Submission to the Australian Sustainable Finance Strategy Consultation Paper (Nov 2023)

Dr Anita Foerster, Associate Professor in Environmental and Climate Change Law, Monash Business School

Ms. Mayleah House, Research Assistant, Monash Business School

Dr. Ingrid Landau, Senior Lecturer in Business and Human Rights Law, Monash Business School

Dr. Vivien Chen, Senior Lecturer in Corporate Law, Monash Business School

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Background

We welcome the opportunity to respond to the Australian Government consultation on an Australian Sustainable Finance Strategy.

We have prepared this submission in our capacity as legal researchers at Monash University's Business School:

- Associate Professor Anita Foerster is a legal academic with over 15 years research experience in environmental and climate change law and regulation. For the last five years, her research has focused on corporate climate risk governance. Anita is the Director of Green Lab, Monash Business School's hub for inter-disciplinary, applied research on climate and sustainability.
- Research Assistant, Mayleah House, is an admitted lawyer and current Masters of Environment and Sustainability candidate at Monash University. Her thesis research focused on the barriers to positive corporate environmental performance resulting from directors' duties. Mayleah has five years professional experience in corporate environmental practices and sustainable finance.
- Dr Ingrid Landau is a legal academic, specialising in employment law, transnational labour regulation and human rights and business. Her recent research has focused on human rights due diligence regulation.
- Dr Vivien Chen is a law academic at Monash Business School. She has researched and published on directors' duties and corporate law for over 12 years. Her research focuses on enforcement of corporate law and she uses sociolegal perspectives to explore its practical workings. She teaches corporate governance, risk and social responsibility.

This submission draws on recent research conducted by the authors exploring opportunities to reform Australian corporate law and associated business regulation to improve corporate social and environmental performance:

Anita Foerster, Mayleah House, Ingrid Landau, Vivien Chen, *Net Zero, Nature Positive and Socially Responsible? Exploring corporate law reform opportunities in Australia* (2023)

For further information: Anita.Foerster@monash.edu

Summary of Recommendations

We welcome the Australian Government's intention to develop a coordinated and ambitious sustainable finance strategy, beginning with a climate-first approach before expanding to broader sustainability objectives. The actions set out in the strategy are critical to enable capital to flow to activities necessary to achieve global sustainability goals, including those set out in the *Paris Agreement* on climate change[1] and the *Kunming-Montreal Global Biodiversity Framework*,[2] and will bring Australia more closely into line with international developments in this area.

There are two broad objectives underpinning the sustainable finance reforms being introduced around the world:

- Managing the financial risks posed to private sector actors by climate change, biodiversity loss and other sustainability issues; and

- Aligning private sector capital and resources to help address these societal sustainability challenges (and away from activities which worsen climate change and biodiversity loss).

These two objectives are both important if sustainable finance reforms are going to effectively contribute to managing the broader systemic risks posed to society by climate change, biodiversity loss and other sustainability challenges.

While both objectives are reflected in the proposed Australian Sustainable Finance Strategy, this submission argues that the second objective requires more emphasis and a more explicit focus.

Our response therefore addresses opportunities to harness private capital and resources to meet critical global sustainability goals, thereby helping to manage the broader, longer term systemic risks posed by climate change and biodiversity loss (not only the associated financial risks posed to private sector actors).

We recommend:

- **Disclosures -** A more explicit adoption of a *double-materiality* approach in Australia's sustainability-related financial disclosure frameworks, as well as clear requirements for entities to align their business models, strategies and activities with relevant global sustainability goals (see pages 3-5).
- **Taxonomies -** The engagement of independent sustainability experts to develop robust criteria for Australia's sustainable finance taxonomy and the introduction of corporate activity reporting to ensure the usability and effectiveness of the taxonomy (see pages 5-6).
- **Transition plans -** A clear requirement for select companies to develop net-zero transition plans aligned with a 1.5°C pathway (see page 6-7).
- **Regulatory frameworks -** More explicit embedding of sustainability objectives into director's duties to counteract a short-term focus on profit maximisation by various company boards and management, which can impede actions necessary to achieve global sustainability goals. Potential corporate law reforms include incorporating a sustainability judgement rule and/or a general sustainability duty for directors that is linked to global sustainability goals in the *Corporations Act 2001* (Cth) (see pages 7-9).
- **Mandatory Due Diligence -** Developing a strong mandatory human rights and environmental due diligence regime as part of Australia's Sustainable Finance Strategy focused on preventing and mitigating social and environmental harms in corporate value chains. By further increasing transparency around business activities that cause or contribute to social and environmental harms and incentivising their prevention and mitigation, due diligence laws provide a firm foundation from which to shift capital and resources away from business activities which cause or contribute to climate change, biodiversity loss and human rights abuses (see pages 9-10).

