

# FIDUCIARY DUTY IN THE 21<sup>ST</sup> CENTURY

## AUSTRALIA ROADMAP

## ACKNOWLEDGEMENTS

The project team would like to thank all of the interviewees and reviewers for their time and contribution to this document, as well as the many organisations in Australia whose work and ideas have helped us get to this point.

In particular, the roadmap has been developed in collaboration with the Australian Council of Superannuation Investors (ACSI).

The PRI will continue to work closely with ACSI in advancing responsible investment practice in Australia.

This roadmap is prepared by the PRI, UNEP FI and The Generation Foundation and does not necessarily represent the views of interviewees and reviewers.

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The roadmap was presented to:

- The FSC ESG working group on 24 August 2016, convened by Jenna Mollross, Policy Manager, FSC.
- The PRI Australia Advisory Committee on 29 September 2016, chaired by Andrew Gray, AustralianSuper.

# INTRODUCTION

[Fiduciary duty in the 21st century](#) concluded that failing to consider long-term investment value drivers, which include environmental, social and governance (ESG) issues, in investment practice is a failure of fiduciary duty. Despite significant progress, many investors have yet to fully integrate ESG issues into their investment decision-making processes.

In January 2016, the PRI, UNEP FI and The Generation Foundation launched a three-year project to implement the report's recommendations, including the preparation of country roadmaps.

These roadmaps enable the PRI and UNEP FI to work with investors, stakeholders and policymakers to support national stakeholders in implementing clear and accountable policy and practice that embraces the modern interpretation of fiduciary duty; an interpretation which requires investors to consider long-term value drivers, of which ESG factors are a core component.

The Australia roadmap makes recommendations in four categories: regulatory action, stewardship and intermediation, corporate reporting and investor education.

1. **Regulatory action:** The Australian Prudential Regulation Authority (APRA) should update paragraphs 34 and 36 of Prudential Practice Guide SPG 530 Investment Governance (and equivalent prudential standards/guidance applicable to its regulated banks and insurers) to clarify to superannuation funds that ESG issues are material to risk and return analysis. They therefore should be incorporated alongside other risk and return factors in investment decision making.
2. **Stewardship and intermediation:**
  - a. The Financial Services Council (FSC) should continue to work with Australian asset managers to strengthen stewardship expectations, including engaging companies on ESG issues.
  - b. Stewardship expectations could be formalised through the development of a stewardship code. This should be industry-led.
  - c. Australian asset owners should incorporate stewardship expectations in the selection, appointment and monitoring of asset managers.

3. **Corporate reporting:** The Australian Securities Exchange (ASX) should continue to enhance corporate reporting and disclosure requirements and guidance. The Australian Securities and Investments Commission (ASIC) should monitor the quality of corporate reporting and disclosure.
4. **Investor education:** Trustee boards should ensure capacity and competence on ESG issues. This should be industry-led.

This work also sets the Australian capital market in a broader international context, as regulators and investors respond to a rapidly-changing investing environment. Following assessment of seven further markets (Brazil, Canada, Germany, Japan, South Africa, UK and US), the PRI, UNEP FI and The Generation Foundation will prioritise the areas to which we will contribute.

ESG integration is defined as the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions.

## PROJECT STEERING COMMITTEE:

- Peter Knight, President, Generation Investment Management
- Fiona Reynolds, Managing Director, PRI
- Nick Robins, Co-Director, UNEP Inquiry into a Sustainable Financial System
- Eric Usher, Head, UNEP Finance Initiative

# STAKEHOLDER FEEDBACK

This roadmap draws on over 20 interviews with stakeholders at different points in the Australian capital market (see list above). There were common themes in the feedback provided by stakeholders that have formed the basis for the analysis and recommendations that follow.

Australia is widely considered to benefit from a stronger network of superannuation funds than other equivalent markets<sup>1</sup>. Larger scheme size can reduce management and advisory costs by giving asset owners a better negotiating position with service providers. Scale can also embed trustee expertise and enable engagement with investee companies through in-house fund resourcing and size of holding.

While not the case for all Australia's asset owners, many of the stakeholders at Australia's larger funds considered asset owners to be product makers, whereas stakeholders in other countries have considered asset owners to be product takers. Interviewees believe this allows Australian superannuation funds to embed investment risks consistent with the liability profile of the fund, such as climate change, in investment decision making.

There is also increased civil society campaigning targeting the financial sector. Market Forces, 350.org, Oxfam Australia, GetUp, No Business in Abuse and similar stakeholder organisations can take some credit for raising awareness of climate change among the electorate and superannuation beneficiaries.

The Australian superannuation sector is characterised by three main segments:

- not-for-profit funds including industry, corporate and public sector funds;
- retail superannuation;
- self-managed superannuation (one to four members).

