



Driving Long-term Investment and Delivering Responsible Financial Markets

A Preliminary Paper on Industry Priorities

NOVEMBER 2015

RESPONSIBLE INVESTMENT ASSOCIATION AUSTRALASIA, LEVEL 9, 387 GEORGE STREET, SYDNEY NSW 2000

“The future of finance needs to be less about leverage, financial engineering, and stratospheric bonuses and more about efficiently and cleanly connecting capital with ideas, long-term investing for the good of society, and delivering on promises to future generations.”

John Rogers CFA, President and CEO of CFA Institute

“. . . the shadow of short-termism has continued to advance—and the situation may actually be getting worse. As a result, companies are less able to invest and build value for the long term, undermining broad economic growth and lowering returns on investment for savers.”

Dominic Barton, a consultant at McKinsey & Company, and Mark Wiseman, president and chief executive officer (CEO) of the Canada Pension Plan Investment Board

Introduction

The importance of focusing capital markets on the longer term is a matter of much international discussion, debate and regulation globally. This global activity on this issue — for example the UK’s Kay Review and Stewardship Codes, the EU Shareholder Directive, Japan’s Ito Review and the work of groups including UNEP Finance Initiative, OECD/G20, Generation Foundation, McKinsey and the Focusing Capital on the Long Term initiative to name but a few — is in response to an ever shorter-term focus of investor and corporation performance at the cost of longer term investment returns and the prosperity of the broader economy.

In Australasia there has not been a focused, comprehensive assessment of the policy and non-policy proposals that have been raised globally to achieve two objectives:

- focus capital on delivering long term value; and
- shift financial markets towards a more responsible and sustainable footing.

Accordingly, in September 2015 RIAA researched, drafted and tabled for discussion the *Green Paper: Driving long-term investment and delivering responsible financial markets* at a roundtable meeting of RIAA members. The *Green Paper* drew on some of the best thinking, policy and regulation, government, industry and non-government reports and thought leadership from recent years and presented a summary of leading proposals for focusing capital on the long term and driving more responsible financial markets (see Appendix 2 for referenced sources).

On October 20, 2015 RIAA convened a roundtable of its members to discuss policy and non-policy proposals put forward in the *Green Paper* and to identify the initiatives most broadly supported by RIAA members as being likely to deliver to those objectives.

A follow up report was provided to participants with a summary of the roundtable discussions and a short-list of initiatives most broadly supported.

This *RIAA Preliminary Paper on Industry Priorities* is the synthesis of the *Green Paper* and roundtable summary and outputs. It provides a discussion paper that will guide the formation of RIAA’s policy and regulatory research and advocacy agenda for 2016 – 2018. This is not a policy position paper for RIAA, but rather a compilation of strong ideas that we believe deserves further exploration to shape more responsible financial markets in Australasia. This policy work forms a pillar of the work we do on behalf of our members, with the ultimate goal to deliver capital to more sustainable assets and enterprises, to shape responsible financial markets, to underpin strong financial returns and a healthier economy, society and environment, consistent with RIAA’s strategic goal.

RIAA’s Strategic Goal:

“To shift more capital into sustainable assets and enterprises, to shape responsible financial markets, to underpin strong financial returns and a healthier economy, society and environment.”

The Problem – policy, regulation, incentives, signals, practices and culture

In Australia, the problem of short-termism has been noted and debated extensively, including positions taken or comments made regarding the problems caused by short-termism from most (if not all) leading finance and business industry bodies including the Australian Institute of Company Directors, the Governance Institute, Business Council of Australia, the Financial Services Council, the Association of Superannuation Funds of Australia among many others.¹

Clearly, the ever stronger focus on short term returns has become a problem that focuses company management on creating earnings in the short term putting at risk the strategies that underpin value in the long term.

“When we treat companies as commodities — that is, when we trade them rather than invest in them — we run the risk of undermining the long-term growth prospects of our economy.”

Michael Sabia is the President and CEO of Caisse de dépôt et placement du Québec

Within the finance sector, there are layers of signals, incentives and practices, as well as institutional and regulatory settings that drive this focus on the short term. For the purposes of our assessment, we grouped these signals and incentives into four categories:

1. **Regulation and Policy** – black letter law as well as regulatory guidance and other policy settings that make it difficult to focus capital on the long term
2. **Investor Tools** – the finance sector suite of tools and methodologies that contain inbuilt mechanisms that over-value the short term at the cost of the long term
3. **Culture** – cultural settings including the all-important incentive structures within the finance industry (asset owners, asset managers and companies) that set an over-weight focus on short term performance
4. **Consumers** – consumers can help focus capital on the long term, and provide a closer alignment of investments with the time horizons and desires of the underlying beneficiaries.

