

27 February 2017

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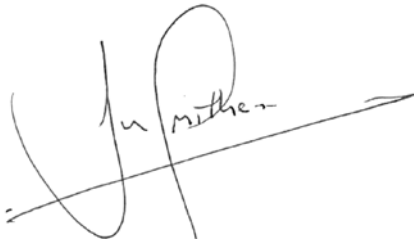
Dear Sir/Madam

Social Impact Investing Discussion Paper

I am pleased to enclose a submission prepared by the Not-for-profit Legal Practice and Charities Committee of the Law Council of Australia's Legal Practice Section.

The Committee would welcome the opportunity to discuss the submission further. In the first instance, please contact the Committee Chair, Ms Jennifer Batrouney QC, on (T) 03 9225 8528 or at (E) Jennifer_Batrouney@vicbar.com.au.

Yours sincerely



Jonathan Smithers
Chief Executive Officer



Law Council
OF AUSTRALIA

Social Impact Investing Discussion Paper

The Treasury

27 February 2017

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The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Law Firms Australia, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

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- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of more than 60,000 lawyers across Australia.

The Law Council is governed by a board of 23 Directors – one from each of the constituent bodies and six elected Executive members. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive members, led by the President who normally serves a 12 month term. The Council's six Executive members are nominated and elected by the board of Directors.

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The Secretariat serves the Law Council nationally and is based in Canberra.

Acknowledgement

The Law Council is grateful to the Not-for-profit Legal Practice and Charities Committee of its Legal Practice Section for preparing this submission.

The Committee was established in March 2016 and comprises leading practitioners in the not-for-profit area from around Australia. The objectives of the Committee include:

- to engage with financial accountability and taxation laws and policies that affect NFP organisations;
- to promote the administration of justice and the development and improvement of laws and policies affecting NFP organisations; and
- to contribute to the implementation of the Law Council's International Strategy.

Introduction

1. This submission, prepared by the Not-for-Profit Legal Practice and Charities Committee of the Legal Practice Section of the Law Council of Australia (the **Committee**), responds to the Australian Government's Social Impact Investing Discussion Paper – January 2017 (**Discussion Paper**).¹ More specifically, this submission engages with a number of the Consultation Questions raised by the Discussion Paper. The Committee welcomes the opportunity to participate in the consultation invited by the Discussion Paper.
2. This submission identifies that there are a number of significant issues that do not appear to have been addressed in this first consultation on social impact investing in Australia. We seek to identify a number of those issues in this submission.
3. Our members are reporting the rapid growth of interest and novel participation in social impact investing in Australia. Therefore it seems that policy and regulatory environment work is needed to, firstly, be responsive to a market that is already developing, and secondly, to cultivate best practice.
4. The Committee's submission makes a number of observations and specific recommendations about actions that may assist the carrying forward of the public policy and regulatory debate.
5. This Discussion Paper should be, we encourage, simply the first part of further and more specific consultation.

Overview of social impacting investing

6. The Australian Government is of course not alone on the international stage in giving social impact investing serious consideration. The USA, Canada, UK and some other European countries have all already developed significant policies and in many cases are enabling law reform for social impact investment.²
7. According to the Social Impact Investment Taskforce established under the UK's presidency of the G8 in 2014:

*The world is on the brink of a revolution in how we solve society's toughest problems. The force capable of driving this revolution is 'social impact investing', which harnesses entrepreneurship, innovation and capital to power social improvement.*³

¹ Australian Government: The Treasury, *Social Impact Investing Discussion Paper* (January 2017) Australian Government
<http://treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Consultations/2017/Social%20Impact%20Investing/Key%20Documents/PDF/Social_Impact_Investing_DP.aspx> ('Discussion Paper').

² D B Reiser, 'Theorizing forms for social enterprise' (2012-2013) 62 *Emory Law Journal* 681; S Toepler et al, New York Springer, 'Social Enterprise' (2009) *International encyclopedia of civil society*.

³ *Impact Investment: The Invisible Heart of Markets. Harnessing the power of entrepreneurship, innovation and capital for public good*, Report of the Social Impact Investment Taskforce (G8), September 2014
<[http://www.socialimpactinvestment.org/reports/Impact%20Investment%20Report%20FINAL\[3\].pdf](http://www.socialimpactinvestment.org/reports/Impact%20Investment%20Report%20FINAL[3].pdf)>.

8. Outside of the Discussion Paper, 'Social Enterprise' is a relatively new but rapidly growing term with numerous definitions. Broadly it includes enterprise by both for-profits and not-for-profits, with dual motives of:
 - achieving public, 'social' good on the one hand;
 - while also delivering financial benefit (private for for-profits and purpose for not-for-profits), profitability or capital gain on the other.
9. In like manner, 'Impact Investing' is a new and growing term used to describe the situation where the funder or investor (be it a Government, a charity, a private enterprise or an individual) is seeking both 'impact' and financial return (sometimes at more modest rates than a pure financial investment). These investments are often sought to be made in 'social enterprises'.
10. Galaskiewicz and Colman in their discussion of *Collaboration between Corporations and Nonprofit Organizations*, quote a definition of Dees (1994, 1998),⁴ of social enterprise - which could be not-for-profit or for-profit organisations - 'that seek to accrue revenues through commercial ventures but also have an interest in *making society better*'.⁵
11. In Australia, there is currently no targeted regulation to encourage, or taxation treatment to shape, the growth of social enterprise and impacting investing. Calls are growing for new targeted enabling regulation and fresh tax incentives.⁶ Our preliminary response to the Discussion Paper's invitation to make submissions on the regulatory issues is made below.
12. The Discussion Paper defines some key terms as follows⁷:

Social enterprises: Business which aim to achieve both financial return and social outcomes.

Social impact investments: Investments made with the intention of generating measurable social and/or environmental outcomes in addition to a financial return.

13. It is noted that the 'social enterprise' definition speaks of 'business', which in the context of the Discussion Paper means *for-profit* business (as opposed to *not-for-profit* or charitable enterprise). This appears to be at odds with the broader use of

⁴ In his works 'Social Enterprise: Private Initiatives for the Common Good' and 'Enterprising Nonprofits'.

⁵ *The Nonprofit Sector: A Research Handbook* (Yale University Press, 2006, 2nd ed, 2006) 191 (emphasis added).

⁶ See eg. Rosemary Addis, Anna Bowden and Donald Simpson, *Delivering on Impact: The Australian Advisory Board Breakthrough Strategy to Catalyse Impact Investment* (September 2014) Impact Investing Australia <http://impactinvestingaustralia.com/wp-content/uploads/0109Delivering_on_impact.pdf> 37 which calls on government to 'Enact regulatory change and policy action that will stimulate and support a market and remove barriers to entry and innovation'. Policy and practical step recommendations of the self titled 'Australian Strategy' in that report include to '[r]egulate to expressly permit mission & program related investment'; '[c]onsider and design targeted tax incentives to promote impact investment'; and '[r]efresh guidance for fiduciaries and trustees'.

⁷ Ibid Appendix B.

the terminology internationally, which encompasses not-for-profits and charities that may consider themselves engaged in 'social enterprise'.⁸

Recommendation 1:

The definition of 'social enterprise' in a 'support' and 'enabling environment' context should encompass both for-profit and not-for-profit enterprise. Both can make financial gain, however, not-for-profit enterprises are subject to the non-distribution constraint and limited to be applied for purpose.

14. It is noted that 'social' and 'social impact' are not defined in the Discussion Paper. Positively this may provide great flexibility for enterprises and investors to seek to 'do good' as interpreted through their own lens. Negatively it may lead to investor disappointment. If the government participates in impact investing it is noted that the 'good' in view is determined by Government⁹ priority.¹⁰ For Charity and not-for-profit lawyers, this begs the question of how 'social impact' is related to 'charitable purpose'? The Discussion Paper does not address this. For reasons the Committee outlines below this is essential.

