



**LEGISLATIVE ASSEMBLY FOR THE AUSTRALIAN CAPITAL  
TERRITORY**

**STANDING COMMITTEE ON PUBLIC ACCOUNTS**

(Reference: [Financial Management \(Ethical Investment\)  
Legislation Amendment Bill 2010](#))

**Members:**

**MR B SMYTH (The Inquiry Chair)  
MS C LE COUTEUR (The Chair)  
MR J HARGREAVES**

**TRANSCRIPT OF EVIDENCE**

**CANBERRA**

**TUESDAY, 22 MARCH 2011**

**Secretary to the committee:  
Ms A Cullen (Ph: 6205 0142)**

**By authority of the Legislative Assembly for the Australian Capital Territory**

Submissions, answers to questions on notice and other documents, including requests for clarification of the transcript of evidence, relevant to this inquiry that have been authorised for publication by the committee may be obtained from the Legislative Assembly website.

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## **Privilege statement**

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*Amended 21 January 2009*

**The committee met at 1 pm.**

**PENDER, MR HOWARD**, Executive Director, Australian Ethical Investment Ltd

**THE INQUIRY CHAIR:** Welcome everyone to this inquiry into the exposure draft of the Financial Management (Ethical Investment) Legislation Amendment Bill. I would like to welcome everybody to this public hearing of the Standing Committee on Public Accounts, which will be inquiring into the draft bill.

I note for information that the committee made a statement to the Assembly on 28 October 2010 setting out how it has determined and agreed to progress this inquiry. A copy of that statement is available from the committee secretary, if you are interested.

On behalf of the committee today I would like to thank you, Mr Pender, for attending and would ask: have you read the privilege card lying on the table before you and do you understand the privilege implications of the statement?

**Mr Pender:** Yes, I have; I do.

**THE INQUIRY CHAIR:** Thank you. Before we proceed to questions from the committee, would you like to make an opening statement or perhaps make an opening statement and use a PowerPoint presentation?

**Mr Pender:** Yes, I would. I am a director of Australian Ethical Investment and corporate analysis enhanced responsibility. Some of the views that I put might be my own, though. I have prepared a PowerPoint which I would like to go through. I thought it would be useful just to run through some definitions and categories to assist you with having a discussion about what ethical investment is.

**THE INQUIRY CHAIR:** Before you begin, given we have got a PowerPoint and people might not be able to see the screen, if you would speak to each of the slides that would be good for the people who are listening.

**Mr Pender:** Yes, I am going to speak to all of them. I am just going to go through a few definitions which are relevant to understanding different forms of ethical investment. The first one is screening a portfolio. That means restricting the investable universe. Some screening is based on negative criteria, screening what you do not want—no tobacco manufacture, say.

Some screening comes from a set of values. Some screening is based on norms. There is a distinction usually made between values and norms screening. So values might be the screening that a religious organisation uses. Norms refers to, for example, the labour norms of the International Labour Organisation, or something like that.

ESG stands for “environmental, social and governance”. Engagement with investee companies is about dialogue, seeking to improve performance on environmental, social and governance issues, with a view usually to improving returns. Shareholder advocacy is engagement plus filing and supporting resolutions with a view to improving returns and improving performance on the ESG issues. Lastly, integration

is the explicit inclusion of ESG risk into traditional financial analysis, which is often combined with engagement.

Ethical investment is sometimes called sustainable and responsible investment. It is usually split into two categories: ethical investment and responsible investment. Ethical investment involves screening portfolios. As I have just said, sometimes those screens are based on values and sometimes they are based on norms.

Ethical investment also includes community finance, which might be, for example, microfinance. It is not such a common activity in Australia because we are a very well banked community, but, in other countries where banking services do not cover the whole community, lending to community finance institutions—which are like our building societies and credit unions—is a common facet of ethical investment. The last part of ethical investment is shareholder advocacy.

Responsible investment involves engagement and integration, but it is often distinguished from ethical investment. Just before we go to who does what, I want to go back in history a bit to remind you of the history of the British East India Co because it is a good way to think about what ethical investment means without getting caught up in your own feelings about issues today.

The British East India Co had a monopoly on the sale of opium to China. There became in the UK a social concern about the issue. The use of opium was perfectly legal in the UK, but it was illegal in China. Eventually, the externality—the problems that came from the distribution of opium to China—was effectively ended by the nationalisation, at virtually zero price, of the British East India Co. Shareholders who put money in prior to 1813 did very well. They made money—lots of it, very large dividends. If you put your money in a bit later, by the 1820s and the 1830s, you did not do so well. If you put your money in near the end, you just lost it.

Lots of ethical investment-responsible investment issues have that dimension. I think with global warming you can see a similar pattern of events where, prior to 1988, no one really cared about it, except a fairly limited range of scientists. People started to talk about action in the period from 1988 to 2008. There are increasing calls for action. Finally, there was an international treaty. Now we are trying to work another international treaty. It looks reasonably likely today that there will be prices on the emissions of carbon in the near future in Australia.

You can tell a story like the history of the British East India Co with regard to global warming. You can tell it with regard to a lot of other issues. But on some ethical issues you cannot tell such a story. But the point about that is that there are reasons why some of these issues—early identification of important ESG issues—can be positive for returns for shareholders.

Here is one of my favourite slides. It is again on the same theme. It is very hard, for someone listening, to describe this slide. It is a slide about uranium mining. There are two slides of a picture of a uranium mine that say “mine”, “mine”, and then there is the waste and it says “ours”. It is a good example of an obvious externality in the industry. We have just seen the externality in Japan in the last few weeks—a large radius of hundreds of thousands of people having to be evacuated from their homes

because of the externality of this industry.

I will just come back to the distinction between responsible investment and ethical investment, or what is sometimes called socially responsible investment. Usually, ethical or SRI investment is a thing done by retail investors, foundations, not-for-profits, religious bodies or government bodies. Probably the best known example in the world is the Norwegian government pension fund, which has a set of guidelines based on a combination of engagement and ethical exclusion using both values and norms-based screening. People are actually just starting to copy wholesale those guidelines. I saw an Italian insurance company just a few weeks ago copy the guidelines of the Norwegian government pension fund.

The US state governments are quite heavily involved in shareholder advocacy. Responsible investment is undertaken by more traditional institutional investors where the mandate that they operate on is more risk and return focused—for example, a vanilla private sector super fund. A large number—I would not say a majority, but a significant number of them—in Australia have signed up to the United Nations principles on responsible investment, and they integrate. They do integration; they integrate ESG issues into their financial analysis and they engage. But their purpose is still very much focused on financial risk and return as the motivating dimension.

I just want to talk about the situation in the ACT. The self-government act says that the public money of the territory can be invested as provided by enactment. There is not much high level legal constraint on that enactment, except for the obligation to make laws for the peace, order and good government of the territory.

The ACT Treasury choose to be a responsible investor at the moment. As far as I can see, that is a choice that they are making with the support of the executive but without any explicit enactment as to the situation.

The ACT parliament could choose to be a socially responsible/ethical investor if it wanted. It could do that so that its investment activities were consistent with the intent of other ACT laws. It is important to understand that the ACT parliament does not have private sector trustee-like obligations, which the ACT Treasury might choose to assume in the absence of some enactment.

Just to comment a bit more on the current situation in the ACT, the ACT Treasury, I think, has gone further than any other Australian state in this regard. However, there are two dimensions of its activities that I do not think are appropriate. First of all, it outsources engagement in a somewhat secretive fashion, as if it is a private sector investor. I do not think that is an appropriate use of public moneys. I think if it is going to engage with companies it should be public about those companies and the issues.

