Melbourne

Submissions in Response to the Social Impact Investing Consultation Paper

Social Impact Investing: Growing the Market to Scale in Australia

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Submissions

We welcome this opportunity to make submissions on how best to facilitate the growth of the Australian social impact investment market. It is increasingly clear, given the long-term structural constraints on government expenditure, that social impact investing will play a critical role in unlocking private capital for the purpose of solving some of our society's most intractable problems. We are therefore pleased to present our submissions in response to the Consultation Paper below.

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Consultation Question		Submission
1.	What do you see as the main barriers to the growth of the social impact investing market in Australia? How do these barriers differ from the perspective of investors, service providers and intermediaries?	The principal barriers to the development of the social impact investment market have been widely discussed and are generally well understood. These include problems in scale, liquidity and in generating a pipeline of projects, such as: • social impact investments being generally small-scale, bespoke and illiquid; • existing service providers being historically grant-focused organisations lacking the resources for complex contractual negotiations; • the lack of a transaction pipeline that develops expertise and justifies further investment in people and investable products; • investors and intermediaries having a lack of visibility of those projects that are in the pipeline; • investors and intermediaries facing high due diligence and transaction costs relative to the small scale of investment opportunities; and • a shortage of advisers with the specialist expertise to advise on social impact investments. There are other more specific structural barriers for particular markets. For those transactions which rely on achieving a specified benchmark, for instance, there is not always accessible high-quality data to measure outcomes to determine the level of success (and therefore payment). Market participants will inevitably have different sensitivities to a particular barrier depending on their role in the market and subjective circumstances. However, there issues are frequently interlinked, and the commonality of interest between market participants in the creation of viable, successful social impact investment market is sufficiently strong that individual perspectives can be transcended.
2.	What do you see as the future for social impact investing in Australia: for example, can you foresee the development of new	There is clearly great optimism about the potential development of a social impact investment market. The 2016 Investor Report published by Impact Investment Australia (**IIA**), which surveyed 123 investors with over $333 billion under management, concluded that within five years those already active indicated that they planned to triple their impact investment portfolios.[1] While we share this optimism, we caution that the market will only achieve its potential if the barriers identified above are overcome. This is likely to require significant short-term Government assistance in terms of institution building, regulatory and financial support with a view to creating the environment and structures for a viable self-sustaining market that provides a return to government on its on initial investment

[1] *2016 Investor Report* (March 2016), Impact Investment Australia, Key Finding #2, 7.

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	structures for social impact investing?	through both savings and increased tax and other revenues from social enterprises. In this respect we see government support for renewable energy projects and more recently the establishment of social housing funds in Victoria and New South Wales as being precedents for market-building investment in social impact investing. We note that a body performing similar functions has been recommended and comprehensive described by the Advisory Australian Board on Impact Investing (**AAB**) in its *Blueprint* published in October 2015.[2] Our strong view is that the future of social impact investment must be to become a mainstream asset class. This is imperative to ensure that there is the scale to attract capital in sufficient amounts to make a difference and the expertise (and potential rewards) to drive innovation. In this regard we see structures involving, initially, government co-investment, as referred to above and as contemplated in the recent social housing procurement process undertaken in NSW, as being the right model. However, we have some concerns about the 'scalability' of social impact bonds unless sufficient volume can be initiated so as to enable portfolio investments. In the short term, we therefore do not expect these to be able to attract institutional investors, which will impede the growth of this market and limit the scale of challenges this mechanism can address. We see that innovation around the current social impact bond structure to create an instrument that can attract a broader range of investors is a necessary prerequisite if it is to be used by Governments on the scale needed to make it a worthwhile policy option available to address more systemic issues.
3.	Are there any Australian Government legislative or regulatory barriers constraining the growth of the social impact investing market?	The legislative and regulatory barriers affecting the social impact investment market are well known and have been extensively canvased in other contexts. We do not propose to exhaustively detail the specific legislative and regulatory constraints, however the key issues to which such analyses consistently return are: • *Fiduciary Duties*: ensuring that there is no residual doubt that impact can be considered in addition to risk and return by fiduciary decision makers such as philanthropic and superannuation trustees. To do so may require amending the *SIS Act*, the *Corporations Act*, and possibility other legislation. Our view is that while this may be worthwhile as a practical matter this issue becomes less important as the social impact market matures and is mainstreamed; and • *The Status of Private Ancillary Funds (**PAFs**) as Sophisticated or Professional Investors:* clarification of the status of private ancillary funds for the purposes of the Corporations Act prospectus provisions to facilitate investment by them into social impact bonds and other 'securities' for Corporations Act purposes. We have commented on aspects of this below.