Social Impact v Charitable Purpose - risks to not-for-profit status, tax concessions & validity of trusts

Defining social 'impact'

15. It is telling that the phrase 'social impact' is not defined by any of the Working Groups associated with the Social Impact Investment Taskforce established under the UK's presidency of the G8 in their various reports in late 2014. There appears merely to be an assumption that 'social impact' means '**public good**' as drawn from the subtitle of the overarching Taskforce Report, *Impact Investment: The Invisible Heart of Markets - Harnessing the power of entrepreneurship, innovation and capital for public good* (emphasis added).¹¹
16. The NSW Government has published some work in the social impact space. However, even though the NSW Government has policy released in 2015,¹² an Office of Social

⁸ It is noted that Social Traders define social enterprise as, 'organisations that - [a]re driven by a public or community cause, be it social, environmental, cultural or economic; [d]erive most of their income from trade, not donations or grants; and [u]se the majority (at least 50%) of their profits to work towards their social mission': Social Traders, *Social Enterprise Definition* <<http://www.socialtraders.com.au/about-social-enterprise/what-is-a-social-enterprise/social-enterprise-definition/>>.

⁹ This is because Government is usually providing the 'return' to investors linked to the anticipated public purse savings.

¹⁰ Discussion Paper, 23 (Principal No 4).

¹¹ *Impact Investment: The Invisible Heart of Markets. Harnessing the power of entrepreneurship, innovation and capital for public good*, Report of the Social Impact Investment Taskforce (G8), September 2014 <[http://www.socialimpactinvestment.org/reports/Impact%20Investment%20Report%20FINAL\[3\].pdf](http://www.socialimpactinvestment.org/reports/Impact%20Investment%20Report%20FINAL[3].pdf)>.

¹² NSW Government, *Social Impact Investment Policy* (February 2015) <<http://www.osii.nsw.gov.au/assets/office-of-social-impact-investment/files/Social-Impact-Investment-Policy.pdf>>.

Impact Investment, a web site,¹³ and two pilot programs,¹⁴ all of this material recognises that terms surrounding this area require more precise definition. The NSW Government is proposing to publish, 'Social Impact Investment Principles'¹⁵ and 'Social Investment Statements of Opportunities' which, in the later case, is about limited government resources being 'focused on those areas which have the greatest likelihood of success and meet Government's priorities'.¹⁶ The clear message from this Office of Social Impact Investment is, at least, that the *impact* in view will be as determined by government from time to time.

17. Galaskiewicz and Colman in quoting a definition of Dees (1994, 1998)¹⁷, of 'social enterprises' speak of the 'impact' of '*making society better*'.¹⁸
18. The 'good' or 'better' are for more than an individual, family or small group of people. Rather, the focus is on the society or the public (or perhaps a sufficient section of the public). There are clear echoes of the requirement that charitable purpose is for 'public benefit' as opposed to 'private benefit'.
19. The Discussion Paper limits its view of the role of not-for-profits and charities in social enterprise to roles of *investors* (in social enterprises) or *service providers* (in the delivery of the social good).¹⁹ These are certainly roles that not-profits and charities currently, and the Committee anticipates will continue to, take in social enterprise. However, for reasons outlined below, the role of charities and not-for-profits in social impact investing is not so limited.
20. The Discussion Paper invites consultation in relation to social enterprise that has a dual or blended purpose of both social impact and financial return for funders or investors. At first blush this would seem to exclude charities or not-for-profits from being the 'social enterprise' - or does it?

Can not-for-profits & charities be social enterprises?

21. To what extent may not-for-profits and charities be social enterprises themselves? Many may consider that they already are, especially if they engage in 'business like'/profit making activities. Finding Australia's Social Enterprise Sector (**FASES**) research shows that many of Australia's social enterprises are run by charities.²⁰ For example, not-for-profits and charities may in their provision of affordable/social housing make profits to reinvest in their purposes.
22. It is well settled in Australian law that a charity (and indeed a not-for-profit) may engage in business enterprise to drive profits and wealth to apply to the advancement of its purpose.²¹ Unhelpfully, and incorrectly in the Committee's view,

¹³ NSW Government, Office of Social Impact Investment <<http://www.osii.nsw.gov.au/>> .

¹⁴ These programs include the Newpin Social Benefit Bond and the Benevolent Society Bond.

¹⁵ 'The NSW Government will publish Australia's first Social Impact Investment Principles. These principles will identify the elements that Government seeks in social impact investment transactions': Social Impact Investment Policy, above n 4, 4.

¹⁶ Social Impact Investment Policy, above n 4, 5.

¹⁷ In his works 'Social Enterprise: Private Initiatives for the Common Good' and 'Enterprising Nonprofits'.

¹⁸ *The Nonprofit Sector: A Research Handbook* (Yale University Press, 2006, 2nd ed, 2006) 191.

¹⁹ Discussion Paper, 15.

²⁰ Social Traders, *Social Enterprise Research*, <<http://www.socialtraders.com.au/about-social-enterprise/fases-and-other-research/social-enterprise-in-australia/>>.

²¹ *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Ltd* [2008] HCA 55.

the Australian Taxation Office has conflicting statements on its web site about not-for-profits making profits.²²

23. The overlap between social enterprise and charity is immediately apparent in the social/affordable housing example. Social/affordable housing was a key emphasis of the Media Release of the Hon Scott Morrison MP at the time of his release of the Discussion Paper.²³ The provision of affordable housing to people experiencing or at risk of homelessness comes within the legal meaning of charity. The Australian Charities and Not-for-profits Commission (ACNC) in its *Fact Sheet: Social Housing providers and the ACNC* clearly recognises that social housing providers may be charities:

*The ACNC registers organisations as charities. Organisations that provide affordable housing to people experiencing or at risk of homelessness that meet the [legal meaning of charity](#) and our [requirements for registration](#) can register as charities with the ACNC. A housing provider must be a not-for-profit to register with the ACNC.*²⁴

24. For determining the meaning of 'charity' and 'charitable purpose' in any Commonwealth Act we first turn to the *Charities Act 2013* (Cth) (**Charities Act**).²⁵ The degree of the overlap between 'social impact' and 'charitable purpose' is apparent from the key s 12(1) of the Charities Act which is reproduced below (**emphasis added**):

Definition of charitable purpose

(1) In any Act:

charitable purpose means any of the following:

- (a) the purpose of advancing health;*
- (b) the purpose of advancing education;*
- (c) the purpose of advancing **social** or public **welfare**;*
- (d) the purpose of advancing religion;*
- (e) the purpose of advancing culture;*

²² 'Not-for-profit (NFP) organisations are organisations that provide services to the community and do not operate to make a profit. A few examples are childcare centres, art centres, neighbourhood associations, medical centres and sports clubs. All profits must go back into the services the organisation provides and must not be distributed to members, even if the organisation winds up' (emphasis added): Australian Government, Australian Taxation Office, *Not-for-profit organisations* (12 January 2016) <<https://www.ato.gov.au/general/aboriginal-and-torres-strait-islander-people/not-for-profit-organisations/>>

²³ Australian Government, The Treasury, 'Social impact investing discussion paper released' (Media Release, 28 January 2017) <<http://sjm.ministers.treasury.gov.au/media-release/004-2017/>>.

²⁴ Australian Government, Australian Charities and Not-for-profits Commission, *Factsheet: Housing providers and the ACNC*, <https://www.acnc.gov.au/ACNC/FTS/Fact_Type_Housing.aspx>.

²⁵ It is acknowledged that the legal meaning of 'charity' in Australia is also informed by judicial decisions, but for the purposes on the submissions in this paper the *Charities Act 2013* (Cth) provides sufficient insight.

(f) the purpose of promoting reconciliation, mutual respect and tolerance between groups of individuals that are in Australia;

(g) the purpose of promoting or protecting human rights;

(h) the purpose of advancing the security or safety of Australia or the Australian public

(i) the purpose of preventing or relieving the suffering of animals;

*(j) the purpose of **advancing the natural environment**;*

*(k) **any other purpose beneficial to the general public** that may reasonably be regarded as analogous to, or within the spirit of, any of the purposes mentioned in paragraphs (a) to (j);*

Note: In the case of a purpose that was a charitable purpose before the commencement of this Act and to which the other paragraphs of this definition do not apply, see item 7 of Schedule 2 to the Charities (Consequential Amendments and Transitional Provisions) Act 2013.