Secondly, it delegates voting rights to external investment managers. As far as I can see, and possibly I am wrong, it does not appear to disclose its voting record in regard to companies it owns. I think, again, that is an inappropriate use of public moneys.

The question that we are sitting here today to ask is: how could the ACT be a socially responsible ethical investor if it wanted? I think the first answer is by passing the

proposed screening bill which is on the table. The immediate question is: is it going to affect the returns? That is the first question people will ask. I think if the screening bill that I have seen was passed it would be pretty unlikely that it would affect international returns. Screening is not severe enough.

With the exception of one criterion, I do not think it would affect Australian returns. There is one criterion, which is the “mining processing or sale of coal or extraction of oil”. That would exclude a significant number of companies. In that case, you get back to the British East India Co-global warming situation: are you actually going to improve your returns by screening out those companies or is there a risk they might be worse? I think there is a risk on that particular criterion that there might be times when they are worse.

In general, there is very extensive literature on the impact of screening on returns and the general conclusion is that there is no risk of adverse impact, providing the screening is not excessive. If you screen so that you only own 10 out of 200 companies, say, listed in the ASX 200—listed on the Australian Stock Exchange—you are going to have a problem. If you do not screen so onerously, there is no adverse impact and quite often there is a positive impact.

I want to talk a bit more about another answer to the question: how the ACT could be a socially responsible ethical investor. I think the first answer has been well addressed by the current bill. The second one is a facet of ethical investment in other countries, less well-known in Australia, that I just want to spend a bit of time on. It generally goes under the heading “shareholder advocacy”. Its prevalence varies across countries a lot because it depends on local corporations law how it works effectively. It is a very healthy aspect of US corporate democracy and has been for 40 years.

There has been a recent upsurge of interest in the UK and France, where shareholder resolutions were put on Tar Sands’s operations in Canada to BP and Shell last year in London and Total in France. It will be put in the next couple of months. There are other European countries where it is a common activity and other European countries more like Australia where it is not well known. A fund that we have recently developed lodged the first four resolutions on climate change issues with Australian Stock Exchange listed companies last year. By definition, this activity has no adverse impact on returns.

**MR HARGREAVES:** Before you go on, you mentioned in the last dot point that there were a number of other countries. Could you tell us who they are, please?

**Mr Pender:** I could send Andrea a table I have—

**MR HARGREAVES:** Yes, that would be helpful.

**Mr Pender:** which sets out the situation in different countries. Let me just go on a bit, John—

**MR HARGREAVES:** You have given the UK, France and the US, but you mentioned a number of others. I think you said about four or something of that order. I just wanted to know who they were.

**Mr Pender:** There are more than four. The four was about the four resolutions that Australian Ethical has put. I will come back to your question after I have described the situation in the US, because it is just a bit easier to understand. I just want to tell you about a US body called the Interfaith Centre on Corporate Responsibility. It is like resolution central in the US, and do not be confused by the religious connotation of the name.

Every American large denomination in the US is a member of this body and was involved in its foundation, but state governments are members, asset managers are members and lots of foundations are members. It has a membership that goes well beyond a religious affiliation now. And they put a very broad spectrum of resolutions. In a typical year they might put 200 or 300 resolutions to American companies. It is a positive force in American corporate democracy.

I would strongly encourage you, as members of this committee—if there are particular issues where there is widespread support for action on an issue but it does not extend to screening out companies, then think about mandating a level of ACT involvement in shareholder advocacy.

I recently spoke to a large number of US asset managers. We were going to speak on resolutions we are putting to a couple of Australian companies. We asked to sit in on a meeting beforehand. The speakers we heard were two treasurers—public servants but treasurers—of US states, and they were speaking on a resolution that they were putting to a US company to improve its worker safety. It is quite a common activity of US states to support these resolutions.

I just want to describe to you the pattern of one particular activity to give you a bit more feel for how this body works. Australian Ethical is a member of this body, I should say—the ICCR. It is the only Australian member. I picked a particular issue. There are dozens of issues you could pick, but one they have focused on—they have just started their resolution activity this year—is travel and tourism provider involvement in child trafficking.

The ACT has got a human rights act recognising the rights of children. I am sure you are all aware of that. I think you could reasonably use shareholder advocacy to support the broad intent of that act. In 2005 the ICCR developed and supported a number of codes to assist the management of large companies to educate their staff to signs of children being trafficked. They started that in 2005. This is a long, thorough, well-researched activity of this body. They encouraged large listed US companies in the hotel, airline and cruise ship operator industries to adopt these codes. Then they started to focus on the companies with poor performance in this area. Then they started engaging with those companies to improve performance.

In 2011 they are going to put their first resolutions to the laggard companies to adopt this code. Those two resolutions are going to Delta Air Lines and Carnival Corporation. Carnival owns the old P&O that many of you will know. It is an enormous company. It has revenue four times the size of the ACT government's. It is dual listed in London and New York. There is little doubt in my mind that the ACT would own shares in Carnival. It is just such a large company that it would be hard for

you to avoid.

Will the ACT support this resolution? I am not going to read you the detail of the resolution, but I will just read out the actual wording of the resolution to indicate how I just cannot understand how the ACT would not support such a resolution. I will read out the resolution that will be put. It will be put in a few months time to the AGM of Carnival Corporation. It reads:

The shareholders request the Board of Directors adopt a human rights policy that includes prohibiting the sexual exploitation of minors, and to prepare a report by December 2011 to be made available to shareholders concerning the implementation of this policy, prepared at reasonable cost and omitting proprietary information.

That resolution will be put to Carnival. I do not know whether the ACT government will support that or not. My impression is that if it had been put last year probably the ACT would not have. I just cannot for the life of me see how any of you—

**MR HARGREAVES:** Why is that?

**Mr Pender:** Because as far as I can see, the ACT Treasury generally supports management in these situations.

**MR HARGREAVES:** You just said that the ACT government would not support it.

**Mr Pender:** The ACT—

**MR HARGREAVES:** The ACT government and Treasury are different things.

**Mr Pender:** Sorry, I—

**MR HARGREAVES:** I really want to hear what—

**Mr Pender:** I accept that point, and I made that point a bit earlier. As I understand it, the ACT Treasury has not got a policy of supporting these sorts of resolutions, and there is no way that I am aware of to find out in regard to any particular resolution whether they have or they have not. From my reading of their policy—the first time they put out any material one could glean anything about their policy from was in their last annual report. It appears to me in general that they support management and they have no policy of considering resolutions like this. They delegate the voting rights to the external investment managers, as I understand the situation. That is not unusual amongst Australian states; don't get me wrong. But it is unusual amongst American state governments. There would have been—last year the ICCR in the US put 300 resolutions and there would have been resolutions on human rights issues very similar to that resolution I just described in regard to Carnival.

I have no way of knowing whether the ACT Treasury supported those resolutions or not, but for the life of me I cannot understand—I can understand how Meredith and Caroline could have a reasonable disagreement with Brendan about an issue as to whether we should screen out companies involved in the genetic modification of crops. It seems to me to be something where it is your job. It is a manifestation of

your task here to have a pleasant dispute about an issue like that. But I cannot understand how all three of you could not support a resolution like this to a cruise boat operator who has proved to be a laggard in introducing a reasonable code to ensure that its staff are reasonably sensitive to issues of trafficking in children and child prostitution. I just cannot understand that.

**MR HARGREAVES:** Can I just ask for your view on this bit. The bit that I am having difficulty with is not about whether or not one would support the resolution or not—I think you would have to be an absolute son of a bitch not to support that—but that this committee is charged with reporting to the parliament, which in fact makes recommendations to the government of the day, and the ACT Treasury is just an arm of that. Quite frankly, and I hope my colleagues agree with me, I do not give a rat's arse what they think, the Treasury think, about their policies; they are supposed to reflect the policies of the government of the day.

