

Chapter 1

Introduction

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1.1 On 21 June 2012, on the recommendation of the Selection of Bills Committee, the Senate referred the Government Investment Funds Amendment (Ethical Investments) Bill 2011 (the Bill) to the Finance and Public Administration Legislation Committee (the committee) for inquiry and report by 22 August 2012. The reasons for referral were for the committee to consider the provisions of the Bill and to hear from experts on the implementation and effects of the Bill.¹

Conduct of the inquiry

1.2 The inquiry was advertised in *The Australian* and through the Internet. The committee invited submissions from peak organisations, interested parties, and the Commonwealth Government.

1.3 The committee received 13 submissions relating to the Bill and these are listed at appendix 1. The committee considered the Bill at a public hearing in Melbourne on 8 August 2012. Details of the public hearing are provided in appendix 2. References to the committee *Hansard* are to the proof *Hansard*; page numbers may vary between the proof and the official *Hansard*. The public submissions and transcript of evidence may be accessed through the committee's website at:

http://aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=fapa_ctte/index.htm.

Overview of the Bill

Purpose of the Bill

1.4 The Bill proposes to amend the *Future Fund Act 2006* (FF Act) and the *Nation-building Funds Act 2008* (NBF Act) in order to constrain the investments of the four funds (the Future Fund and the three Nation Buildings Funds) to investments which are consistent with socially responsible investment practices. The Bill would require the development of Ethical Investment Guidelines (EI Guidelines) by Ministers responsible for Australian sovereign funds. The Future Fund must take all reasonable steps to comply with the EI Guidelines.²

1 Senate Selection of Bills Committee, *Report No. 7 of 2012*, Appendix 1, 21 June 2012.

2 Explanatory Memorandum, p. 2.

Provisions of the Bill

1.5 The Bill proposes to amend the FF Act to insert a definition of a 'prohibited financial asset'. A prohibited financial asset means a financial asset that is specified as a prohibited financial asset in the EI Guidelines. It also proposes to insert new sections 20A, 20B and 20C into the FF Act, which would:

- require the responsible Ministers to make, by legislative instrument, the Future Fund EI Guidelines with the Guidelines making provision for socially responsible ethical investment practices including, but not limited to, environmental concerns, human rights concerns, labour practices and the manufacture of weapons of war;
- require the EI Guidelines to specify, as prohibited financial assets, investments in companies that manufacture or produce tobacco, cluster munition components, and nuclear weapons (including maintenance and simulation of nuclear weapons);
- require the responsible Ministers to consult with the Future Fund Board on the EI Guidelines and require the tabling in each House of the Parliament any submissions by the Future Fund Board for the making or varying of the EI Guidelines together with the legislative instrument; and
- require the Future Fund Board to take all reasonable steps to comply with the EI Guidelines. In addition, if the responsible Ministers are satisfied that the Board has failed to comply with the EI Guidelines, the responsible Minister may direct the Board, in writing, to give an explanation of the failure and to take action to comply with the EI Guidelines.³

1.6 The Bill also proposes, for each of the funds described in the NBF Act, to insert a definition of a prohibited financial asset and the establishment of EI Guidelines (proposed sections 38A, 157A and 232A), in a manner identical to provisions for the Future Fund. The same consultation and compliance provisions are also proposed in relation to the three funds under the NBF Act.⁴

1.7 For each of the four funds, the Bill also provides for the divestment of any financial assets that are prohibited financial assets within the meaning proposed held on the day the Schedule commences. These assets must be realised within a period of 12 months from the commencement of the Schedule.⁵

3 Explanatory Memorandum, p. 4.

4 Explanatory Memorandum, p. 4.

5 Explanatory Memorandum, p. 5.

Financial impact

1.8 The explanatory memorandum does not include a financial impact statement. The financial impacts may arise as a result of the Bill and are explored in more detail in chapter 2, including:

- a change in the returns on investments achieved by the Future Fund; and
- on-going costs arising for monitoring what companies are involved in.

