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FINANCIAL SERVICES INSTITUTE OF AUSTRALASIA

Finsia's submission to the Parliamentary Joint Committee on Corporations and Financial Services on the Inquiry into Corporate Social Responsibility (CSR)

19 May 2006

Ms Kelly Paxman
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
Parliament House
PO Box 6100
Canberra ACT 2600

via email: corporations.joint@aph.gov.au

Dear Ms Paxman,

Finsia, the Financial Services Institute of Australasia, welcomes the invitation from the Parliamentary Joint Committee on Corporations and Financial Services to provide comment on the Inquiry into Corporate Social Responsibility (CSR).

Finsia emerged in late 2005 as a result of the successful merger between the Australasian Institute of Banking and Finance (AIBF) and the Securities Institute of Australia (SIA). Finsia is the leading financial services educator and membership body for financial services professionals throughout Australia and New Zealand. Finsia encompasses the experience and expertise of the AIBF and SIA that date back to 1886 and supports a strong membership of over 21,000 members plus 19,000 students studying for postgraduate and vocational qualifications.

For further information, please contact Mr Russell Thomas, Senior Policy Adviser, Consumer and Public Policy on 612 8248 7508, via email: r.thomas@finsia.edu.au or by mail, Level 3, NAB House, 255 George Street SYDNEY NSW 2000.

Yours sincerely

Brian Salter F Fin
Chief Executive Officer

1. Introduction

Finsia has 21,000 members and 19,000 students in more than 50 countries, and is the leading educator and membership body, building careers and raising standards in financial services. With a broad membership, Finsia is in the unique position to engage a wide range of stakeholders and draw upon the expertise of its members on key public policy issues and initiatives.

For the purposes of this submission, Finsia will concentrate on matters 'e', 'f' and 'g' under the Committee's Terms of Reference, namely:

e. any alternative mechanisms, including voluntary measures that may enhance consideration of stakeholder interests by incorporated entities and/or their directors

f. the appropriateness of reporting requirements associated with these issues

g. whether regulatory, legislative or other policy approaches in other countries could be adopted or adapted in Australia.

The committee has received many submissions and heard evidence on the scope of directors' obligations under the Corporations Act, and whether or not the current framework encourages organisational decision-makers to have regard for the interests of stakeholders other than shareholders. For Finsia's purposes in this submission, the task of encouraging greater corporate social responsibility (CSR) will be approached from another perspective: **in terms of investor demand for sustainable responsible investments (SRI).**

1.1 Finsia's Sustainable Responsible Investing research project

Through its consumer and public policy function, Finsia has approached a broad range of industry representatives (investment managers, analysts, advisers, lawyers and academics) who are responsible for, or have an interest in, SRI and improving the way in which companies report the social and environmental impacts of their activities.

According to initial research, Finsia noted the apparent lack of independent consumer research into Australians' understanding of, and attitude towards, SRI. In the post-Super Choice environment, research that links changing community attitudes towards corporate behaviour with the 'mainstreaming of SRI', would not only assist industry practitioners to respond better to investor demand (especially through superannuation product), but also demonstrate to Government and regulators that SRI investments provide the best driver for improving corporate behaviour.

Finsia's campaign has been kicked-off with qualitative research (focus groups) into consumer awareness of, and attitudes towards, SRI.

In this submission, Finsia will provide information to the Inquiry on:

1. relationship of SRI to corporate social responsibility
2. the growth and impact of the SRI funds industry
3. findings from the SRI focus groups, conducted in Sydney by ANOP, in May
4. identification of the legal and regulatory frameworks that could be inhibiting the further uptake of SRI funds.

2. Relationship of SRI to Corporate Social Responsibility

Broadly, Finsia regards the management of stakeholder interests to be compatible with managing shareowners' interests, especially over the long term. Corporations that demonstrate good corporate social responsibility, from Finsia's perspective, are companies that have appropriate regard for all manner of risks that arise from their operations, in the short and long term, including the impact of the corporation's activities both natural and human environments.

A narrow perspective would emphasise the potential costs that arise from litigation or regulatory risk. However, this minimalist view only captures the risks that legislators and regulators have been able to identify and protect the community against. Responsible corporations are those who diligently and honestly assess the risks of their operations to other stakeholders, both now and in the future.

The responsibility for identifying and managing these risks does not, however, rest with corporations alone. The financial services industry – from fund managers and their buy-side analysts, investment banks and client advisory divisions – all have a responsibility to source, analyse and report to investors on all matters of risk that impact on company operations, both in the current reporting season and over a long-term horizon.