You have said you do not believe that Treasury would do this or Treasury would do that, but how do you feel about the actual government of the day? Do you think, for example, that the government of the day does not know this is going on and therefore now is a good opportunity to tell it, or that the government of the day has been hitherto reluctant to go down this track?

**Mr Pender:** Probably a bit of both.

**MR HARGREAVES:** If they do not know—you cannot have both; you cannot be half pregnant. You either know about something and have a view or you do not know something and do not have a view.

**Mr Pender:** You have not chosen to know, I think, is the situation.

**MR HARGREAVES:** No, you cannot do that. That is a cop-out.

**Mr Pender:** But that is the situation. I have looked, John, to try and see what the ACT Treasury's attitude is to some of these issues. Their public reporting, as far as I read it, says that they delegate responsibility to external investment managers who will mostly vote with management. A resolution like this, typically—I will just give you a bit more background to this—

**MR HARGREAVES:** Hang on. Go back just a little peg. Thank you for your advice, but you are talking about what the Treasury would do in instructing their investment managers to do X, Y and Z. I accept that and I accept that that is the way it works, but it seems to me that the shareholders—that is, the general public in the ACT, the community of the ACT, through their government of the day—I am starting to get the feeling that you might believe that they are not instructing their servants, the Treasury, to instruct their fund managers to go in a certain direction.

**Mr Pender:** That is correct. That is what I am saying.

**MR HARGREAVES:** And that our role in fact is to suggest to the government of the day that it should instruct its managers to do that.

**Mr Pender:** Correct. And I think by enactment there is absolutely no question you have the power to do that. The ACT Treasury has chosen to be a responsible investor as if really it is a private sector operation and it has chosen to do that in the absence of enactment on the subject from the legislature. It has done better than many other Australian states but I think there is a long way you could go with a reasonably high degree of bipartisan support on issues like this.

If you do not mind, Brendan, I would just like to describe for you a bit more the pattern of this sort of resolution, and I will also answer John's question about the geographic pattern of this activity. Typically in the US these sorts of resolutions rarely pass; they rarely get a majority vote. The ICCR say they have a win if they can withdraw the resolution because that means that the company have agreed—and that happens quite often; no company wants shareholders turning up at their AGM discussing these sorts of issues. A resolution like this might typically get, after a few years, 15 per cent of the vote. That is usually enough to change company policy.

I will give you an example. You might all recall that Google about nine or 12 months ago started to stand up to the Chinese government a bit more. That started about three or four years ago when the ICCR started putting resolutions that US internet related companies should not host information in a country where the country might use that information against its citizens. The first resolution on that was actually put to Yahoo. It did not pass. I cannot remember the number but I think it got about 10 to 20 per cent of the vote in favour, so the resolution lost. But Yahoo changed its policy not long afterwards and then the other US internet companies, ISPs, people like Google, started to change too. This is a healthy aspect of US corporate democracy. It is how they change things there and I think the ACT should be involved with it.

The pattern: we do not have this in Australia because you are required to have 100 shareholders to support a resolution here. With the resolutions we have put, Australian Ethical has organised the support of 100 individuals. Those requirements vary quite a lot in different countries. For example, in some of the Scandinavian countries and Canada it is more like the US; it only takes one shareholder to put a resolution. But the law stops them being vexatious by other means: if you do not get three per cent you cannot put it again; if you do not get six per cent the next year you cannot put it again. They have other arrangements to stop vexatious activity. There are circumstances in Germany where it is quite easy and circumstances where it is quite hard. I will send Andrea a table that describes this but it is quite a mosaic of different patterns of activity all over the world. In some countries it is quite a common activity; in others like Australia it is quite rare.

**THE INQUIRY CHAIR:** We are at this point in the discussion: this is not included in the exposure draft. Can you tell the committee whether or not there is legislation in the US, for instance, to include this, or is this just action that governments or bodies take on their own behalf? Are you suggesting that if such a bill came forward we should have a section on this?

**Mr Pender:** Yes. I think you should amend this bill as it sits at the moment. I think you should agree amongst yourselves where you think that screening is appropriate, and I think there is no question there are some areas where it is, but I can imagine that amongst yourselves you will disagree, pleasantly, where it is not. But I think there is a

far broader set of situations where advocacy is appropriate and advocacy does not raise the issue of returns. There is no change. People still hold the companies. They do not change their portfolio weightings. They just say: “Okay, I accept I am going to own this company. I am not entirely happy with things it does. I am going to be a vocal person for change, supporting change, resolving proposed changes.” I think you should add stuff like that to the bill as it is, yes.

To answer your question, in the US I do not know if it is legislated. There is quite a variation in pattern amongst US state governments. Last year or the year before, Connecticut sponsored something like 25 resolutions, which was a very large number, the largest I have ever seen any one shareholder do. I would presume there was some sort of legislative support for that in Connecticut. I could put Andrea on to people at ICCR who could give her a lot more background on those issues.

The two I told you about, where I was speaking at the proxy adviser broadcast, neither of those states were members of the ICCR; they were just having trouble with worker safety in their state with this particular company and so they decided to put a resolution to their board about it. They were doing it kind of on the fringes of the ICCR, which is a pretty common situation for US states as well.

**THE INQUIRY CHAIR:** Are there any questions about advocacy, and then we might go to the substance of the bill.

**MS LE COUTEUR:** What I should do first is something that I planned to do right at the beginning. Just to be clear, I am still a shareholder in Australian Ethical, and previously was, in fact with Mr Pender, a director of Australian Ethical. PAC has discussed this. I do not believe there is any conflict of interest. If this bill were to be passed, it is unlikely to in any way directly advantage Australian Ethical. But in order to avoid any appearance of not being up-front, I certainly have a connection with Australian Ethical. Following on from the question you just asked, did the state in fact buy shares in this company specifically for advocacy or was it just part of their enormous—

**Mr Pender:** They would have an enormous portfolio, Caroline. I said that two treasurers were speaking at the proxy governance broadcast. One of them involved a situation very like that in the ACT. It was on behalf of a defined benefit pension fund for state government employees at that stage. They would have had a portfolio. I have forgotten how big Connecticut is but it is not enormous. But some of these states are far larger than the ACT. They would have in their portfolios every American top-1,000 company. They just cannot afford not to. They might not, on a day, have some, but they are not buying them for this purpose; they own them anyway and they are being vocal investors. They are not choosing to screen them out and say, “We’re not going to hold you if you don’t have a good record on worker safety.” They are saying, “We’re going to deal with this worker safety issue by putting a resolution or supporting a resolution to your company.”

**MS LE COUTEUR:** Were they going to move up from that to going more broadly into advocacy? You are saying this was their first foray into it.

**Mr Pender:** No, sorry. For whom did I say it was the first foray? Not for Connecticut,

no.

**MS LE COUTEUR:** I thought that for a couple of them you said they had some specific issues with workers' occupational health and safety.

**Mr Pender:** The ICCR, on this issue—

**MS LE COUTEUR:** I may have misunderstood you.

**Mr Pender:** They would put numerous resolutions. What I said was that, for this issue of child trafficking, this is the first year that they have put a resolution. They started in 2005 to engage with the companies on the issue. It is not a “get cross with the company, put a resolution tomorrow” sort of activity. It is a long, methodical, slow-burn contact with the companies for years in advance sort of activity.