(l) the purpose of promoting or opposing a change to any matter established by law, policy or practice in the Commonwealth, a State, a Territory or another country ...

25. A charity for the purposes of any Commonwealth Act is then defined in s 5 of the Charities Act reproduced in part below (**emphasis added**):

charity means an entity:

*(a) that is a **not-for-profit** entity; and*

(b) all of the purposes of which are:

*(i) **charitable purposes** (see Part 3) **that are for the public benefit** (see Division 2 of this Part); or*

(ii) purposes that are incidental or ancillary to, and in furtherance or in aid of, purposes of the entity covered by subparagraph (i); and

Note 1: In determining the purposes of the entity, have regard to the entity's governing rules, its activities and any other relevant matter.

Note 2: The requirement in subparagraph (b)(i) that a purpose be for the public benefit does not apply to certain entities (see section 10).

(c) none of the purposes of which are disqualifying purposes (see Division 3); and

(d) that is not an individual, a political party or a government entity.

26. The Committee queries whether the government intend the 'social' mission be broader than the meaning of charitable purpose or would there be greater certainty if the mission must be within the meaning of charitable?

Removing existing conflicting regulator guidance on the meaning of 'not-for-profit'

27. 'Not-for-profit' while not defined in the Charities Act, does have a relatively settled technical (albeit not statutory) meaning that somewhat different to its ordinary meaning. Recently the Supreme Court of South Australia effectively adopted the guidance published by the ACNC and the ATO saying that '[t]here is no definition of not-for-profit in the ACNC Act but, ... some assistance can be gleaned from information published by the [Australian Charities and Not for Profits] Commission [(ACNC)] and the Australian Tax Office [(ATO)].'²⁶ In summary, a not-for-profit has a **distribution constraint**. The ACNC and the ATO guidance which was effectively endorsed by the recent South Australian decision is (emphasis added):

ACNC:

Generally, a not-for-profit is an organisation that does not operate for the profit, personal gain or other benefit of particular people (for example, its members, the people who run it or their friends or relatives)...

Not-for-profits can make profit, but any profit made must be applied for the organisation's purpose(s).²⁷

ATO:

A not-for-profit (NFP) organisation does not operate for the profit or gain of its individual members, whether these gains would have been direct or indirect. This applies both while the organisation is operating and when it winds up.

An NFP organisation is not an organisation that hasn't made a profit. An NFP organisation can still make a profit, but this profit must be used to carry out its purposes and must not be distributed to owners, members or other private people.

Clauses – NFP character

The tax law does not prescribe the words that an NFP organisation must have in its constituent documents.

The following example clauses would be acceptable to us, provided that other clauses do not contradict them. The organisation's actions must be consistent with this requirement.

²⁶ *The Lutheran Laypeople's League of Australia Inc* [2016] SASC 106 (11 July 2016) [49] (Hinton J).

²⁷ Australian Government, The Australian Charities and Not-for-profits Commission, *Register my Charity* <https://www.acnc.gov.au/ACNC/Register_my_charity/Who_can_register/What_is_NFP/ACNC/Reg/What_is_NFP.aspx>.

Example clauses

Non-profit clause: 'The assets and income of the organisation shall be applied solely in furtherance of its above-mentioned objects and no portion shall be distributed directly or indirectly to the members of the organisation except as bona fide compensation for services rendered or expenses incurred on behalf of the organisation.'

*Dissolution clause: 'In the event of the organisation being dissolved, the amount that remains after such dissolution and the satisfaction of all debts and liabilities shall be transferred to another organisation with similar purposes which is not carried on for the profit or gain of its individual members.'*²⁸

28. Not all not-for-profits are charities, but all charities must be not-for-profits.
29. Charities or not-for-profits cannot retain that status, and the tax concessions that ordinarily come with it, if they attract investment by way equity funding (private ownership) or provide return to investors (private distribution of profits). These actions fundamentally breach the non-distribution (or private benefit) constraint. Charities and not-for-profits need to attract their funds via donations, grants, or debt. It is noted that 'work-a-rounds' to the non-distribution constraint are sometimes used. For example, a Pty Ltd (or unit trust) may be formed that is partly owned by the charity and partly owned by investors.
30. Social Impact Bonds are contractual/debt instruments which provide 'return' linked to impact. A question for further consideration is when, if ever, does a bond with 'return' linked to impact over-step the non-distribution constraint? Initially this may be able to be addressed by published guidance from the ACNC and the ATO.
31. Further, charities and not-for-profits may form subsidiary or related for profit legal structures in order to be able to offer 'equity style' investment and return to investors.

Recommendation 2

That the ACNC and the ATO consider publishing guidance on the effect on not-for-profit status of charities and not-for-profits participating in or paying financial returns, directly or via related entity, linked to impact.

Recommendation 3

That the ATO remove or clarify its unclear guidance on its web site about not-for-profits not operating to make a profit.

32. The consequences of a loss of not-for-profit status are significant and potentially enterprise ending. These include a loss of tax concessions, along with other liability exposure both for the entity and its officers, and the loss of the charitable or other community services of the entity.

²⁸ Australian Government, Australian Taxation Office, *Is your organisation not-for-profit?* (20 July 2015) <<https://www.ato.gov.au/Non-profit/getting-started/is-your-organisation-not-for-profit/>>.

33. In many cases the social or environmental benefit (impact) seeking to be delivered by a social enterprise may also be charitable, depending on **who** (a for-profit business or not-for-profit enterprise) delivers it and for **what purpose** (public or private financial return) it is delivered. Some key boundaries, the Committee submits, need to be drawn and articulated. Why do such boundaries need to be clearly drawn and articulated?

'Social enterprise' and 'charitable purpose' boundaries

34. A stated key driver of the consultation on the Discussion Paper is the growth of the social impacting investing market and creating an enabling environment for its development.²⁹ Put simply, governments wish to unlock and see private capital applied for public social benefit, and maximise the impact of the funding they are directly providing for public social benefit.

35. Sector identity and boundaries, especially when there is overlap, are important for a number of reasons including:

- Regulation – who regulates participants?
- Accountability – to whom and for what are participants accountable?
- Ownership / Risk allocation – who stands to gain / lose?
- Costs & Confidence – costs of entry, operations and the confidence of funders often linked to perceived or real level of regulatory oversight?
- Targeted Tax Incentives – who receives what tax incentives and on what conditions?

36. David Billis, a leading commentator from the UK in his edited book on social enterprise, writes:

[S]ector identity remains powerful and important. It ... provides a deep-rooted and fundamentally different way of responding to problems. ... [S]ector title ... readily understood by citizens, ... appears to have reasonable clarity of ownership and accountability, and can consequently form the basis of public debate and policy. Sector characteristics and alleged advantages, although they may deviate from the ideal model, still provide a benchmark for what things ought to be like and for how they should work. And if there were indeed any doubt about the continued power of sector concept, it is only necessary to open a daily paper and engage with the discussion as why tax payers should bail out the banks.³⁰

37. It is critical for public trust and confidence that 'social enterprise' has a meaning understood by the public and is distinct from 'charity'. This will safeguard against the phrase 'social enterprise' growing in popular understanding as an equivalent of 'charity'. Further, if social enterprises are unregulated, and there is no requirement

²⁹ Discussion Paper, 5.

³⁰ D Billis (ed), *Hybrid Organisations and the Third Sector: Challenges for Practice, Theory and Policy* (Palgrave Macmillan, 2010) 8.

that social enterprises make a minimum contribution to society, then social enterprises gain the benefits of the title with no corresponding obligations.

Recommendation 4

That Australian Government policy recognise and articulate the place and role of not-for-profits and charities in social enterprise and social impact investing other than just a service provider or impact investor.

Recommendation 5

That Australian Government policy recognise and articulate the boundaries of the roles of existing (or new) regulation and regulators relating to social enterprise, especially the role of the limits of the role of the ACNC.

