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, 2 AUGUST 2011

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

By authority of the Legislative Assembly for the Australian Capital Territory

WITNESSES

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Amended 21 January 2009

The committee met at 2.02 pm.

DONALD, MR SCOTT

Evidence was given via teleconference—

THE INQUIRY CHAIR: Good afternoon, and welcome to the public hearing of the Standing Committee on Public Accounts inquiry 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 and agreed to progress this inquiry. A copy of that statement is available from the secretary.

On behalf of the committee, I would like to thank you, Mr Donald, for agreeing to appear today by conference phone. I understand that you have been sent a copy of the privilege card?

Mr Donald: Yes, I have.

THE INQUIRY CHAIR: Have you read the card and do you understand the implications of the statement?

Mr Donald: Yes.

THE INQUIRY CHAIR: Would you like to make an opening statement?

Mr Donald: Certainly. I teach trusts and corporate law at the University of New South Wales, in the Faculty of Law. I worked for approximately 10 years for a company called Ipac Securities and more recently, for approximately 14 years, for Russell Investments. In those roles, and more recently in my private capacity, I have advised the governments of the Commonwealth of Australia, New Zealand and Queensland on investment governance. I have also advised public sector bodies in New South Wales, Victoria and South Australia, particularly in superannuation and insurance.

My interest in the bill before you therefore stems from two related strands. Firstly, as an adviser to major institutional investors, I am interested in the practicalities and governance issues that arise from ethical investments and from the proposal that is embedded in this bill. Secondly, as a member of the Faculty of Law, I am obviously very interested in the peculiarly legal issues that the proposal inspires.

I have a number of observations on the draft that I have before me. Would it be appropriate for me to introduce those now?

THE INQUIRY CHAIR: Go right ahead.

Mr Donald: I would like first to address the notion of a list of prohibited investments which I have noticed is envisaged for investments by instrumentalities and also within the superannuation context. The first comment I would make there is that the notion that the sponsor of an investment fund should impose rules on how the fund is or is

not to be invested is entirely respected in the law. There are cases in the charities and superannuation area that question such practices by trustees or other investors, but there are a great number of trust law cases in which the settler of the trust actually specifies investment guidelines. So it is quite a familiar concept, notwithstanding some of the rhetoric that you sometimes see in the press around such constraints.

The legal issue that arises, though, is whether the guidelines as drafted can be unambiguously interpreted and then implemented. I think that is where most attention should fall with respect to what I see in front of me. I have one or two questions on that score. The first one is of an institutional nature. There seems to be a requirement for identification of investments that are prohibited, but nowhere in the draft that I see is there any description of on whom that duty falls, to identify whether it is or has become a prohibited investment. That obviously has some practical implications in terms of the processes that need to be established around implementation of this. I have a question around why the list is included directly in the legislation rather than inserted into guidelines, to become a disallowable instrument. Very commonly, I think lists such as this can appear as guidelines or in some other form of delegated legislation rather than directly like this.

I have some questions about the definitions. One of the observations I would make of these sorts of provisions and the challenges that they pose in practice around the world is that they can have unintended outcomes. While I am sure these have all been selected very carefully and crafted very carefully, I do observe that some of the definitions potentially capture activities more broadly than are intended. For instance, with the reference to revenue coming from things like genetically modified crops or the manufacture or sale of products that are produced using intensive animal farming, I wonder whether that would potentially capture things like major supermarkets or restaurant chains and so on where clearly the products that they sell may have those attributes, and whether that might not be what you are intending to achieve there—or maybe it is.

Similarly, under the restriction on the manufacture or sale of arms or armaments, that might exclude companies like Boeing, and possibly some of the major software companies. I do not purport to be an expert in terms of Microsoft earnings these days but they do have very large defence contracts. So you may end up capturing in the net there some activities that are not anticipated.

I have a list of other comments. I am conscious that it could be a bit of a download if I go through them all in one go. Would you prefer that I continue to run through them or stop there for an opportunity to discuss?

MS LE COUTEUR: I am happy either way. Personally, I think it might be easier to discuss them as we go; that way my notes do not have to be so good.

THE INQUIRY CHAIR: I am happy to do it either way.