I have in front of me—and I can give Andrea a link to it—a book that they put out, the proxy resolutions book. It lists every resolution for the 2011 season to US companies. It has Australian Ethical, two resolutions that we are putting this year, and it covers an enormous range of issues. I think there are 160 resolutions. The pattern over time is that they settle on issues, engage and then focus on laggards, to put the resolutions. Carnival and Delta are not there without a pretty good reason—that they have not signed up to a code that the ICCR thinks they should sign up to.

**THE INQUIRY CHAIR:** Perhaps we can go back to the bill. I note in your presentation that you start with some definitions. One of the things you did not define was what actually is ethical or an ethical investment. You defined techniques to make this occur, but what is an ethical investment?

**Mr Pender:** I will go back to who does it; I think that is the best way to answer that. For retail investors, everybody potentially has different versions of ethics. If you are rich enough, you can indulge them, if you want to call it that, or pursue them. Sometimes they are whims and sometimes they reflect moral values that lots of people would agree with. I see both.

Australian Ethical has a particular set of principles which are set out in our charter and incorporated into all of our legal documents. But they are designed for a particular pool of people. Foundations, not-for-profits, will often pursue ethical investment consistent with their particular *raison d'être*. In the US, a lot of hospitals have foundations and they will almost always have, in the investment of those moneys, strong health-associated ethical investment criteria. Usually there is some screening; often there is some advocacy obligation as well, into the legal documents, typically. Move Calvary to the US. It has a large endowment. It would have Catholic and health-related ethical investment prescription in its investment documents. And it would pursue those.

**THE INQUIRY CHAIR:** So in this case the ethical criteria would simply be those specified by the investor. There is not a set of consistent ethics across the world that govern all ethical investments?

**Mr Pender:** No. There are Sharia principles of what I would call ethical investment

which reflect a completely different—well, I would not say completely different because actually some of them are reasonably common—or which come from a different tradition. They often end up with similar criteria. As far as examples of government bodies are concerned, like the ACT government, I think the Norwegian government pension fund is the best place to look for an example. They have some ethical exclusion but they also have some of this norms-based screening which I think is a bit more appropriate in a government situation. Brendan, I will happily help Andrea to find a link to those Norwegian pension fund global guidelines. And they have not invested any of it in Norway.

**MS HUNTER:** You do not know the types of screens that are being used by the Norwegian government?

**Mr Pender:** Yes, I do.

**MS HUNTER:** Could you name some of those screens that are being used?

**Mr Pender:** Yes, but I cannot cover them comprehensively. I will give you some examples. They have got strong human rights screens and they have publicly sold very large resource companies on occasions, just dumped them—probably a decent fraction of the whole of the ACT's portfolio—when they have not been able to get the company to comply with their human rights concerns. I am a bit reluctant to start naming companies—

**MS HUNTER:** No, it was more about the screens.

**Mr Pender:** but a company with large operations in Indonesia and Papua. About 18 months ago they just got sick of them. They tried engagement. They did not get what they wanted. Very publicly they dumped their holding in that company. They are quite prepared to do that.

Another example is that they will not hold shares in Walmart because they feel that Walmart is just a large American retailer and they feel their labour relations do not conform to International Labour Organisation norms. That is an example of norms-based screening. They have environmental concerns in their screening as well. I think it is probably a good example for the ACT.

**MR HARGREAVES:** You talk about this screening. To my mind, screening generally keeps people out. It excludes people from having the opportunity to receive investments from ourselves, for example. What about the notion of encouragement of companies?

**Mr Pender:** The bill, as it is written, is what I would call a negative screen. It is common to have on the other side of that a positive screen.

**MR HARGREAVES:** Could you give us an example of a real one?

**Mr Pender:** For sure. At Australian Ethical we have both negative and positive screening. We have negative screening, which is similar in its legal description to the content of the bill in front of you. It is a bit more principle based than specific. We

also have positive screening. I have an obligation, as a trustee of, say, Australian Ethical super, to look for investments that are not contributing to global warming and that will benefit from a move to pricing carbon, say. That is a positive screen. That is quite common, John.

**MR HARGREAVES:** Sorry to interrupt you but that seems to say that we are not going to invest in companies which do not do this. In other words, we are not going to do something. Is there an aspect—

**Mr Pender:** No. It is a positive duty.

**MR HARGREAVES:** Can you give me an example—

**Mr Pender:** We got into wind farms a long time ago, well before they were a feature of the Australian landscape, because we were positively instructed by our legal documents to look for that sort of investment. I think it gets back to Brendan's point that you have got to find, to the extent that you are going to do screening, something that is acceptable to the wider set of the ACT community. I think some negative screens do fit that category. I am not sure that there is going to be a lot of positive screens to actually bend the portfolio to not hold companies that are going to satisfy that. I think a positive instruction to the ACT Treasury to participate in shareholder advocacy on a set of issues should and will likely have bipartisan support.

**MR HARGREAVES:** Are there opportunities where people are being encouraged to make investments where the return is possibly less than optimal but for which the social outcome is actually worth that investment?

**Mr Pender:** That is not usually classified as investment.

**MR HARGREAVES:** What is it classified as, chucking money away?

**Mr Pender:** Effectively what you are saying is that you are donating some of your return. Nothing I have discussed falls into that category at all.

**MR HARGREAVES:** I just raise the issue. Do you have a view on it?

**Mr Pender:** I do not think it would be at all suitable. It is not something we do at Australian Ethical. It is not something that I think would be appropriate for the ACT government to do. I just want to show you this. Remember that I described Ethical Investment as screening portfolios, community finance, shareholder advocacy. Retail investors in other countries, and I am thinking particularly of Europe and the US, will get involved in the way you have spoken in an international version of community finance, micro finance, and there is an acknowledged lower return dimension of it. That does not really happen much in Australia. It really is not considered part of the ethically responsible investment scene.

**MS HUNTER:** Howard, could you explore that a little further? I guess one of the criticisms of or reactions to this idea of investing ethically is that it does not get the same rate of return or a better rate of return. Can you talk a little about your experience and your knowledge of what has been happening around the world, the

rates of return, the rates of return during the global financial crisis and so on? That would be useful.

**Mr Pender:** The first point to make is that shareholder advocacy, by definition, does not affect your rate of return because you are holding the same set of companies. It is being a responsible owner. It is not changing the portfolio at all. Advocacy has got no bearing on return. Screening can potentially have a bearing on return. For some issues, there are theoretical arguments and no shortage of empirical evidence that concern about those issues has supplemented and will supplement and improve returns.

That is why I described the situation with the British East India Co at the beginning. People are past feeling strongly about it. They do not have an emotional opinion. Some people did very well in the beginning, some English shareholders, out of selling opium to China—there is no question about that—but after a while—

**THE INQUIRY CHAIR:** They fought wars over it.

**Mr Pender:** Exactly; they fought wars about it. The British East India Co controlled the English parliament for a while. They had armies. Eventually, the thing unwound and a lot of people lost a lot of money as well. You can see how you can have a positive return. In general, through the GFC, ethical investors did far better.

**THE INQUIRY CHAIR:** Can you validate that statement?

**Mr Pender:** Yes. I do not think I have sent it to Andrea but I could. The best place to look for this sort of information is in the material provided by asset consultants who are hired. The ACT Treasury has some. I do not know who it is today but I have known in the past. The ACT Treasury hires an asset consultant. People writing for asset consultants have written advice for their clients. I could get Andrea a copy of this material dealing with the legal and return dimensions of what you have just said.

But, Meredith, in a context that you are not in, in a context where there are private sector trustees with a common law duty to act in the best interests of the members of the super fund, say, the overwhelming conclusion from all of that material is that, as long as the screens are not too onerous that you are losing a decent fraction of the companies, there is no adverse impact on returns and often you can point to periods, times and situations where there is a positive impact.