The validity of purpose [social impact] trusts that are not charitable trusts

38. Are 'social impact trusts' that are not 'charitable trusts' valid, or do they fail for want of beneficiaries or charitable purpose?
39. The answer to this question is significant, especially in the context of giving effect to testamentary (Will) gifts for social impact purposes that may not be charitable. For a trust to be valid, there must be certainty of objects (beneficiaries or in the case of charitable trusts charitable purposes).
40. Professor Gino Dal Pont gets right to the point when he says, '[w]here a fund might, consistently with the objects of the bequest, in the future be applied other than to strictly charitable purposes, the gift fails'.³¹ He goes on to point out that State trusts legislation³² may save some gifts where there is a mixture of charitable and non-charitable purposes.³³ The degree to which social impact trusts may be saved (or not saved) requires further consideration.
41. Granted, if a Will maker gives a gift to an existing corporate entity (that may be engaged in social enterprise), and that entity is in existence at the time of death of the Will maker, the gift will not fail.³⁴ However, given the many years that often pass between the making of a Will and the death of the Will maker, corporate structures can change and new entities take the place of old entities. It is often in the case that testamentary gifts to charities structured as corporations are 'saved' by way of general charitable intent and the application of the *cy-près* doctrine.³⁵

³¹ Halsbury's Laws of Australia, LexisNexis Australia, *Essential Requirements to Create Charitable Trusts*, [75-365] citing *Re Carson (dec'd); Carson v Presbyterian Church of Queensland* [1956] St R Qd 466; *Public Trustee v A-G* (1997) 42 NSWLR 600, 612 (Santow J).

³² See *Charitable Trusts Act 1993* (NSW) s 23(1) (previously *Conveyancing Act 1919* (NSW) s 37D); *Trusts Act 1973* (Qld) s 104(1); *Trustee Act 1936* (SA) s 69A(1); *Variation of Trusts Act 1994* (Tas) s 4(2); *Charities Act 1978* (Vic) s 7M(1) (previously *Property Law Act 1958* (Vic) s 131(1)).

³³ Halsbury's Laws of Australia, LexisNexis Australia, *Statutory Provisions to Validate Certain Trusts*.

³⁴ Albeit not impressed with any trust terms. Rather it will simply go to the entity absolutely. This could frustrate some intentions of Will makers.

³⁵ This is because these gifts are effectively 'impressed' with charitable trust terms.

42. The Committee raises the question, how would a gift to a social enterprise that is not charitable be 'saved' in such circumstances? The Committee knows of no current legal basis for this to occur.
43. A non-charitable social impact trust (whether established via Will or inter vivos) that identified beneficiaries with sufficient certainty may be valid as a non-charitable trust,³⁶ but in jurisdictions other than South Australia, would be subject to the rule against perpetuities, and have a limited life of 80 years. Charitable trusts, once settled, are not subject to such a time limitation.
44. Again this requires careful consideration of the overlap between 'charitable purpose' and 'social impact purpose', on which the Committee commented at length earlier in this paper.

Recommendation 6:

That Australian Government policy recognise and articulate the differences and overlap between 'social impact trusts' and 'charitable trusts' for the public policy reason of seeking to uphold the intentions of settlors and donors and the validity of testamentary dispositions for 'social impact' purposes.

Consultation questions 1-3:

Q1. 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?

45. The main barriers include:
- Uncertainty about **structural form** (even if the entity is to be a for-profit tax payer). More discussion on this topic occurs later in this paper.
 - Uncertainty of **office holder duties** in the strategic and day to day decision making tension between purpose and profit (when the for-profit form is adopted). It should be noted that that such uncertainty does not exist when a charity or not-for-profit is carrying on the social enterprise because the bed-rock duty is always to purpose, and if any decision seems to favour the profit motive, it is profit for purpose. More discussion on this topic occurs later in this paper.
 - Uncertainty of the **overlap of for-profit and not-for-profit social enterprises**. See above.
 - **Risk to the not-for-profit status of charities and not-for-profits** sharing financial returns with private funders. See above.
 - **Fund manager duties** to investors in funds that seek to invest on other than financial return / risk metrics. More discussion on this topic occurs later in this paper.

³⁶ *Re Denley's Trust Deed* [1969] 1 Ch 373.

- **Adequacy of instructions to fund managers** from beneficiaries who are normally such a large class that it is unlikely that all will provide the instructions. More discussion on this topic occurs later in this paper.
- Potentially **changing of the nature of Trustee / beneficiary relationship to one of principal / agent**, when the trustee acts at the direction of the beneficiary in an investment decision. More discussion on this topic occurs later in this paper.
- **Failure of testamentary gifts** that may be given on trust for 'social impact' as opposed to 'charitable' purposes. See above.
- **Risk to the integrity of money for which a tax concession has been provided**, e.g. money given for a public benefit purpose being applied primarily for private benefit.

Q2. What do you see as the future for social impact investing in Australia: for example, can you foresee the development of new structures for social impact investing?

46. Given the approach of comparable jurisdictions in the development of new structures for social impact investing, and the tensions and challenges being identified without them, it is suggested that this needs careful consideration. More discussion on this topic occurs later in this paper.
47. The following factors are also instructive:
- The development of novel hybrid and layered structures and contractual arrangements (albeit at high bespoke cost) to facilitate existing demand. That is, the demand already exists and appears to be growing from government, investors and service providers.
 - The relatively rapid growth of social impact investing in a relatively short time frame.

Q3. Are there any Australian Government legislative or regulatory barriers constraining the growth of the social impact investing market?

48. Yes. Our preliminary response is developed and articulated in the following observations and submissions in this paper.

The role the Australian Government should play in the social impacting investing market

Consultation questions 4-10:

Q4. What do you see as the role of the Australian Government in developing the social impact investing market?

49. The Australian Government needs to take a lead role as 'return provider' given that it (along with other levels of government) will need to consider providing the financial return / reward for the impact achieved, measured by savings to future anticipated expenditure achieved.
50. The 'return provider' role is quite apart from the Government's role as the provider of regulatory frameworks.
51. Australian regulatory frameworks that govern financial services, corporations and federally registered charities are within Commonwealth legislative capability and therefore, in our view, it is both appropriate and desirable that the Australian Government take a lead role in the development of policy about regulatory response to encouraging social impact investing.
52. Given the responsibility of other levels of Government for services seeking to be provided by social enterprises, the Committee recommends a co-operative approach with the State and Territory governments in this development and any proposed regulatory reform.

Q6. Are there areas where funding through a social investment framework may generate more effective and efficient policy outcomes than direct grant funding?

53. We make the following observations:
 - Direct grant funding has been raised but never taken up as a viable or effective substitute for the tax expenditures used to encourage and subsidise the activities and public benefit delivered by not-for-profits, charities, and DGRs (through the tax concessions they or their donors enjoy).
 - Direct grant funding would require significant resource allocation by Government in appropriately targeting, equitably providing and then acquitting the funding. The movement of governance principally into the hands of the governors of social enterprise entities (some of whom may be volunteers especially in not-for-profits and charities) may be a more cost effective approach.
 - Having the social impact investment focused on the policy objectives of Government would seem to follow from the returns (or tax concessions) being offered by Government in exchange for the savings otherwise achieved.

Q7. What Australian Government policy or service delivery areas hold the most potential for social impact investing? Are there any specific opportunities you are aware of?

54. The Committee recommends targeted and specific consultation with not-for-profits and charities on this question.

Q8. Are there opportunities for the Australian Government to collaborate with State and Territory Governments to develop or support joint social impact investments?

55. Yes, as noted above.

Q9. 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 address these challenges?

56. The Committee does not have a view.

Q10. Are there opportunities for the Australian Government to form data sharing partnerships with State and Territory Governments, intermediaries and/or service providers?

57. The Committee does not have a view.

Australia's Social Impact Investing Principles

Consultation question 11- the Principles:

Q11. We are seeking your feedback on the four proposed Principles for social impact investing outlined in this section.

58. The Committee queries the use of the language 'interventions' in the Discussion Paper. For example, - 'It may be the case that a particular client group is subject to multiple interventions on the Commonwealth and State levels, which could complicate the ability to isolate the effect of the individual intervention.'³⁷ The use of the term 'intervention' may appear to be harsh or disrespectful to clients.

