ashurst

Social Impact Investing

TREASURY CONSULTATION – JANUARY 2017

ASHURST SUBMISSION

27 February 2017

Social Impact Investing Discussion Paper

ASHURST SUBMISSION

Ashurst welcomes and supports the Australian Government's interest in facilitating the development of the social impact investment market in Australia.

OVERVIEW

The potential for this market

We have had experience working on establishing impact investment funds, reviewing social impact bonds, and advising social enterprises on their impact funding options, both in Australia and globally.

We see significant potential for this market to grow and to generate better outcomes across social policy areas at both the national and State & Territory levels – including housing, health, aged care, disability services, employment and education, children and families.

The potential and the better outcomes are built into the market because it focusses on finding new sources of capital for evidence based innovation. It has a broad potential scope, from start-ups to institutional investment, and from local service providers to national and international enterprises.

Australian government role

The Australian government has an important role to play in the growth of this market.

There is a direct role in commissioning or otherwise supporting social impact investment in the areas of social policy administered by the Australian government or where it partners with State and Territory governments in delivering social programs.

There is a much bigger indirect role in creating the incentives, the market infrastructure and the regulatory framework that will build the market. The market is not, and should not be framed as, simply a new method of government procurement. Nor is it just a repositioning of philanthropic investment. The essence of the market is in leveraging non-government actors to develop and apply their specialist capacities for defined social outcomes with funding motivated by financial and social returns.

The first key task of government for this market is to lay the groundwork for non-government actors and non-government funding to be applied sustainably towards achieving better social outcomes. A marker of success of the market will be the growth in the positive social outcomes achieved through non-government services and the new, private sector capital brought into the market.

Impact Capital Australia

The key reform we support is to establish Impact Capital Australia (**ICA**). This has been designed and developed by the Australian Advisory Board on Impact Investing as an independent financial institution to accelerate the pace and scale of development of this market[1].

In our view it is an essential element in the market infrastructure required for social impact investment in Australia. It will enable the Australian government to partner with business and community leaders and to build ICA to:

- act as a market champion
- mobilise additional resources and make better use of government funds
- create a dynamic market, operating at scale, demonstrating and promoting innovation and diversity in participants and products.

[1] R. Addis, S. McCutchan & P. Munro, *Blueprint to Market – Impact Capital Australia*, Impact Investing Australia Ltd, 2015 (Blueprint 2015)

ICA is a vehicle through which the Australian government can show leadership. This will signal interest and legitimacy, inspire confidence for other participants and contribute to early infrastructure and de-risking.

By establishing ICA the Australian government will be able to directly address some the key barriers to the growth of the market in Australia:

- scepticism that commercial financial returns can be achieved when the investment seeks social returns as well,
- lack of sufficient scale to attract institutional investment, and
- the complexity involved in designing and bringing impact investments to market.

Proposed social impact investing principles

We submit that the social impact investing principles set out in section 4 of the Discussion Paper are framed too narrowly.

They describe a model where the Australian government is commissioning the non-government sector to deliver Australian government social policy. This is relevant to social impact bonds but this is only one (relatively small) part of the market. It misses the major part of the social impact investment market that already exists, and it will not contribute to the key drivers for the growth of the market.

The major part of the existing impact investment market in Australia comprises funds like the SEDIF funds established to source and make impact investments, dedicated businesses such as Social Ventures Australia and Impact Investment Group that are helping social enterprises to build capacity for impact investment and making or arranging impact investments themselves, and social investor led funding for innovative enterprises often in their start-up or early growth phases (eg STREAT)[2].

The major potential for growth is in motivating private sector funding for non-government business and activities achieving better social outcomes. This will be driven by empowering and encouraging private enterprises to include social impact investing as part of their business focus, and to seek out opportunities to develop and pursue impact investments in the same way as they pursue any other business opportunity. It will also be driven by empowering institutions, SMSFs, charities and communities to partner with each other to develop and fund impact investments.

None of this requires Australian government procurement. "Value for Money" and a fair sharing of risks and returns with Australian government are not relevant to these drivers.

There is however an important role for the Australian government in building the market infrastructure that will empower and encourage this private sector participation, both *for-profit* and *for-purpose*, and in partnering with investors and businesses in creating a dynamic market.