**THE INQUIRY CHAIR:** You have the slide which shows what a particular investment might do or how it is used. To go back to what is ethical investment, we have had a number of submissions, including from the ethics and integrity adviser to the ACT Assembly. The gentleman said:

However, there is an ethics-related issue raised by the Bill—whether or not a Bill to that proposed effect should be passed in the terms proposed.

In my view it should not. I consider that it would be wrong, misleading and inappropriate to refer to the proposed prohibited investments in terms suggesting that they are not ethical, or to the proposed priority-if-prudent investments in terms that suggest that other investments would not be ethical. Each of the activities encompassed by referred to by the Bill is lawful. Like all lawful

activities, they can be conducted ethically or unethically.

How do you determine what is ethical and what is not? The nub is that there is no definition of ethical in the bill. The ethics adviser is saying that these are lawful activities listed in the bill and he thinks it would be “wrong, misleading and inappropriate” to refer to them as unethical.

**Mr Pender:** I can see his point, Brendan, but I do not agree with it. The problem is that his point might have been accurate if it was made 40 years ago, but ethical investment is now a well-known term of art, and it does have a meaning, and what is in this bill does reflect that meaning. It is really too late for him or you to try and say, “We’re just not going to agree with the going nomenclature.” He has got a point. But it is like saying “I don’t like some particular term because it’s not the right term” when everybody is using that term. You might be right, but it is a bit not to the point.

**THE INQUIRY CHAIR:** One definition “ethical investment” I have found of is that ethical investment is investments in companies that meet ethical and moral criteria specified by the investor. So, again, it is a list that is specified by the investor, whether it is ethical or not. So is that not in real terms philosophy or ideology rather than ethics?

**Mr Pender:** Yes, but within western society and the situation that we are in in Canberra, there is a set of things which are recognised and called “ethical investments”.

**THE INQUIRY CHAIR:** Sure.

**Mr Pender:** At base it is a semantic issue. If you want to have the same deal and change the name, it really does not bother me a lot

**THE INQUIRY CHAIR:** Well, it is not semantics, because it uses a word—

**Mr Pender:** Well—

**THE INQUIRY CHAIR:** Let us go to some of the things in the list. What is unethical about the manufacture or sale of liquor?

**Mr Pender:** A group of people who call themselves ethical investors often screen out people who manufacture alcohol.

**THE INQUIRY CHAIR:** Okay, but does that make it unethical?

**Mr Pender:** It makes it so that there is a word which is commonly associated with the screening out of alcohol, so commonly associated that, if you want to move away from that, you are really moving away from well-known terms of art. I take your point—it is perfectly legal to manufacture alcohol. Going back to your Irish joke, my Irish cousins could not live without Guinness.

**MR HARGREAVES:** The good Lord changed water into wine, but he did not change it back again.

**Mr Pender:** But that is why I said, Brendan, that I think there is a set of activities where it is up to you, as political representatives of the ACT, to say, “This is a set of activities where we think screening is appropriate. This set of activities we think shareholder adequacy is appropriate.” At the edges of that, for sure, have alcohol, do not have alcohol. I am not going to sit here and argue about it. But I am saying—

**THE INQUIRY CHAIR:** You are urging us to pass the bill, and the bill says, “Don’t invest in the manufacture or sale of liquor.” I am just saying that this is the first one on the list.

**Mr Pender:** Yes, and that is the common thing that people who call themselves and are known as ethical investors do. Take it out of the bill, as far as I am concerned, if you do not feel comfortable that it has the support of the ACT community. But ethical investment very commonly involves screening against people who derive a lot of their revenue from the sale of alcohol. Now, sometimes ethical investment involves just adequacy. If I could take the tobacco example, the ICCR regularly puts resolutions to the tobacco companies. They do not put resolutions saying, “Stop selling tobacco; go out of business.” They put resolutions like, “Look, quit focusing your advertising in areas where the kids are buying cigarettes and the parents are buying cigarettes and it’s causing malnutrition in parts of the US.” That is the sort of thing ethical investors sometimes do.

I think the ACT should support that sort of thing. Whether you call it ethical investment, whether you want to have an argument about tobacco or alcohol, to my mind, is a bit irrelevant.

**MS LE COUTEUR:** Could I ask a question—

**THE INQUIRY CHAIR:** Yes, I will just finish, if I may. The bill actually goes on to say that we should prohibit investment if the Treasurer is not satisfied on reasonable grounds that five per cent or less of the relevant body’s revenue comes from that source. The ethics adviser goes on to say:

For example, the provision allowing investment in prohibited investments below a certain threshold appears to suggest that it is permissible to be a little bit unethical. I consider that, as a matter of public policy, that concept should not be countenanced.

Do you have an opinion on what is the level of being unethical that is acceptable, or should we follow the ethics adviser?

**Mr Pender:** I do not agree at all with what he said. I think there are some areas where, if you want to be an ethical investor, you apply a materiality constraint, and there are others where you apply an absolute.

**THE INQUIRY CHAIR:** A materiality—

**Mr Pender:** That five per cent is called materiality. In some areas you apply a materiality constraint. In other areas the jargon is you have a lexicographic constraint.

“Lexicographic” means no trade-offs are permissible. So the whole of economics, basically, rests on an assumption that there are no lexicographic preferences.

For example, I am celiac. When I go into a restaurant, I want gluten free. It does not matter what the price of the gluten-free dish is compared to the meat dish; I just make a lexicographic choice, no gluten. Now, at Australian Ethical, for example, we have a lexicographic preference: we will not participate at all in anything to do with the nuclear fuel cycle. But on lots of other issues we have materiality, and we have different materiality constraints.

I do not agree with him—I am sorry, I do not know that person’s name. I think if you are going to do this, you have to some materiality constraints. You might or you might not want to have some lexicographic constraints. I suspect you probably do not. But I do not see anything wrong with materiality constraints. The ACT has a policy to reduce its own carbon emission footprint. It would be perfectly reasonable for you to say you are not going to invest in companies that do not similarly have a plan to at least reduce their carbon emission footprint.

**THE INQUIRY CHAIR:** I will just finish up then throw across to the committee. The ethics adviser finishes by saying:

In my view, if the Assembly wished to achieve the of the Bill, it would be preferable to amend its terms by deleting all use of the word “ethical” and substituting alternative terminology such as “socially sensitive” that more accurately reflects the policy issues that are sought to be balanced by the Bill.

**Mr Pender:** There is an intellectual arrogance about that, Brendan. That is saying, “I’m going to change well-known nomenclature, because I don’t like it.” It is not that there is not some sense in his dislike; it is just that it is too late. It is called “ethical investment”. Sometimes it is called “SRI”, sustainable and responsible investment. If you say you have got socially sensitive investment, nobody is going to know what you are talking about.

**THE INQUIRY CHAIR:** I hear what you are saying, but this is advice that the committee has.

**MS LE COUTEUR:** Just continuing on, Howard, from what you have been saying, ethics is clearly a debatable subject, but, for the ACT government, we have actually made pronouncements about many things. We have anti-tobacco campaigns, we have anti-liquor campaigns, we have carbon dioxide reduction campaigns et cetera. Would this not be sort of reasonable to take this as the ACT government’s statement of ethics, what we are actively campaign on as a government?

**Mr Pender:** I could not agree with you more, Caroline. That is why one of the reasons I picked that Carnival example is that the ACT has got a human rights bill. It is very strong on trying to recognise the rights of children. How can you not support a resolution for Carnival when you have got a human rights bill? It is just completely hypocritical and inconsistent.