Related inquiries

1.9 The following related Senate committee reports have been tabled:

- Senate Economics Legislation Committee, *Provisions of the Future Fund Bill 2005*, February 2006;
- Senate Standing Committee on Foreign Affairs, Defence and Trade, *Non-Proliferation Legislation Amendment Bill 2006*, February 2007;
- Senate Standing Committee on Foreign Affairs, Defence and Trade, *Cluster Munitions (Prohibition) Bill 2006*, May 2007; and
- Senate Foreign Affairs, Defence and Trade Legislation Committee, *Criminal Code Amendment (Cluster Munitions Prohibition) Bill 2010 [Provisions]*, March 2011.

Background to the Bill

1.10 The Future Fund was established in 2006 as a Sovereign Wealth Fund (SWF) to assist future Commonwealth governments to meet the cost of public sector superannuation liabilities by delivering investment returns on contributions to the Fund.

Sovereign wealth funds

1.11 The Future Fund is among a growing number of SWFs that have been established in various countries, in some cases fuelled by the rapid accumulation of assets or export surpluses and in other cases by concern over the global financial crisis. SWFs have become significant players in the international capital markets and are estimated to hold close to \$US5 trillion in assets, of which \$2.88 trillion is oil and gas related.⁶

1.12 There are over 60 SWFs, with numbers increasing steadily from the 1970s onwards and rapidly in the 2000s. Australia's Future Fund is the 13th largest fund and

6 Sovereign Wealth Fund Institute, *Sovereign Wealth Fund Rankings*, <http://www.swfinstitute.org/fund-rankings/>, (accessed 28 June 2012).

on a country-by-country comparison of fund size, Australia is ranked tenth.⁷ SWFs are established for a range of reasons, including to protect and stabilise the budget and economy from excess volatility in revenues/exports; diversify from non-renewable commodity exports; earn greater returns than on foreign exchange reserves; assist monetary authorities to dissipate unwanted liquidity; increase savings for future generations; fund social and economic development; and sustain long term capital growth for target countries.⁸

1.13 A number of SWFs have formed the voluntary International Forum of Sovereign Wealth Funds (IFSFW), which meets to exchange views on issues. The IFSWF and the International Monetary Fund have established the Santiago Principles as a guide to generally accepted principles and practices for SWFs. The Future Fund has been a significant contributor to the IFSWF.⁹

Responsible and ethical investment

1.14 As SWFs hold substantial assets, there has been considerable interest in their investment policies. Screening and/or influencing investments by non-financial criteria by different groups for various reasons has occurred through history. Some notable examples include screening out investments involved with slavery in the 18th century; engagement on workers' rights and screening of alcohol, tobacco and weapons in the 19th century; civil rights and liberties campaigns in the 20th century; shareholder activism on Napalm and Agent Orange in the 1960s; the emergence of environmental campaigns in the 1970s; and the divestment and loan renewal refusals associated with the anti-apartheid movement in the 1980s.¹⁰

1.15 Over the last couple of decades there has been a substantial growth in screening and/or influencing investments by non-financial criteria and the establishment of many investment funds focussed on responsible and ethical investment. The report by the ACT Legislative Assembly Standing Committee on Public Accounts on its inquiry into the exposure draft of the Financial Management

7 Wikipedia, *List of countries by sovereign wealth funds*, http://en.wikipedia.org/wiki/List_of_countries_by_sovereign_wealth_funds, (accessed 28 June 2012).

8 Sovereign Wealth Fund Institute, <http://www.swfinstitute.org/what-is-a-swf/>, (accessed 28 June 2012).

9 International Working Group of Sovereign Wealth Funds, <http://www.iwg-swf.org/>, (accessed 28 June 2012).

10 JD Cronin, *From Ethical Investment to Investment Ethics – Towards a normative theory of investment ethics*, A thesis submitted to fulfil the requirements for the award of a Doctorate of Philosophy, Queensland University of Technology, 2004, pp 80–84.