Increasingly, more of Australians' retirement savings are held in superannuation funds. Australians' increased exposure and reliance on equity markets for their retirement only heightens the responsibility of the financial sector to identify and minimise risks to long-term returns.

2.1 Sustainability and non-financial risk reporting

Clearly, many analysts and investment managers would already, in varying degrees, take these matters into consideration when investing or making a recommendation on a company stock, particularly given the growing recognition that these matters may have a direct or indirect impact on the financial value of a particular stock. However, the decisions made are only as good as the information relied upon.

For the most part, much of the available information comes from companies themselves in fulfilling their reporting obligations under the Corporations Act and the ASX Business Rules. However, many of these risks are not adequately revealed by existing measures required by international financial accounting standards.

To this end, Finsia supports the UN Global Reporting Initiative (GRI) and, locally, the ASX Corporate Governance Council's consideration of including 'non-financial reporting of ESG considerations' in the ASX Principles of Good Corporate Governance as guidance towards best practice in company reporting. Many larger companies, of course, voluntarily prepare Corporate Social Responsibility reports, and these variously draw upon the recommendations made by the GRI framework, or other similar reporting initiatives.

These developments are still in their infancy and many industry practitioners would consider the development of mandatory standards for 'non-financial reporting' premature. However, the ongoing discussion and refinement of these reporting frameworks depends upon there being a demand for such information.

2.2 Industry engagement and education

Some companies have been forerunners in the compilation and release of CSR reports, and there are also a number of research firms that have emerged, who specialise in collecting CSR information on companies and provide this information to SRI fund managers and asset consultants.

However, the improvement of company consideration and reporting of CSR matters requires a whole-of-industry approach.

In short, Finsia regards the task of raising company standards in the consideration and reporting of sustainability and non-financial risk information to be one of engagement and education. There are a number of important industry and wider social trends, which are coalescing around both CSR and SRI, that together have the potential to raise the importance of risk and corporate sustainability in the investment community, namely:

- superannuation choice – there are many more people, especially Generation X and Y, who are making investment decisions for the first time
- emerging research that demonstrates SRI funds can offer equal, or superior, performance to mainstream funds
- greater understanding of the consequences of environmental risk to individual companies and whole industry sectors
- increased community expectation that corporations will not merely focus on short-term profits, but have regard to other stakeholders affected by their operations, and the potential impact on future generations
- the deepening pool of superannuation funds under management – the structure of super investments provides the longer-term perspective that is considered to be required for CSR.

Finsia believes that an industry-responsive, investor-driven approach, evidenced through the growing SRI funds under management, will provide the most positive and significant long-term impact on CSR.

3. SRI funds: growth and impact

According to the Ethical Investments Association (SRI) 2005 Benchmarking Report, SRI has grown by 70% on 2004. This impressive performance has been driven by "superannuation funds adopting SRI policies for existing portfolios, strong investment performance and capital raised by new SRI funds".[1]

In fact, Sustainable Responsible Investment (SRI) in Australia has been steadily gaining pace since the early 1990s. In 1999, the Ethical Investment Association (EIA) was formed to promote the concept and practice of SRI in Australia. The EIA has developed the world's first SRI certification program with the intention of "helping consumers make informed choices regarding investment opportunities that take environmental, social and ethical considerations into account as well as financial returns".

The EIA should be commended for launching a SRI Superannuation Centre, where people are provided with a list of SRI options found in managed funds, industry funds and master funds. The centre also lists financial advisers who provide SRI advice. This information is available on EIA's website.

With respect to SRI investment performance in Australia, the median Sustainable & Responsible Investment (SRI) manager has outperformed the broader benchmark S&P/ASX 200 index over 1, 2, 3 and 5 years to 31 March 2006.[2]

SRI plays a direct role in influencing corporate attitudes to CSR through the various mechanisms employed by SRI fund managers, including:

- growth in negative screening that will reduce the availability of capital to companies that are judged to be acting against the best interests of society and the environment, prompting companies to develop processes to address these concerns;
- growth in positive screening and best-of-sector methodologies that will make more capital available to companies that are involved in positive industries and that are operating in a manner that can be seen as 'best practice'

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[1] Ethical Investors Association, *Sustainable Responsible Investment: A Benchmarking Survey conducted by the Ethical Investments Association (EIA)*, October 2005 (available through the EIA website: www.eia.org.au).

[2] AMP Capital SRI Industry Performance Study, May 2006. See Appendix 1.

- growth in engagement strategies that will lead to direct interaction between fund managers concerned about specific risk issues and those companies who are identified as operating in a manner that does not take CSR into account.

