MinterEllison

27 February 2017

Housing Unit Manager
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The Treasury
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By email: socialimpactinvesting@treasury.gov.au

Dear Sir / Madam

Social Impact Investing Discussion Paper

MinterEllison welcomes the opportunity to respond to the Australian Government's Social Impact Investing Discussion Paper.

We **enclose** our submission, which draws upon our experience working with a range of clients across the public and private sectors. We have not answered each of the questions posed for consultation, but have limited our response to those areas where we feel we can add value.

We support the Government's focus on facilitating the growth of the social impact investment market in Australia, and look forward to participating as it develops.

Yours faithfully
MinterEllison

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MinterEllison submission on the Social Impact Investing Discussion Paper
27 February 2017

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?

There are a number of structural impediments to the growth of the social impact investment market as an alternative asset class. There is apparent demand and allocation of funds within superannuation and other investor groups for this emerging asset class – including pools of money looking specifically for ethical or social investment opportunities, but a lack of product, scale and standardisation.

Some of the structural issues (deal size, tax, availability or certainty of wholesale investor exemptions and so-on) will be covered later in this submission.

There is also a real issue in relation to building scale and depth, which could be overcome by:

(a) pilot programs;

(b) cost compensation models to create market (at least in the initial phase to build capacity and knowledge, and to identify and resolve issues);

(c) modelling assistance, including sponsoring data collation and analytics to build the requisite data sets;

(d) facilitating the development of national approaches and funding models;

(e) standardisation, perhaps by supporting a few projects across different jurisdictions or that share a common cause, to build data models and metrics;

(f) larger deal size – there is a need to test the market, but most social impact bonds (**SIB**s) have been relatively small in size, limiting investor and service provider opportunities and economies of scale to spread cost;

(g) increasing scale, which is required to warrant service providers and intermediaries investing or diverting resources to build the capacity to cover this sector;

(h) opening up investment in certified 'social enterprises' to Private Ancillary Funds (**PAF**s) and Public Ancillary Funds (**PuAF**s) – which must currently invest in or donate to deductible gift recipients (**DGR**s), thus broadening the class of potential investors;

(i) recognition that many of the benefits from SIBs instituted by State or Territory Governments flow to Federal Government (for example, welfare savings). Accordingly, there needs to be an appropriate sharing mechanism or Federal Government needs to support the State and Territory SIB markets through co-funding or top-up payments to make marginal SIBs more viable and encourage and create the market; and

(j) using COAG and other forums to conform regulatory frameworks which stymie the creation of a 'national' market (or preclude or inhibit comparability or building national databases).

Other initiatives to build capacity within the sector could include:

(a) establishing a social investment fund (equivalent to the Clean Energy Finance Corporation in the green energy space) or facilitating establishment of private equivalents (through tax or other incentives) to catalyse / promote development of the market (through first loss or other support mechanisms) which leverages other investments;

(b) supporting contract readiness to assist with capacity building in the social enterprise sector. The Government could consider establishing an equivalent to the UK Investment and Contract Readiness Fund, creating a multiplier effect by raising capacity of participants;

(c) channelling part of Significant Investment Visa investment – eligible venture capital investment – into SIBs and other social enterprise creation; and

(d) broadening the definition of social procurement (beyond Indigenous) to include other 'certified' social enterprises and developing a national standard approach.

Other structural barriers relate to:

(a) the absence of one common, national 'data market', which would facilitate standardisation and sharing across states and territories to remove artificial barriers that add complexity and cost and provide a deeper data pool for better statistical analysis);

(b) accessing open data, which would assist with standardisation and simplification of privacy consent processes needed to build the necessary cohort / sample size for data collation and quality data analysis;

(c) social benefit bond funding may not be readily available to small or community-based not-for-profit organisations that do not have the assets or resources to undertake to repay (or secure the repayment of) the standing charge. Further analysis of our suggestions above regarding capacity building should seek to address this issue;

(d) broadening the investor base, and ensuring that PAFs, PuAFs, superannuation funds and other institutional investors have access to the market to provide a wider pool of investors and a new supply of funding, and to avoid the risk that traditional donors simply become 'investors', thus not increasing the supply of funding for social impact projects and social enterprises; and

(e) technical issues relating to:

    (i) PAFs and their ability to meet wholesale investor tests and otherwise participate in the market (non-DGR status of investments); and

    (ii) superannuation trustees' ability to satisfy fiduciary duties, including the sole purpose test. One path forward is to allow social impact investments where the members have, in essence, given approval to do so, whether through the fund rules, PDS or notification processes.