[2] *Blueprint to Market: Impact Capital Australia (*October 2015), Impact Investment Australia

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Role of Commonwealth Government		
4	What do you see as the role of the Australian Government in developing the social impact investing market?	In the short-to-medium term, governments are likely to need to lead the development of the Australian social impact investment market. This has been recognised recently by a number of major economic institutions including the Productivity Commission,[3] the Senate Economics References Committee[4] and the Financial System Inquiry.[5] The Social Impact Investment Taskforce, a body established by the UK Government during its presidency of the G8, has articulated three roles for governments in developing the social impact investing market: *Market Builder* • develop an impact investment system with a range of participants; • increase the flow of resources to social impact investment organisations; and • provide incentives to encourage greater participation and scale. *Market Steward* • remove barriers to investment; • remove red tape that impedes sustainable blended models of profit and purpose; and • reduce red tape preventing greater participation by investors *Market Participant (where appropriate)* • better targeted government spending, directing capital to policy priorities; • increase focus on efficacy and outcomes; and • channel funding to innovative and effective solutions for otherwise intractable problems. Of these, we see the most immediately important as being the *Market Builder* role. In particular, we encourage the Government to seize the opportunity the develop institutional infrastructure to catalyse the market.
5	Do you see different roles for different levels of government	Yes. Most social outcomes targeted by social impact investments are areas of primarily state responsibility and therefore it is likely to be a state or territory level government which will initiate any proposed investment opportunity. However, there are clear efficiencies in having the institutional infrastructure developed by the Commonwealth Government and in co-ordinating inter-governmental initiatives such as data

[3] *Contribution of the Not for Profit Sector* (2010), Productivity Commission

[4] *Investing for Good: The Development of a Capital Market for the Not-For-Profit Sector in Australia* (2011), Senate Economics Committee

[5] *Final Report* (November 2014), Financial System Inquiry

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	in the Australian social impact investing market? For example, the Australian Government as co-funder with State and Territory Governments continuing to take the lead in developing social impact investments?	sharing and a common approach to measurability. The Commonwealth Government also has a potential leadership role in catalysing a national market through its funding arrangements via the states. For instance, it is possible to see how a fund similar to the recent asset recycling fund established by it to encourage asset sales by a state, might be used to incentivise social impact projects by making a pool of funds available to it subject to the state initiating particular projects and achieving specific outcomes.
6	Are there areas where funding through a social investment framework may generate more effective and efficient policy outcomes than direct grant funding?	Social impact investments have been designed across a wide range of areas of public policy including: • housing; • public health (including mental health); • juvenile detention and anti-recidivism projects; • education; and • conservation and the environment. This is proof of its flexibility as a tool that can be deployed effectively in widely different contexts. However, social impact investments will usually be most effective in helping to solve highly specific problems where success or failure can be measured and there is expertise residing in the private sector that allow it to conceive and execute a programme in a way that the public sector may not be able to, or in a manner that results in significant savings. While we have argued that scale is imperative to establish the social impact investment market, it should noted that there will be many policy issues that require the resources (both people and financial) of the state to address. It seems to us that there is a risk that public confidence in the potential for social impact investments may be lost if it seen as a form of privatisation by stealth.
Areas of Opportunity		
7	What Australian Government policy	The most fertile ground for social impact investment is where interrelated public problems combine in complicated ways, rendering traditional linear public policy responses inadequate and rewarding innovation.