Sure, there are some things where I have some sympathy where, particularly in

regards to screening, you have got to find a set that has a degree of broad community support, but I think many of those ones in that screen will do, but, outside that set, there is an enormous number of criteria. What ACT citizen would object to the ACT supporting a resolution that a cruise line is a bit more sensitive to use of its ships for trafficking and prostitution of children? No-one would be opposed to that? Who would be?

**MS HUNTER:** Howard, I was wondering how easy you think it would be for the government to find a fund manager or managers who could implement the types of screens outlined in the bill, both within Australia and also overseas.

**Mr Pender:** The amounts of money that you have, Meredith, it is no issue at all. I even go further: absolutely no problem finding a fund manager. I know specialist asset consultants in the US and who operate in Australia who only deal in this sort of area as well. So you could easily find fund managers and relatively easily find asset consultants specialising in this area. So it just is not a problem.

I just want to say something to Brendan: the English collect information better; the Americans use it better. The people who collect all this information, Brendan, they are called Ethical Investment Research and Information Services. They have been going out of London for probably 30 or 40 years, and you name a criteria, and EIRIS have got a database of 4,000 or 5,000 listed companies all around the world. To answer Meredith's question, you name a criteria, anybody who subscribes to EIRIS can pick that criteria and immediately see all the companies that are an issue, because you are joining a big club. You are not pioneering it.

**MR HARGREAVES:** Talking about having to look up things, the government of the day is required to publish details of contracts which entail the expenditure of public funds, and anybody can pick it up and look it up. No doubt you have done that just to see where the money has been expended. Are you aware that it is automatic by process and that the government also publishes annually the names of people with whom contracts are entered into to make money? For example, if I build a road I am going to give you a whole series of contracts that I am spending money on to build the road. But if I actually buy and sell shares during the course of the year to make money to supplement that, are you as a citizen able to just pick up on any report and see any of that?

**Mr Pender:** No, not that I am aware of.

**MR HARGREAVES:** Do you see any inconsistency in that?

**Mr Pender:** Yes.

**MR HARGREAVES:** Thank you for that.

**Mr Pender:** Particularly, I see an inconsistency with the ACT Treasury secretively using public money to engage in companies and not making public who those companies are. I think it is inappropriate that ACT Treasury is acting like a private citizen doing things that are perfectly appropriate for a private citizen to do but which are not appropriate for a treasury to do when funded by taxpayers.

**THE INQUIRY CHAIR:** Why do you come to that conclusion—that it has no private sector trustee like obligations?

**Mr Pender:** I come to the conclusion that the ACT parliament has no private sector trustee like obligations, because you are constituted as a parliament under the Australian constitution. The case law is that the ACT government is like a state government. The ACT Treasury has chosen to act as if it has some private sector sort of responsibilities, but that is a choice that it has made and it is perfectly appropriate for you to deny, confirm in some circumstances or pass an act to say anything about it. It is entirely up to the legislature that you are members of.

**THE INQUIRY CHAIR:** A closing remark, perhaps.

**Mr Pender:** I would really like to see you do something in this regard with a level of support across the parties. I think that the people of the ACT could see and be proud of what you do. It would sadden me to see this bill disappear into a dispute between the parties about genetic modification of crops or alcohol. There are things that I think you can screen and there is a larger set of things where I think you can very reasonably mandate shareholder advocacy. It would really sadden me to see if differences about what is the right thing to do mean that you do not do any right thing.

**THE INQUIRY CHAIR:** Thank you for your appearance today. As you have indicated through the hearing, you will provide some additional information or extra information to the committee through the secretary for the committee. We thank you for that. When available, a proof transcript will be forwarded to you to provide an opportunity for you to check the transcript and suggest any corrections if required.

**Meeting adjourned from 2.04 to 3.15 pm.**

**PATERSON, MR DUNCAN**, private individual

**THE INQUIRY CHAIR:** We resume this public hearing of the Standing Committee on Public Accounts inquiring into the exposure draft of the Financial Management (Ethical Investment) Legislation Amendment Bill 2010. I note for information that the committee made a statement to the Legislative Assembly on 28 October 2010 setting out how it has determined to progress this inquiry. A copy of that statement is available from the committee secretary. On behalf of the committee, I would like to thank you, Mr Paterson, for attending today. I need to ask you whether you have read the privilege card on the table before you and do you understand the privilege implications of the statement?

**Mr Paterson:** Yes.

**THE INQUIRY CHAIR:** Thank you. Before we proceed to questions from the committee, would you like to make an opening statement?

**Mr Paterson:** I am the CEO of CAER, now known as Corporate Analysis Enhanced Responsibility. We have been in operation for about 10 years providing services to investors in Australia and around the region who are concerned about environmental, social and governance issues. I am also the president of the Responsible Investment Association Australasia, which is the peak body for responsible investment in Australia. I am a director of ASRIA, the Association for Sustainable and Responsible Investment in Asia, which is the peak body for responsible investment across the pan-Asian region.

I have recently been appointed to the Investment Advisory Board of ACT Treasury. I believe Andrea has made you aware of that. It is slightly awkward timing, and I do feel somewhat awkward on the matter, because I put in the submission that we put in prior to being invited to apply for that position. So I do find myself somewhat conflicted. Obviously, I am not going to be able to answer questions on behalf of any of our clients or on behalf of the board. I am on the board as an individual, not as a representative of CAER. That is my little preamble.

**THE INQUIRY CHAIR:** Is there anything that you would like to say on the issue of ethical investment or the draft bill that is before the committee?

**Mr Paterson:** My comments are contained in our submission, which is quite a brief one. There are two main points that I wanted to make in the submission. The first point was that the commentary that I had been reading at the time around the bill and around the territory signing of the UNPRI I felt was slightly misguided. There were comments that were linking the new UNPRI to adopting a negative screening approach to responsible investment. In fact, if you are familiar with the new UNPRI it is quite hostile to negative screening. It is a methodology in responsible investment. I just wanted to clarify that.

I was reading statements to the extent that the territory had signed there but had not screened any companies out there; therefore, there was something wrong. That is not the intent of PRIs. I felt that the record needed to be set straight there. I also wanted to put on the record that in the view of myself and probably in the view of CAER, the

ACT has been quite proactive in the field of responsible investment in Australia. Becoming a PRI signatory is not a small or insignificant step. There are no other government instrumentalities in Australia that have taken the same step.

The only comparative one in our region is the New Zealand superannuation scheme. That was set up under rather different circumstances as well. I thought it should be noted that amongst the governmental instrumentalities in Australia, the ACT government was actually taking quite a leading role. It would be quite nice to see the government take a stronger and more proactive line on responsible investment, because you can trade on the fact that you were the first to sign the PRI.

**MR HARGREAVES:** Can you define the difference between responsible investment and ethical investment?

**Mr Paterson:** Yes. We have recently released a paper in conjunction with Phil Preston from Seacliff Consulting, who was previously working for Colonial First State investment management; so he comes from a reasonably mainstream background. One of the key findings in that paper, and I am happy to send it around to the committee members, was that the difficulty trustees often face when they look at the area of responsible investment is around definitions and terminology. The line that we sought to draw in that paper was one that distinguished between ESG-themed products and ESG practices. Both fall within the sphere of responsible investment. ESG-themed products have been around a lot longer.

**MR HARGREAVES:** For the benefit of Hansard, can you explain what ESG is?

**Mr Paterson:** ESG stands for environmental, social and governance. The industry is laden with jargon. Please feel free to pick me up whenever I drop a piece of jargon on you. The field of ESG-themed products, which is ethical products, sustainable products, green products, can be identified because they seek to differentiate themselves on the basis of their methodologies. So they will market themselves to people in a certain way if they are a retail product or if they are a wholesale product, they tend to be in the group of wholesale products that are managed by organisations that have got a set of particular stakeholders.