2. 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?

There is enormous potential for the creation of an alternative asset class in social impact investing and development of social enterprise and social procurement. There is a considerable appetite in the corporate community for:

(a) shared value models; and

(b) using commercial skills and networks to solve social problems.

There are pools of capital looking for 'ethical' sustainable and socially aware investments, and an emerging class of social entrepreneurs building social enterprises as well as philanthropic and other investors looking for opportunities to deploy capital. Groups such as the Legal Models Working Group have recommended hybrid structures combining a for profit investment vehicle (capital for impact investors) with a not-for-profit mission-based vehicle (DGR, charity status), and there is much happening in the international realm that can be adapted for Australian circumstances.

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

The Australian Government has a role in reducing information asymmetry and other barriers for investors and participants in social impact investing. The Australian Government is well placed to collate and provide information and other investment tools, including facilitating platforms, networks or gateways to bring together investors and other participants.

5. Do you see different roles for different levels of government 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?

There is a natural delineation in participation due to the different roles of the States and Territories and the Commonwealth. From this perspective, it makes sense for States and Territories to continue leading in developing social impact investments. The Commonwealth is well placed to, and should continue to, co-fund, sponsor and build capacity, including on a national scale where relevant.

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

This is an issue worthy of more detailed consideration (and data collation) as to whether particular areas of disadvantage might be more receptive to social enterprise models. There are many social enterprises tackling the creation of pathways to employment and employment readiness (for disabled, long-term unemployed and those with mental health issues, for instance) and some data which suggests they provide more effective long lasting solutions.

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

Most definitely, particularly given that the costs and benefits of relevant programs are shared by the different levels of government (and often asymmetrically).

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

While data sharing has the potential to create opportunities for social impact investing, it also presents regulatory challenges. In particular, privacy – both in relation to regulatory compliance as well as the management of community attitudes and expectations – will be a key challenge to the successful implementation of data sharing arrangements between Commonwealth, State and Territory Governments and private sector organisations for social impact investment purposes. Secrecy provisions in legislation (which restrict the collection, disclosure and use of certain 'protected information', and extend beyond personal information) may also limit these kinds of data sharing arrangements.

Privacy and data protection laws across Australia are inconsistent and fragmented. In its draft report on Data Availability and Use (October 2016), the Productivity Commission noted that there were more than 500 privacy and secrecy provisions in Commonwealth legislation alone.[1] Inconsistency and multi-layered privacy laws can therefore be a barrier to data sharing between government and private sector entities who are subject to different (and sometimes multiple) privacy and secrecy law obligations.

Requirements under Commonwealth, State and Territory privacy laws also limit the circumstances in which personal information may be collected, used and disclosed. For example, subject to certain exceptions:

(a) 'sensitive information' such as health information should generally only be collected with the consent of the individual;[2]

(b) personal information should be collected directly from the individual concerned (i.e. not from a third party) without their consent, unless the collection is required or authorised by law, or direct collection would be unreasonable or impracticable;[3] and

(c) personal information that was collected for a particular purpose should not be used or disclosed for another purpose.[4] With regard to this point, data sharing arrangements for social impact investment purposes may (depending on the particular purpose of the data

[1] Productivity Commission, Commonwealth of Australia, *Draft Productivity Commission Report*, (October 2016) 28.
[2] Australian Privacy Principle 3.3.
[3] Australian Privacy Principle 3.6.
[4] Australian Privacy Principle 6.

exchange) have 'function creep' risks for an entity, whereby data is being used and/or disclosed for a different function or context to which it was originally collected by the entity.

Data quality is another potential barrier to effective data sharing arrangements and outcomes. Diversity in data sources at various levels of government and in the private sector, and differences in the form in which data is collected and stored, can present challenges for quality control, including addressing data inconsistencies.

One way of overcoming potential privacy risks is to limit data sharing to de-identified information where possible. Advances in de-identification technology, including the use of synthetic data, provide opportunities to facilitate the sharing of data without breaching privacy laws. There would of course need to be appropriate controls in place to ensure the risk of re-identification remains at an acceptably low level, as the risk profile of datasets may change over time as greater quantities of data are shared and produced. The need to ensure data is adequately protected would also need to be balanced against the need to preserve the integrity of the data.