While this is not intended to be a comprehensive list of the various strategies used by SRI fund managers, it does serve to illustrate the manner in which the finance community can positively influence and promote CSR. It is also important to note that 'mainstream' fund managers are increasingly adopting SRI criteria, without promoting themselves as such.

4. Consumer research on SRI: focus groups

The initial phase of the consumer research was conducted in May in Sydney by ANOP in the form of focus groups. The overarching aim of the research was to understand Australians' awareness and attitudes to sustainable (and socially) responsible investments.[3]

Key aspects that were explored included:

- understanding of terminology used – relevance and impact
- information sources of SRI and CSR
- expected behaviours and corporate policies associated with SRI and CSR
- relationship of SRI to philanthropy and community participation
- are expectations of SRI and traditional investments performance different?
- current exposure / participation of CSR programs and impact on attitudes and behaviours
- actual investment in SRI options and factors driving investment proportion and different investment types (superannuation, direct stocks, managed funds).

For the purposes of these focus groups, the sample selection consisted of three age-based segments (30-44 yrs, 45-54 yrs and 55-65 yrs), each with superannuation and a mix of direct and indirect share ownership and who were considered 'active' investors. The 'active' category included not only those who buy and sell equities but also those who participate in investment decisions.

Preliminary findings from the SRI focus group research indicate that Australians:

- are significantly concerned about issues that arise from corporate operations – especially environmental and labour concerns (see s 4.1 and 4.2 below)
- have difficulty understanding how their ethical or moral concerns can be expressed through their investment choices, and therefore influence corporate behaviour (see s 4.2 and 4.3 below), and
- will increasingly select SRI options once they understand that SRI fund options are available and have a proven track record in not only matching, but also outperforming, the market index (see s 4.4 below).

In short, Australians are concerned by corporate behaviour, but do not have sufficient understanding of how investments can influence that behaviour. More investments could be directed to SRI superannuation and other managed funds, if industry (and Government) took a more active role in educating Australians about SRI.

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[3] Some SRI managers refer to Social Responsible Investment, whereas others use the term Sustainable Responsible Investments. For the purposes of the research, we used the term, Socially Responsible Investments.

4.1 Environmental, social and governance issues have significant resonance with Australians

Australians are very concerned about the natural environment and particularly weather patterns – drought and severe storms – as symptoms of global warming. There is a belief that things have to change and companies, just as they as individuals, have to be more environmentally aware. Increasingly, consumers are conscious of making or trying to make 'sustainable investments'.

The collapse of HIH, OneTel and others has had an adverse impact on the regard that consumers have of senior corporate management. Consumers are now more suspicious of companies and their directors.

4.2 Consumers are familiar with terms such as 'sustainability', 'governance' and 'risk', but only a few members had heard of SRI before

Conceptually, 'sustainable investments' resonates more immediately with Australians than does 'SRI'. Sustainability is related more to investments in companies that have a genuine concern for the future of the environment – green companies.

Primarily, investors look for a stable company with evidence of steady and sustainable growth. These companies are good investments because they are perceived to provide asset growth and income. Returns are still a critical consideration.

However, increasingly investors are using their own 'moral compass' to guide some of their selections. Consequently, issues such as governance, worker conditions, and the treatment of consumers are impacting on investment decisions.

4.3 Due to a lack of awareness of SRI and SRI products, most consumers do not know how to connect their ethical beliefs with their investment choices

Although the industry may consider SRI investing to have had a relatively long lead-time, many consumers have only recently begun to formulate a response to the need to make more informed investment decisions. They tend to be drawn to 'green' companies because they are easy to spot and understand rather than address the wider decision making associated with socially responsible investing.

However, while a company's success, their contribution to society, environmental credentials and workforce treatment creates interest and does generate a more positive image among consumers, they remain highly sceptical of major corporations. 'Spin' was a word frequently used by consumers to describe corporate actions. Consumers were aware of the need for this type of promotion to take place but more credence was given to actual corporate behaviour.

The marriage of communication of corporate policies and corporate action was perceived to be the most powerful in driving investor interest.

4.4 Many Australians do not realise that SRI options are available, but if presented with the option, would allocate part of their portfolio to SRI.

Traditionally, most Australians, when given the choice between an investment with higher returns and an investment in an ethically responsible company, which contributes to society or the environment, the majority would have chosen higher returns. However, this research indicates that support for this pathway, especially among younger Australians, is beginning to weaken.

> *"We need to have some balance; I want good returns but I would trade a little of return if I knew the companies I invested in were doing the right thing."*

Within an overall portfolio or pooled investment, such as a managed or superannuation fund there is a willingness to place a share usually less than 20% and more likely 10% in an SRI. This is a signal that interest is growing and translating into investment decisions.