[1] The *2015 Paris Agreement* (United Nations Framework Convention on Climate Change, UNFCCC) seeks to limit global warming to well below 2°C above pre-industrial temperatures (and pursue efforts to limit warming to 1.5°C above pre-industrial temperatures) (Article 2.1(a) and 4.1).
[2] The *2022 Kunming-Montreal Framework* (Convention on Biological Diversity, CBD) sets out global biodiversity goals and associated action-oriented targets including to halt extinctions (Goal A), to ensure at least 30% of terrestrial, inland water and coastal and marine ecosystems are effectively conserved and managed (Target 3), and at least 30% of degraded systems are under effective restoration (Target 2).

Detailed Response

Priority One – Establish a framework for sustainability-related financial disclosures

Sustainability-related financial disclosures are useful tools to help align private capital and resources with global sustainability goals. **However, their impact could be enhanced if companies are explicitly required to disclose *not only* the financial risks posed by sustainability issues to company interests *but also* the risks and impacts of company activities on social and environmental issues like climate change and the way in which they are aligning their business with relevant sustainability goals so as to manage these risks (i.e. a *double materiality* framing)**.[3]

As currently framed, the disclosure reforms set out in the proposed Australian Sustainable Finance Strategy (and associated climate risk disclosure standards)[4] focus largely on reporting financial risks to company interests. This leads to fairly weak and indirect incentives to address the risks and impacts of business activities on people and the environment, and thereby the systemic risks posed by issues such as climate change and biodiversity loss. The reasons for this are set out below:

- Current disclosure obligations in Australian corporate law are principles-based and focus on reporting *material financial risks* posed to companies.[5] There are no specific legal requirements for a company to report on the risks and impacts of its business on people and the environment, nor on how the company is addressing these. However, companies may be required to do so if the social and environment risks and impacts of their business activities can be framed as a material risk to the company itself.

- This style of legal obligation allows companies the latitude to take their own context into account and exercise their judgment in assessments of materiality and reporting of risks. Companies have considerable discretion to define when the impacts of business activities on environmental and social matters will constitute material risks and can therefore avoid comprehensively disclosing on the risks and impacts of their activities on people and the environment.

- It is important to emphasise that financial risks to company interests, and the way in which a company might best manage those risks at the entity scale, does not necessarily align with the risks and impacts posed to people and the environment by business activities and what is needed to manage associated systemic risks in a timely way. For example, there is potentially a very significant mismatch between the pace and scale of emissions reductions required to meet climate change temperature goals established by the international Paris Agreement and the pace and scale of risk management approaches that an individual company engaged in emissions intensive activities (e.g., fossil fuel production) may adopt to manage the financial risks posed to their business by climate change.

- In recent years, the financial materiality of climate change for companies across a range of sectors has been increasingly acknowledged. Many Australian companies now provide some reporting on climate-related risks. Companies are also under increasing pressure from investors and other market stakeholders (who are focused on addressing broader, systemic risks) to align their risk management approaches to the goals of the Paris Agreement, and to set and report on targets to manage these risks (including emissions reduction

[3] As set out in European sustainability reporting standards that apply to the EU Corporate Sustainability Reporting Directive, *double materiality* encompasses both *impact materiality* and financial materiality. It requires disclosure of matters that meet *either* of these materiality thresholds, rather than both. From an impact materiality perspective, a sustainability matter is material for a company if it "*is connected to actual or potential significant impacts by the undertaking on people or the environment over the short-, medium- or long-term*" and includes impacts "*directly caused or contributed to by the* [company] *in its own operations, products or services and impacts which are otherwise directly linked to the* [company's] *upstream and downstream value chain*…" The materiality of an actual impact is determined by its severity (i.e., scale, scope, and irremediable character) while materiality of a potential impact is determined by its severity *and* likelihood. See: European Financial Reporting Advisory Group, *ESRS 1 General Principles* (Exposure Draft, April 2022) 11-13.

[4] AASB, *Australian Sustainability Reporting Standards – Disclosure of Climate-related Financial Information (Exposure Draft)* (October 2023).

[5] *Corporations Act 2001* (Cth), ss 295-97, 299, 299A, 307-8; Australian Securities and Investment Commission (ASIC) *Regulatory Guide 247- Effective Disclosure in an Operating and Financial Review*

targets that align with Paris Agreement goals).[6] Yet without explicit legal requirements and disclosure standards in place, company reporting has been highly variable and often of poor quality. Investors and civil society stakeholders have raised consistent concerns about the quality and usefulness of climate disclosures.[7] Companies are not always providing comprehensive disclosures of the financial implications of climate change.[8] Nor are they setting out transition strategies, using relevant targets and metrics to measure and compare progress and performance.[9]

- The proposed introduction of mandatory climate risk reporting in Australia will help to address this. Covered entities will have clear obligations to report on climate-related governance, strategy, risk management and relevant metrics, irrespective of their own materiality assessments. Yet the focus of the reforms is more on reporting financially material risks posed to company interests than on ensuring company risk management aligns with Paris Agreement goals so as to help manage systemic risks posed by climate change. For example, covered entities will be required to report on greenhouse gas (GHG) emissions,[10] to disclose a climate transition strategy where they have one,[11] and to report on self-determined transition targets.[12] However, at this stage, there is no clear regulatory direction for companies to align their climate risk management with Paris Agreement goals.