We submit that the key principles for an effective social impact investment market are:

- recognition and advocacy of social investment as a proper and valued investment market, which seeks both a financial and a social return with robust and transparent measurement and evaluation of both;
- a "technology-neutral" platform for the market, allowing the market to develop a range of different and varied impact investment products and structures, and adapting existing legal vehicles and systems to permit and empower social investment;
- an incentive structure that extends to commingled *for-profit* and *for-purpose* funds, allowing charitable incentives and exemptions to trace through to the *for-purpose* activities and outcomes
- a regulatory system that protects the integrity of the social investment mission.

---

[2] For further examples see Blueprint 2015, p10-11; also Rosemary Addis, John McLeod, Alan Raine *IMPACT-Australia, Investment for social and economic benefit*, March 2013, pp 13-16

LEGAL AND REGULATORY REFORMS

Against that background, we have focussed in this submission on a number of legal and regulatory reforms that will facilitate the development of the social impact investment market in Australia.

Most of the relevant reforms are at the Australian government level, not the State and Territory level.

The current Australian legal and tax framework is not designed for investment and enterprises that seek both a financial and a social return. Indeed in many respects it is specifically designed to quarantine the financial from the social. This is evident in aspects such as tax requirements, trustee and director duties, and the corporate vehicles available under Australian law. The law does not currently facilitate commingling of *for-profit* and *for-purpose* investment, nor does it provide many options for community-led procurement, particularly at scale.

We have outlined in this submission several reforms that will help to remove the regulatory barriers and balance the incentives so that social impact investment can thrive alongside both philanthropy and established debt and equity markets.

In summary, in addition to establishing the ICA we suggest reforms in the following areas:

- *Benefit companies*: we support the changes to the Corporations Act 2001 advocated by B Lab Australia and New Zealand to include a new voluntary corporate structure, to be known as a "benefit company"[3]
- *Fiduciary duties*: Fiduciary duties: we recommend legislative amendment to clarify the duties of directors, charitable trustees and superannuation fund trustees in respect to making impact investments
- *Financial services regulation*: we suggest extending to impact investment fundraisers the exemptions from the fundraising, debenture and managed investment scheme provisions that are available to charitable investment fundraisers
- *Sophisticated investors*: we support the changes to the sophisticated investor test as it applies to PAFs that are proposed in section 5.1 and submit that they should be extended to SMSFs
- *Commingled funds*: we recommend extending PBI tax exemptions to permit investments in commingled fund entities where the activities of the entity are in furtherance of the PBI's charitable purposes
- *Social capital funds*: we suggest that a market-specific legal structure is established as an option for impact investment funds, aimed at supporting start-up and capacity building funds in a similar way to the support given to venture capital investment through the Venture Capital Act.

We have commented briefly on each of those areas for reform below.

For reference our comments above on the Australian government role and ICA relate to consultation question 4, and our suggested legal and regulatory reforms relate to section 5.

1. BENEFIT COMPANIES

The Benefit Company reform provides a direct solution to a recognised legal problem for this market.

The most common legal vehicle for business in Australia is a company incorporated under the Corporations Act. This vehicle is not designed for businesses that intend both to make a profit and create a public benefit. Current corporate law inhibits impact investment in two main ways:

- first, it is not clear to what extent the directors can, in their management of the company's business, take into account social outcomes or the interests of other stakeholders, consistently with their statutory and fiduciary duties, and

[3] See "Developing model legislation for Australian B Corps" at http://bcorporation.com.au/benefitcorp_au

- second, while it is possible to set out the mission in the company's constitution, it is difficult to ensure that the company stays governed by this mission through corporate succession, capital raising and changes in ownership.

As a result businesses that wish to pursue or invest in social outcome objectives are inhibited by uncertainty both in their own decision-making and in attracting investment that is dedicated to a social outcome objective and wishes to ensure that their investment is not able to be diverted away from that objective.

The Benefit Company would be a new corporate structure regulated within the Corporations Act, available as an option for people wishing to incorporate with its features. The principles for designing a Benefit Company are that it would be a *for-profit* company limited by shares, subject to the usual corporate solvent trading obligations, with 4 key features distinguishing it from the traditional *for-profit* company[4]:

- it must have as a core objective the creation of a "general public benefit" as well as one or more specific public benefits,
- it must provide an annual benefit report and third party certification of compliance with its mandate,
- directors must consider specified non-shareholder interests in their decision making, including stakeholders, environment, long term interest and the company's mandate, and
- shareholders will have standing to require compliance with the general public benefit obligations in the company's constitution.