This roadmap focuses on superannuation funds given their size and projected. However, the recommendations to asset owners are also relevant to funds such as Victorian Funds Management Corporation,

Funds SA and TCorp, which provide fund management services to public authorities, as well as Future Fund, which is Australia's sovereign wealth fund..

As noted in [Fiduciary duty in the 21st century](#), portability is a core principle of the Australian superannuation system, with members generally having the right to move assets between funds. However, the majority of Australian superannuation funds remain in the 'default' option and therefore onus remains on the fiduciary to take all material factors into account.

Some stakeholders explained that, while still the exception, some beneficiaries, particularly millennials, increasingly want to engage with their retirement providers on environmental and social issues<sup>2</sup>. This has added to the rising demand for ESG information and methods.

Finally, stakeholders took interest in the growth of responsible investment regulation across the globe. Japan, Hong Kong, Singapore and Malaysia have recently adopted voluntary stewardship codes, which include commitments to sustainability. A 2015 amendment to South Korea's National Pension Service Act requires the National Pension Service to take account of ESG issues, including when exercising voting rights. As part of China's presidency of the G20 in 2016, a green finance study group was established to "develop options on how to enhance the ability of the financial system to mobilise private capital for green investment"<sup>3</sup>. The UK's pensions' regulator recently clarified that trustees of UK pension funds should consider ESG factors where they are financially significant. Some stakeholders considered recent global interest in responsible investment as an opportunity for Australia's financial sector regulators to clarify their expectations with regard to ESG factors.

As of December 2016, there are 118 Australian signatories to the PRI: 34 asset owners, 72 investment managers and 12 service providers. Combined assets under management are over AUD\$2 trillion.

1 <http://thenewdaily.com.au/money/superannuation/2016/08/14/which-country-has-best-superannuation/>

2 How millennials could upend Wall Street, <https://www.brookings.edu/research/how-millennials-could-upend-wall-street-and-corporate-america/>

3 <http://unepinquiry.org/g20greenfinancerepositoryeng/>

# THE EVOLVING LANDSCAPE OF FIDUCIARY DUTY

Australia's pension market has one of the highest growth rates of pension fund assets in the world. Willis Towers Watson values Australia's pension assets at US\$1.48 trillion as of end of 2015, split 87% defined contribution (DC) to 13% defined benefit (DB)<sup>4</sup>. Despite this growth, the legal framework for investment decision making in Australia has not changed substantially in recent years.

ASX recently issued requirements for ASX-listed companies to disclose on an "if not why not" basis their material exposures to economic, environmental and social sustainability risks and how they intend to manage those risks (referred to below). In March 2013, ASIC published regulatory guide 247, Effective disclosure in an operating and financial review<sup>5</sup>. It states:

**An [operating and financial review] should include a discussion of environmental and other sustainability risks where those risks could affect the entity's achievement of its financial performance or outcomes disclosed, taking into account the nature and business of the entity and its business strategy.**

In February 2016, the Senate opened an inquiry into carbon risk disclosure<sup>6</sup>. The Turnbull-led government ratified the Paris Climate Treaty in November 2016, with Environment and Energy Minister Josh Frydenberg responsible for taking forward the government's implementation of the Paris Agreement in Parliament<sup>7</sup>.

Recent legal opinion, prepared by Barrister Noel Hutley SC and the Centre for Policy Development, found that company boards must consider climate-related business risks in their decision making as part of their duties under the Corporations Act 2001 (Cth), which regulates companies<sup>8</sup>.

Internationally, pension regulators have made considerable progress in clarifying investors' fiduciary duties. In October 2015, the US Department of Labor clarified that ESG factors should be part of an investor's primary analysis. The Ontario Pension Benefits Act, introduced in January 2016, requires pension funds in Ontario to disclose in their investment policies "information about whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated."

Passed in November 2016, Europe's Occupational Retirement Provision Directive will require European occupational pension funds to disclose how they consider ESG issues in their investment approach through a statement of investment policy principles and establish risk management processes for emerging ESG issues<sup>9</sup>.

The PRI identifies almost 300 policies or initiatives covering the relationship between finance and ESG issues, of which over half date from the past three years<sup>10</sup>.