- Compared to climate change, biodiversity loss is less easily understood and quantified as a financially material risk at the entity scale. For example, some biodiversity dependencies and impacts (e.g., pollinator collapse) pose clear financial risks to companies in some sectors, but others (e.g., ecosystem decline and species extensions) might pose minimal financial risks, especially in the short term.[13] Accordingly, these risks are unlikely to be broadly picked up by the processes that companies use to assess financial materiality, which focus on their own strategy and context and tend to adopt relatively short (3-5 year) timeframes.

- While understanding of the financial materiality of biodiversity risks is certainly increasing (e.g., through the work of the Taskforce on Nature-related Financial Disclosures), the experience with climate risk reporting in Australia suggests that until specific reporting standards are introduced and mandated, the quantity and quality of corporate disclosures will remain inadequate. Further, unless companies are obliged to disclose information about the risks and impacts posed by their business activities and to align their risk management with relevant sustainability goals, sustainability-related financial disclosures are unlikely to contribute significantly to shifting private capital and resources away from harmful activities.

The introduction of mandatory climate risk disclosure requirements in Australia is an important step forward and the commitment to develop reporting standards for other sustainability issues like biodiversity and First Nations rights is also positive. Yet, there are opportunities to strengthen these disclosure requirements in ways that will help to better align private sector capital and resources to global sustainability goals:

- **A more explicit adoption of *double materiality*** – To the extent that it will require companies to report on GHG emissions and transition targets, the proposed Australian climate risk disclosure standard will require some reporting of 'impact materiality' in line with a double materiality approach. Yet for emerging sustainability risk issues such as biodiversity loss, which pose systemic risks, but are harder to quantify as financially material risks at the entity scale, a more explicit adoption of double materiality is warranted. If

[6] For example, Climate Action 100+ is an investor engagement initiative that urges companies to disclose in line with TCFD, to set science-based emissions reduction targets aligned to Paris goals, to disclose decarbonisation strategies to deliver on these targets, and to report regularly on progress.
[7] Investor Group on Climate Change, CDP and Principles for Responsible Investment, *Confusion to Clarity* (Report, June 2021) 4; Market Forces, *Investing in the Dark* (Updated Report, 2019).
[8] AASB and AUASB, *Climate-related and Other Emerging Risks Disclosures: Assessing Financial Statement Materiality Using AASB/IASB Practice Statement 2* (April 2019).
[9] TCFD, *2021 Status Report: Taskforce on Climate-Related Financial Disclosures* (2021); Anita Foerster and Michael Spencer, 'Corporate Net Zero Pledges: a triumph of private climate regulation or just more greenwash?' 32(1) (2023) *Griffith Law Review*, 110-142.
[10] AASB, *Australian Sustainability Reporting Standards – Disclosure of Climate-related Financial Information (Exposure Draft)* (October 2023), Cl 31.
[11] Cl 14(iv).
[12] Cl 14(v) and 31.
[13] Audrey Irvine-Broque and Jessica Dempsey, 'Risky Business: Protecting nature, protecting wealth?' *Conservation Letters*, 2023; e12969.

sustainable finance reforms are to contribute effectively to aligning private capital and resources with global sustainability goals, this requires a re-alignment away from harmful activities that contribute to problems such as climate change and biodiversity loss. An explicit requirement to report on impact materiality (i.e., the impacts of business on climate change, biodiversity loss and other sustainability issues) can help to support this shift.

- **Embed requirements to align with relevant global sustainability goals** – Given the mismatch between the financial materiality of sustainability risks at the entity scale and what is needed to address systemic risks posed by climate change in a timely way, many best practice climate risk disclosure and management standards, including the TCFD, emphasise the importance of aligning entity-scale risk management with global climate goals, as set out in the Paris Agreement. European sustainable finance reforms also adopt this approach – for example, under the proposed EU Directive on *Corporate Sustainability Due Diligence*, covered entities would be required to develop and implement transition plans to ensure their business model and strategy are aligned or compatible with the transition to a sustainable economy and achieving climate neutrality by 2050, as well as *with limiting global warming to 1.5°C* in line with the Paris Agreement.[14] Reporting standards that underpin the EU *Corporate Sustainability Reporting Directive* also emphasise the importance of alignment with global goals. For example, the draft climate change reporting standard sets out requirements that covered entities disclose transition plans in line with Paris Agreement objectives;[15] and the draft biodiversity reporting standard mandates covered entities to disclose a transition plan that demonstrates how their business model and strategy is, or will become, compatible with relevant targets set out in the *Kunming-Montreal* Global Biodiversity Framework and the EU's own biodiversity strategy.[16]

  The Australian Sustainable Finance Strategy does require covered entities to assess climate-related risks against emissions reduction scenarios aligned with the more ambitious 1.5°C Paris Agreement temperature goal.[17] However, the strategy could be strengthened with a more explicit adoption of this approach in relation to risk management disclosures, such as target-setting and transition planning (see further comments below).