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	or service delivery areas hold the most potential for social impact investing? Are there any specific opportunities you are aware of?	One area we believe is particularly appropriate for this approach is in affordable housing. We note that New South Wales. through its Social and Affordable Housing Fund and its tender for the development 3000 subsidised houses, has shown that is possible to develop a structure that attracts a combination of not-for-profit organisations and major infrastructure specialists. More recently, last week the Victorian Government announced that it will invest $1 billion in a fund to increase the state's social housing stock, after the accommodation waiting list had blown out to more than 33,000 people. Treasurer Tim Pallas described the social housing growth fund, to be set up over the next four years, as modelled on the Commonwealth's Future Fund: any revenue it earns will be used as a funding stream to encourage the private and philanthropic sector to build new social housing and offer subsidised rent to those in need. A separate fund will offer low interest loans and loan guarantees to community housing providers, who struggle to secure finance from traditional lenders. Meanwhile the management of 4,000 public housing properties will also be transferred to the community housing sector.
8	Are there opportunities for the Australian Government to collaborate with State and Territory Governments to develop or support joint social impact investments?	As discussed above in our response to question five, there are ways in which the state and territory governments and the Commonwealth can play complementary roles in developing and supporting social impact investment programs. We have noted in a number of contexts our view of the importance of generating scale of transactions for market development. We see a particular opportunity in different levels of government working together to create programs of a scale that can generate savings at both levels, although we recognise that this can of course give rise to complexities and sensitivities, such as the data sharing issues discussed below.
Data Sharing		
9	What are the biggest challenges for the implementing the Australian Government's public data policy in the social impact investing market? What can do the Australian Government do to	One of the major barriers to the social impact investment market, particularly to the development social impact bonds, is having the data available to measure both the problem and the outcome. Capturing data in a form that can be publicly utilised is the biggest challenge to breaking down this barrier. There is both a technological and a political aspect to this. Some Governments have begun to address this issue. For example, the UK Cabinet Office has published the unit cost of over 600 areas of service provision. Similar work is underway in NSW, which, as part of its Social Impact Investment Policy, will publish cost and performance data. In the longer term we ultimately anticipate that advances in technology will be critical in solving this challenge. For instance, in the critical engineering field of privacy analytics, sophisticated de-identification techniques to allow for the unlocking of health data for secondary use has fast-tracked the development of a cancer learning health system and assisted in the treatment of HIV through the de-identification of EMR data of HIV+ patients. Recent amendments to the Privacy Act have also rendered the re-identification of de-identified public data a criminal offence, further reinforcing the frameworks for responsible use of public data.

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	address these challenges?	However, the need to create this new offence in itself points to the justifiable potential for concerns about sharing government data about individuals with private service providers and potentially intermediaries and funders such as banks or institutional investors. It is likely that any such arrangement would need to have extremely strict parameters to ensure public confidence is maintained. Nonetheless, as the Productivity Commission's Interim Report made clear in November 2016, the use of public data is a vital resource in future public policy and especially in the realm of social impact investing.
10	Are there opportunities for the Australian Government to form data sharing partnerships with State and Territory Governments, intermediaries and/or service providers?	See our response to question nine above.
Four Proposed Principles		
11	We are seeking your feedback on the four proposed Principles for social impact investing. They are: 1. value for money; 2. robust outcomes-based measurement and evaluation; 3. fair sharing of risk and return; and 4. a deliverable and relevant	These four principles are an appropriate starting point with which to approach social impact investing. We do however note that the interpretation of the principles will be important in balancing policy issues and resolving competing tensions. For instance, the term "fair" would need to be construed in light of the risks assumed by private parties, the rate of returns offered and the level of difficulties faced in the unique circumstances of any particular project.

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	social outcome.	
Reducing Regulatory Barriers		
12	Are there any issues other than those identified relating to control that would suggest the options presented will not be sufficient to solve the problem?	We are not aware of any other issues than those relating to control.
13	Are there examples of recent situations where a PAF has considered that it is sufficiently controlled, or not sufficiently controlled, that fall outside these situations?	We are not aware of any recent examples.
14	Do the options canvassed provide sufficient certainty around when a PAF is controlled by a sophisticated investor? Are there better options that are not discussed?	In our view the options canvassed in the Consultation Paper are the best options for providing certainty to PAFs. We note that other options have been publicly canvassed, for example in submissions to the Financial System Inquiry, but in our view these have limitations when compared to the canvassed options.

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15	How could these options be best incorporated within the appropriate legislation?	The amendment presented on page 26 of the Consultation Paper is a suitable approach.
16	Is a written statement from the board of directors of the PAF sufficient evidence of the status of the trust as a sophisticated investor, or should a letter from an independent third-party be required?	We do not consider a written statement from the board of directors to be adequate given that the directors are: • unlikely to have an independent understanding of the relevant financial position in order to make the necessary statement; and • likely to be potentially conflicted by the fact that they will have been appointed by the controlling beneficial owner of the PAF . We would therefore favour an amendment which specifically requires a letter from an independent third party.
17	What qualifications should the independent third-party person be required to hold?	As the issue is a financial one we suggest a qualified accountant as defined for the purposes of s88B of the Corporations Act in the ASIC. Class Order 01/1256.
Sophisticated Investor Issue		
18	Is it common for a natural person involved with a PAF to meet the professional investor test, but not the sophisticated investor test, or	It is less common for PAFs to be controlled by "professional investors" as opposed to "sophisticated investors" because the category of professional investors was designed to capture corporate entities rather than individuals. However, the principle is the same. We advocate for the same ‘substance over form' approach to apply to PAFs controlled by professional investors.