Australians are more likely to regard ethical investments as trade-offs with lower returns in a portfolio of mostly mainstream investments. A few participants were able to make the connection between 'best practices' and higher long-term returns. But this was a minority position and indicates that further education is required for consumers to understand the links between CSR and good investments.

With a deeper understanding of SRI and its processes (ie. screening / weighting techniques) and given how consumers are using their own moral compass, we could reasonably expect that investment proportions would quickly move to SRI.

Clearly, industry faces the challenge of raising the prominence of SRI investment options with investors, both at the level of financial planning (more advisers need to be aware of SRI investments) and at the level of education – giving investors information on how companies are screened or weighted according to their nominated CSR activities.

5. Legal and regulatory barriers to the further update of SRI in Australia

Whereas SRI was not explicitly addressed in the current PJC Inquiry's Terms of Reference, clearly there is a strong relationship between CSR and SRI, and Finsia believes that further attention should be directed at some of the legal and regulatory barriers that may be inhibiting the full potential for SRI in Australia.

Finsia welcomes the recent release of the United Nations Environment Programme, 'Principles for Responsible Investment', in particular, the objective that

> *"Principles provide a framework for achieving better long-term investment returns and more sustainable markets."*

Unfortunately, however, the legal framework that underpins fiduciary duties of superannuation (or pension) trustees and fund managers differs across the developed world. In some jurisdictions, including Australia, this legal framework may pose difficulties for the inclusion of environmental, social and governance (ESG) considerations in investment decisions.

In her chapter on the Australian position in the recent report by international law firm Freshfields Bruckhaus Deringer to the United Nations Environment Program Finance Initiative, 'A legal framework for the integration of environmental, social and governance issues into institutional investment', Blake Dawson Waldron lawyer Sarah Carlisle, made the following observations,

> *"Whereas the US has led the ESG market, Australia has been slower to adapt. Australian commentators suggest that some of the key factors contributing to the relatively slow growth of ESG in Australia are:*
>
> *. . .*

- *Confusion over whether ESG is consistent with fund managers' fiduciary responsibilities to their fund members or investors – which is associated with the perception that ESG is a poor performer when compared to the broader market because it results in a restriction of the 'investable universe'.*
- *A lack of superannuation fund choice for employees – until recently, employees have not been able to direct their employers on where to invest compulsory employer superannuation contributions but new legislation allows employees to choose where these funds are invested, enabling employees to choose superannuation funds adopting ESG strategies…"*[4]

The introduction the Choice of Super legislation in 2005 certainly has provided the platform for translating investor interest in ESG considerations into their superannuation funds, which are the primary investment vehicle for most Australians.

5.1 Superannuation trustees and fund managers

Traditionally, Carlisle argues, Australian superannuation fund managers have taken the view that their legal fiduciary duties to fund members, and the Sole Purpose Test, preclude them from undertaking investment decisions based wholly or primarily on ESG considerations.[5]

A trustee's fiduciary duties, including the duty to maximise returns for fund members, have traditionally been regarded as precluding ESG based investment by superannuation trustees because of a perception that SRI investments perform poorly in terms of financial returns when compared with traditional investments. However, as noted above, emerging research demonstrates that SRI funds can offer equal, or superior, performance to mainstream funds.

There is also a conventional view in Australia that SRI investment is inconsistent with a trustee's fiduciary duties because it creates a more volatile investment portfolio, since it can restrict diversification (for instance by excluding investments in certain sectors such as tobacco or gambling), and thereby increase the risk weighting of the portfolio. However, Carlisle argues that and by adopting a "best of sector" approach to SRI investment (which allows investment in the best performers in every sector, rather than excluding investment in certain sectors), investment portfolios need not be unduly restricted. Furthermore, with the adoption of modern portfolio theory, provided the trustee's overall investment strategy yields a positive financial result, a trustee will not be in breach of its fiduciary duties in pursuing an SRI strategy.

There is some debate over whether s 62 of the Superannuation Industry Supervision Act 1993 (Cth) (ie. the Sole Purpose Test) should be considered a sole, or rather, a dominant purpose test. Under this view, superannuation fund trustees who take social or environmental factors into account to satisfy the test may do so, providing the primary purpose of investment was the provision of monetary benefits to members upon retirement. However, this is a contested view of a trustee's duties under the Sole Purpose Test.