MS LE COUTEUR: You started off by saying it was not clear who had the responsibility to actually work out these things in the legislation. What we have got in here is the Treasurer, because basically all we are saying is that the government will work out internally how they implement the legislation rather than trying to suggest

exactly how it is going to be implemented. That is how it was written, rather than saying a specific role within the government. The Treasurer is responsible for investment; therefore they would have this as well.

Mr Donald: I guess my observation on that is: does subsection (5) therefore impute a responsibility on the Treasurer to have a process to identify that?

MS LE COUTEUR: Subsection (5)?

Mr Donald: It is the one that says if the Treasurer becomes aware—

MS LE COUTEUR: Yes, the Treasurer would have to put in place something so that they know what is going on. We would argue that they have to do that, anyway, from an investment point of view. We must have somebody looking at our investments. This would become part of that responsibility. It is not trying to specify administratively how it would happen. It is only trying to specify that it would happen. We figure it is not really the role of legislation to try and do the administrative arrangements.

Mr Donald: No, it is not, but it may actually play out—and I stopped just before I got to this point. One of the things that is not clear at the moment, and perhaps that is the way you intended it, is who will be accountable for a contravention and to what extent you would anticipate there being any consequences for that contravention beyond just sale of the asset.

MS LE COUTEUR: I guess we are anticipating that the government, as represented by the Treasurer, would be responsible. We are not suggesting things like fines or something like that. We are seeing this as the government being responsible, in the way that it is responsible for many things.

Mr Donald: Okay.

MS LE COUTEUR: The other one you mentioned was why the list is in the legislation rather than delegated—58A.

Mr Donald: Yes, 38A and 58.

MS LE COUTEUR: It does have, under (4), that you can do a declaration of additional things as well.

Mr Donald: Yes.

MS LE COUTEUR: So we are certainly open to the idea. Your statements about disallowable instruments are quite reasonable. In an ideal world, it would be finetuned with disallowable instruments. I guess part of the reason for putting it in the legislation at the beginning is that, without any concept of what we are talking about, the legislation becomes meaningless or difficult to comprehend. I think it was necessary, from the point of view of debate, to have some idea of what we were thinking about. Clearly, there will be debate about it in the Assembly. This list may or may not stay as is, as a result of the Assembly process. It seemed that the thing to do

was to put clearly what we felt was a possible list, as part of the exposure draft.

THE INQUIRY CHAIR: Any comment, Scott?

Mr Donald: Putting it in the legislation does a few things. One is that it advertises them very prominently, since they are arguably more accessible to the public in that form than if they were in some other instrument which the public may be less aware of. So there is certainly that. It seems to me it is desirable that that list, wherever it appears, should be comprehensive and people should not have to go through multiple places trying to find what that list is, because that would be confusing. Particularly if there was any ambiguity as to which one prevailed, that could be a bit of a problem.

MS LE COUTEUR: The other reason, which maybe I should have stated at the beginning, is that this legislation has not been put forward by the government. It has been put forward by the crossbenches, and it is much harder for us to do regulations and disallowable instruments. It is just a practical reality as to what we can do. Your other question was around inadvertently excluding things. We have got the concept of materiality at five per cent. I take your point; we do not want to exclude a software company—we do not want to exclude Microsoft simply because many defence organisations use Windows as their operating system. But that is the idea of the materiality at five per cent. It is used by many other organisations and, to the best of my knowledge, it has been quite practicable.

Mr Donald: It has. It does require you to have a process in place to track that and to define what revenue means. But I think those are both practical issues that can be resolved. I guess what I am pointing to is that with any of these definitions you need to be careful that you have not picked up things that you are not intending to. One of the suggestions I would make—and I do not have the technology to do this for you, unfortunately—is to ask the consultants or the index providers to act on a screen based on what this list looks like, and just have a look at it and see if it is actually picking up things that you do not intend to.

I do recall—and this list does not offend this particular test—back in the early 90s where some ethical funds decided that they would exclude companies that had a liquor licence and then promptly discovered that every listed company in Australia had a liquor licence, in order to serve alcohol in the boardroom. I guess what I am nervous about with those sorts of rules, particularly where they are legislated and therefore very difficult to change, is that they can have completely perverse, unanticipated consequences. I think it would behove someone to have a close look at that and to make sure there is nothing surprising coming out of it.