Priority Two – Develop a sustainable finance taxonomy

A Sustainable Finance Taxonomy can play an important role in directing capital flows towards economic activities that substantially contribute to climate mitigation and other sustainability objectives and is therefore an important element of the proposed Australian Sustainable Finance Strategy.

However, experience in developing the European Taxonomy highlights the tendency for policy or energy market considerations to trump best available scientific evidence in the delineation of activities that substantially contribute to sustainability objectives, thereby undermining the credibility of the taxonomy. For example, the 'significant contribution' screening criteria for certain activities associated with fossil gas and nuclear energy have been lowered to classify those activities as 'sustainable' in a transitional activity category, despite adverse climate and environmental impacts.

The proposed Australian Sustainable Finance Strategy indicates a preference for including transition activities within an Australian taxonomy, but does note the need for 'rigorous, science-based criteria to define activities that can credibly support the transition – and on what timeframes.' **The robustness of such activity criteria will be determinative of the success of this initiative. Therefore, it is important to ensure that relevant independent experts are engaged in the development of these criteria and decisions are made based on independent expertise.**

[14] Council of the European Union, *Proposal for a Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and Amending Directive – 4 Column-Table* (Proposal, 6 June 2023) art.15.
[15] European Financial Reporting Advisory Group, *Draft European Sustainability Reporting Standards ESRS E1 – Climate Change* (Nov 2022)
[16] European Financial Reporting Advisory Group, *Draft European Sustainability Reporting Standards ESRS E4 – Biodiversity and Ecosystems* (Nov 2022)
[17] Cl 22.1 and B12.1.

As the consultation paper identifies, there are a range of options for embedding the taxonomy into regulatory arrangements in Australia including requiring corporate activity alignment reporting. This would be in line with the EU approach which requires each of the entities covered by the *Corporate Sustainability Reporting Directive* to also disclose the proportion of the company's turnover, capital expenditure and operating expenses that are taxonomy-aligned. **Corporate activity reporting against the Taxonomy is distinct from the sustainability-related financial disclosures discussed above and can help to shift the focus of disclosures beyond financial risks posed to company interests, to how company activities align with, support a transition to, or detract from important sustainability objectives.**

While it may increase the reporting burden for covered entities, **corporate activity reporting will nonetheless be critical to the success of the Taxonomy initiative** - for investors to accurately report on their own portfolio alignment, they need to understand whether their investee companies and other assets' economic activities contribute to, or harm, each of the taxonomies' objectives.

Priority 3 – Support credible net zero transition planning

As noted above, net-zero transition planning can help to align climate risk management at the entity scale to the goals of the Paris Agreement, and thereby contribute to the management of systemic risks posed by climate change. Transition plans can be used to require companies to develop goals, actions, and accountability measures to align their business activities (and associated impacts such as GHG emissions) with global goals and best practice expectations. Investors and other market stakeholders are increasingly seeking the disclosure of corporate net-zero transition plans to provide them with additional qualitative information about a companies' preparedness to manage climate risks and the robustness of their commitment to net-zero targets.[18]

As the consultation paper recognises, many Australian companies have set net-zero climate targets (75% of the ASX200). However, these commitments are rarely supported by robust transition strategies that set out Paris-aligned interim targets, capital allocation strategies and accountability measures such as tying executive remuneration to climate performance.[19]

While the draft Sustainable Finance Strategy aims to support more transparent, credible, and ambitious transition planning and disclosure by Australian firms, there appears to be no immediate intention to mandate their development and disclosure. Instead, the proposed approach is to require companies to disclose a transition strategy where they have one, and to report on self-determined transition targets, with no clear regulatory direction for companies to align their climate risk management with Paris Agreement goals.

This approach rests on an assumption that institutional investors will have sufficient incentives and resources to steward investee companies to align their climate risk management with Paris Agreement goals. While investors certainly can exert influence over investee companies, stewardship is costly and resource-intensive and changes in individual companies can take many years of sustained pressure. Placing those expectations and associated costs on institutional investors (particularly superannuation funds) is not necessarily in the best financial interests of their members. Additionally, relying on investor stewardship may limit the ambition of corporate transition plans. Considering the Australian Government has now legislated the temperature goals of the Paris Agreement in the *Climate Change Act 2022* (Cth), it is appropriate that the Government takes steps to ensure corporate entities align to a similar ambition, to maximise the likelihood of achieving Paris Agreement goals in a timely fashion.