(Ethical Investment) Legislation Amendment Bill 2010 (ACT Bill) provides a more detailed account of the development of the responsible and ethical investment.¹¹

1.16 The Responsible Investment Association Australia (RIAA) describes Responsible Investment as 'an umbrella term to describe an investment process which takes Environmental, Social, Governance (ESG) or ethical considerations into account.'¹² Responsible Investment involves one or more of the following:

- screening investments based on ESG factors to either exclude investments (negative screening) or favourably include investments (positive screening);
- identifying 'best-of-sector' based on ESG factors;
- thematic investments that adhere to particular ESG or ethical themes;
- impact investing by actively placing capital in funds aimed at ESG issues;
- integration of ESG issues onto more general investment decision making;
- engagement by asset managers with companies on ESG issues; and
- exercise of shareholder rights, such as voting.¹³

1.17 There has been some evolution in the terminology from different timeframes and different regions. 'Responsible Investment' is sometimes used interchangeably with the term 'Socially Responsible Investment' (SRI). The SRI acronym is also used for Sustainable and Responsible Investing, which appears to be more European in its origin.¹⁴ Responsible Investment is 'broader in scope and more contemporary in nature than the term ethical investment, and covers the full spectrum of investment practices and processes where environmental, social and/or ethical issues are considered before an investment decision is made.'¹⁵

International developments

1.18 There have been a number of international developments in Responsible Investment, including initiatives by the United Nations, the SWF Institute, European forums and individual countries. In 2006, the United Nations launched the Principles

11 ACT Legislative Assembly Standing Committee on Public Accounts, *Inquiry into the exposure draft of the Financial Management (Ethical Investment) Legislation Amendment Bill 2010*, December 2011, pp 11–24.

12 RIAA, *What is Responsible Investment?* <http://www.responsibleinvestment.org/what-is-responsible-investment/responsible-investment-defined/>, (accessed 24 July 2012).

13 RIAA, *Responsible Investment Annual 2011, A benchmark report on Responsible Investment in Australia and New Zealand*, November 2011, p. 8.

14 European Sustainable Investment Forum (EUROSIF), *European SRI Study*, revision edition 2010, p. 8.

15 ACT Government, *Submission to the ACT Legislative Assembly Standing Committee on Public Accounts, inquiry into the exposure draft of the Financial Management (Ethical Investment) Legislation Amendment Bill 2010*, p. 12.

for Responsible Investment (UN PRI) initiative to promote Responsible Investment. A network of participants has been established, including pension funds, insurance companies, sovereign wealth and development funds, and investment managers. The goal is to grow investor interest in ESG issues and the best long-term interests of beneficiaries by supporting signatories in their fulfilment of the principles for Responsible Investment.¹⁶ UN PRI is a statement of principles that is deliberately non-prescriptive in terms of the Responsible Investment methodologies used by signatories:

It is not the case that becoming a UN PRI signatory means that an investor should begin screening companies out of their investible universe. This is certainly one of the approaches taken by signatories, but it is by no means the only valid approach, with other approaches used by asset owners with an outsourced funds management model including things like engagement and voting on shareholder resolutions, for instance.¹⁷

1.19 As at May 2012, there were 125 Australian entities which had signed the UN PRI, including superannuation and other assets managers, investment managers, professional service partners and the Australian Capital Territory. Australia was ranked third behind the US (156 signatories) and the UK (145 signatories).¹⁸ As at 31 July 2012, the Commonwealth and the Future Fund were not signatories, however approximately 15 per cent of the Future Fund's investment managers are signatories.¹⁹

1.20 The SWF Institute has also developed an index (the Linaburg-Maduell Transparency Index) to rate the transparency of SWFs. The index is made up of 10 principles for transparency, with each principle adding one point to the index for a fund if the SWF Institute judges that the principle is complied with. One of the principles is that an SWF provides guidelines on ethical standards, investments policies, and enforces those guidelines. The Future Fund is one of a group of nine funds which received the maximum rating in the second quarter of 2012.²⁰

1.21 The European Sustainable Investment Forum (EUROSIF) is a pan-European network and think-tank focussed on developing sustainability through European Financial Markets. EUROSIF has indicated that:

16 Principles for Responsible Investment, *Annual Report 2012*, p. 24 and see 'About the PRI Initiative' in front matter.

17 CAER, *Submission to the ACT Legislative Assembly Standing Committee on Public Accounts, inquiry into the exposure draft of the Financial Management (Ethical Investment) Legislation Amendment Bill 2010*, p. 1.