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	visa-versa?	
19	Does this lack of control provision restrict PAFs established by professional investors from investing in impact investment products?	As in relation to "sophisticated investors", PAFs established or controlled by professional investors are restricted from investing in impact investment products to the extent that offerings have largely been structured so that they comply with the prospectus exemptions, such as the NSW Social Benefit Bonds.
20	Are there any similar issues about the application of the sophisticated investor test and/or professional investor test for investment by PAFs in financial products other than securities that are structured as impact investment products?	We are not aware of any analogous issues as they apply to financial products other than securities.
Relevance to the Rest of Corporate Law		
21	If the Government were to amend any of these definitions to provide clarity for PAFs, would there be any consequences for	The amendments as presented on page 26 of the Consultation Paper would need to be carefully drafted to avoid attempts to employ PAFs as a way to circumvent disclosure requirements otherwise imposed by the *Corporations Act.* We have not identified any unintended legal consequences of this change, although our consideration of this issue has been limited.

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	other activities regulated by the Corporations Act, or other Commonwealth legislation?	
22	Are there relevant parts of the Corporations law, or other Commonwealth legislation and guidelines, which represent a barrier to PAFs investing in impact investment products?	We are not aware of any other material parts of Australian corporate law, or other Commonwealth legislation and guidelines, which represent a barrier to PAFs investing in impact investment products.
Superannuation and Social Impact Investing		
23	What guidance in particular would provide a desired level of clarity on the fiduciary duty of superannuation trustees on impact investing?	The historic development of trust law has left some trustees concerned that a trustee who invests for social impact and sacrifices financial return may become personally liable to the trust. We note in the United Kingdom, trust law has evolved such that trustees of any charity can decide to invest ethically even if the investment may result in a lower return than an alternate investment. The law only requires justification from the trustee as to why it is in the best interest of the charity to invest in this way and permits the following reasons • that another investment conflicts with the aims of the charity; or • the charity might lose supporters or beneficiaries if it does not invest ethically; or • that there is no significant financial detriment.[6] We support a similar reform to Australian law. However we caution against putting too much emphasis on legislative reform. It is generally

[6] *Charities and Investment Matters: A Guide for Trustees (CC14)* (1 October 2011), The Charity Commission (United Kingdom)

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		accepted that superannuation trustee can engage in social impact investing within the current legal framework. Further, as noted above, this issue become less important where the market develops and the scale, range of products and liquidity increases.
Program Related Investments		
24	To what extent are the current arrangements for program related investments appropriate? Should changes be made to: 1. recognise the total loan, rather than only the discount rate between a commercial rate and the concessional loan rate, for the purposes of meeting the ancillary's funds minimum annual distribution; and 2. allow ancillary funds to make program related investments to non-DGR organisations?	We do not have any comment on program related investments.
25	What is the level of	We do not have any comment on program related investments.

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	demand from both DGR and non-DGR organisations who could be recipients of program related investments?	
26	What are the costs of administration for organisations receiving program related investments compared with receiving irrevocable donations?	We do not have any comment on program related investments.
27	Given the recent changes to the ancillary fund guidelines regarding program related investments, and noting the issues associated with making further changes, are there alternative mechanisms for promoting program related investments outside of ancillary funds?	We do not have any comment on program related investments.

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Directorial Liability		
28	Have you faced a legal impediment as a director of a social enterprise from making a decision in accordance with the mission of the enterprise, rather than maximising financial returns, that only a change in the legal structure could resolve? If so, what amendment to Commonwealth legislation, regulation or ASIC guidance would you consider is needed to address this problem?	Please see our comments in relation to fiduciary duties in our response to question 23 above.
29	Would making a model constitution for a social enterprise assist in reducing the costs for individuals intending to establish a new entity? What other standard products or other industry-led solutions	A model constitution would be likely to save some establishment costs for new entities, although frankly we do not expect the savings to be material. It would clearly be helpful if the base documents such as the bond documents for social impact bonds were to be standardised and for a clear market standard to develop in relation to investor due diligence requirements. However, the experience in most markets (for example the loan market) is that volume and the commercial incentive to create a commodified product, quickly and easily understood by investors, drives commodification and standardisation. While transactions are small, irregular and bespoke and where no clear investor cohort has developed extracting these savings is likely to be very difficult.

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	would assist in reducing the costs for individuals intending to establish a social enterprise?	

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