Mandating the preparation and disclosure of net-zero transition plans for selected large companies, and requiring these to align with a specific and ambitious temperature goal (e.g., 1.5°C) (along the lines of the European approach detailed above) would be a more direct and effective way to ensure that the Sustainable Finance Strategy helps shift private capital and resources away from climate-damaging activities in alignment with global climate goals.

[18] Above n 6.
[19] Foerster and Spencer above n 9.

Further, given the commitment to also develop disclosure standards for biodiversity risk reporting in Australia, there is an opportunity to develop expectations in relation to biodiversity risk management, including requiring companies to prepare transition plans detailing their strategy to address biodiversity risks and dependencies, reduce adverse impacts and enhance positive impacts on biodiversity in alignment with relevant global and national goals. The draft EU biodiversity reporting standard noted above provides a useful model.[20]

Priority 8 – Ensuring fit for purpose regulatory frameworks.

We agree that existing legal and regulatory frameworks for corporate governance certainly enable, and in many cases, require company directors to integrate sustainability *risk* considerations into corporate decision-making and governance. **However, there are a number of barriers and challenges associated with the existing legal framework that can prevent company directors from taking steps to address climate change and other sustainability considerations in line with relevant sustainability goals (e.g. reduce GHG emissions in line with the Paris Agreement), where to do so would conflict with the short-term financial interests of the company and its shareholders.** These challenges include:

- **Material Risk Framing –** In Australia, it is now widely accepted that climate change is relevant to the legal duties of company directors, particularly the duty of due care and diligence set out in s180 of the *Corporations Act 2001* (Cth): where climate change poses material risks to company interests, company directors must inform themselves of foreseeable risks posed to company interests and must take proportionate measures to manage these risks.[21] As understanding of the financial materiality of biodiversity risks increases, taking proportionate measures to manage these risks in the best interests of the company will also be required.[22]

  However, the way in which directors' duties are legally defined and interpreted in Australia has the effect of imposing limited requirements on directors to consider sustainability issues only where they pose material risks to company interests, with considerable discretion afforded in terms of responding to these issues. The duty of care and diligence is procedural in nature: it requires directors to be able to demonstrate that they have considered sustainability risks to the company and taken steps to manage those risks, as opposed to obligating them to take certain actions to mitigate those risks.

  For matters like climate change, where company risks increasingly intersect with company impacts (i.e., heavy emitters potentially face greater transition and reputational risks), directors should now arguably be considering a range of activities to avoid and mitigate those impacts (i.e., reducing emissions). However, what is legally required is a thorough consideration and assessment of appropriate course of action with respect to the company's interests. The duty of care and diligence and associated business judgment rule defence[23] provide directors with relatively large discretion concerning responses to climate risks.

  As such, it is reasonably open for directors to decide to continue to pursue climate-damaging activities as part of their business model if the risks associated with these activities can be appropriately managed (e.g., through diversifying business activities and investing resources and capital in alternatives over time). As noted above, there is a potentially a very significant mismatch between the pace and scale of emissions reduction required to meet climate change targets established by the international Paris Agreement and the

[20] Above n 16.
[21] Noel Hutley QC and Sebastian Hartford-Davis, *Climate Change and Directors' Duties: Memorandum of Opinion* (2016); Noel Hutley QC and Sebastian Hartford-Davis*, Climate change and directors' duties (Supplementary Memorandum of Opinion*) (2019); Noel Hutley QC and Sebastian Hartford-Davis, *Climate Change and Directors' Duties: Further Supplementary Memorandum of Opinion* (2021)
[22] Sebastian Hartford David and Zoe Bush, *Nature-related risks and Directors' Duties – Joint Memorandum of Opinion* (24 October 2023).
[23] A director who takes action (or decides not to act) based on an informed, rational assessment of the company's best interests, may be protected from liability for breach of the s180(1) duty by the statutory defence - the business judgement rule (s180(2)).

pace and scale of risk management approaches that an individual company engaged in high emitting activities may adopt to manage the risks posed to their business by climate change.

Greater limitations arise for biodiversity loss and other sustainability challenges, as these issues are not broadly accepted by the market as systemic risks and the impacts of offending business activities do not yet easily translate to material risks posed to company interests.