When considering how data sharing opportunities could be used and implemented, it is important to strike a balance between the protection of privacy and the potential public benefits of social impact investing. The success of such data sharing partnerships will depend on support from not only government and private sector parts, but also the public. Community attitudes about what constitutes an invasion of privacy are not necessarily reflected in law, and some individuals may not support their data being shared and used for social impact investing purposes, particularly if they do not perceive these purposes to have a direct personal benefit. Perceptions about a loss of respect for privacy can result in loss of public confidence in government and private sector data sharing partners. For private sector bodies in particular, a loss of public confidence could impact on their business and customer relationships, and therefore businesses may be reluctant to share customer data (even if it is de-identified).

Transparency and consultation with the public and/or affected individuals about proposed data sharing arrangements can assist in building a 'social licence' for such activities. Having regard to the different privacy and data protection laws that apply in each jurisdiction, there should also be engagement with privacy regulators at the Commonwealth, State and Territory levels (as well as relevant industry specific regulators) to ensure clear data governance measures are in place, including a framework for the resolution of privacy complaints.

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?[5]

To enable a PAF (through its trustee) to invest in the full suite of financial products (for example, bonds, shares, collective investment vehicles) without the need to give the trustee of the PAF a regulated disclosure document (such as a prospectus or a Product Disclosure Statement):

(a) the issuer will need to ensure that it (the issuer) does not need to give a regulated disclosure document to the trustee of the PAF because of an existing disclosure exemption Chapter 6D or Chapter 7 (as applicable) of the *Corporations Act 2001*; [6] or

(b) the *Corporations Act 2001* will need to be formally amended to specify, or otherwise make expressly clear, that the trustee of a PAF (or certain PAFs controlled by high net worth individuals) does not require to be given a disclosure document.

In relation to paragraph 12(a) above, the disclosure exemptions in Chapters 6D and 7 are different in relation to: (A) 'sophisticated investors' and 'professional investors' under subsections 708(8) and 708(11) respectively for securities (including bonds), and (B) section 761G for almost all other financial products. These tests have developed over time, but they represent the legislature's intention to regulate financial products under two chapters with two sets of disclosure exemptions. Interpretative difficulties in current legislation include the following:

(a) as a trust is not a legal person but rather operates through its trustee, it is not clear how a trust could be 'offered' securities (s.708(8)(d)) or 'acquire' other financial products (s.761G(7)(ca) as inserted by Corporations Regulation 7.6.02AB). In this regard, the

[5] This response also includes our submission on questions 13, 14, 15, 16, 20.

[6] There are regulatory requirements other than disclosure, such as needing to hold an Australian financial services licence, but our response is limited to disclosure as this seems to the focus of the Discussion Paper. However, see our comments in response to question 22.

reference to a 'company or trust' in these sections is further complicated where a trust (such as PAF) is operated by a corporate trustee;

(b) the notion of a 'trust controlled by the person' (s.708(8)(d), s.709(9B), s.708(9C), s.761G(7)(ca) and ss.761G(7A) and 761G(7B) as inserted by Corporations Regulation 7.6.02AC) is unclear because:

(i) a trust is not a legal person. A reference to a 'trust controlled by a person' could be taken to mean controlling the trustee (such as a corporate trustee), controlling the trust as a beneficiary (for example, by being able to give directions to the trustee under the terms of the trust deed) or controlling the assets of the trust; and

(ii) to the extent that it refers to controlling the assets of a trust, s.50AA(4) states that a person (eg a trustee) is not taken to control a trust if the person is under a legal obligation to exercise its capacity to influence the decisions about the trust's financial and operating policies for someone other than the person's members (eg the beneficiaries). In this regard, the expansive definition of 'entity' in s.64A assists in the interpretation of s.50AA(4). Relevantly, the control test in s.50AA evidently seeks to refer to a company's control of its own assets, rather than assets it holds for the benefit of persons other than its shareholders. It should also be noted that joint capacity to influence the trust's financial and operating policies does not of itself amount to control of the trust (s.50AA(3)), which may be relevant in circumstances where the corporate trustee of a PAF has only two directors;