In combination, the failure of incentives and signals across each these four areas to focus capital on the appropriate time horizon has created perverse and unwanted outcomes that result in the allocation of capital towards chasing short term returns, rather than building long term value, putting at risk not just the longer term returns of investors, but equally the long term prosperity of the broader economy. Rather than capital providing the fuel of the real economy,

¹ See for example: Governance Institute <http://www.governanceinstitute.com.au/my-blog/blog/2013/getting-the-terms-of-reference-right-an-important-first-step-for-the-financial-system-inquiry/>; AICD, *Curbing Excessive Short termism*, <http://www.companydirectors.com.au/Director-Resource-Centre/Publications/Book-Store/Short-termism-thought-leadership-paper>; Business Council of Australia, *Beyond the Horizon: Short-Termism in Australia*, <http://www.bca.com.au/publications/beyond-the-horizon-short-termism-in-australia>

the combination of perverse incentives can drive companies to deplete the capital base (economic, natural and human capital) that underpins their own future prosperity and that of the whole economy.

For the long term focused universal owner, these impacts unavoidably impact negatively on future returns.

The current state of play puts at risk much more than the returns of an individual investor, but rather risks the long term prosperity of the nation, and health of the economy, but equally of society and the environment.

Summary of initiatives that can focus capital on the long term

This *Preliminary Paper of Industry Priorities* draws from the vast international literature on this issue with examples referenced throughout each identified priority and also in Appendix 1 for those currently identified as lower priority.

The *Preliminary Paper of Industry Priorities* provides detailed explanation of each proposal, references the key sources of these proposals, and suggests Australasian-specific changes required to implement them.

Importantly, all of these proposals or initiatives are aimed at achieving one of two objectives:

- **To focus capital on the long term**, which by its nature is not just about holding equity in companies for longer, but also is about unlocking capital towards assets required in the long term, in light of issues that are likely to shape that future; and
- **To drive a more responsible and sustainable financial market**, one that delivers for the real economy and brings value to society.

The nine initiatives listed in the following section that we deem most useful in achieving these two objectives are:

1. Improving corporate and investor disclosure and reporting
2. Establishing stewardship principles for institutional investors
3. Clarifying key terms in statutes in the context of ESG and responsible investing
4. Supporting longer term investment holdings via tax law
5. Creating appropriate and aligned incentives
6. Strengthening asset owner competency and capability
7. Strengthening industry culture around ethics
8. Observing consumer primacy
9. Redefining default investment options

These nine initiatives are detailed in the following section.

1. Regulation and Policy

1.1. Improving Corporate and Investors Disclosure and Reporting

Proposal A: Corporate disclosures should focus increasingly on a discussion of forward looking strategy that support long term value creation, including ESG factors, using narrative reporting with tools such as integrated reporting. The emphasis should be to focus on how the company is delivering a strategy for long term value creation.

Detail: Investors are typically interested in how corporate strategy is expected to evolve and be implemented over the time period that aligns to their investment horizon. Long term investors will typically be focused on their assessment of how a company can generate cash over the long term and create shareholder value. Narrative based reporting which encapsulated the company's strategy to profit from and/or manage risks related to megatrends, externalities, key environmental and social issues and low-risk high impact events can inform the investment decisions of long term focused investors. An important vehicle for enhancing corporate disclosures comes from the local stock exchange listing requirements. One opportunity for driving enhanced disclosures that is being increasingly taken up around the world is listing requirements stipulating the disclosure of ESG issues.

Key Sources: There have been several organisations and landmark reports that have called for improved disclosure from companies to support long term investment decisions.