THE INQUIRY CHAIR: How would you suggest that people get around that?

Mr Donald: The first thing to do is to get someone who runs an index or consults on this sort of stuff to actually do this test and just to identify which securities in some major index, say the MSCI index, actually would be cut out, and then have a look and see if that is consistent with what the committee is actually hoping to achieve.

The other, I would suggest, is that there might be a get-out clause so that, if it is found that a particular rule is generating these sort of perverse outcomes, it can be relatively

easily adjusted. What you do not want to have happen is for something like this to be placed in legislation and, down the track at some point, unanticipated now but in five years time, it transpires that something is working in a way that is quite dysfunctional but cannot easily be redressed or cannot easily be changed. In a private law context, the parties could get together and agree to amend the contract or whatever, but the legislative cycle being what it is, it could end up being quite dysfunctional. So there could be some sort of get-out clause for the Treasurer, in the same way that the Treasurer can make an order or can issue a declaration. It might be possible to create something similar on the flipside.

THE INQUIRY CHAIR: Do you want to move on to your next point?

Mr Donald: Yes. One of the things that happens in a private law context like trust law is that if you have something that is titled something like a prohibited investment and it is purchased on behalf of a trust, very often that will be interpreted as being beyond the power of the trustees—ultra vires the trust. In this case it does not sound that way because it sounds from the description that, once the Treasurer is aware that it is a prohibited investment the Treasurer then has a responsibility to sell it. So presumably that means that the transaction was valid. This is something you could put to the parliamentary draftsman. You may want to be very clear about the fact that the purchase of the investment, even if it is a prohibited investment, is intra vires. I am not sure what capacity the parliamentary draftsman has for that kind of provision, but I know that, for instance, in Corporations Law and some other areas, where it is intended that something needs to be reversed, they specifically say, "Some deficiency or some contravention of this does not make the act ultra vires."

MS LE COUTEUR: A good point.

Mr Donald: It is kind of important regarding the issues around accountability as well, because presumably if the Treasurer is delegating investment of any of these moneys, the issue is not simply the sale of the asset; it may also be that you might seek compensation for purchase of an asset. If an agent has purchased an asset that they ought to have known was a prohibited asset, you might want to ask them to give you compensation for the commissions paid, any diminution of value et cetera.

MS LE COUTEUR: Yes, a good point.

THE INQUIRY CHAIR: Does that exist somewhere? Is there an example of where that works currently that you can point us to?

Mr Donald: For the most part, if you have a contract with an investment manager—I do not have one in front of me, unfortunately—and the investment manager buys something that is outside the contract, it is really up to them to compensate. It is fairly standard. It would not be ultra vires the purchase; the purchase would still be valid but it was outside their agreed mandate. That is essentially what you are doing here.

THE INQUIRY CHAIR: What if the agent did not know that he or she was contravening or purchasing something that was actually included on the list?

Mr Donald: That is where it comes back to my suggestion. You need to be careful

about who is accountable for knowing what is on that list. In order for that particular mechanism to work, you need to impose the obligation on the agent to verify that those provisions are met. Failing that, you lose that right to get recompense. For the most part, the parties that are most likely to be able to, in practical terms, make that happen efficiently are likely to be either the custodian and/or the investment manager, if you have appointed a delegated investment manager.

THE INQUIRY CHAIR: Moving along, your next point?

Mr Donald: There are two practical issues. One is the benchmark for performance assessment. These prohibitions are quite extensive. I do not mean that in a pejorative sense or in any way to suggest that that is likely to lead to a better or worse outcome in terms of overall investment performance for the programs, but the range of permissible securities is a subset of the broader set that might otherwise be possible and you might want to consider having a bespoke benchmark to measure against.

MS LE COUTEUR: Yes, that is a good point—probably a bit outside the sphere of legislation, though.

Mr Donald: It is certainly outside the sphere of legislation but in terms of—

MS LE COUTEUR: Practically.