(c) for the purpose of the sophisticated investor test in s.708(8)(c) and the wholesale client test in s.761G(7)(c), it is not clear whether a trustee 'has' the relevant net assets or gross income, where the trustee holds legal title to the trust's assets but holds them in a fiduciary capacity only (ie they are not assets held absolutely by the trustee in its own books and records). In relation to professional investor test in s.708(11), and paragraph (e) of the professional investor test in s.761G(7)(d) as amended by Corporations Regulation 7.6.02AE, this issue is resolved in that that test includes a person who has assets held 'under a trust that the person manages', but this formulation is not in the sophisticated investor test in s.708(8)(c) and the wholesale client test in s.761G(7)(c). This difference is important because of the different asset tests thresholds – namely, $2.5m for the s.708(8)(c)/s.761G(7)(c) assets test and $10m for the s.708(11)/s.761G(7)(d) test – a distinction that has troubled the financial services industry in relation to self-managed superannuation funds;

(d) in relation to the sophisticated investor test in s.708(8)(d) and the wholesale client test in s.761G(7)(ca):

(i) it is not clear whether the relevant accountant's certificate is to be given by the applicant's accountant or the controller's accountant. (This analysis assumes that a certificate is required for these tests to verify income or asset amounts, even though the wording of these provisions refer narrowly only to sub-paragraphs (c)(i) and (c)(ii), which in themselves do not refer to the certificate.) If it is to be the applicant's accountant, the applicant may not be aware of the financial position of the controller. If it is to be the controller's accountant, the controller would be giving information about itself in relation to someone else's application. While in some instances the applicant and its controllers may be related and thus financial information could be shared between them, we have experience with large fund managers who have questioned about which person the accountant's certificate should be given;

(ii) as 'control' is a legal question, it is not appropriate for an accountant to 'certify' control over any entity. The question of 'control' requires, among other things, an analysis as to whether the control test in s.50AA applies (see paragraph (e) below), and, if it does, a legal judgment about the application of that test to the corporate structure of an investing entity. As such, it is tantamount to an accountant giving a legal opinion; and

(e) different 'control' tests may apply the sophisticated investor test in s.708(8)(d) and the wholesale client test in s.761G(7)(ca), on the one hand, and the professional investor test in paragraph (e) of the professional investor test in s.761G(7)(d) as amended by

Corporations Regulation 7.6.01AE, on the other hand. This is because the Explanatory Statement to the Corporations Amendment Regulations 2005 (No. 5) (which introduced Corporations Regulation 7.6.01AE) says the 'control' test is not the test in s.50AA because section 50AA relates to control of an entity, but rather 'the ordinary meaning' of control applies for the purposes of that paragraph.

In relation to paragraph 12(b) above, if the Australian Government considers law reform to be necessary or desirable, we consider that the following principles be kept in mind:

(a) any amendment to the disclosure exemptions should have regard to consequences for the operation of the legislative infrastructure as it relates to trusts other than PAFs. For example, any change to the *Corporations Act 2001* dealing with the control of trusts should have regard to its application for all other trusts. Therefore, the Government should consider creating a new category of exempt investor relating to the trustee of a PAF, rather than amending definitions that apply to other categories (unless that is also the intention);

(b) the control test in section 50AA applies in respect of the entire *Corporations Act 2001*, including in relation to laws dealing with takeovers (Chapter 6). Further, the 'fiduciary carve-out' in subsection 50AA(4) also applies to a wide range of contexts under the *Corporations Act*. Again, any legislative change may be best dealt with by inserting a specific exemption for the trustee of a PAF rather than making changes to sections and definitions that are widely used (and widely understood) in different contexts; and

(c) the drafting of any exemption should take into account that a PAF is required under legislation to be structured as a trust that has a corporate trustee. As such, the legal investor would be a company (albeit one that operates in a fiduciary capacity). Some of the problems in the *Corporations Act 2001* tests for sophisticated investors/professional investors and wholesale clients stem from the imprecise use of terminology, such as referring to a 'trust' where a trust is not a legal entity under law, as set out above.