18 Principles for Responsible Investment, *Annual Report 2012*, p. 4.

19 Cross matching of the list investment managers appointed by the Future Fund Board of Guardians, 4 June 2012, http://www.futurefund.gov.au/investment/investment_managers (accessed 4 July 2012) and the Signatories to the Principles for Responsible Investment, <http://www.unpri.org/signatories/index.php?country=Australia>, (accessed 4 July 2012).

20 Sovereign Wealth Fund Institute, <http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/>, (accessed 13 August 2012).

Currently, at least eight countries in Europe have specific National SRI regulations in place that cover their pension systems: United Kingdom (2000), Germany (2001), Sweden (2001), Belgium (2004), Norway (2004), Austria (2005) and Italy (2005). Spain is in the process of introducing such SRI requirements into the existing 2002 Pension Funds law. In Italy, the disclosure obligations applying to all complementary pension funds started in January 2008.

There are presently no mandatory transparency laws at the EU level requiring investors to disclose the ESG issues of their investments.²¹

1.22 Some of the Responsible Investment laws and regulations are focussed specifically on SWFs or pension funds, while others that have substantially broader application to investors generally have also been explored. For example, the Dutch Parliament passed a resolution to ban cluster munitions for all Dutch investors. The resolution was later overturned by the interim Minister of Finance.²²

1.23 In terms of initiatives by particular countries, Norway is one of the more prominent examples. Norway's Government Pension Fund Global (GPFG) is a large SWF that considers ethics and human rights in its investment objectives and is perceived as an activist shareholder and also uses exclusions in some cases.²³ A range of policies adopted by other countries are summarised in the submission provided by the Department of Finance and Deregulation.²⁴

1.24 In our region, the New Zealand Superannuation Fund (NZSF) has had a Responsible Investment policy for several years and began excluding companies involved with tobacco in 2007, and companies involved with cluster bombs and nuclear weapons in 2008.

Australian developments

1.25 There has been some development of private sector Responsible Investment activities in Australia. According to the 2011 Responsible Investment Annual, approximately half of the funds under the management of Australian asset managers integrate ESG principles in investment practices. Typically, such an approach would involve integrating ESG issues into the selection of assets and exercising ownership rights (including voting and engagement).²⁵

21 European Sustainable Investment Forum (EUROSIF), *European SRI Study*, revision edition 2010, p. 19.

22 European Sustainable Investment Forum (EUROSIF), *European SRI Study*, revision edition 2010, p. 42.

23 ACT Legislative Assembly Standing Committee on Public Accounts, *Inquiry into the exposure draft of the Financial Management (Ethical Investment) Legislation Amendment Bill 2010*, December 2011, p. 37.

24 Department of Finance and Deregulation, *Submission 8*, pp 4–5.

25 Department of Finance and Deregulation, *Submission 8*, p. 4.

1.26 The proportion of investors applying the subset of ESG principles relating to exclusions and screening is somewhat smaller. The RIAA 2011 Benchmark Report as at November 2011 noted all types of mainstream managed investment portfolios in Australia totalled approximately \$936 billion in June 2011. Of this amount, investment portfolios applying ethical prohibitions and prioritisation screens accounted for \$11.5 billion, or approximately 1.2 per cent.²⁶

1.27 In addition to private sector developments, Responsible Investment issues have been explored by Australian Governments and Parliaments, including the ACT and the Commonwealth. At the Commonwealth level, some consideration was given to Responsible Investment issues about a decade ago. The *Financial Services Reform Act 2001*, 'requires product disclosure statements issued in respect of managed investment funds and other investment products to disclose the extent to which labour standards or environmental, social or ethical considerations have been taken into account by the manager of the fund or product in selecting, retaining and realising investments.'²⁷

1.28 More recently, in its inquiry into the Convention on Cluster Munitions, the Joint Standing Committee on Treaties (JSCOT) recommended that the Australia Government have regard to:

...preventing investment by Australian entities in the development or production of cluster munitions, either directly, or through the provision of funds to companies that may develop or produce cluster munitions.²⁸