This solution can be achieved by amendment to the Corporations Act.

2. FIDUCIARY DUTIES

Directors' duties

The Benefit Company reform is directed at *for-profit* businesses and their investors which wish to include a public benefit focus in all of their affairs.

There is a far broader set of *for-profit* firms and investors which do not define their business by a focus on public benefit but nonetheless wish to have the option to pursue a positive social outcome when a particular opportunity is presented or they identify an opportunity of that kind.

If every company in Australia considered that it was clearly able, if it so decided, to pursue social as well as financial outcomes in a particular transaction or area of business, this would significantly open up the potential for business to get involved in impact investment.

As noted above, it is not clear to what extent the directors can, in their management of the company's business, take into account social outcomes or the interests of other stakeholders, consistently with their statutory and fiduciary duties.

Under Australian corporations law the directors of a corporate entity are under strict duties to act with care, skill and diligence, in good faith and in the best interests of the company as a whole[5]. While directors (and managers) are afforded some judgment as to what actions benefit the company as a whole[6], these duties arguably restrict directors to pursing activities that generate the highest level of profits for the shareholders, rather than those which are targeted at a blend of profit and public benefit outcomes.

---

4 Refer Sam Morrissy, *Benefit Corporations: a sophisticated and worthy reform*, B Lab Australia Policy Working Group, at https://www.dropbox.com/s/kba6l7qa8xdw7ws/Benefit_corporations_worthy_reform_February_2016.pdf?dl=0

5 *Corporations Act 2001* (Cth), ss 180-184.

6 *Re HIH Insurance Ltd; ASIC v Adler* (2002) 168 FLR 253; *ASIC v Fortescue Metals Group Ltd* (2011) 274 ALR 731; *ASIC v Rich* (2003) 174 FLR 128.

This issue can be addressed by amendments to the Corporations Act which confirm that the objects of a company may include social and environmental impact and other public benefits, and that, without limiting their solvent trading obligations, the directors will not be in breach of their duties if they give weight to those objects in their decision making as part of their consideration of the best interests of the company as a whole.

Superannuation trustees

There are requirements under the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) and other superannuation regulation that have been viewed by trustees of some superannuation funds as preventing them from making investments which target both a financial return and a social return.

APRA has issued guidance on its Prudential Standard SPS 530 Investment Governance stating that:

> "SPS 530 does not prohibit impact investment where appropriate risk and return considerations are met. Indeed, the standard does not make any distinction between different types of investments."

In response to consultation question 23, we suggest that achieving the desired level of clarity for superannuation trustees requires both legislative amendment and administrative guidance.

Legislative amendment is required because section 62 of the SIS Act provides that superannuation trustees must ensure that the fund is maintained solely for the provision of benefits for or in respect of the members of the fund. While prudential guidance can clarify that this does not exclude investments that are designed to achieve a social return and well as a financial return, a prudential standard is of no effect to the extent that it conflicts with the Act[7] and therefore it cannot remove any remaining legal uncertainty as to the effect of section 62.

We suggest that the legislative amendment and further guidance should be based on the following principles:

- the sole purpose test does not exclude investments that are designed to achieve a social return and well as a financial return (ie "**social investments**")
- a trustee may properly include social investments in its investment strategy and asset allocation targets, taking into account their diversification and liquidity characteristics and other contributions to the fund's portfolio
- the trustee should satisfy itself that the rate of return on the social investment is commensurate with the risk
- the trustee should satisfy itself that the social investment has information disclosure and valuation protocols that are sufficient to enable the trustee to discharge its duties both when the investment is made and during the life of the investment, and to comply with its own disclosure obligations.

These principles do not affect the policy purposes of the superannuation system. They are intended to explain the place of social investment in the prudent management of superannuation funds.

Charitable trustees

We suggest that the powers of charitable trustees to make social investments should also be clarified.

At general law there is a distinction between the investment of the assets of the charity and the distribution of grants. While an impact investment may involve a philanthropic grant within a multi-layered financing for the project, one of the key features of the impact investment market is that it gives opportunities for charities to make social investments where they further the charity's purposes.