In relation to the options presented in the Discussion Paper, we make the following suggestions:

(a) any new exemptions in respect of PAFs should cover both the offer of securities (Chapter 6D) and other financial products (Chapter 7). As such, section 708(8) is not the only relevant section;

(b) drafting a specific exemption to certain kinds of PAFs (ie those funds controlled by a sophisticated investor/professional investor or a wholesale client for Chapter 6D and Chapter 7 purposes respectively) is the best approach to legislative drafting. An entirely new standalone exemption could be drafted, rather than seeking to make amendments to the rules generally. In this regard, there is merit in drafting an exemption to the effect that a trustee of a PAF is not required to be given a disclosure document (or, more broadly, is deemed to be a sophisticated investor/professional investor or a wholesale client – something that is also relevant to licensing and scheme registration issues under Chapter 7), if it could be demonstrated in an administrative manner by the applicant trustee that a certain donor or director(s) or other controllers are a sophisticated investor/professional investor or a wholesale client);

(c) making amendments to, or deeming certain control outcomes in relation to, s.708(8) do not achieve the stated purpose of exempting a PAF controlled by a professional investor (as opposed to a sophisticated investor);

(d) the drafter should be mindful of the interpretative difficulties above, relating to such matters as the control of a trust, that the trustee is not a legal person, and about whom the accountant is to make a certification;

(e) the first test about the director being the both the largest donor and satisfies the sophisticated investor test is preferable to the other test about the majority of directors, as the latter test would discourage board diversity (ie having a board with a majority of directors who are not high net worth individuals but nonetheless are capable and appropriate directors could be in the public interest); and

(f) there is merit in continuing to have an independent qualified accountant certify the income and assets of an entity and its controller, rather than the applicant company making such certifications. However, the problem of an accountant giving a legal opinion should be kept in mind. One option is to have a legal practitioner give a certificate (or advice) about the control of an investing entity, while an accountant could continue to certify assets and income amounts.

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

We consider that the current requirement of a 'qualified accountant' continues to be an appropriate third party who could make certifications about the income and assets of a person (but not necessarily the 'control' of a person).

We consider that the definition as set out in s.88 of the *Corporations Act 2001* and in ASIC Corporations (Qualified Accountant) Instrument 2016/786 remains appropriate.

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 visa-versa?

It is not common for a natural person to meet the professional investor test because:

(a) the definition of 'professional investor', as set out in s.9 of the *Corporations Act 2001*, lists a broad category of persons, most of whom typically will be bodies corporate; and

(b) the sophisticated investor tests are generally designed to be more relevant for natural persons, as they are intended to capture those natural persons that are high net worth individuals; and

(c) even where reliance is placed on having or controlling asset of $10 million, typically control of such sums of money are held through bodies corporate and not natural persons.

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

A category of exempt investor based on a trust 'controlled' by a professional investor would broaden the disclosure exemptions, and therefore may improve the likelihood of a PAF (though its trustee) investing in investment products where the issue of a regulated document imposes a practical barrier to the offer of such products.

However, as indicated in our response to question 12 above, we consider that a better approach would be to draft exemptions applicable to PAFs rather than drafting a new exemption based on the professional investor test, as a new exemption could have unintended consequences for the offer of investment products to persons other than trustees of a PAF.

21. 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?

Amending the definitions of (or exemptions relating to) 'sophisticated investor'/'professional investor' (Chapter 6D) or 'wholesale client' (Chapter 7) may, depending on the nature of the amendments, have consequences for other parts of the *Corporations Act 2001* (apart from disclosure), including the following:

(a) whether a managed investment scheme requires registration with ASIC (see the exemption for wholesale funds in s.601ED(2));

(b) the kind of authorisations required for a financial services provider (Part 7.6);

(c) whether the 'hawking' restrictions apply (see ss. 736(2), 992A(3A) and 992AA(2));

(d) whether the regulation of debentures under Chapter 2L applies (see s.283AA); and

(e) the consumer protection provisions in the *Australian Securities and Investment Commission Act 2001* (Cth).

We have not considered the impact of any of the above provisions have in relation to a PAF or offering an investment or any other financial service to the trustee of a PAF. We only raise these provisions because the retail investor/wholesale investor distinction is important to much of the infrastructure of corporations laws, particularly in relation to 'consumer protection safeguards' (for example, requiring regulated disclosures or the holding of licences).

As indicated in our comments in relation to question 12, amending the definition of 'control' in s.50AA is relevant to general corporate law provisions, including the provisions relating to the meaning of key terms such as 'associate' (s.12) and 'subsidiary' (s.46 ff) as well as regimes dealing with takeovers (Chapter 6) and related party transactions (Chapter 2E).