59. The Committee also queries how measuring and reporting on what might, for clients, be sensitive/personal information, might be done in a manner that respects the privacy and dignity of outcomes in the lives of those seeking to be measured? Again we recommend targeted consultation with the not-for-profit and charitable sector.

60. A further question as part of that consultation is: what research or evidence exists regarding potential damage that may be caused to clients by being put under the microscope in terms of measurement and having outcomes in their lives linked to financial reward being enjoyed by those who might have put the money up to help fund services to them? To what extent could resentment or injury in the lives of clients be caused? The answers to these questions are outside the Committee's expertise. However, they are important questions to be considered in the consultation.

61. In relation to the disclosure of relevant information to investors, the Committee questions the suggestion that it be *disclosed publicly* if the social enterprise is a private enterprise and not otherwise subject to public reporting. Small modest offerings can in part be instructed by the 20/12/2 rule, which allows companies to raise not more than \$2million in any 12 month period from not more than 20 known investors without having to meet the requirements for full compliance with

³⁷ Discussion Paper, 21.

Disclosure and Prospectus obligations.³⁸ Disclosure attaching to these types of funding does not need to be made public.

62. Absent some scale around disclosure required for modest investment, the costs of documenting disclosure will make modest investment capital raising prohibitive and perhaps limit the participants to sophisticated investors and Social Investment Funds.
63. Additionally, if the disclosure requirements approach the Disclosure and Prospectus type requirements for public capital raising, this may create cost barriers to entry which are prohibitive.³⁹
64. It seems to us that a number of parts of the Discussion Paper are not relevant to investments in social enterprises or investments in third party funds with a portfolio of social enterprise investments, where government is not involved. The Committee recommends separate consultation specifically on non-government related social enterprises and investment in social enterprises. There are different issues to consider when investing in social enterprises without the government connection. For example, there are no consequences enforced by government where there is a lack of measurable impact.

Recommendation 8:

That the Australian Government engage in further consultation on the issues when government is not involved as a 'return provider'.

Reducing Regulatory Barriers

Private Ancillary Funds as sophisticated investors

65. In relation to Private Ancillary Funds (PAF) as sophisticated Investors, the Government has asked for comment on the proposed solution to control of a PAF:

Control of a PAF for the purposes of s708(8) of the Corporations Act could be demonstrated if either of these conditions is met:

- *a director of the trustee is both the largest financial donor to the PAF and satisfies the sophisticated investor test; or*
- *the majority of the directors of the trustee themselves satisfy the sophisticated investor test.*⁴⁰

66. Given that the governance duties of the directors of a PAF are owed both individually and collectively, it would seem to us that the test needs to be tied to a 'majority of the directors' of the trustee. In addition the directors which meet the test would need to vote in favour of the investment to ensure the decision is actually being made by the sophisticated investors.

³⁸ *Corporations Act 2001* (Cth) s 708(1).

³⁹ We do not comment on law reform in relation to 'crowd funding'.

⁴⁰ Discussion Paper, 26.

67. It is contrary to the governance of a charitable trust and the PAF guidelines to allow a PAF to be a sophisticated investor on the basis that the major donor who is also, perhaps, the sole shareholder, is alone a sophisticated investor. On this analysis then, any change to these provisions along the lines suggested above should also be available to all charitable trusts, including public ancillary funds and testamentary trusts.

68. In relation to PAFs as sophisticated Investors, the Government has also asked for comment on the proposed solution to evidence of control of PAFs:

Control of a PAF for the purposes of s708(8) of the Corporations Act could be evidenced in writing either by:

- *an independent and qualified accountant (or alternative suitable person) having provided a certificate within the preceding six months stating that the PAF meets one of these conditions; or*
- *the board of directors of the trustee providing a letter stating that the PAF meets one of these conditions.⁴¹*

69. It seems to us that evidence should not be left to the board of directors themselves but rather be certified by an appropriately qualified independent professional.

Consultation questions 12-21:

Q12. 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?

Q13. 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?

Q14. 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?

Q15. How could these options be best incorporated within the appropriate legislation?

Q16. 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?

Q17. What qualifications should the independent third-party person be required to hold?

Q18. Is it common for a natural person involved with a PAF to meet the professional investor test, but not the sophisticated investor test, or visa-versa?

Q19. Does this lack of control provision restrict PAFs established by professional investors from investing in impact investment products?

Q20. 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?

⁴¹ Discussion Paper, 26.

Q21. If the Government were to amend any of these definitions to provide clarity for PAFs, would there be any consequences for other activities regulated by the Corporations Act, or other Commonwealth legislation?

70. The issues around PAFs becoming sophisticated investors apply broadly and will considerably open up the investments a PAF can consider, beyond impact investing. It will be important to ensure these decisions are made within the terms of the PAF's investment strategy and the applicable PAF Guidelines and Trust Law.
71. PAFs can make investments to generate income and growth for the sole purpose of benefitting charitable item 1 DGRs within the terms of the guidelines and relevant Trustee Act and common law duties applicable to trustees of charitable trusts. Therefore a lower than market rate of return, or a high level of risk, would need to be clearly authorised in the trust deed and permitted by the Guidelines. If it is not an expected market rate of return and prudent level of risk, then it will not be a permissible application of trust funds for investment purposes but may be an application for the charitable purpose referred to as a 'program related investment' which is discussed later in the paper. Any opening up of the sophisticated investor provisions does not change the restrictions for the application of money for the purpose of investment to be for an income or capital growth strategy only.
72. Further specific consultation is required on the question which isn't directly asked in this paper, that is, whether charitable trusts/PAFs should be able to invest for lower returns to achieve a charitable purpose as a dual purpose investment.

Recommendation 9:

That the Australian Government engage in further consultation whether charitable trusts/PAFs should be able to invest for lower returns to achieve a charitable purpose as a dual purpose investment.

73. The Committee does not comment further on questions 12 - 22. In relation to superannuation law and social impact investment we comment as follows.

Superannuation law and Social Impact Investment

Consultation question 23:

Q23. What guidance in particular would provide a desired level of clarity on the fiduciary duty of superannuation trustees on impact investing?

74. The authors of this paper are not superannuation law experts but they do have expertise in trust law. The Committee is currently seeking further advice from the Law Council's Superannuation Committee. Should any further input need to be provided, it will be provided by addendum to this submission at a later date.
75. In addition to fiduciary duties and 'best interests' duties⁴² in the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**), the SIS Act currently imposes a 'sole

⁴² SIS Act s 52.

purpose' test on trustees of super funds, which materially includes, '*the provision of benefits for each member of the fund on or after the member's retirement.*'⁴³

76. If a superannuation trustee is to make decisions other than on financial return and risk, it would seem almost impossible to argue that this is somehow in the best interests of the member or members in providing benefits to the member or members on or after their retirement. The duties are not to create a better world and more balanced Government budget. The duties are owed to the members. Superannuation wealth is at its heart, enforced saving of the member for retirement. It is the wealth of the member, not the trustee, held on 'solemn' trust to be managed, preserved and grown for provision of benefits of the member in his or her retirement.
77. Therefore, absent some clear and informed consent (and perhaps direction) of a member, it seems that a superannuation trustee who chose a lower financial return from an impact investment would do so at their peril. Can a trustee of a pooled fund act on less than informed consent (and perhaps direction) of 100% of the affected members in making a lower return investment that achieves impact? The trustees' duties are owed to all the members/beneficiaries as a group.
78. Can a trustee properly discharge their duties to beneficiary members by making a decision to take a reduced financial return in exchange for social impact? Judicial consideration of this is limited, but a few cases provide some guidance.
79. The 1985 English decision, *Cowan v Scargill* [1985] Ch 270, concerned a pension scheme for miners. Union representatives on the committee of management voted against investments in overseas oil and gas. The court decided that most, if not all, cases would require trustees to seek the greatest possible financial benefits, rather than non-financial benefits. The following extracts from the judgment are instructive:

*The duty of the trustees towards their beneficiaries is paramount. They must of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests.*⁴⁴

*In considering what investments to make trustees must put on one side their own personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views that they hold.*⁴⁵

80. The principle in *Cowan v Scargill*, in a superannuation context, that 'best interests' means the '**financial** best interests'⁴⁶ of members has been cited with approval in a

⁴³ Section 62(a)(i) of the SIS Act.