---

[7] Superannuation Industry (Supervision) Act 1993 (Cth), s34D(2).

There is some uncertainty as to the extent to which a charitable trustee can in the exercise its investment power properly make a social investment. A classic statement of the issue is found in *Harries* v *Church Commissioners*[8]:

> "[By] their very nature, and by definition, investments are held by trustees to aid the work of the charity in a particular way: by generating money. That is the purpose for which they are held. That is their raison d'etre. Trustees cannot properly use assets held as an investment for other, viz., non-investment, purposes."

In England the *Charities (Protection and Social Investment) Act 2016* has addressed this uncertainty by providing that an incorporated charity has, and the charity trustees of an unincorporated charity have, the power to make social investments. It has also clarified that this power can only be used consistently with any restrictions applying to the use of a relevant permanent endowment, and is subject to certain duties relating to seeking and considering advice on the proposed social investment.

We suggest that similar legislation is introduced into Australia by way of amendment to the *Charities Act 2013* (Cth).

3. FINANCIAL SERVICES REGULATION

When funds are sought to be raised for impact investment the fundraiser will generally be subject to financial services regulation. Relevant regimes can include the debenture provisions (Chapter 2L.1 of the Corporations Act), the managed investment provisions (Chapter 5C), the disclosure and other fundraising requirements (Chapters 6D, Part 7.9 and other provisions), and the requirement to hold an AFSL (section 911A).

Many social impact enterprises and funds have strong similarities with small charities. They are often in the nature of start-ups and focussed on capacity building in the social enterprise sector. They have very limited resources and a mandate that aims at maximising the funds for the social outcome. Their investors are generally motivated by the social outcome and put less weight on the financial return, viewing that more as a measure of efficiency in achieving the social outcome.

While the small scale offerings prospectus exemption (section 708) and the proposed *Corporations Amendment ("Crowd-Sourced Funding") Bill 2016* will provide some relief, it will not be comprehensive and the regulation will continue to be a significant barrier for many of the smaller social impact enterprises and funds. It particularly inhibits community led procurement of impact investments.

ASIC provides relief to charitable investment fundraisers from the fundraising, managed investment, debenture and licensing provisions of the Corporations Act under the ASIC *Corporations (Charitable Investment Fundraising) Instrument 2016/813*.

We suggest that consideration is given to providing impact investment fundraisers with similar relief. The relief could be limited to certain categories of impact investment fundraisers so that it is targeted to those fundraisings where the considerations of size, community focus and investor objectives warrant the exemption.

4. SOPHISTICATED INVESTORS

PAFs

There is a strong case for deeming all PAFs to be controlled by a sophisticated investor as there are sufficient investor protections within the existing PAF Guidelines. In particular:

- The trustee of a PAF must be a corporation and investments made by the PAF are the subject of detailed legislative "Guidelines" set out in the Private Ancillary Fund Guidelines. Failure to comply with the "Guidelines" is an offence and can result in penalties of 10 to 30 penalty units for failure to comply.

---

[8] *Harries* v *Church Commissioners for England* (1992) 1 WLR 1241, 1247 by Sir Donald Nicholls V-C.

- Guidelines 13, 14, 15 and 16 deal with requirements that must be observed concerning the management of the fund and obligations of and concerning the trustee including the requirement for at least one of the individuals involved in the decision making of the trust to be an independent person with a degree of responsibility to the Australian community as a whole.
- Guidelines 24 – 29 relate to requirements for preparation of financial accounts, audit of those accounts and lodgement of the audit report with the ACNC.
- Guidelines 30 – 42 provide detailed requirements concerning "Investment Strategy" including that the strategy must have particular regard to risk assessment in relation to each investment, exposure to the fund from inadequate diversification, liquidity of investments, perceived or actual material conflicts of interest etc; "Investment Limitations" relating to borrowing of money and giving security over the assets of the fund; and the fund entering into "Uncommercial Transactions and Benefits to Founder/Donor".

Amend Guideline 41

We also suggest a related modification to Guideline 41 to remove a barrier to investments that seek both a financial and a social return.

At present Guideline 41 prohibits investments by PAFs on "uncommercial terms" unless the investment is with a DGR and in the course of furtherance of the fund's purposes or if the investment is more favourable than would be expected if it had been made on an arms length basis. This may be interpreted to restrict investment by PAFs in social impact investment products in certain cases given that the investment decision will take into account social return as well as financial return.