Some super trustees who have taken an avid interest in sustainability investments, may justify their investment decisions on the basis of the end result (companies with good CSR out-perform in the long-term) rather than the purpose. On this basis, "environmental, social and ethical investments are simply the means to an end (namely the provision of retirement benefits to members), rather than ends in themselves."[6]

[4] United Nations Environmental Program Finance Initiative: Innovative financing for sustainability (Freshfields Bruckhaus Deringer), *A Legal framework for the integration of environmental, social and governance issues into institutional management*, October 2005, pg 44.

[5] Ibid.

[6] Ibid, pg. 45-46

Another approach for superannuation fund trustees wishing to pursue an SRI strategy is to make sure the investment strategy trustees are required to formulate under the SIS Act provides for SRI investment. Provided that the primary purpose of the investment strategy is to provide retirement benefits for fund members, rather than investment purely for social or ethical objectives, trustees acting in accordance with the strategy should be safe from claims that they are in breach of the Sole Purpose Test.

Clearly, however, there is a strong view that s 62 does not enable or promote the inclusion of ESG considerations in an investment strategy.

Finsia suggests that further clarity over the operation of this provision would give superannuation trustees more confidence in allocating investments to SRI managed funds.

The situation for fund managers is broadly the same. Fund managers owe a fiduciary duty to their clients to maximise returns. This has traditionally been regarded as precluding SRI investment by fund managers, for the same reasons as those relating to superannuation trustees outlined above.

Given the out-performance of many SRI-fund options, many fund managers have argued that the inclusion of ESG considerations in investment decisions is consistent with modern portfolio theory and the fund manager's fiduciary responsibilities.

However, Finsia considers that as with the Sole Purpose Test, fund managers and trustees would benefit from greater clarity (and protection) from the law on the scope of their fiduciary responsibilities with respect to SRI investments.

5.2 The 'modern prudent investor rule'

Given these uncertainties, Government and regulators may consider the adaptation for Australian purposes, of the US-style 'modern prudent investor rule' (see UNEP, page 8):

> *"The modern prudent investor rule, which incorporates both a duty of care and a duty of loyalty, emphasises modern portfolio theory and provides that:*
>
> *(i) investments are assessed not in isolation but in the context of their contributions to a total investment portfolio;*
>
> *(ii) there is no duty to 'maximise' the return of individual investments, but instead a duty to implement an overall investment strategy that is rational and appropriate to the fund.*
>
> *(iii) the investment portfolio must be diversified, unless it is prudent not to do so; and*
>
> *(iv) the prudence of an investment should be assessed at the time the investment was made and not in hindsight".*[7]

Finsia suggests that further research be conducted into the impact of the Sole Purpose Test and fiduciary responsibilities of fund managers, to ensure that investment managers have the appropriate scope for incorporating ESG considerations into their portfolios under management.

Finsia also suggests that further clarity regarding the interrelationship between the Sole Purpose Test and SRI investment, perhaps through the issue of detailed guidelines by APRA, would give superannuation trustees more confidence in allocating investments to SRI managed funds.

[7] Ibid., pg. 8.

5.4 Investment disclosure and financial advice

Under section 1013D(1)(l) of the Corporations Act, the product disclosure statement for products with an investment component must include disclosure about 'the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment'. Further requirements are set out in the Corporations Regulations and ASIC Policy Statement 168 (Disclosure: Product Disclosure Statements).

With respect to financial advice, under ASIC Policy Statement 175.110, licensees are advised to form their own view about how far s 945A (the 'know your client' rule) requires that inquiries be made into a client's attitude to environmental, social or ethical considerations. At best, this is a 'matter of good practice', but there are no mandatory requirements for advisers to broach these issues, and therefore SRI- style options with their clients.[8]

Finsia suggests further research be conducted and engagement had with the financial planning industry and consumer groups on the possibility of including ESG considerations explicitly under the 'know your client rule' (s945A), perhaps in similar terms to those in section 1013D(1)(l) (namely, the client's attitude to "labour standards or environmental, social or ethical considerations" forming part of their investment decisions).

Finsia welcomes any requests for further information on the matters expressed in this submission. Please do not hesitate to contact Mr Russell Thomas, Senior Policy Adviser, Consumer and Public Policy on 612 8248 7508, via email r.thomas@finsia.edu.au or by mail, Level 3, NAB House, 255 George Street SYDNEY NSW 2000.

Appendix 1: SRI out-performance in Australia

	1 year	**2 years**	**3 years**	**5 years**
ASX 200	30.35%	27.97%	26.43%	14.83%
SRI Median	31.00%	28.19%	27.02%	17.08%

Source: AMP Capital SRI Industry Performance Study, May 200

[8] ASIC Policy Statement 175, part 110.