4 Global Pension Assets Study 2016, <https://www.willistowerswatson.com/en/insights/2016/02/global-pensions-asset-study-2016>

5 <http://download.asic.gov.au/media/1247147/rg247.pdf>

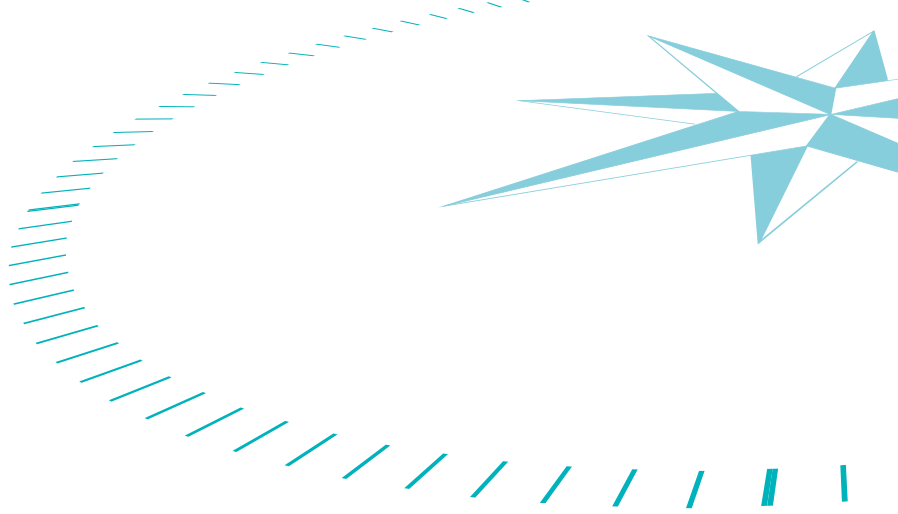
6 [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate/Economics/Carbonriskdisclosure45/Terms\\_of\\_Reference](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Carbonriskdisclosure45/Terms_of_Reference)

7 [http://www.climate-energy-college.net/files/site1/docs/6561/Working%20Paper\\_1\\_14June2016.pdf](http://www.climate-energy-college.net/files/site1/docs/6561/Working%20Paper_1_14June2016.pdf)

8 <http://www.futurebusinesscouncil.com/wp-content/uploads/2016/10/Fiduciary-Duties-and-Climate-Change-Legal-Opinion-7.10.16.pdf>, Business leaders heed warning on climate change risks, <http://www.theaustralian.com.au/business/companies/business-leaders-heed-warning-on-climate-change-risks/news-story/8386a77f2a5066b4e785ff9da601edb6>, Company directors to face penalties for ignoring climate change, <http://www.theage.com.au/business/company-directors-to-face-penalties-for-ignoring-climate-change-20161030-gsdwha.html>

9 <http://data.consilium.europa.eu/doc/document/ST-10557-2016-ADD-1/en/pdf>

10 <https://www.unpri.org/about/pri-teams/policy/responsible-investment-regulation>



Australia benefits from strong responsible investor industry organisations, notably: ACSI, the Responsible Investment Association Australasia (RIAA) and the Investor Group on Climate Change (IGCC). ACSI is a collaboration of (mostly) Australian asset owners focusing on ESG investment risks and opportunities. RIAA is an industry body for responsible and ethical investors across Australia and New Zealand, with over 165 members with assets under management of over AUD\$1 trillion. IGCC is a collaboration of investors from Australia and New Zealand focussing on the impact that climate change has on the financial value of investments.

The FSC facilitates an ESG working group<sup>11</sup>. The Association of Superannuation Funds of Australia (ASFA) is an industry body focussing on policy, research and advocacy on behalf of their members. The Australian Institute of Superannuation Trustees (AIST) provides professional training and support for trustees and funds staff, policy research and advocacy.

We acknowledge the many successes of Australia's well-established responsible investment industry. Where action is already underway, we do not seek to duplicate efforts.

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<sup>11</sup> Includes the following members: AMP Capital Investors Limited, Aberdeen Asset Management Limited, Perpetual Limited, BlackRock Asset Management Australia Limited, K&L Gates, BT Financial Group, KPMG, MLC/NAB, Allen & Overy, Colonial First State Global Asset Management, PricewaterhouseCoopers, Henry Davis York, Goldman Sachs Asset Management Australia Pty Ltd, ANZ Wealth, King & Wood Mallesons, Australian Ethical Investment Ltd



# RECOMMENDATIONS

- 1. Regulatory action: The Australian Prudential Regulation Authority (APRA) should update paragraphs 34 and 36 of Prudential Practice Guide SPG 530 Investment Governance (and equivalent prudential standards/guidance applicable to its regulated banks and insurers) to clarify to superannuation funds that ESG issues are material to risk and return analysis. They therefore should be incorporated alongside other risk and return factors in investment decision making.**

APRA is the prudential regulator of the Australian financial services industry and oversees the superannuation industry, as well as banks, insurers and reinsurers (together holding nearly AUD\$5 trillion in funds on behalf of depositors, policyholders and beneficiaries). APRA's mission is to: "establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system."

APRA is responsible for regulating the APRA-regulated sector of the superannuation industry under the Superannuation Industry (Supervision) Act 1993 (SIS Act). They have established a set of enforceable prudential standards applying to Registrable Superannuation Entities (RSE).

They have also issued a suite of prudential practice guides (PPGs) to support administration of the prudential standards, which outline APRA's expectations regarding sound practice and provide added clarity and expectations regarding compliance with the prudential standards. PPGs do not create enforceable obligations but do send strong market signals.