⁴⁴ *Cowan v Scargill* [1985] Ch 270, 286 (emphasis added).

⁴⁵ *Ibid* 288.

⁴⁶ See *Commonwealth Bank Offices Superannuation Corporation Pty Ltd v Beck* (2016) 334 ALR 692, [146] (Bathurst CJ): '*I am conscious of the fact that it has been commonly stated that the best interests of*

number of Australian decisions, including by the Supreme Court of Victoria in, *Asea Brown Boveri Superannuation Fund No 1 Pty Ltd v Asea Brown Boveri Pty Ltd, McKeown, Gray & ABB Properties (Vic) Pty Ltd* [1999] 1 VR 144 and the Court of Appeal of the Supreme Court of NSW in *Commonwealth Bank Offices Superannuation Corporation Pty Ltd v Beck* (2016) 334 ALR 692.

81. The 1992 English decision of *Harries v Church Commissioners for England* makes it clear that trustees cannot make contrary decisions on moral or ethical grounds.⁴⁷ Sir Donald Nicholls V-C in that decision stated:

*trustees should not make investment decisions on the basis of preferring one view of whether on moral grounds an investment conflicts with the objects of the charity over another. This is so even when one view is more widely supported than the other.*⁴⁸

82. The Vice-Chancellor did recognise an exception, 'when the objects of the charity are such that investments of a particular type would conflict with the aims of the charity'.⁴⁹ An example included a cancer charity refusing to invest in tobacco shares. This is perhaps consistent with investment portfolio choices of beneficiaries (see further comments below).
83. Additionally the duties of the trustee of care, skill, diligence and prudence,⁵⁰ would not permit a trustee to blindly follow the direction of beneficiaries. In superannuation trusts with large numbers of beneficiaries, it would seem practically impossible for trustees to obtain direction from all of the members.
84. Assuming that instructions could be taken and the duties of care, skill, diligence and prudence discharged, to what extent does a trustee acting on instructions of a beneficiary change the nature of the relationship to one of principal and agent potentially exposing the beneficiary to liability in contract or tort? Taking instructions is of course not the same as consulting with members and taking their views into account. The Committee would expect that this distinction is already well understood by superannuation trustees. If not, guidance may be helpful.
85. Any guidance would not alter the fiduciary duties owed by the trustees at law and therefore would appear to be an inadequate response.
86. A change in the law that allowed or even obliged trustees of superannuation funds to consider social impact as one factor in their investment decisions, may not be enough as the 'best interests' and 'sole purpose' duties point to direct financial benefits to provide for members in their retirement. If law reform went even further, to somehow seek to re-define provision for retirement as including 'social good', superannuation fund members may well wonder if this might be indirect taxation of their superannuation wealth.

beneficiaries in a superannuation fund are normally their best financial interests: Cowan v Scargill [1985] Ch 270 at 287.

⁴⁷ [1992] 1 WLR 1241.

⁴⁸ Ibid 1247, as quoted by B J Richardson, 'Fiduciary Relationships for Socially Responsible Investing: A Multinational Perspective' (2011) 48(3) *American Business Law Journal* 597, 610.

⁴⁹ Ibid 1246, as quoted by Rosy Thornton, 'Ethical Investments: A Case of Disjointed Thinking' (2008) 67(2) *Cambridge Law Journal* 396.

⁵⁰ SIS Act s 52(2)(b).

87. It is foreseeable that '*Social Impact Super Funds*' (as stand alone funds or sub-funds within a larger fund) may be permitted where that investment portfolio choice had been given to members with the choice to accept a slightly lower rate of return in exchange for social impact. The degree of Disclosure required would require some careful examination. Of course there may well be longer term cost to the Australian Government if the impact is not successful by the member not having the same level of superannuated income in retirement to supplement the Age Pension.

Recommendation 10:

That further consultation take place on what changes to the law may be desirable or required to trustee duties and purpose requirements in the superannuation context to facilitate social impact investing using superannuation monies.

Recommendation 11:

That consideration be given to appropriate Disclosure for superannuation member choice of 'social impact investment portfolio' with reduced rates of financial return. This of course should not occur without consideration of the inter-relationship with the 'sole purpose' test and trustee duties.

Program-related investments, and non-transparent indirect expansion of the DGR categories

Consultation questions 24-27:

Q24. 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?**

88. This question recognises that charitable trusts are currently only able to make investments to generate income or capital growth to further their purpose or to provide benefits to their charitable purpose. It is extremely difficult for trusts to make a dual purpose investment. It is arguable that charitable companies are not as restricted as charitable trusts and are able to make lower than market rate of return investments which also seek to further their charitable purpose. This is because the relevant restrictions on investments in the various State and Territory Trustee Acts likely do not apply nor do the common law duties of trustees of charitable trusts (unless charitable company assets are impressed with implied charitable trust obligations). It seems to us that further consultation around the necessity of retaining this difference would be beneficial, especially given non-DGR grant making foundations are no longer required to be set up as a trust in order to receive income tax exemption.

89. In relation to 24.1, the Committee cannot see the logic in recognising the total loan rather than only the discount, as meeting part of the distribution requirement. If the total is to be counted, it seems to us that the distribution should be by way of gift rather than loan.

90. Is the discount the correct measure if the charity could not have received a loan other than from a PAF? How is a loan to be accounted for/considered by the trust? If the purpose of the loan is to benefit the charity then the provision of all the money is made as part of the grant making strategy rather than part of the investment strategy. If only the difference between the market rate and the amount charged is taken to be the benefit and therefore part of the minimum distribution, does that require the provision of the money as a loan to be accounted for and considered an investment? If so, then it does not come within the investment strategy, as below market rate of return. Does this cause a problem of compliance with the Guidelines? Further consultation on this point should be obtained from accountants but the current treatment presents a barrier due to the lack of clarity.
91. In relation to 24.2, it should be remembered that a PAF investing in term deposits or shares (albeit subordinated) is a type of loan. However, these investments are made at market rates with the PAF looking for a market return (as it should). To permit a PAF to loan at discounted rates to registered charities, in social impact bonds (in partnership with a Government agency), or an investment made through a social impact intermediary, is essentially expanding the tightly controlled DGR categories by less than fully transparent means.

Recommendation 12:

That there be further consultation on dual purpose investments by charitable trusts compared to companies.

Recommendation 13:

That total loans, rather than the discount rate between commercial rate and concessional loan rate, not be taken into account for purposes of meeting the ancillary fund minimum annual distribution.

Recommendation 14:

That there be further consultation on the accounting treatment of discounted loans and compliance with the PAF Guidelines.

Recommendation 15:

That ancillary funds not be permitted to loan at discounted rates to non DGRs.

Q25. What is the level of demand from both DGR and non-DGR organisations who could be recipients of program related investments?

Q26. What are the costs of administration for organisations receiving program related investments compared with receiving irrevocable donations?

Q27. 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?

92. The Committee does not comment on consultation questions 25 - 27 as these are perhaps best responded to by the accounting profession.

Legal structures for Social Enterprises

93. The Committee notes that the Discussion Paper reports that the Prime Minister's Community Business Partnership raised the following concern (need):

... putting in place the legal structures necessary to establish a NFP entity that can raise equity capital, or to transition a growing entity from a NFP to for-profit structure, is unreasonably expensive.

94. The Committee makes the following comments on this concern as expressed:

- firstly, a NFP entity cannot raise equity capital and remain a NFP, as this offends the non-distribution constraint (discussed above); and
- secondly, changing a NFP structure to a 'for-profit' structure is a substantial re-allocation of wealth from that which was to be applied for 'purpose', to the application of wealth for 'private benefit'. The Committee expects that the ATO, ACNC (if applicable), donors, and State and Territory Attorneys-General (as the protectors of charities) may have legitimate and actionable concerns.