- **Focus on short-term financial interests** – In addition to the duty of due care and diligence, company directors are subject to a legal duty to exercise their powers and discharge their duties in good faith in the *best interests* of the company (s 181, *Corporations Act 2001* (Cth)). The current legal position on the *best interests duty* is that directors have the scope and discretion to make decisions to improve corporate sustainability performance *if* they can establish that such a course of action is beneficial and generates wealth for the company in the long term. As a matter of law, directors are not confined to maximising profits or shareholder returns *in the short-term*.[24] Indeed, the best interest duty provides considerable discretion over the factors that directors can consider when determining the company's best interests (e.g., the environment and impacted communities).[25]

  Nevertheless, a narrow, short-term focus on profit maximisation has become a dominant social norm.[26] Although explicit empirical evidence on how directors balance and trade-off short-term against longer term considerations in various decision-making contexts is limited, there is some evidence to suggest that Australian company directors prioritise short-term financial interests above taking actions to positively contribute to social and environmental outcomes.[27] The fact that public-facing and heavily-scrutinised Australian companies are proceeding with expansionary fossil fuel projects in conflict with the goals of the Paris Agreement illustrates that the permission to integrate sustainability considerations into decision-making is insufficient to incentivise improved corporate sustainability performance at the extent and pace necessary to achieve global climate goals.

- **Mismatch between investor duties and corporate duties –** For universal owners (e.g., superannuation funds and large, divresfieid institutional investors) investment returns are affected by the performance of the economy, which is, in turn, underpinned by the stability of environmental and social systems. Negative sustainability externalities associated with individual companies (i.e., their adverse impacts on climate, biodiversity, inequality and other systemic sustainability issues) can affect the performance of the economy as a whole and the performance of other companies within a diversified investment portfolio, arguably diminishing investment returns over the long term.[28] Accordingly, universal owners have a portfolio imperative and an implied duty to invest for positive sustainability outcomes.[29] Yet narrow interpretations of directors' duties enable company directors to prioritise short term profit maximization over longer-term

[24] Beate Sjåfjell, 'Beyond Climate Risk: Integrating Sustainability into the Duties of the Corporate Board' (2018) 23 *Deakin Law Review* 41, 49.
[25] Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations* (Report, December 2006); Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Responsibility: Managing Risk and Creating Value* (Report, June 2006).
[26] Beate Sjåfjell et al, 'Shareholder Primacy: The Main Barrier to Sustainable Companies' in Beate Sjåfjell and Benjamin J. Richardson (eds), *Company Law and Sustainability: Legal Barriers and Opportunities* (Cambridge University Press, 2015).
[27] Empirical research exploring company directors' understanding of the links between their legal duties and social and environmental risks in Australia is limited. A 2006 study surveyed how Australian directors approached the determination of the best interests of the company: Meredith Jones et al, 'Corporate Governance, Shareholder Primacy and the Interests of Employees: Evidence from a Survey of Australian Directors' in Shelley Marshall, Ian Ramsay and Richard Mitchell (eds), *Varieties of Capitalism, Corporate Governance and Employees* (Melbourne University Publishing, 2009) 130. Of 367 Australian directors surveyed, 44% prioritised the interests of shareholders above that of stakeholders (including the company, employees, customers, suppliers, lenders/creditors, the community, the environment, and the country) whilst 40.4% prioritised the interests of '*the company*.' Only 0.6% and 0.3% of directors prioritised the environment and the community respectively. Whilst the researchers did not define '*the company*,' participants seemingly considered it to be broader than shareholders given 55% said that acting in the company's best interests meant balancing the interests of all stakeholders.
[28] Frederick Alexander, 'The Benefit Stance: Responsible Ownership in the Twenty-First Century' (2020) 36(2) *Oxford Review of Economic Policy* 341, 349.
[29] Principles for Responsible Investment, *A Legal Framework for Impact – Australia: Integrating Sustainability Goals Across the Investment Industry* (Report, September 2022); Freshfield Bruckhaus Deringer, Principles for Responsible Investment, United Nations Environment Programme Finance Initiative, and the Generation Foundation, *A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making* (Legal Report, July 2021).

value objectives that appropriately incorporate sustainability considerations. This is clearly in conflict with evolving investor duties and potentially could lead to divergent positions whereby company directors can legally excuse decisions to pursue activities with adverse sustainability impacts by virture of their legal duties, despite institutional shareholers of the company seeking to mitigate or prevent those impacts in accordance with their own duties.

Given these challenges and barriers, the proposed Australian Sustainable Finance Strategy would benefit from additional, targeted consideration of potential corporate law reforms, including to the legal duties that govern company directors.

Indeed, reforms to directors' duties are being actively considered as part of the EU Sustainable Finance Strategy,[30] and have been recently introduced in comparative jurisdictions like New Zealand.[31] Where sustainability expectations are continually evolving, it is imperative that directors' duties are modernised to ensure that companies act in the best interests of society as well as their shareholders.