APRA adopts a principles-based approach in its prudential framework, recognising the complexity and diversity that exists among regulated entities and seeks to avoid a 'one-size-fits-all' approach. Adopting a principles-based approach allows supervised entities to use a variety of compliance approaches, rather than APRA seeking to direct the business operations of a regulated entity through detailed prescription.

Paragraph 23 of SPS 530 requires that an RSE licensee have:

**... sufficient understanding and knowledge of the investment selected, including an assessment of any factors that could have a material impact on achieving the investment objectives of the investment option.**

Management of ESG factors supports enhanced operational performance and financial prospects in investee companies<sup>12</sup>. Therefore, neglecting analysis of ESG factors in investment decision making may cause the mispricing of risk and poor asset allocation. We therefore interpret paragraph 23 of SPS 530 to require the consideration of ESG factors in investment decision making. However, terminology elsewhere in SPS 530 is not consistent with paragraph 23, with ESG factors referred to as 'ethical', 'not readily quantifiable in financial terms' and 'non-financial'.

Specifically, paragraphs 34-36 of SPG 530 address ESG issues. They were introduced in 2013 to support the government's response to the recommendation of the super system review (commonly known as 'the Cooper review') that ESG issues are relevant matters for RSE licensees to consider<sup>13</sup>.

34. The SIS Act requires an RSE licensee, when formulating an investment strategy, to give regard to the risk and the likely return from the investments, diversification, liquidity, valuation and other relevant factors. An RSE licensee may take additional factors into account where there is no conflict with the requirements in the SIS Act, including the requirement to act in the best interests of the beneficiaries. This may result in an RSE

<sup>12</sup> ESG and financial performance: aggregated evidence from more than 2000 empirical studies [https://www.db.com/newsroom\\_news/ESG\\_study\\_Jan16.pdf](https://www.db.com/newsroom_news/ESG_study_Jan16.pdf)

<sup>13</sup> Stronger Super, <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm>

licensee offering an ‘ethical’ investment option to beneficiaries to reflect this approach. **An ‘ethical’ investment option is typically characterised by an added focus on environmental, sustainability, social and governance (ESG) considerations, or integrates such considerations** into the formulation of the investment strategy and supporting analysis.

35. APRA expects that an RSE licensee would have a reasoned basis for determining that the investment strategy formulated for such an investment option is in the best interests of beneficiaries, and that it satisfies the requirements of s. 52 of the SIS Act for liquidity 3 Refer to s. 52(6)(vi) and (vii) of the SIS Act. and diversification.<sup>4</sup> While ESG considerations may not be readily quantifiable in financial terms, APRA expects an RSE licensee would be able to demonstrate appropriate analysis to support the formulation of an investment strategy that has an ESG focus.

36. In offering such investment options, a prudent RSE licensee would be mindful **of exposing the interests of beneficiaries to undue risk** stemming from matters such as a lack of diversification, where investment in some industries are excluded or a positive weighting is placed on certain nonfinancial factors **as a result of ESG considerations**<sup>14</sup>.

Contrary to paragraph 34, ESG integration does not involve relegating the pursuit of a financial return to unrelated objectives (social or ethical). It is important to clarify the difference between financially-motivated ESG integration and other potentially relevant factors including ethical and reputational considerations. The PRI defines ESG integration as “the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions”. ESG integration is a distinct and different concept to ‘ethical investment’<sup>15</sup>, which refers to negative or exclusionary screening of companies engaged in activities deemed unethical by the investor, based on religion, international agreements, such as the Universal Declaration of Human Rights, or ethical preference, such as excluding alcohol<sup>16</sup>.

Our recommendations seek to clarify that ESG integration is less a product or concept than it is part of the process and technology of investment analysis. Ultimately, the consideration of ESG factors has become one of the core characteristics of a prudent investment process.

ESG integration provides investors with an expanded set of tools for evaluating the operational performance and financial prospects of investee companies. The recent PRI report, [A practical guide to ESG integration for equity investing](#) indicates that investors can treat ESG factors in the same way as any other financial factor using existing quantitative methodologies.

Investors also face a number of systemic risks, such as the stability of systemically important financial institutions and the impacts of climate change. Climate change may significantly alter the investment rationale for particular sectors, industries and geographies and may have generalised negative impacts on economic output. Many of Australia’s superannuation funds are universal owners and, in effect, “own the market”, making diversification from generalised risks impossible. Given this, systemic risks, particularly those arising from ESG issues, should be proactively identified and assessed as part of prudent investment decision making.

The PRI’s report, [Global guide to responsible investment regulation](#), identifies that policy effectiveness is hampered by mixed signals through the investment chain, and therefore, it is also necessary to align product-level disclosures as set out in ASIC’s regulatory guide 168, Disclosure: Product disclosure statements (and other disclosure obligations)<sup>17</sup>.