Director liability

95. The Discussion Paper reports that the second concern raised by the Prime Minister's Community Business Partnership is that *'directors of social enterprises may breach their legal obligations if they do not act to maximise profits, even if this is contrary to the mission of the entity'*.

96. We agree with this second concern. Even if the Constitution of the entity gives expression to the dual motive of impact and profit, 'for-profit' regulatory regimes are built on the premise of what is in the best interests of the entity being governed allowing other interests to be taken into account. The bedrock is financial benefit (or 'shareholder primacy'). The following passage from The Hon Justice Ashley Black (a Judge of the Supreme Court of New South Wales) in April 2013 in a leading text is instructive:

There is a reasonably wide consensus that, although directors owe their duties to the corporation, it is legitimate for directors to have regard to a range of interests including the interests of the community, the environment, employees, customers and suppliers in exercising those duties. This formulation of directors' duties is wider than the 'shareholder primacy model', which would hold that the corporation's purpose is to maximise its owners' wealth and the directors' role is to achieve that objective. It is narrower than the widest view of "corporate social responsibility", which holds that a corporation should give as much weight to interests of employees, consumers and the environment as to its shareholders. This formulation broadly corresponds to the "corporate benefit" approach identified in the Corporations and Markets Advisory Committee's (CAMAC) Discussion Paper, November 2005, which relies on the benefit which a corporation may gain from adopting corporate social responsibility practices. CAMAC distinguishes this approach from an "ethics based" approach which suggests a wider ethical obligation for a corporation to take corporate and social responsibility into account. CAMAC's discussion paper acknowledges that the duties of directors under s 180 (care and diligence) and s 181 (good faith) of the Corporations Act

do not expressly oblige or allow directors to take the interests of stakeholders (other than shareholders) into account in considering the company's best interests, but notes that courts have allowed directors to take non-shareholders' interests into account where it is commercially justifiable to do so. The Joint Parliamentary Committee, in its recent report in respect of corporate social responsibility, also expresses the view that the Corporations Act permits directors to have regard to the interests of stakeholders other than shareholders in exercising these duties. This reconciliation of corporate and wider interests works well where a particular initiative which would advance environmental, employee or community objectives can also be said to serve corporate interests. However, this reconciliation will fail if such an objective cannot be reconciled to shareholders' interests even in the middle or long term.⁵¹

97. Other leading Australian Corporations Law commentators have stated:

If the altruistic purpose being considered by management cannot be couched in terms of what's good for the corporation then management will have acted improperly.⁵²

The decided cases in this area indicate that management may implement a policy of enlightened self-interest on the part of the company but may not be generous with company resources when there is no prospect of commercial advantage to the company.⁵³

98. The same concerns flow through considerations at a change in control event.

99. Implicit in the Community Business Partnership's analysis is an assumption that most social enterprises are for-profit. The extensive research undertaken through the FASE's research project (2010-2016) reveals this is not the case, and most social enterprises are structured as not-for-profits.⁵⁴

100. Therefore, it is important that there is further consultation and debate in regard to the legal constraints faced by both not-for-profits as for-profits.

Recommendation 16:

That further consultation on social enterprise and social impact investing consider the involvement of not-for-profits and charities (not just for-profits) in social enterprise.

UK - Community Interest Companies (CICs)

101. CICs were first established in the UK in 2005 pursuant to the *Companies (Audit, Investigations and Community Enterprise) Act 2004*.

⁵¹ *Australian Corporation Law Principles & Practice*, LexisNexis Australia, [3.2A.0010]

⁵² A Lumsden and K McPherson, *Corporate social responsibility: Corporate governance* (Australian Corporation Practice, LexisNexis Australia, 2013).

⁵³ *Ibid* [31.395] quoting H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, 2013, looseleaf, vol 1) [8.130].

⁵⁴ Social Traders, *Social Enterprise Research - Research Findings*, <<http://www.socialtraders.com.au/about-social-enterprise/fases-and-other-research/social-enterprise-in-australia/>>.

102. CICs are limited companies which operate to provide a benefit to the community they serve. There are 3 different types of CICs. One of them uses the company limited by guarantee as the underlying structure, and is essentially not-for-profit. The other two options use private and public company structures as a base – and these structures can make returns to investors and are not not-for-profit.⁵⁵ However, the purpose of CIC is **primarily one of community benefit** rather than private profit. Whilst returns to investors are permitted, in the 'for-profit' forms, these must be balanced and reasonable, to encourage investment in the social enterprise sector whilst ensuring true community benefit is always at the heart of any CIC.⁵⁶
103. It seems that only 25% of CICs have adopted the limited by share version of the structure making distributions possible.
104. CICs are subject to an 'asset lock' and 'dividend-cap' that are 'designed to ensure that the assets of the CIC (including any profits or other surpluses generated by its activities) are used for the benefit of the community.'⁵⁷
105. In CICs, community benefit is prioritised because CICs must pass the 'community interest test'. The test is met if a reasonable person would consider that the activities of the CIC are carried on for the benefit of the community. There has been some criticism that the regulator has set the dividend caps too low, making the shares an unattractive investment.⁵⁸
106. The CIC regulator is a dedicated regulator, seeking to be 'light touch' (as opposed to 'heavier touch' of charities). Regulatory functions include to:
- determine if an entity qualifies as a CIC;
 - review annual disclosures;
 - monitor compliance;
 - work to improve brand recognition for the social enterprise sector; and
 - publish guidance material and model constitutions for CICs.
107. CICs cannot be charities.⁵⁹
108. It is not possible within the time-frames of the consultation called for by the Discussion Paper to examine and comment on the reasons for the introduction of the CICs in the UK and how successful or otherwise it may have been in that

⁵⁵ Department for Business Innovation and Skills, Office of the Regulator of Community Interest Companies, *Information and guidance notes - Chapter 3: Limited companies* (May 2016) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524151/cic-12-1333-community-interest-companies-guidance-chapter-3.pdf>.

⁵⁶ Department for Business Innovation and Skills, Office of the Regulator of Community Interest Companies, *Leaflets - Information Pack* <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524217/13-783-community-interest-companies-information-pack.pdf> 5.

⁵⁷ *Ibid* 5.

⁵⁸ D B Reiser, 'Theorizing forms for social enterprise' (2012-2013) 62 *Emory Law Journal* 721.

⁵⁹ Tom Pratt, 'Q&A: Setting up a Community Interest Company', *The Guardian* (Online), 1 December 2009 <<https://www.theguardian.com/society/2009/dec/01/setting-up-community-interest-company>>.

jurisdiction.⁶⁰ The Committee submits that this needs further detailed consideration and consultation.

US – Benefit Corporations

109. In the US, from beginnings in 2008, as at the end of 2013, more than half the States have adopted regulation for Benefit Corporations.⁶¹ Benefit Corporations incorporate under State corporate statutes, are tax payers like usual corporations, but articulate their social commitments in their governing documents.⁶²

110. While the Benefit Corporation is not the only new alternative 'specialized structural option'⁶³ for social enterprises in the US, it is still instructive to consider some of the considerations in the introduction of this hybrid corporate form, as surveyed by Rawhouser and Cummings. They include:

- **Organisational flexibility v regulatory enforcement.** The Benefit Corporation form has provided flexibility relieving directors of 'for-profits' of potential breaches of duties if the shareholder return and value imperative is not given supremacy. Equity investors in Benefit Corporations have an interest, information and standing to seek to hold the directors to account.⁶⁴ This provides *some* 'self-regulation'. However, the role of corporate regulators in providing any meaningful oversight of purpose other than profit and shareholder value is far from clear.
- **Stakeholder clarity v stakeholder confusion.** Investors are put on *notice* that these corporations have interests other than shareholder return and value at their heart. Disclosure and notice to investors are already essential elements of the corporations' law framework in Australia. However, there is evidence in the US that there is widespread confusion about whether Benefit Corporations are charitable. The Committee refers to its earlier recommendations about policy and regulatory guidance about the overlaps and differences between 'social enterprise' and 'charitable purpose'. In our view this education work will be just as important if a new specialised corporate form is introduced in Australia for 'social enterprises'.