Mr Donald: Yes, with respect to how it works and how it gets reported in the parliamentary records and so on, it will be important to have the ability to demonstrate that the performance has been good or bad, but against a benchmark that makes sense as opposed to something that could be quite some distance from what is actually measured.

MS LE COUTEUR: Yes.

Mr Donald: My experience with that type of process is that bespoke benchmarks are not that cheap but they are not as expensive as some people would have you believe, either. The investment managers and others who may feel that it is a lot of work for them may well represent that it is quite expensive. If you speak to people who produce these benchmarks, they may feel that it is less expensive.

You also, as a practical matter, need to consider how breaches of these rules are actually reported. Let us speculate that there are securities which start off being acceptable investments but become prohibited investments at some point through change in the corporate structure or something. They may be identified and may actually be sold out of a portfolio prior to the Treasurer being aware of it. So, in a practical sense, you would want to have some kind of system set up so that not only breaches that the Treasurer was aware of but also perhaps breaches that were addressed before the Treasurer needed to act get identified.

MS LE COUTEUR: Yes, absolutely.

Mr Donald: Finally, still on this list of prohibited investments, I notice that the focus is on assets or on business activities rather than on investment practices per se. What I

am thinking of here is some of the bad press that has been around things like short selling, participating in pools of assets where potentially there are undesirable investors investing in them and so on. I was wondering whether that was something that you had considered and rejected or if that was too hard. Certainly, when people talk about ethical investing in a generic sense, I think they are increasingly recognising that it is not just about the assets that you buy, it is also about the investment practices that you participate in.

MS LE COUTEUR: That is an excellent comment and probably one that deserves some further thought. To quite an extent we looked at what other funds have done. I think that is an excellent idea. Certainly, if this goes ahead, there would have to be, with respect to the way the legislation is set up, the possibility for expansion or contraction in the future.

Mr Donald: Certainly, there has been some negative press around particularly some superannuation funds where it has been found that the superannuation fund has been short selling the stock of the sponsoring employer.

MS LE COUTEUR: That is very sweet!

Mr Donald: Those are not the words that the trustees used when they discovered it, no, and certainly not the members.

THE INQUIRY CHAIR: I am sure.

Mr Donald: That is something that, I guess, in Australia we see a little of but I was much more exposed to it in the UK where people were investing in private equity and hedge funds that were unregulated and where there was not necessarily visibility as to who the co-investors were. So you had things like the front-running scandals in the US; you had money laundering issues and a bunch of other issues which really caught many people in the mutual fund business in the UK by surprise. It strikes me that some consideration at least should be given to the possibility of thinking about those things.

THE INQUIRY CHAIR: That is good advice. Thank you for that.

Mr Donald: Those were my observations on the prohibited investment kind of notion and the way it was expressed in three different places in the proposed legislation. I have some observations also on the superannuation proposals specifically. The first is that I am not sure—perhaps you can clarify this for me—whether the superannuation moneys to which the Territory Superannuation Provision Protection Act applies have elected to be subject to the SI(S) Act—the Superannuation Industry (Supervision) Act.

MS LE COUTEUR: I do not believe they would be. I am not giving in any way a formal legal opinion. The ACT government does not in fact operate a superannuation fund. The situation is that there are employees of the ACT government for whom the ACT government has an obligation, but that money goes to ComSuper. This is only off the top of my head but I would not have thought that the SI(S) Act would be relevant, given that all we are doing is creating—from a superannuation point of view our obligation is to give money to ComSuper. How we choose to do it is, to a large

extent, up to us. If we chose to have no super fund and we chose one year to just appropriate all the money, it would be very bizarre but I do not think it would be contrary to our superannuation obligations.

Mr Donald: I am not sure exactly how all the various moneys—

THE INQUIRY CHAIR: What comment or what advice do you have to offer?

Mr Donald: Actually, and curiously, the advice was not to worry too much.

MS LE COUTEUR: We have chosen not to worry.