For instance, a healthcare superannuation fund would reasonably want to distinguish itself on the basis of avoiding tobacco, a Christian superannuation fund might want to distinguish itself on the basis of avoiding alcohol or, if it is Catholic, contraception. ESG practice refers to the broader approach where an investor does not seek to differentiate what they are doing on the basis of their ESG practice but they do take environmental, social and governance criteria into consideration when they make investment decisions. That is the broad distinction that we drew in that paper. I think it is quite a valid one and we are trying to encourage more and more people to use that sort of language.

From a personal point of view, I think the ESG-themed products, ethical products, generally put much more thought and effort into the selection of the criteria they are using and the amount of research they put into the processes. They have a greater responsibility towards transparency about the investments they are making. The group that you would call ESG integration funds, the ones that are using ESG practice but are not seeking to differentiate themselves on those grounds, tend to be taking a much

more relaxed approach to the criteria they are choosing, the way they implement them and that sort of thing.

You can draw them on a sort of continuum with more committed to the process at one end and less committed to the process at the other end. But the point we make in the paper is that they are all on a continuum rather than necessarily distinct buckets, because that can get quite confusing.

**MS LE COUTEUR:** You mention negative commentary around the UNPRI and the ACT government, and I am probably responsible for some of that because we asked—

**MR HARGREAVES:** What is this “probably” business?

**MS LE COUTEUR:** Yes, possibly more than probably. At various public hearings I have asked questions of Treasury about it and come to the conclusion from what they have said that signing up to UNPRI appears to have made absolutely no difference to what the ACT government has done. They have been very clear that they have not made any investment decisions in either direction as a result of it and they have not been clear whether they have actually been involved in any motions at AGMs or specifically involved in any advocacy. They have been very murky about that.

It may be that they have had some involvement through third parties, but they certainly have not been in a position to say that it was actually anything that they did. From where I am sitting, on the basis of asking, it appears to be something that has been signed up to but not something that has actually made a tangible difference. I was wondering whether you want to say more about the difference that the UNPRI is making or could be making. It is not seeming obvious that there is much happening.

**Mr Paterson:** It is interesting. One of the big criticisms of the UNPRI is that it is a bit of a toothless tiger. I would certainly concede that point. If you look at the most recent Responsible Investment Association benchmarking report, about one per cent of the funds under management in Australia have some kind of more rigorous ESG-themed approach applied to it. About eight to nine per cent have a clear ESG integration approach, and those tend to be the superannuation funds that have signed up to the UNPRI.

There is a great deal of commentary out there that the UNPRI is not sufficiently aggressive in the way it polices the actions of its signatories. That works in both directions, though, and I do have some sympathy for the UNPRI because they are establishing a set of frameworks which are not meant to be onerous for the people who sign on. They are meant to be statements of principle rather than a listing of things that one ought or ought not do. Really, the only requirement, once having signed up to the UNPRI, at this stage is that you fill out the UNPRI survey at least after 12 months of having been a signatory.

I think one can make valid criticisms of the UNPRI in terms of encouraging it to become more rigorous over time. I certainly think that the UNPRI is heading in that direction. I know, for instance, that there have been comparisons between the UNPRI—and “PRI” stands for “principles for responsible investment”—and the UN global compact and the ability of people to sign up to the global compact and not

particularly do anything at all. In the last 12 months we have seen that global compact take a rather stronger line and start to kick out members who cannot demonstrate that they have taken action on the basis of their becoming a signatory to the global compact. I anticipate that within the next couple of years we will see similar things happening from the UNPRI.

At the moment the big challenge that the PRI are facing is that they are introducing compulsory membership fees. I suspect that in the next 12 months they are not going to be really hassling their members because they will be hassling them to pay bills rather than hassling them to get tougher on ESG criteria. So we are probably looking at a couple of years before more onerous requirements are brought out as part of the UNPRI.

Having said that, the UNPRI does require you to accept that environmental, social and governance criteria are an important part of the investment decision-making process. They require you to accept that you ought to act in a collaborative manner, that you should push for disclosure, all those sorts of things. By signing up to that and accepting that, large pools of capital like the ACT Treasury are doing positive things. They are certainly sending a signal to the market and to service providers that they are concerned about ESG.

I know that, having worked in this industry in Australia for over a decade now, 10 years ago, if you went to a fund manager and said, "Are you worried about ethical issues; are you worried about environmental, social and governance issues?" the answer would have been, "No, because no-one is asking me about it." The more people who sign on to the UNPRI and have their name appear on the PRI website, the harder it will be for fund managers to give that kind of answer. So you are going to see some incremental changes as a result. It is not a transformative approach at all; it is an incremental approach.

**THE INQUIRY CHAIR:** Does CAER have an opinion on the bill that we are looking at? Sorry, you are appearing as an individual. Do you as an individual have an opinion on the bill or does the organisation that you work for have an opinion on the bill? We can cover both bases.

**Mr Paterson:** I do not think it is CAER's role to have an opinion on things like this. CAER as an organisation is committed to violent neutrality in this area. So we provide research to a broad range of different clients. We provide research to people who invest in everything on the market but only engage with those companies, all the way across to clients like Australian Ethical Investment, who are at the deep and green end of the market and who are heavily committed to the environmental, social and governance procedures that they have. We do not say that one is better than the other or one is worse than the other. We think it is a good thing if investors are taking environmental, social and governance criteria into account and we would always encourage investors to do that sort of thing.

**MR HARGREAVES:** The statement was made that going down the ethical investment approach and having ESG right up front will not necessarily make any difference to your rate of return. Is that a fair statement?

**Mr Paterson:** It is a fair statement that responsible investment products over time have demonstrated an ability to outperform the market. I am talking specifically here about ESG-themed products. That is looking purely at the issue of market-based returns. There are a range of other issues that investors take into account when they choose products. I am not particularly qualified to comment on the broad range of criteria you could look at. It is not a given that if you take into account environmental, social and governance criteria you will do better.

I think the main purpose behind statements like that is simply to point out that there are investors out there who are looking at these issues and they are not necessarily losing money. I would not turn that around and say that you are guaranteed to make better money. One of the difficulties we have struggled with over the years in this industry is the economics 101 argument that says if you restrict your portfolio at all, you will therefore lose money. I think that has been proven to be wrong over time by those fund managers out there who are restricting their policies and are not necessarily losing money.

**MR HARGREAVES:** Would that point to the width of the portfolio? You say that cross-fertilisation within the portfolio is going to take care of that.

**Mr Paterson:** There are a range of different factors and it will range across different sorts of fund managers. For instance, you could have a very large fund manager like Hermes in the UK, who take an engagement approach where they will try and change the company's behaviour from an environmental, social and governance approach and therefore increase the market cap value of the company, and another company which might seek to exclude themselves from a sector which, they say, from an environmental, social and governance reading, will perform more poorly in the longer term. There are different sorts of approaches.

I guess I sometimes push back against this notion that there ought to be one particular definition for ethical investment or responsible investment. There is no one particular definition for a great many terms which are commonly used in the finance sector. To say that necessarily ethical investment needs to be defined and everyone needs to agree which criteria you use and which criteria you do not I think is simply unfair. So it depends on the methodology of the fund manager.

**THE INQUIRY CHAIR:** If the Assembly were to pass this bill, this is black-letter law then. How do you deal with something that does not have a strict definition in the sense of the law? Does this make it something that just ends up in the courts, and let the court decide? Should we have a definition in the bill, if it was to come to the Assembly?

