits, including nature and biodiversity?**

**Priority 11: Promoting international alignment**

> **What are the key priorities for Australia when considering international alignment in sustainable finance?**

Interoperability will be key. Disclosure and reporting should be aligned as much as possible with the ISSB and emerging international disclosure regimes. Consistency in terminology and reporting frameworks will help facilitate overseas capital investing into Australian sustainable assets.

With fund labelling, as we have noted above, interoperability should mean the ability to export and import sustainable investment strategies with less friction. An industry-led labelling regime via an enforceable code, rather than a legislated regime, will maximise the ability of products to be more responsive to global conditions.

With the developing sustainable finance taxonomy, Australia should seek to align with strategically important trade partners. For instance, the International Platform on Sustainable Finance has undertaken a Common Ground Taxonomy exercise to assess overlap between the EU and Chinese taxonomies in the areas of climate change mitigation and adaption.

**Priority 12: Position Australia as a global sustainability leader**

> **What are other key near-term opportunities for Australia to position itself as a global leader in sustainable finance and global climate mitigation and adaptation?**
>
> **What are some longer-term international sustainability goals for Australia where sustainable finance can play a role?**
>
> **What are the key market, regulatory and institutional barriers to increasing private sector engagement in blended financing opportunities? How can these barriers be overcome?**
>
> **What are other means to mobilise private sector finance toward sustainability solutions in the Indo-Pacific region?**

**Priority 12 recommendations:**

**Recommendation 12: Reducing barriers to sustainable investment**

Government can play an important role in de-risking innovative sustainable solutions where these are aligned with national priorities, making these investments more attractive for co-investment and shortening the timeframes for transition.

As we have noted above, investment responds to activity in the real economy and companies undertaking emissions reductions. The real economy is affected by government policy that disincentivizes high carbon activities. Policymakers can incentivise real economy emissions reduction and co-investment in climate solutions by de-risking innovative sustainable solutions.

Many of the investments needed to achieve the government's sustainability objectives have inferior absolute and risk adjusted prospective returns when compared against other possible investments. While Australia's superannuation and managed funds system has a deep capital base, there is importantly a primary fiduciary duty to members. Government incentives which result in superior prospective returns could make co-investment more attractive.

Some ways members have suggested that government can help to directly enhance real economy transition and de-risk investments to incentivise private capital include:

- Using well established funding models such as PPPs to de-risk projects.
- Robust whole of economy government targets with supportive policies.
- Ongoing support of research and development in early or pre-commercial stage science and technology to support innovation and de-risk innovative technologies needed to shorten transition timelines for key industries. For instance, with aviation, sustainable aviation fuel is practically years away from viability. Government assistance can help de-risk this early stage technology and shorten transition timeframes.
- Related to the above point, commercialisation of no carbon alternatives to high carbon activities (eg cement, steel etc).
- Develop a robust timber strategy that supports biodiversity that isn't reliant on plantations and allows for whole of life value add.
- Improve building standards to ensure the built environment is electrified, efficient and healthy in a warmer climate.
- Support training in trades and professions that enable and facilitate climate mitigation and adaptation.
- Proceed in a way that is simple, consistent and not reliant on expensive subsidies.
- Australia could establish a green development bank that can issue debt like the German KfW.
- The remit of the CEFC could be expanded.
- The government could support the expansion of social banks, mutuals and microlending.
- Government could support household transition financing through local government.