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?

A barrier to investment may arise where the issuer of an impact investment product would not be able to issue that product to a trustee of a PAF for regulatory purposes, such as, for example, requiring the issuer to prepare a regulated disclosure document (such as a prospectus or Product Disclosure Statement) or to hold an Australian financial services licence with a retail authorisation.

These regulatory hurdles for the issuer may be removed where the trustee of the PAF is taken to be a wholesale investor.

The policy threshold for the Australian Government is to determine whether some or all trustees of the PAF should not be required to be treated as wholesale investors, even where the size of the fund is small (say $2m or less). That is, whether the 'control' of the fund by a high net worth individual is sufficient to remove consumer protection provisions that may otherwise apply.

In addition, the investment limitations in the *Private Ancillary Fund Guidelines 2009* may present a barrier to some investments. The Government should consider whether there is evidence that such restrictions will make some investments unlawful or impracticable.

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

Superannuation fund trustees are confronted by a complex web of legal and regulatory hurdles when turning to consider the possibility of incorporating social impact investments into their portfolios. It is unsurprising then that Australian superannuation fund trustees have tended to err on the side of caution when presented with the opportunity to divert from their traditional blue-chip equities portfolios.

With interest by superannuation funds steadily growing in the benefits of social impact investing, we believe that further guidance as to the issues discussed below should be provided (preferably by the Australian Prudential Regulation Authority (**APRA**)) to overcome barriers to incorporating social impact investments into superannuation fund trustees investment strategies.

Legal barriers to social impact investing

Section 52(2)(b) of the SIS Act (standard of care)

Section 52(2)(b) of the SIS Act requires a trustee to exercise the:

> *'same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments.'*

Section 52(6)(a) of the SIS Act requires a trustee to 'formulate and give effect to an investment strategy with regard to the whole of the circumstances of the entity' including a number of considerations set out in that section including: investment risk; liquidity; cost; the fund's cash flow requirements; tax consequences and the availability reliable valuation information for the investment.

Sections 52(2)(b) and 52(6)(a) do not include reference to how social impact investments should be considered in light of the requisite standard of care considerations imposed upon trustees.

We believe that further guidance as to whether trustees may incorporate *social impact considerations* into their investment decisions is necessary to build confidence in trustees that such factors could be incorporated within their investment strategy.

Section 52(2)(c) of the SIS Act (best interests requirement)

Assuming the trustee has the power to make the investment, section 52(2)(c) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) requires a trustee to discharge their duties and exercise their powers in the *best interests of the fund's beneficiaries*.

The general law in Australia interprets this to mean in the best *financial interests* of the beneficiaries (i.e. superannuation fund members). This requires trustees to maximise the financial return on members' compulsory contributions to assist them in securing a comfortable retirement.[7]

Similarly, section 29VN(a) of the SIS Act makes specific reference to the *financial interests* of the fund's beneficiaries and places additional obligations on trustees in relation to a MySuper product. A trustee of a regulated superannuation fund that includes a MySuper product must 'promote the financial interests of the beneficiaries of the fund who hold the MySuper product, in particular returns to those beneficiaries.' Given that the majority of Australians of working age are beneficiaries of a MySuper product, this requirement is of particular importance in assessing the barriers to social impact investment for trustees.

Despite these provisions, the courts have conceded that it would not be realistic to conceive of a situation where the trustee owes its members an unqualified duty to only consider financial interests when acting for the best interests of beneficiaries. Further, in the case of certain trusts (typically religious based trusts), the courts have accepted that the trustee exclude certain types of investments if it would be contrary to the values commonly held by the beneficiaries of that trust.[8]

Therefore, while there are cogent arguments that social impact investing may not be barred from a trustee's approved list of investments (where the investment is financially viable with an underlying purpose of providing retirement benefits to beneficiaries), we believe that to increase the prevalence of social impact investing in Australia in the context of superannuation fund investment strategies, APRA should further clarify the scope of the trustees to invest in social impact investments consistently with the best interests requirement. In doing so, we believe the guidance should have particular regard to the interpretation of financial interest and how such an interest might involve a social impact investment strategy.