### Next steps:

- APRA should clarify and update paragraph 34 of SPG 530 to clarify the difference between ESG integration and ethical investment options as articulated above.
- APRA should clarify and update paragraph 36 of SPG 530 to clarify that investors should consider all financial factors, which include ESG factors. Redrafting paragraph 34 could make paragraph 36 unnecessary, in which it could be deleted. In clarifying paragraphs 34 and 36, APRA should continue to recognise the legitimacy of ethical and reputational considerations provided that prudential and fiduciary standards are met, for example, managing risk and acting in the best interests of members.
- Institutional investors should ensure they have adequate policies, skills, advice and systems for identifying, integrating and providing transparency on their management of long-term systemic risks, such as climate change.

<sup>14</sup> Emphasis added.

<sup>15</sup> ILG and the value of responsible investment, <http://www.cisl.cam.ac.uk/publications/publication-pdfs/ilg-the-value-of-responsible-investment.pdf>

<sup>16</sup> The UK Law Commission sets out a two-test approach, concluding that the law “permits trustees to make investment decisions that are based on non-financial [or ethical] factors provided that: they have good reason to think that scheme members share the concern; and there is no risk of significant financial detriment to the fund.”

<sup>17</sup> <http://download.asic.gov.au/media/1240931/rg168-published-28-october-2011.pdf>



## 2. Stewardship and intermediation:

- a) **The FSC should continue to work with Australian asset managers to strengthen stewardship expectations, including engaging companies on ESG issues.**
- b) **Stewardship expectations could be formalised through the development of a stewardship code. This should be industry-led.**
- c) **Australian asset owners should incorporate stewardship expectations in the selection, appointment and monitoring of asset managers.**

The PRI's Principle 2 states: We will be active owners and incorporate ESG issues into our ownership policies and practices<sup>18</sup>. The PRI's reporting and assessment framework has more detailed definitions including on engagement and voting<sup>19</sup>.

In 2002, IFSA (Investment and Financial Services Association, now the Financial Services Council), introduced a non-binding corporate governance guide for fund managers and corporations, revised in 2009<sup>20</sup>, known as the 'blue book'.

For companies, it includes guideline 1:

**A company should also disclose its policies and performance regarding other issues, including its risk management framework and material environmental and social issues [...] as part of its annual disclosure.**

For asset managers, it includes guideline 5:

**Fund managers should engage companies on significant environmental and social issues that have the potential to impact on current or future company reputation and performance.**

The FSC has reviewed the 'blue book', but as of December 2016, the revision is not yet public. Since 2009, many peer markets have introduced stewardship codes with regulatory oversight. Examples include UK, Japan, Hong Kong and Malaysia. Singapore's stewardship code, proposed by Stewardship Asia, is supported by the Monetary Authority of Singapore (MAS)<sup>21</sup>. Signatories to the UK code include Australian institutional investors<sup>22</sup>.

There have also been international efforts to advance stewardship, notably by the International Corporate Governance Network (ICGN).

ICGN recently published its Global Stewardship Principles<sup>23</sup>, including:

**2. Investors should commit to developing and implementing stewardship policies which outlines the scope of their responsible investment practices.**

**6. Investors should promote the long-term performance and sustainable success of companies and should integrate material environmental, social and governance (ESG) factors in stewardship activities.**

Stewardship activity is a long-term instrument; its benefits accrue over several years. Stewardship practices should be a source of competitive differentiation, particularly among investment managers. Asset owners should appoint, select and monitor asset managers on their ability to align stewardship activities with the asset owner's investment beliefs, policies and guidelines. This creates a chain of custody which ensures investments are managed in line with these expectations. It is important that committing to good-practice stewardship is a meaningful activity and reporting against it enables an assessment of them.

Voting is also an important component of active ownership. In 2013, the FSC published Standard No.13 which requires disclosure of voting policies and voting activity. The standard is mandatory for FSC members who operate superannuation schemes.

Proxy voting is common practice in Australia. In its research paper, *Institutional Proxy Voting in Australia*, ACSI makes a series of recommendations including enabling online voting and split voting.