Reforms which embed sustainability into corporate law frameworks as a way to counter a short-term focus on profit maximisation at the expense of inadequately regulated social and environmental externalities, have been debated in academic circles for many years.[32] Of the various reforms proposed, two options appear to have particular salience for the current Australia situation:

- **A sustainability judgement rule[33]** – To reinforce the relevance of current and future sustainability performance and other longer-term considerations to the best interests of the company, a sustainability judgement rule could be added to the *Corporations Act 2001* (Cth). This would provide that company directors would not be liable for a breach of directors' duty for making a decision to improve the company's current and future sustainability performance even in situations where this may not directly align with short-term profit generation goals of various shareholders.

- **A general sustainability duty linked to global sustainability goals[34]** – An additional, stand-alone sustainability duty could be added to the *Corporations Act 2001* (Cth) to require company directors to take all reasonable steps to prevent social and environmental harms and to improve their company's social and environmental performance. This could be accompanied by a provision that the overarching purpose of a corporation is to create sustainable value by balancing the interests of shareholders and other stakeholders and by operating in accordance with agreed social and environmental parameters (e.g., net-zero and nature-positive parameters derived from global sustainability agreements). In acting in the best interests of the company, directors would have an obligation to promote this purpose and ensure the company's impacts do not exceed these parameters. A corporate sustainability regulator could be responsible for monitoring performance and enforcing compliance.

[30] European Commission and EY, *Study on Directors' Duties and Sustainable Corporate Governance* (Final Report, July 2020). Following this study, the European Commission subsequently proposed that a directive should be introduced to clarify that directors' duties to act in the best interest of the company requires them to consider human rights, climate change and environmental consequences in the short-, medium- and long-term. This proposal was supported by the European Parliament but rejected by the European Council. Whether or not it is passed will be determined by ongoing negotiations.

[31] Recent reforms to the Companies Act 1993 (NZ), s 131 clarify that directors "may consider matters other than the maximisation of profit (for example, environmental, social and governance matters)".

[32] See e.g., Sjåfjell above n 24; Sjåfjell et al above n 25; Nick Grant, 'Mandating Corporate Environmental Responsibility by Creating a New Directors' Duty' (2015) 17(4) *Environmental Law Review* 252; Julia Maskill, 'Extending Directors' Duties to the Natural Environment: Perfect Timing for Greener Companies in Aotearoa New Zealand? (2016) 22, *Auckland University Law Review* 281; John Quinn, 'The Sustainable Corporate Objective: Rethinking Directors' Duties' (2019) 11(23) *Sustainability* 6734; Sarah E Light, 'The Law of the Corporation as Environmental Law' (2019) 71(1) *Stanford Law Review* 137, 141; Jacqueline Peel et al, 'Governing the Energy Transition: The Role of Corporate Law Tools' (2019) 36(5) *Environmental and Planning Law Journal* 459, 461-464; Christopher Bruner, 'Corporate Governance Reform and the Sustainability Imperative' (2022) 131(4) *The Yale Law Journal* 1217-1277, 1221; Shelley Welton, 'Neutralizing the Atmosphere' (2022) 132(1) *The Yale Law Journal* 171; The British Academy, *Principles for Purposeful Business: How to Deliver the Framework for the Future of the Corporation* (Report, 2019).

[33] This option is modelled on recommendations developed by Professor Ben Richardson, University of Tasmania. See: Ben Richardson, *The Private Sector, Business Law and Environmental Performance* (2007).

[34] Similar duties have been proposed by a number of legal academics including Beate Sjåfjell (above n 24 and 25), Ben Richardson (above n 31), John Quinn (above n 30) and Nick Grant (above n 30).

Include Mandatory Human Rights and Environmental Due Diligence in the Sustainable Finance Strategy

Mandatory human rights and environmental due diligence laws are being introduced around the world to increase corporate accountability for social and environmental harms caused, or contribteud to, by business activities. These types of laws are now in place in Germany,[35] France,[36] Norway,[37] the Netherlands,[38] and the EU is currently finalising their Directive on *Corporate Sustainability Due Diligence*[39] as part of their broader sustainable finance reforms.

These laws require large companies to assess actual and potential adverse impacts on human rights and/or the environment caused by, or substantially contributed to, by the company's activities, or which may be directly linked to the company's operations, product or services by its business relationships. Companies are required to take reasonable steps to prevent harms occurring, and, where harms occur, to address these. Some of these laws provide a civil remedy for victims of harms,[40] and the EU Directive proposes to assign responsibility and oversight for due diligence to company directors.[41]

Australia already has modern slavery legislation – the *Modern Slavery Act 2018* (Cth) – that requires large entities to report publicly on modern slavery risks in their supply chain and what they are doing to manage these risks. However, there is little evidence that mandatory disclosure is sufficient on its own to drive the desired changes in company behaviour at scale. Analysis of reporting practice over the first few years of operation shows that many companies are failing to comply with the requirements of the Act. Further, the quality of statements is low, with many incomplete and superficial. There has also been a failure to disclose obvious risks and impacts, and very few companies are reporting on effective actions taken to address risks. This has been attributed to a lack of enforcement mechanisms, very little focus on remediating risks and impacts, and insufficient regulatory oversight and support. [42] Further, this legislation focuses narrowly on a particular subset of serious human rights violations. Other human rights abuses in the supply chain and environmental harms remain unaddressed.