The restriction should be removed. One way of doing so might be to clarify that an investment is not on "uncommercial terms" merely because the investment decision is based on a triple bottom line assessment and takes into account and gives weight to the social return as well as financial return. Another approach could be to clarify that an investment will be taken not to be on "uncommercial terms" if it is in a social impact investment listed on a Commonwealth approved list of such investments or otherwise within an approved category (eg in a Social Capital Fund of the kind described further below).

SMSFs

There are many "Mum and Dad" SMSFs where one or both of the members/directors of the fund qualify as sophisticated investors under the net assets or gross income tests in section 708(8)(c) of the Corporations Act but the SMSF itself does not, and (due to the 50/50 nature of the "Mum and Dad" membership) the SMSF is not correctly characterised as being "controlled" by a person who meets those tests for the purposes of section 708(d).

This is anomalous and particularly inappropriate for impact investment since the SMSF is often the most appropriate family vehicle to hold impact investment products as part of a portfolio. In addition, the SMSF's (sophisticated investor) member/directors are directly involved in the investment decisions, and are entitled to design the SMSF's investment strategy specifically for their own retirement objectives.

We suggest that the Corporations Act is amended to provide that where at least one of the member/directors of an SMSF is a sophisticated investor then the SMSF itself will also be a sophisticated investor.

5. COMMINGLED FUNDS

Following the decision of the High Court and Federal Court in *Commissioner of Taxation* v *Word Investments* (2008) 236 CLR 204 and *Commissioner of Taxation* v *Hunger Project Australia* (2014) FCAFC 69, the ACNC has expressed the view that a fundraising institution can be a PBI although it does not itself provide direct benevolent relief but rather provides that relief under a collaborative relationship or common purpose with others which may not be PBIs (such as through organisational

structure, shares planning and processes) - see *Commissioner's Interpretation Statement: Public Benevolent Institutions* (CIS 2016/03) paragraph 5.6.

We suggest that consideration should be given to allowing PAFs to give funds to non-DGRs (including, for example, a qualifying Social Capital Fund as described below) for the sole purpose of the funds being spent on public benevolent purposes in conjunction with the social enterprise or enterprises carried out by or funded by the non-DGR.

This would effectively be an application of current policy, adjusted to be "technology-neutral" in relation to the structures used for the social investment market.

For prudential purposes, initially a limit of say 20% of funds held by the PAF at the previous 1 July could be placed on the amount of funds which could be applied in this way by the PAF. The PAF Guidelines would need to be accommodated to provide for this. PAF trust deeds would also need to be amended. A statutory power to amend may be required in relation to some PAFs.

The PAF Guidelines could spell out the conditions under which such amounts may be paid to the approved non-DGR. For example, the conditions could require:

- the PAF and non-DGR to enter into an MOU identifying a recognisable group that would benefit from the funds provided by the PAF;
- a clear way in which the benevolent relief will be delivered; and
- annual reporting requirements for both the non-DGR and the PAF as to the expenditure of the funds to the ACNC.

6. SOCIAL CAPITAL FUNDS

In our view there is limited value in developing a model constitution for a social enterprise (Qn. 29). The area where most legal structuring work is required is not at the social enterprise level but at the investment fund level. It is at that level that there are particular complications in designing a structure for commingling *for-profit* and *for-purpose* funds in a way that protects the mission, preserves the charitable exemptions and permits the financial return.

We suggest there would be significant value in developing a model "social capital fund" that would be recognised as an approved social investment fund for PAF investment (see the discussion on Guideline 41 in section 4 above and on non-DGR investments in section 5 above) and for relevant tax incentives.

This kind of fund will have some parallels with venture capital funds. There is a segment of the social investment market that is focussed on innovation and on supporting social enterprises through the capacity building and early implementation phases (which have parallels with start-up and early commercialisation phases for venture capital). In addition, as the social impact investing market matures, there will be a greater need for social investment for scaling up a social enterprise in a similar way to later stage venture capital.

We suggest that consideration is given to providing tax incentives to a complying "social capital fund" designed with the same kind of objectives as for venture capital through the *Venture Capital Act 2002* (Cth) (ie: in terms of encouraging innovation and investment) adjusted for the financial dynamics of social investment.