<sup>18</sup> <https://www.unpri.org/about/the-six-principles>

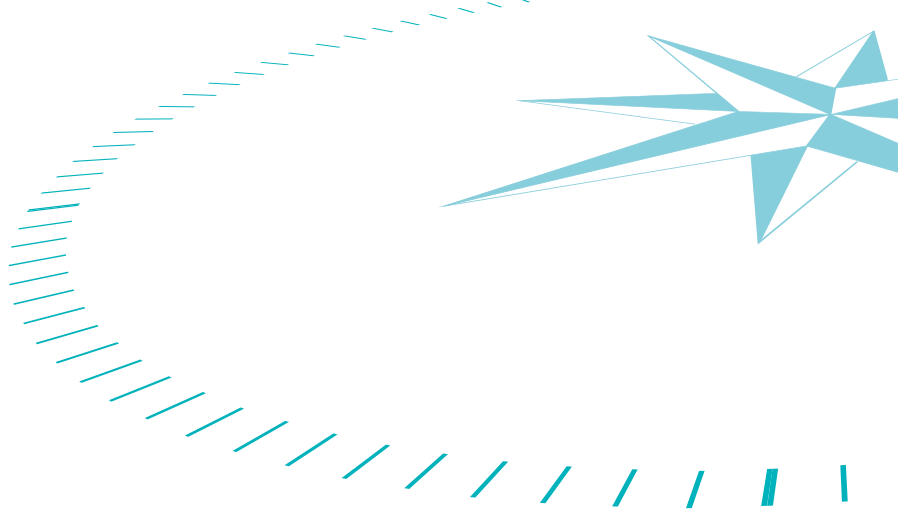
<sup>19</sup> <https://www.unpri.org/about/pri-teams/reporting-and-assessment>

<sup>20</sup> [http://www.fsc.org.au/downloads/file/IFSAGuidanceNotes/2GN\\_2\\_Corporate\\_Governance\\_2009.pdf](http://www.fsc.org.au/downloads/file/IFSAGuidanceNotes/2GN_2_Corporate_Governance_2009.pdf)

<sup>21</sup> See <http://aiccc.net/wp-content/uploads/2015/12/AIGCC-final.pdf>, page 11

<sup>22</sup> UK Stewardship Code statements, <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code/UK-Stewardship-Code-statements.aspx>

<sup>23</sup> ICGN Global Stewardship Principles, <https://www.icgn.org/sites/default/files/ICGNGlobalStewardshipPrinciples.pdf>



### Next steps:

Based on feedback from stakeholders, we see four actions to advance stewardship activities in Australia.

- The FSC should publish the revised 'blue book' to reflect international best practice. They should regularly report on good stewardship practice.
- The FSC should monitor oversight of Standard No. 13 and report regularly on good-practice, including the voting of international proxies.
- Asset owners should ensure their investment policy incorporates active ownership in their investment decision making and that of their agents<sup>24</sup>.
- Stewardship expectations could be developed into a formal stewardship code, with opportunity for institutional investors to sign up, in a similar way to the UK stewardship code. This should be industry-led.

### 3. Corporate reporting: The Australian Securities Exchange (ASX) should continue to enhance corporate reporting and disclosure requirements and guidance. The Australian Securities and Investments Commission (ASIC) should monitor the quality of corporate reporting and disclosure.

Recommendation 7.4 of the Australian Securities Exchange (ASX) Corporate Governance Council Principles and Recommendations (Third Edition), published in March 2014, requires each ASX-listed company to disclose, on an “if not, why not” basis, its material exposures to economic, environmental and social sustainability risks and how it intends to manage those risks<sup>25</sup>.

In 2016, the first reporting cycle since its revision, the number of “no reporting” companies in ACSI’s research has dropped from 26 to nine for the ASX200. For the first time, the ASX100 has zero “no reporting” companies<sup>26</sup>.

Since its publication, there have been a number of global initiatives to advance the quality of corporate disclosure. The FSB established its Task Force on Climate-related Financial Disclosures (TCFD) and in March 2016 issued its first report referencing seven principles for effective disclosure<sup>27</sup>. In the US, the Securities and Exchange Commission (SEC) published a Concept Release on Regulation S-K, which included reference to sustainability reporting<sup>28</sup>. In Europe, member states are responsible for implementing the non-financial reporting directive<sup>29</sup>. The French energy transition law<sup>30</sup>, which requires carbon disclosure by companies and institutional investors, has developed international recognition.

A definitive list of ESG issues does not exist. Any such list would inevitably be incomplete and would soon be out of date. However, ACSI and FSC *ESG reporting guide for Australian companies 2015*, sets out the key ESG risks and opportunities companies should consider<sup>31</sup>. This aligns with the PRI Reporting and Assessment Framework definitions<sup>32</sup>, which is provided for guidance purposes for those new to responsible investment:

**Environmental:** Issues relating to the quality and functioning of the natural environment and natural systems. These include: biodiversity loss; greenhouse gas (GHG) emissions, climate change, renewable energy, energy efficiency, air, water or resource depletion or pollution, waste management, stratospheric ozone depletion, changes in land use, ocean acidification and changes to the nitrogen and phosphorus cycles.

**Social:** Issues relating to the rights, well-being and interests of people and communities. These include: human rights, labour standards in the supply chain, child, slave and bonded labour, workplace health and safety, freedom of association and freedom of expression, human capital management and employee relations; diversity; relations with local communities, activities in conflict zones, health and access to medicine, HIV/AIDS, consumer protection; and controversial weapons.