Section 62 of the SIS Act (sole purpose test)

Section 62 of the SIS Act requires that the trustee of a regulated superannuation fund must ensure that the fund is maintained solely for one or more of a range of identified core purposes or for one or more core purposes, and one or more ancillary purposes. Various purposes are listed within section 62 (i.e. the provision of benefits for retirement).

In APRA's *Superannuation Circular No. III.A.4* it was noted that:

> *'care should be exercised by trustees and investment managers when considering investments to ensure that the provision of retirement benefits for members is the overriding consideration behind the investment decision.'*

Social impact is absent from the list of core and ancillary purposes in section 62, and there is no indication that a social impact investment strategy could be read into any of the purposes. However, there is a reasonable argument that given the premise of social impact investing to provide both social and financial returns if the investment is part of a properly considered and formulated investment strategy, the risk of offending section 62 is slight.

We believe that further clarification regarding the interpretation of the sole purpose test, with direct reference to the incorporation of social impact investments in investment strategies, is necessary to provide confidence and willingness to invest in social impact investments. We suggest that the

[7] *Cowan v Scargill* [1985] Ch 270.
[8] *Bishop of Oxford v Church Commissioners* [1991] PLR 185.

guidance clarify whether trustees can incorporate a social purpose as a corollary of a financial purpose in the context of the sole purpose test set out in section 62.

Doctrine of powers

Similar to the sole purpose test and best interest requirement discussed above, the doctrine of powers suggests that a trustee must only exercise their powers for a proper purpose.

It has been interpreted in general law that proper purpose refers to the purpose which the trustee was granted that power, including the provision of post-retirement benefits to beneficiaries.

The scope of the doctrine of powers, however, remains uncertain with the proliferation of varying interpretations. For example, it has been suggested:

(a) that if the improper purpose is so material that it played a significant part in influencing the trustee's investment decision, then it may be regarded as tainting the proper exercise of the trustee's power;

(b) that if the dominant purpose underscoring the trustee's power was to secure collateral benefits for those who are not beneficiaries, then that power will have been exercised for an improper purpose; or

(c) that if the investment power would not have been exercised 'but for' the existence of that improper purpose, such as the provision of collateral benefits to non-members of the fund, then the exercise would be for an improper purpose.

We suggest that guidance is needed on the ability for funds to incorporate social impact investing in investment strategies consistently with the requirement that trustees act for the proper purpose of their beneficiaries. We believe that the interpretation of proper purpose needs clarification, particularly as to whether a trustee would be in breach of the doctrine of powers if a social impact objective arose in conjunction with the investment's financial purpose.

Further guidance

Accordingly:

(a) on the face of it, superannuation trustees are required to maximise financial benefits or returns and are generally precluded from investing for other ‘non-financial’ purposes, such as bringing about social change;

(b) those financial products, such as SBB’s or SIB’s which have a strong financial return may therefore come within financial risk-return guidelines and could on that basis alone form part of a well-constructed and diversified portfolio (provided there is no undue risk or skewing, there is a reasoned basis and appropriate analysis for the investment strategy);

(c) a grey area emerges for those investments or enterprises more focussed on social impact over financial return – where the benefit is shared or not fully captured by member returns;

(d) *APRA Prudential Practice Guide – SPG 530* (paragraphs 34-36) already provides some guidance in relation to the ability of a registrable superannuation entity licensee to take additional 'non-financial’ factors into the investment strategy process, including an added focus on environmental, social and corporate governance considerations (albeit there is a strong argument which has gained recent market – and legal – acceptance that such factors go to long term value and are consequentially financial in nature);

(e) on a literal construction, trustees are required to invest in the financial best interests of members and will be precluded from social impact investing where the primary benefits are not returned to members, are not captured entirely by members or are not purely financial in nature. A more liberal construction might seek to take a longer term view and a broader view of benefit, but there are risks in this approach;

(f) one path forward is for further APRA guidance to be provided that such investments are permitted where the members have, in essence, given approval to do so – whether through the fund rules, PDS or notification processes. The fund could provide power to make such investments (still as part of a balanced and diversified portfolio) in the knowledge that members had authorised such investments thus reducing the risk of liability to trustees for alleged breach of duty.

24. To what extent are the current arrangements for program related investments appropriate? Should changes be made to:

24.1. 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

24.2. allow ancillary funds to make program related investments to non-DGR organisations?