1.29 In October 2010, the Government introduced the Criminal Code Amendment (Cluster Munitions Prohibition) Bill 2010 (Cluster Bomb Bill) in the House of Representatives. The Cluster Bomb Bill included legislative measures to ensure consistency between Australian law and the UN *Convention on Cluster Munitions* (the Convention). Australia signed the Convention on 3 December 2008 but has not ratified it, as the Cluster Bomb Bill remains before the Parliament as of 31 July 2012. Enactment of the Cluster Bomb Bill, along with other non-legislative measures, would place Australia in a position to ratify the Convention.²⁹

1.30 In its inquiry into the provisions of the Cluster Bomb Bill, the Senate Foreign Affairs, Defence and Trade Legislation Committee (FADT Committee) examined

26 Responsible Investment Association Australasia, *Responsible Investment Annual 2011, A benchmark report on Responsible Investment in Australia and New Zealand*, November 2011, p. 12, 14.

27 Paul U Ali and Martin Gold, Stellar Capital and The University of Melbourne Centre for Corporate Law and Securities Regulation, *An appraisal of socially responsible investments and implications for trustees and other investment fiduciaries*, June 2002, p. 2.

28 Joint Standing Committee on Treaties, *Report No 103: Treaties tabled on 12 March and 13 May 2009*, 18 August 2009, p. 27.

29 Explanatory Memorandum, Criminal Code Amendment (Cluster Munitions Prohibition) Bill 2010, p. 2.

prevention of both direct and indirect investment in cluster munitions by Australian entities generally.³⁰ The FADT Committee recommended that the Senate pass the Cluster Bomb Bill.³¹

1.31 In relation to the positive impact of this legislation on the Future Fund, during Senate estimates in May 2011 the Future Fund informed the committee that it had excluded investment in two companies involved with cluster bombs and land mines towards the end of 2009 and a further group of companies in April 2011.³² The Future Fund is now listed in the financial institutions pioneering disinvestment in cluster munitions 'Hall of Fame' by IKV PAX CHRISTI/FAIRFIN.³³

1.32 The extent to which the Future Fund has adopted and applied Responsible Investment policies has also attracted attention with information being sought on its investments in entities involved with nuclear weapons, tobacco and gambling. The Future Fund's holdings include:

- at 13 May 2011, investments of \$179 million in 22 companies that may be involved with nuclear weapons,³⁴ by January 2012, the level of investment had decreased to around \$125 million;³⁵
- as at 14 February 2012, the value of tobacco stocks was \$225 million,³⁶ up from \$147 million as the start of January 2011;³⁷ and
- as at 31 March 2011, over 150 million dollars was invested in companies involved with casinos and gaming.³⁸

30 Senate Foreign Affairs, Defence and Trade Legislation Committee, *Criminal Code Amendment (Cluster Munitions Prohibition) Bill 2010 [Provisions]*, March 2011, Chapter 6.

31 Senate Foreign Affairs, Defence and Trade Legislation Committee, *Criminal Code Amendment (Cluster Munitions Prohibition) Bill 2010 [Provisions]*, March 2011, p. 60.

32 Mr David Neal, Acting General Manager and Chief Investment Officer, Future Fund, *Estimates Hansard*, 26 May 2011, pp F&PA 24–26.

33 IKVPAX CGRRISTI & FAIRFIN, *Worldwide investment in cluster munitions a shared responsibility*, June 2012 Update, pp 23–24.

34 Future Fund, *Publicly available information released after an FOI disclosure*, The ICANW sought documents on the Future Fund's equity holdings in certain companies, 13 May 2011, http://www.futurefund.gov.au/data/assets/pdf_file/0018/4581/FOI_Disclosure_Log_doc_A174749.pdf, (accessed 5 July 2012).

35 *Senate Hansard*, 8 May 2012, Question on Notice 1516, pp 2781–82.

36 Additional Estimates 2011–12, Future Fund, Answer to Question on Notice, No. F65.

37 Mr Mark Burgess, Managing Director, Future Fund management Agency, *Estimates Hansard*, 23 May 2012, p. F&PA 47.

38 Future Fund, *Publicly available information released after an FOI disclosure*, *Bloomberg News requested documents on the Future Fund's equity holdings in casino and gambling companies*, 8 July 2011, http://www.futurefund.gov.au/data/assets/pdf_file/0018/4581/FOI_Disclosure_Log_doc_A174749.pdf, (accessed 5 July 2012).