**Governance:** Issues relating to the governance of companies and other investee entities. In the listed equity context these include: board structure, size, diversity, skills and independence, executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls and risk management, and, in general, issues dealing with the relationship between a company’s management, its board, its shareholders and its other stakeholders. This category may also include matters of business strategy, encompassing both the implications of business strategy for environmental and social issues, and how the strategy is to be implemented.

25 <http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf>

26 ACSI, Corporate Reporting in Australia, June 2016

27 Phase 1 Report, <http://www.fsb.org/wp-content/uploads/TCFD-Phase-1-report.pdf>

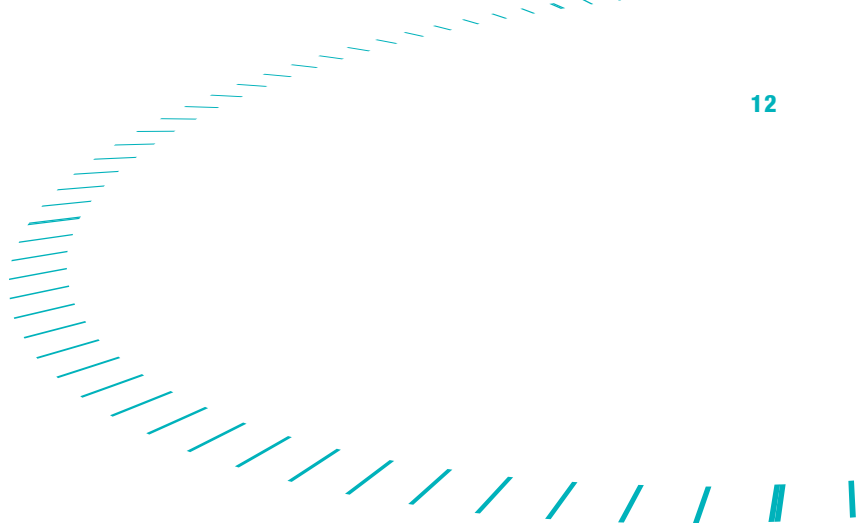
28 Securities and Exchange Commission, Business and Financial Disclosure Required by Regulation S-K <https://www.sec.gov/rules/concept.shtml>

29 Banking and Finance: Non-Financial Reporting, [http://ec.europa.eu/finance/company-reporting/non-financial\\_reporting/index\\_en.htm](http://ec.europa.eu/finance/company-reporting/non-financial_reporting/index_en.htm)

30 [https://www.unpri.org/download\\_report/14573](https://www.unpri.org/download_report/14573)

31 [http://www.fsc.org.au/downloads/file/PublicationsFile/2016\\_0302\\_ESGReportingGuideFinal2015.pdf](http://www.fsc.org.au/downloads/file/PublicationsFile/2016_0302_ESGReportingGuideFinal2015.pdf)

32 [https://www.unpri.org/download\\_report/6309](https://www.unpri.org/download_report/6309)



### Next steps:

Consistent with our recommendations to the SEC, we recommend that ASX update principle 7 of its Corporate Governance Council Principles such that:

- ESG factors are disclosed with the annual report and other appropriate documents, showing clear links between ESG factors and the company's business model and risk factors.
- ESG factors are subject to assurance as with financial data. We suggest a phased introduction.
- Corporations report using common performance metrics to allow for comparability, in particular, by industry, portfolio and across times series.
- Corporations disclose additional company-specific ESG risks and opportunities.

We also recommend ASX sign the UN Sustainable Stock Exchanges (SSE) initiative. Of the world's stock exchanges 60 have made public commitments to be sustainable, including Sydney Stock Exchange, so in this regard, ASX is in the minority. ASX should also consider offering ESG-related training for issuers, a sustainability index and green bond listings, which the SSE can support.

Australian superannuation funds tend to be heavily weighted towards domestic equities, resulting in exposure to energy, resources and financial stocks, for which corporate disclosure on ESG factors is particularly important. There was considerable interest by institutional investors in continuing to advance the quality and in particular, the comparability, of ESG disclosures by Australian companies.

#### 4. Investor education: Trustee boards should ensure capacity and competence on ESG issues. This should be industry-led.

To ensure that superannuation funds can fulfil their fiduciary duties, trustees must have the knowledge and competence to fully incorporate ESG factors in the management of their members' assets.

Section 52 (52A) of the SIS Act requires trustees (and their directors) to "act in the best interests of beneficiaries" and to "exercise the same degree of care, skill and diligence as a prudent superannuation trustee (prudent superannuation entity director)". The standard of care and diligence to which trustees and their directors are held was heightened from that of an ordinary prudent person to a professional superannuation trustee/director in 2013, as part of the Stronger Super Reforms (see definition of 'superannuation trustee' in section 52(3) and 'superannuation entity director' in section 29VO(3)). Although APRA is yet to issue guidance on the practical import of this heightened standard of care, it clearly adds support to the case for trustee boards to ensure capacity, competence and professionalism on ESG issues<sup>33</sup>.