Mr Donald: The reason I picked it up originally was that the SI(S) Act has a range of duties on trustees, one of which is to formulate an investment strategy having regard to a range of things. However, the first part of that section talks about having regard to the circumstances of the fund. It seems to me that these quite specific prohibitions that are being suggested would form part of those circumstances. So even if the trustee of any funds that were subject to this were to attempt to comply with this, if they were required to comply with this, they would be able to do so because the circumstances of the fund would include the fact that they had those prohibited investments. So the investment covenant that they have regard for risk return, diversification and so on, would apply subject to those circumstances.

I raise it because you may have some who might point to an inconsistency between the quite prescriptive list that is there and the much more open-ended test that is in SI(S).
Personally, I suspect that it is not a problem, both because it practically may not be a problem because if nothing applies, SI(S) does not apply, and because I think you could read SI(S) to say there is a context here which has been provided by the sponsor of this fund being the territory government.

MS LE COUTEUR: The point here is that the ACT government is not actually holding this money in trust. These are public funds rather than trustee money. We are not running a super fund.

Mr Donald: I appreciate that. That was why I was not sure at the start. I know some of the state governments—and I was not sure whether the territory government had done this—had volunteered to respect the SI(S) obligations even though they were not necessarily either bound by them or even necessarily organising their affairs in the way that other employers might. I just table that; it sounds like it may not be an issue.

One of the other issues that I picked up as I was reading is the fact that there is a positive requirement to have regard for ethical investment. It is currently, as I read it, phrased sort of as a ceteris paribus condition—if all else is equal then ethical investment should prevail. The problem that you may have in implementing that is that perfect substitutability almost never occurs. So somebody attempting to bypass that set of priorities would be able to bypass it on the basis that the investment that was purchased which did not have the ethical characteristics was different in some respect that made it important that it be bought rather than the ethical one. I am also nervous about what "give priority" actually means. Does it mean it has to be

purchased before, to the exclusion of or what?

MS LE COUTEUR: Do you have any suggestions as to how better to formulate it?

THE INQUIRY CHAIR: Go back to the drafters.

MS LE COUTEUR: Apart from going back to the drafters.

Mr Donald: I think it is very hard.

MS LE COUTEUR: It is a reasonable comment. How can we do it better?

Mr Donald: Off the top of my head, or even having thought about it now for a week or two, I do not have an obvious silver bullet for this one, as to how you would do it. I have another problem which I will raise with you as well. As drafted currently, where the prohibition talks about investment in a relevant body that has exposure to these things, and a five per cent materiality limit, the reference here does not make any reference to the relevant body. It talks about "an investment being a defined ethical investment if it includes investment in any one of the following activities". As a practical matter, one of the things I would have done is phrase that the way you phrased the other half of the requirement, which is "investment in a relevant body that is engaged in the following activities".

MS LE COUTEUR: Yes, that is probably an excellent idea. You could say the materiality thing possibly should be—

Mr Donald: You might want materiality because otherwise you run the risk of having inconsistencies between the two lists. You could have a coal producer that also happens to generate renewable energy.

MS LE COUTEUR: Yes, that is what I was thinking of, or simply greenwash. You have a horrible company that has put a small amount of money into an exemplary project to look wonderful.

Mr Donald: Exactly.

MS LE COUTEUR: I had only thought of it when reading through it now with you. That is possibly not a bad idea. This is one of the advantages of having consultation on this stuff.

THE INQUIRY CHAIR: What else would you like to bring to our attention? Keep going, you are doing well.

Mr Donald: I think I am running out of ideas at this point. In fact, the last of my observations is that you do need to make sure that you cannot get into a situation where something is both a defined ethical investment and a prohibited investment at the same time.

MS LE COUTEUR: That is an excellent point.

Mr Donald: Otherwise that really will confuse—

MS LE COUTEUR: It would, and it would create great merriment.

THE INQUIRY CHAIR: A good point. Caroline, do you have any questions?

MS LE COUTEUR: Scott, do you have any more general comments about the effectiveness of doing the screens in the way that the legislation is envisaging?