**Mr Paterson:** Of what is an ethical issue and what is not? I do not think I am particularly qualified to answer that question. The definition that is used by the New Zealand superannuation scheme is that they will not invest in companies which act in a manner which puts the reputation of the New Zealand government at risk, essentially. It is a reputation-based issue. That is all they have included in legislation.

**MR HARGREAVES:** The definition is what something isn't, not what something is. They are saying, "We won't invest in you." Our definition of it is that we don't do

that; we won't invest in this range of activities. What we have not said is that we will invest in that range of activities. I was going to the notion recently about the way in which we are encouraged to put our investments not into oil or not into something else. But there does not seem to be a conversation about what we should be putting our investment into, and whether there is a risk that that investment will have a lesser rate of return than the other stuff. What I heard you tell us just now about the New Zealand definition is, "I haven't got a definition but I'll tell you what it's not." Is that a fair understanding of where they are at?

**Mr Paterson:** I would not describe it as a definition. It appears in their statement of investment principles, which is the legislative thing that superannuation funds are required to have. It sets out what they believe when they make investment decisions. The furthest they have gone in terms of definition in New Zealand is to say that we should not invest in a way which goes against the reputation of the New Zealand government. So primarily they have used that to look at treaties the New Zealand government has signed or areas where there are clear legislative conflicts between an industry and the government itself.

**MS LE COUTEUR:** Given that we have signed up to the UN PRI and arguably not a lot has happened to that, are there ways within that framework where the government could do more? If you cannot answer that, given your circumstances, that is fine.

**Mr Paterson:** In what respect? Within the framework—

**MS LE COUTEUR:** Within the framework. We have signed up to the UN PRI. Arguably—certainly, I would argue—on the basis of the evidence presented to date, it has achieved very little to nothing. Are there things that we could do within that framework that would have some more tangible outcome?

**Mr Paterson:** I do not think that the framework is prescriptive at all, so there are any number of things that you could do within the framework of the UN PRI, which would range from negative screening to engagement. I do not think it is prescriptive at all. I would face difficulties if I was asked what the ACT government ought to do, just because of the position I find myself in. I do not want to feel as though I am speaking on behalf of the board.

**MR HARGREAVES:** It is an unfortunate piece of timing.

**MS LE COUTEUR:** Yes.

**MR HARGREAVES:** We are trying to look into the way our Treasury ought to do something and you find yourself in a position of advising them what to do. It can become a particularly circular argument after a while. In a funny kind of sense we are all caught by the timing of it all. That is a little bit unfortunate, but I have to say that I have found that in the comments you made about the definitions and what Mr Pender was talking about one of the problems about making any kind of law is that you have got to start with what you are trying to do and then make a law to bring it into effect. Having a definition of what you are trying to do out front is absolutely critical. Otherwise the legislation does not work, because there are escape clauses and doorways out all over the place.

I am struggling with a definition around ethical investment or responsibility—call it what you will—where I can say whether or not this piece of legislation fits. At the moment, what I am getting is a piece of legislation over here and then people saying, “Yes, but it is this general idea.” I am not a big fan of making legislation around a general idea. I think it is a suck it and see approach, and as soon as you do that there will be winners and losers. The object of good legislation is that there are no losers. I am particularly appreciative of the views that you have put around the conflict in people’s minds around that definitional thing. That has been very helpful.

**THE INQUIRY CHAIR:** I notice that in your submission you say that CAER provides research on a range of institutional investors in over 300 companies in the region. What sort of companies do you provide advice on?

**Mr Paterson:** We have the ASX 300 and the NZX 50, so it is actually 350 stocks.

**THE INQUIRY CHAIR:** In the ASX 300, I assume there would be some alcohol companies, for instance.

**Mr Paterson:** Several.

**THE INQUIRY CHAIR:** What sort of advice would you provide on those sorts of companies?

**Mr Paterson:** It does depend on the nature of the client. We do have clients who are in the church-based area; they would be looking for information which would enable them to avoid investments in companies that are heavily involved in alcohol. Alcohol itself is not really the example I would use. It does tend to be an either-or one.

There are a range of metrics that you use and materiality thresholds that you use. For instance, we use materiality thresholds of zero to five, five to 10 and up to 33 per cent of revenue, but different clients have got different levels of sensitivity about the levels they set for their criteria. We also use materiality thresholds based on what type of involvement they have in the industry, so it could include retail and the manufacture of alcohol or it could include just the manufacture of alcohol. And the same thing applies to tobacco.

There are other criteria areas where revenue thresholds are not appropriate. If you look at the issue of controversial weapons, for instance, there are very few companies globally who would make any more than one per cent of revenue from components for controversial weapons. Pornography is an issue which we cover for some church-based clients. There is no company, to my knowledge, that is listed globally that makes more than one per cent of revenue from direct involvement in the production of pornography.

So it does depend on the nature of the client and the degree of sensitivity they have. Our work is based on the notion that we do not say what is a good or a bad company. We work with the client and identify what the client’s sensitivity thresholds are. And we seek to give the client the information in the way which is most relevant to them. Rather than just having a simple ethical rating, we have—

**THE INQUIRY CHAIR:** So the client would set their criteria for investment.

**Mr Paterson:** We have got quite a complex database. We have got a complex software platform. A client can go in and pick the different sorts of issues that they are concerned about.

**THE INQUIRY CHAIR:** So in that regard the client sets their own ethics against what their organisation wants to achieve.

**Mr Paterson:** Because there is no centrally agreed definition of what is ethical and what is not. What you can achieve is consensus around what sorts of things are particularly offensive and what sorts of things are not. But it is particularly difficult to come up with a central definition of what is ethical that would be agreeable to all people.

**MS LE COUTEUR:** One of the things in the legislation is a materiality test which is five per cent. Have you got any views—you mentioned that your clients use a range of tests—as to what would be an appropriate level for the legislation?

**Mr Paterson:** I would not be able to comment on what would be an appropriate level for the legislation. I would say that generating more than five per cent of revenue from all of the activities in the legislation would knock off a lot of companies, and it is quite a strong threshold. The AMP responsible investment leaders product, for instance, uses 10 per cent as their materiality threshold. I am just picking some funds off the top of my head. Obviously it is all public information; it is in their PDS.

It is not unreasonable to use a threshold of five per cent, but it would depend on the number of criteria that you are choosing to use. We do have clients who would use five per cent as a materiality threshold, but they probably would not have as many criteria as are in the legislation, across as many industries. We do have clients who use a zero materiality threshold.

This is not going to help John, but one of the difficulties of picking a definition with a materiality threshold is that you have perverse outcomes. For instance, I gave the example of cluster munitions. I know that some of the publicity that has been around in the past around investments by the ACT has been involved with weapons manufacture. Five per cent probably would not catch some of those companies. So if you do pick a very simple materiality threshold-based approach, it has strong advantages because it is easy to communicate what you are doing but it has disadvantages because inevitably it will have some perverse outcomes. So you will have companies that make less than five per cent of revenue from tobacco, for instance; they may be the largest tobacco manufacturer in a country, but globally they make less than five per cent.

I hope I have not wandered too far off what I am allowed to say there. We are always supportive of people taking into account environmental, social and governmental criteria. The way you do it is the important thing really, and, as I say, there is no single definition.

**THE INQUIRY CHAIR:** Do you want to make a closing statement or any final comments?

**Mr Paterson:** No.

**THE INQUIRY CHAIR:** In that case, thank you very much for appearing today. The proof transcript will be forwarded to you to provide an opportunity for you to check the transcript and suggest any corrections.

**The committee adjourned at 3.45 pm.**