A strong mandatory due diligence regime should be considered as part of Australia Sustainable Finance Strategy.

Mandatory due diligence laws which focus explicitly on preventing, mitigating and remediating social and environmental harms in corporate value chains, have considerable potential to complement the other reforms set out in the strategy. In particular, they can help to increase transparency and accountability around business activities that contribute to social and environmental harms, pressuring companies to take all reasonable steps to prevent and minimise harms – a fundamental foundation to help to move capital and resources away from business activities which worsen climate change, biodiversity loss and human rights abuses.

Further, the proposed EU Directive will have significant implications for a large number of Australian companies. This includes entities that are among the estimated 4,000 non-registered EU entities to fall within its scope by virtue of their financial and employee thresholds; or that are subsidiaries of either an EU or non-EU entity that fall within the Directive's scope; or that have an established business relationship with an EU or non-EU entity that falls within the Directive's scope. **From the perspective of maintaining international competitiveness and Australia's international standing, this is an opportune time for Australia to consider similar law reform opportunities.**

[35] *Supply Chain Due Diligence Act 2021* (Germany)
[36] *Corporate Duty of Vigilance Law 2017* (France)
[37] *Transparency Act 2022* (Norway)
[38] *Child Labour Due Diligence Law 2019* (Netherlands)
[39] Council of the European Union, *Proposal for a Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and Amending Directive – 4 Column-Table* (Proposal, 6 June 2023)
[40] This includes the French law (above n 35) and the proposed EU *Directive on Corporate Sustainability Due Diligence* (ibid), Art 22.
[41] EU *Directive on Corporate Sustainability Due Diligence*, Art 64. This proposal is supported by the European Parliament.
[42] See discussion in: Olivia Dean and Shelley Marshall, 'A race to the middle of the pack: an analysis of slavery and human trafficking statements submitted by Australian banks under the UK Modern Slavery Act 26(1) (2020) *Australian Journal of Human Rights*, 46-73; Jolyon Ford and Justine Nolan, Regulating transparency of human rights and modern slavery in corporate supply chains: the discrepancy between human rights due diligence and the social audit' 26(1) (202) *Australian Journal of Human Rights* 27-45; Paul Redmond, 'Regulating through reporting: an anticipatory assessment of the Australian Modern Slavery Acts 26(1) (2020) *Australian Journal of Human Rights* 5-26; Freya Dinshaw et al, *Broken Promises: Two years of corporate reporting under Australia's Modern Slavery Act* (Human Rights Law Centre, 2022); Amy Sinclair, Freya Dinshaw et al, Paper Promises? Evaluating the early impact of Australia's Modern Slavery Act (Human Rights Law Centre, 2022); Shelley Marshall et al, *Australia's Modern Slavery Act: is it fit for purpose?* (Human Rights Law Centre, 2023).

Conclusion

Sustainable finance reforms have an important role to play in supporting the net-zero transition in Australia in line with the goals of the international Paris Agreement. Similarly, these reforms can help Australia to address key sustainability issues such as biodiversity loss, in line with Australia's commitments under the Global Biodiversity Framework. They can also help address critical social justice issues including respect for the rights of First Nations peoples.

However, it is important that sustainable finance reforms do not detract from the urgent need to directly regulate activities that contribute to climate change, biodiversity loss and other social and environmental harms (e.g., through taxation, emissions trading, licensing and project approval regimes, cultural heritage protection laws).

In making this submission, we express support for many of the proposed reforms and make suggestions for ways in which they could be strengthened to better align private capital and resources with sustainability objectives. However, it is important to reiterate that **sustainable finance reforms are no substitute for strong, effective direct regulation of business activities that contribute to climate change, biodiversity loss and other sustainability challenges.**

Accordingly, these reforms should be framed as complementary to a broader climate, environmental and social justice reform agenda that includes reforms to federal environment protection laws to ensure that impacts on climate change and biodiversity (including cumulative impacts) are properly considered and mitigated as part of project assessments and approvals, and that commits to ongoing improvement of the recently reformed Safeguard Mechanism to ensure that it is effective in reducing emissions from our highest emitters. [43]

[43] Jacqueline Peel, *Legal Opinion – Gaps in the Environment Protection and Biodiversity Conservation Act and other federal laws for protection of the climate* (Report for the Climate Council, 2023)