⁶⁰ However there is some evidence that the CIC structuring options have experienced greater uptake than US Benefit Corporations. While 31 US states have enacted the model legislation research shows that numbers of Benefit Corporations had reached only 2144 in 2015. This is an extremely small uptake, and may be an indicator that the structure does not meet the needs of social enterprises. This figure can be contrasted with the figure of 11,000 CICs in the UK. The number of L3Cs is actually not that different to the number of benefit corporations. See E Berrey, *How Many Benefit Corporations Are There?* (2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2602781.

⁶¹ H Rawhouser and M Cummings, 'Benefit Corporation Legislation and the Emergence of a Social Hybrid Category' (2015) *York University, Working Paper Draft*.

⁶² *Ibid* 6.

⁶³ The benefit corporation is not really a 'structure'. It is a set of extra obligations applied to traditional companies.

⁶⁴ While a 'benefit enforcement proceeding' may be available under legislation, this does not enable enforcement of the dual purpose by those with standing. The benefit corporation legislation does not require that impact be prioritised, it only requires that the listed stakeholders and interests be 'considered' by decision makers. Therefore, the only cause of action available would be to allege that the 'consideration' did not occur. There is no cause of action available to challenge whether the directors appropriately balanced profit or purpose, unless a court would be willing to imply that this a requirement of a benefit corporation structure even though it is not specified in the legislation. The model legislation does not provide for any particular remedies that could flow from a 'benefit enforcement proceeding'.

111. Regulatory requirements for Benefit Corporations in the US do not require a prioritisation of either profit or impact. Professor Reiser is among those calling for the need for prioritisation of impact over profit as is the case in the UK.⁶⁵

112. Other criticisms of Benefit Corporations have included:

- the reporting framework enables ad hoc reporting that cannot be compared side by side;
- there is no register of benefit corporations or central information point; and
- the lack of robust requirements to prioritise purpose mean that a company could run exactly in the same fashion as a normal for-profit, and simply 'consider' purpose, and benefit from the branding associated with the structure.

113. It is not possible within the time-frames of the consultation called for by the Discussion Paper to examine and comment on the reasons for the introduction of Benefit Corporations (and other alternatives) in the US and how successful or otherwise it may have been in those jurisdictions. The Committee submits that this needs further detailed consideration and consultation.

Specialized form Branding – signalling trust – but only with a regulator

114. Professor Reiser suggests that a specialized legal form for 'social enterprises' will signal creditability and trust when the social good objective is required to be prioritized over the profit and shareholder value objective. She goes on to say that without enforcement the prioritization is meaningless and trust will not be created by the brand.⁶⁶

High establishment costs

115. The Committee notes the following statement in the Discussion Paper:

The diversity of social enterprise makes it unlikely that there will be any one structure that would be suitable for a majority of for-profit/ not-for-profit/ charitable entities.

116. Not for profit and charitable entities already have a range of legal structures they can use including public 'companies limited by guarantee' registered under the *Corporations Act 2001* (Cth).

117. A specialised legal form, for social enterprise with equity investors, is really a hybrid between a 'for-profit' and 'not-for-profit', as it is neither 'fully' one or the other.

118. As is the case for both for-profits and not-for-profits diversity of structuring does not reduce the need for structuring options and the utility of those structures for investors, governors and regulators and others. In our submission, a specialised legal form that may accommodate a large number of intended 'social enterprises' would

⁶⁵ D B Reiser, 'Theorizing forms for social enterprise' (2012-2013) 62 *Emory Law Journal* 681.

⁶⁶ *Ibid.*

appear at this early stage, worthy of some more detailed exploration of merits and costs.

119. It would seem to us that specialised legal form would reduce not only establishment costs but also the 'hidden costs' of governors and investors needing to take bespoke expensive advice on how their duties are discharged and risks managed.

Recommendation 17:

That in conjunction with the work about alternate specialised legal forms, this analysis should include consideration of what existing and intended 'social enterprises' may be accommodated within such and form and which may not.

120. The Committee notes the following statement in the Discussion Paper:

... it appears that both a 'mission lock' and 'asset lock' may be obtained by providing for these things in the company's constitution or quarantining assets in a trust.

121. The Committee does not agree. Constitutions (which are essentially contracts) and trust terms (a mixture of legal and equitable obligations) may be changed. Therefore it is really not a 'lock', other than at the collective 'will' of the controllers (or a sufficient majority of them). If the collective will is less than unanimous, and 'social enterprise' assets are also impressed with terms of charitable trust, disappointed investors may have claims.
122. Terms of trust may of course be altered in the manner contemplated in the terms of trust and most modern trust deeds contain extensive and broad powers of amendment. The 'locks' in this context are really private contractual covenants. Fetters on power of amendment are again essentially private contractual covenants.
123. The enforcement of private contractual covenants requires recourse to the courts. It is expensive and time consuming. Further, not all impact investors would have standing to take such court action. If locks are in place in a constitution, then only those who effectively have power to change (or block changes) to that constitution have control. An impact investor via debt mechanisms will not be in a position to influence whether or not an asset lock is maintained (unless it is pursuant to a contractual covenant in the debt instrument).
124. Additionally 'mission lock' and 'asset lock' without some priority given to 'social impact' over profit, and some significant guidance to assist in navigating the tension, may be of little real benefit to governors in balancing the competing demands of impact and profit in their decision making.

Recommendation 18:

Private covenants in Constitutions and Trust Deeds do not provide sufficient 'asset lock' and 'mission lock' in a way that would be well understood by investors and the public.

Consultation questions 28-29:

Q28. 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?

125. In our submission, the need for a specialised legal form, needs to be examined, by reflecting of the reasons for, and lessons from, comparative jurisdictions. It seems to us that absent such background work, it is too early to be considering what legislative amendments might be required and what they might be.

Recommendation 19:

That the next stage of consultation be the need for a specialised legal form by examining in detail the reasons and lessons from comparative jurisdictions.

Recommendation 20:

That consideration of potential legislative amendments in relation to director liability be deferred until after this comparative law work has been done.

Q29. 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 would assist in reducing the costs for individuals intending to establish a social enterprise?

126. In our submission this needs to be placed in the context a broader policy consultation on whether specialised legal form might be required. Having said that, model constitutions assist, as is evident by the Replaceable Rules in the *Corporations Act 2001* (Cth) and the model constitutions published by the ACNC.

Recommendation 21:

That a model constitution only be considered after the work on desirable specialised legal form has been done.

Tax incentives for social enterprise and social impact investing

127. The Committee notes that the Discussion Paper does not address how social enterprise and social impact investing might be encouraged and shaped through target tax concessions.
128. The Committee recommends the inclusion of consultation on this aspect in the next round of consultation again considering what might be occurring in comparative jurisdictions.⁶⁷
129. At first glance it might seem that returns to social impact investors provided by Government appear to be a form of taxation expenditure. However where the level of return is linked to anticipated savings to the public purse the appropriateness of it being considered taxation expenditure needs to be more closely considered.

Recommendation 22:

That subsequent consultation explore what taxation incentives either to investors or enterprise may be appropriate.

Recommendation 23:

Tax incentives may provide some response to reduced returns, especially if the same net return is achieved.

Conclusion

130. The Committee, welcomes the consultation invited in the Discussion Paper as the first stage in further consultations, which in our view are required, not only for the growth of the social impacting investing market and creating an enabling environment for its development,⁶⁸ but also for certainty for governors and investors in the 'early adopters' who are already underway in the 'social enterprise' space.
131. If the demand for 'social enterprise' is going to grow in Australia in the short to medium term at the pace and to the size predicted, further policy and regulatory work seems to be not only warranted but also highly desirable.
132. For further comment or clarification on any of the matters raised in this paper please contact Jennifer Batrouney QC, Chair, Not-for-profit Legal Practice and Charities Committee on (T) 03 9225 8528 or at (E) Jennifer_Batrouney@vicbar.com.au.

⁶⁷ This would include the UK Social Investment Tax Relief Scheme.

⁶⁸ Discussion Paper, 5.