The aim of the model "social capital fund" would not be to require all social investment to be made through a qualifying social capital fund but rather to set out a standard legal structure that addresses the mission and governance issues raised by a commingled fund in a way that satisfies policy requirements for the tax incentives contemplated above.

Fund sponsors would then have the option of setting up their fund as a qualifying social capital fund (which would be designed to be a relatively simple and quick process) or designing a more transaction-specific structure and then seeking advice and rulings on its tax and regulatory treatment.

Thank you for the opportunity to make this submission. We would be pleased to discuss any aspect of it with you.

The contact person for this submission at Ashurst is:

Michael Ryland
Partner

T +61 2 9258 5627
M +61 419 192 727
michael.ryland@ashurst.com

Ashurst Australia
27 February 2017

About Ashurst

Impact investment practice

Ashurst has a dedicated impact investment team that combines our expertise and experience in corporate and structured finance with our social enterprise and pro bono practices and our work in government contracting. We have acted on social benefit bond transactions in the UK, such as the *Peterborough* bonds, and on leading impact investment projects in Australia such as the *SEDIF* funds and the Australian Advisory Board's *Impact Capital Australia*. We have experience bringing together private sector finance, not-for-profit enterprises and institutions, and government programs and expertise.

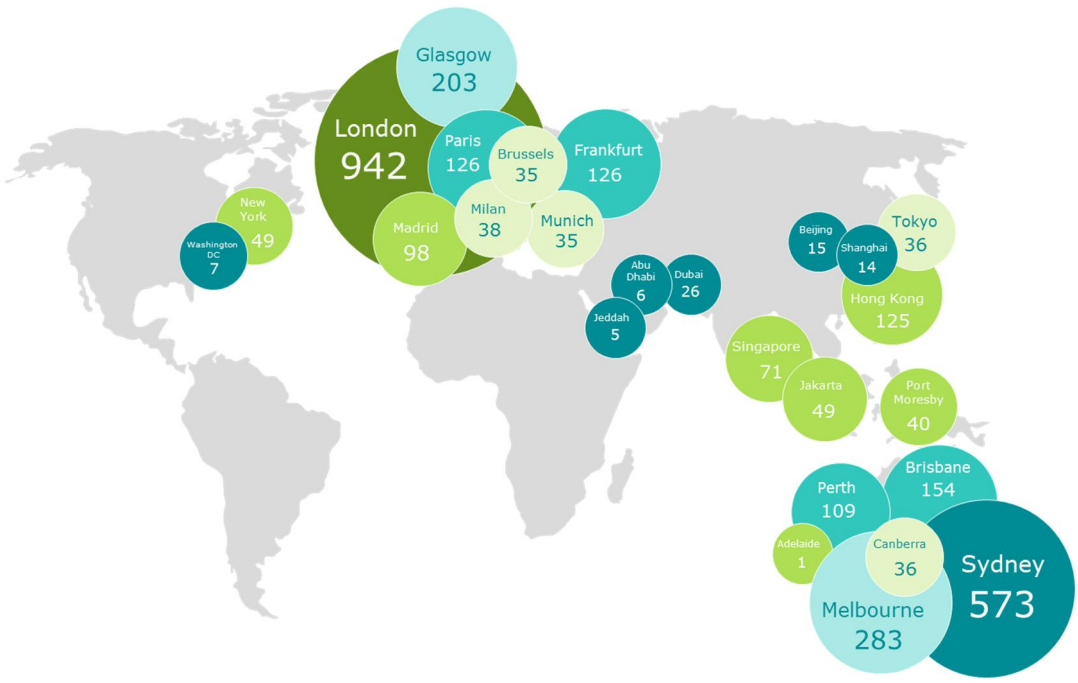
Global firm

Ashurst is a leading international law firm with a history spanning almost 200 years.

We currently have a network of 25 offices in 15 countries and a number of referral relationships that enable us to offer global reach and insight, combined with an understanding of local markets.

Our network of over 400 partners and 1,400 lawyers working across 10 different time zones includes experts in:

- corporate and commercial,
- employment,
- banking and finance,
- construction and infrastructure,
- energy and resources,
- intellectual property,
- environment,
- financial services regulatory,
- medical regulatory,
- litigation,
- media and communications,
- property,
- restructuring and insolvency, and
- tax.



ashurst

www.ashurst.com