A significant number of Australian-registered charities and social enterprises are not endorsed as deductible gift recipients, which restricts the ways in which PuAFs and PAFs can support social causes. By permitting PAFs and PuAFs to invest in non-DGRs, it would allow them to support a wider range of causes than currently permitted under the tax laws and 'open up' the category of potential beneficiaries.

We appreciate that there may be concerns with extending the category of PAF/PuAF beneficiaries to non-DGRs. A solution would be to 'ring fence' the categories of non-DGRs to those that have been registered as charities by the Australian Charities and Not-for-profits Commission, so that any PRIs made to non-DGRs are made in furtherance of the PAF/PuAF's charitable objects. This would be consistent with the Government's historical support of philanthropy by offering tax concessions/benefits to donors.

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

Our DGR and non-DGR charitable clients strongly support initiatives designed to deliver alternative income streams beyond the more 'traditional' revenue sources of private donations and government grants/funding. This could include program related investments (PRI) from public and private foundations. DGRs and non-DGRs are also encouraged by the potential for program-related investments to lead to further funding by giving donors the ability to 'recycle' returns into further social enterprises, and the ability to attract other donors/investors to their cause.

Although DGRs and charitable entities have identified the added administration that would be involved with any program-related investment initiative, they do not necessarily regard this as a negative and see the potential alternative income sources as outweighing any additional compliance burden.

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

In our experience, program-related investments generally involve higher administration costs than for irrevocable donations. Public and private foundations typically undertake a greater degree of due diligence when making these investments to ensure their funds are being used appropriately and to ensure their support does not jeopardise their tax status. As such, PRIs are more resource-intensive for the recipient.

However, this can have positive outcomes for many DGRs and charities by encouraging them to develop robust internal systems and, in many cases, the added administrative obligations are no more than those imposed on them from receiving government grants and funding.

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?

Several countries have introduced legal structures designed to encourage and facilitate social enterprises and impact investments, and to address the problems faced by them in adopting the more 'traditional' legal forms. Examples include the Community Interest Company in the United Kingdom and the Community Contribution Company (C3) in Canada. There are also low-profit limited liability companies (L3C) and Benefit Corporations in the US. A new legal entity designed for social enterprises could provide valuable recognition of the clear social and/or environmental missions that combine with their commercial activities, and add to their credibility in the community's eyes. Another option would be to adapt the available existing legal structures to fit within a social enterprise framework, although there may be difficulties with this approach given the characteristics of such enterprises.

The current legal form options in Australia for social enterprises are restrictive in that they preclude access to funding through donations or government grants (company limited by shares) or equity finance (not-for-profit structures). We encourage the Government to consult with relevant stakeholders and consider new legal forms for social enterprises that provide an alternative or additional way for promoting program related investments, which could be adopted without significant complexity or cost.

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

In line with the comment in response to question 27, the threshold issue is whether a hybrid form of social enterprise (or profit with purpose) entity should be considered (equivalent to entities such as CIC in the UK, PPBs / CICs or C3s in Canada or B Corps in US or equivalents in other jurisdictions), which:

(a) maximises fund raising capacity, whether through grants and donations or equity capital;

(b) is tax efficient (benefiting from tax free status or social impact incentives or exemptions), thus maximising funds available for front line services;

(c) permanently commits resources to the social mission or objective (asset locks); and

(d) is able to raise impact capital with limited ability to distribute (dividend or distribution limits or locks) to reward such investors without detracting from overall mission.

This is consistent with the recommendations of the Legal Models Working Group, which recommended either creation of new forms or adapting existing legal forms.

There may also be some benefit in producing model constitutions for 'for profit' social enterprise vehicles with embedded social mission objectives and guidance in relation to the issues with and effectiveness of such constitutional provisions. It is apparent that some capacity building needs to occur to educate the sector in relation to the range of choice of legal forms and structures and their respective trade-offs, costs and benefits.

Consideration should also be given to reducing ASIC and other up-front fees associated with establishing such vehicles.

To the extent that a social enterprise is seeking to raise donations, the current State and Territory fundraising licensing regulations should be overhauled, standardised and, if possible, brought under the control of a single body, such as the Australian Charities and Not-for-profits Commission. There are significant time and compliance costs in dealing with the raft of State and Territory measures which currently exist – these are inconsistent with encouraging social investment and cut across the establishment of innovative 'jurisdiction-less' platforms.