The Australian Institute of Superannuation Trustees (AIST) provides professional training and support for trustees and fund staff. AIST established a fund governance framework, which was last issued in 2014. This framework sets out principles of good governance, including a section on the inclusion of environmental, social and governance factors into the investment process.

##### AIST Fund Governance framework: 7.1 Environmental, social and corporate governance risks

**Environmental, social and corporate governance (ESG) risks are important risks for trustees to consider as part of their investment processes. None of these risks, of course, should be considered in isolation, but rather, integrated with financial risk considerations. Trustees need to consider the environmental and social impacts of their own operational activities and perceptions of their own fund governance practices.**

**Disclosure of the trustee's approach to ESG risks, both through its investment portfolio, and through its own operations, should demonstrate that trustees have a comprehensive approach to addressing ESG factors. We encourage funds to disclose to members:**

- **Relevant environmental, social and corporate governance policies incorporated in the fund's investment policies;**
- **The governance framework and strategies for managing corporate governance, environmental and social issues at the trustee level; and**
- **The fund's proxy voting policies and any material voting behaviour.**

##### Trustee directors should consider independent third party assurance of ESG reports.

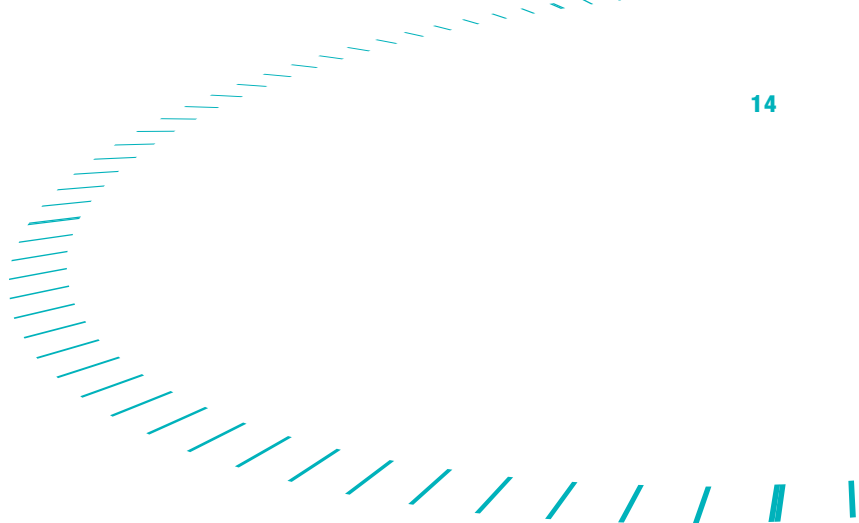
The Investor Group on Climate Change (IGCC) has hosted trustee training with AIST and Mercer, including considering the concrete steps required to include climate change risk in investment decision making<sup>34</sup>.

##### Next steps:

ESG factors should be referenced in training materials for new trustees. Boards should regularly evaluate training needs and, if necessary, provide additional training to existing trustees such as AIST's education programme, ACSI's educational resources, IGCC's trustee workshops or the PRI Academy.

<sup>33</sup> Superannuation Industry (Supervision) Act 1993, latest version, <https://www.legislation.gov.au/Details/C2016C00919/Download>

<sup>34</sup> <http://projects.igcc.org.au/trustee-training-on-climate-change/>



### About the PRI

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance issues and to support signatories in integrating these issues into investment and ownership decisions. The six Principles were developed by investors and are supported by the UN. They have more than 1,500 signatories from over 50 countries representing US\$62 trillion of assets. They are voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues into investment practices. In implementing the Principles, signatories contribute to developing a more sustainable global financial system. For more information, see [www.unpri.org](http://www.unpri.org).

### About UNEP FI

The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique global partnership between the United Nations Environment Programme (UNEP) and the global financial sector founded in 1992. UNEP FI works closely with over 200 financial institutions who have signed the UNEP FI Statements as well as a range of partner organizations to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realize the adoption of best environmental and sustainability practice at all levels of financial institution operations. For more information, see [www.unepfi.org](http://www.unepfi.org).

### About The Generation Foundation

The Generation Foundation ('The Foundation') is the advocacy initiative of Generation Investment Management ('Generation'), a boutique investment manager founded in 2004. The Foundation was established alongside Generation in order to strengthen the case for Sustainable Capitalism. Its strategy in pursuit of this vision is to mobilise asset owners, asset managers, companies and other key participants in financial markets in support of the business case for Sustainable Capitalism, and to persuade them to allocate capital accordingly. For more information, see [www.genfound.org](http://www.genfound.org).

### CREDITS

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