Mr Donald: If you take the long-range view of this, there is no doubt far more attention placed on this type of concern today than there was 15 years ago. One of the positive by-products of that is that there is also a lot more technology available to facilitate the implementation of such a strategy than there would have been 15 years ago. If you had tried to do this sort of thing 15 or 20 years ago, you would have constrained the opportunity set of investment managers that you might use, it would have been very expensive to set up some of the systems and so on. I think that is relatively much easier today than it would have been then, by virtue of developments, particularly in northern Europe and elsewhere, where there are like-minded organisations that have got these sorts of screens and things in place and in a sense have funded the development of technology to help to make these things happen. You can piggy-back on that technology development. Given that most of the custodians operating in Australia are part of global networks in one way or another, formally or informally, that technology is available at a cost today that would be a fraction of what it would have been 15 years ago.

Apart from that, with what you are doing I think you are much more prescriptive than many of the initiatives that I have seen in the last decade in Australia around things like sustainable investing and so on. That is not to say that is a bad thing; it is just to point out that there are a bunch of folks promoting responsible investment practices and responsible investment products. There are a bunch of folks who have services in the same sort of space as well. I would suggest that what you are attempting to do here falls somewhere on that spectrum. It is not right at the extreme of the spectrum but it is more ambitious than most people are in this space. I do not mean to apply any value to that, positive or negative. I just make the observation that if you read the press and people say, "There's a groundswell of support for sustainable investing," that is certainly true, but you have to recognise that what some people mean by sustainable investing is a very diluted version of it, and other people have a much more committed conception of what that is. So you need to recognise that, when you see these vast numbers of dollars being committed to this kind of investing, not very much of it would be in the category that you are pointing to. Most of it would probably be less ambitious than what you are trying to do. That is not a bad thing, incidentally; I am just saying.

THE INQUIRY CHAIR: No, I take your point.

MS LE COUTEUR: Yes. I was going to ask some general questions about risk and return but I think we have probably had enough evidence from various people about that, unless there is anything specific that you want to say on potential impact on risk for return for the portfolio.

Mr Donald: Not especially, since I have not seen what they have told you. Certainly,

markets are increasingly aware of these sorts of issues, particularly around environmental sorts of issues, but also human rights and other sorts of issues, and those sorts of risks are being priced in ways that they were not even five or six years ago. The risk and return ramifications of this sort of process or mindset may be different than they would have been if you did a study based in 2000, for instance.

MS LE COUTEUR: You said many other people are taking a less ambitious approach. Would they have focused more on governance issues which are easier to do in terms of internally reorganising things and not so much on the environmental and social?

Mr Donald: I have a rather more cynical read of it, which is that some people subscribe to the rhetoric but do not necessarily follow through—

MS LE COUTEUR: I would not be disagreeing with your comments.

Mr Donald: which your process does not permit you to do, because you actually created them as prohibited investments as opposed to saying the right things. Aspiring to certain types of practices is quite different from actually prohibiting certain investments, particular types of investments. It is partly that. It is also that by being quite precise about the sorts of issues that you want to pay attention to, you potentially go beyond where some people have gone. So the precision makes it more difficult for it to be diluted, basically. Partly the practice does not match the rhetoric, but also, when you look into the rhetoric as to what is actually required, it is not as ambitious as prohibiting investment in certain things and prioritising investment in other things. It can very often be got around. For instance, many superannuation funds and investment managers sign up to the UNPRI, as you would be aware—

MS LE COUTEUR: As we are aware.

Mr Donald: Yes, but if you actually look at their product offering, they have a sustainable fund but it need not necessarily be the default for that organisation. If you happen to be in one of the other funds that are badged differently then they will argue, "To be true to label, we don't necessarily pay attention to the PRI-type principles in that environment." And they justify it by saying that that fund is held out to be something different. That matches market practice, I guess.

THE INQUIRY CHAIR: It might be human nature. Scott, we might leave it there. We are out of questions at this stage, unless there is something final that you would like to say.

Mr Donald: No. I commend you on your initiative in investigating this. I am certainly very happy to assist the committee in any way that might be appropriate in the future, and wish you the best of luck.

THE INQUIRY CHAIR: That is very kind. On behalf of the committee, I would like to say thank you for your participation today via the phone. When the proof transcript is available, we will forward it to you to provide an opportunity to check the transcript and, if necessary, make any corrections. I now declare the public hearing closed.

The committee adjourned at 2.45 pm.