- The Generation Foundation has recommended that integrated reporting become mandatory.
- The Cox Review has suggested *“Company reports should also include a clear description of long-term strategy, progress towards previously declared long-term goals, and actions taken and investment made in pursuit of these objectives”*.
- Also, The Kay Review specifically recommended that *“High quality, succinct narrative reporting should be strongly encouraged”*.
- The recommendation was supported by the UK Government which has since undertaken consultations with key stakeholders on their views of narrative reporting. The consultation found that there was a strong desire to avoid unnecessary reporting “volume” which can impact readability. The UK government has committed to legislating to improve narrative reporting and work with the FRC to improve the quality of financial reports.
- The Sustainable Stock Exchange Initiative is driving work to achieve this outcome, and already there has been some strong progress made in South Africa, Singapore, among many others. We have recently seen improvements in the ASX through the Corporate Governance Principles recommendation 7.4, *“that a listed entity should disclose whether and if so how it has regard to economic, environmental and social sustainability risks”*.

Recommended regulatory, policy and/or industry change for Australia:

- ASX reporting guidance that specifies system or format preference for identifying, analysing and disclosing material financial and non-financial aspects both past and anticipated, such as for example through integrated reporting
- Strengthening ASX listing requirements (for example by encouraging the ASX to become a signatory to the Sustainable Stock Exchange Initiative)
- Consider the utility of promoting the work of Sustainability Accounting Standards Board (SASB).

Proposal B: Investor disclosures should be relevant, complete and timely so that clients and members can more easily compare and contrast the fund and product performance in terms of returns and ESG risks and opportunities. The disclosure of investment strategies applied to funds and products as well as the underlying holdings becomes central to increasing transparency and accountability in the investment sector.

Detail: In terms of driving more transparency and accountability in the investment sector, particularly for retail investors, a number of international jurisdictions have moved to requiring pension funds to disclose full stockholdings on a regular and timely basis. In Australia there has been an attempt to align with international peers. The portfolio disclosure obligations in section 1017BB of the Corporations Act 2001 (Cth) would require trustees of registrable superannuation entities to publish information about the fund's portfolio holdings on (potentially) a look-through basis twice annually on a publicly-accessible section of the fund's website. In a similar vein the choice product dashboard obligations in section 1017BA of the Corporations Act would require superfunds trustees to publish key information about choice investment products on a public-assessable section of the funds website in order to enable greater comparability of superannuation products. For various reasons, the introduction of these suggested amendments has been delayed.

Furthermore, under section 1013DA of the Corporations Act 2001 (Cth), product issuers are required to disclose in their "Product Disclosure Statements how labour standards or environmental, social or ethical considerations are taken into account in selecting, retaining or realising an investment". To date these requirements are given only a cursory consideration, with the vast majority of Product Disclosure Statements stating they don't consider these issues. With the developments in responsible investment in Australia, with for example 78 asset managers having signed on to the Principles for Responsible Investment, it is clear that there is a need to strengthen the way investment organisations are reporting in compliance with this (and related ASIC Regulatory Guide 65 (Nov 2011)).

Recommended regulatory, policy and/or industry change for Australia:

- Strengthen ASIC RG 65 Section 1013DA disclosure guidelines with a view to facilitating meaningful disclosures on the extent to which product issuers disclose whether and how labour standards, environmental, social or ethical considerations are taken into account for investment products.
- Require responsible investment strategies implemented in investment products to be disclosed in Product Disclosure Statement (or equivalent) building on ASIC RG 168 on Product Disclosure Statements
- Enact portfolio disclosure (in section 1017BB) and choice product dashboard obligations (in section 1017BA) of the Corporations Act 2001 (Cth).

Proposal C: Abandon short term quarterly earnings as well as earnings guidance

Detail: Many argue that quarterly earnings reporting and quarterly earnings guidance should be abandoned. The focus on short term earnings may distract corporate executives from investing in the long term, and provide incentives to manage earnings and costs in the short term. Short term focused equity investors typically focus on the drivers of immediate price changes, such as earnings announcements, earnings guidance, news flow, market themes and the actions of other investors. These factors are not necessarily drivers of long term value creation (and destruction). It has been suggested that the practice of quarterly earnings and earnings guidance is likely to drive this. Under current ASX continuous disclosure listing rules, earnings guidance is not required, and companies are required to provide financial reports on a half yearly and annual basis.

Key Sources:

- Kay's recommendation that companies should de-emphasize quarterly reporting, and that quarterly reporting should be optional, rather than mandatory, is supported by the UK Government.
- The EC has brought forward proposals to move away from mandatory quarterly reporting.
- Other reports have also supported the move away from mandatory quarterly reporting including Generation Foundation, AICD and the Cox Review.
- Recent article highlighted how some investors are starting to support companies who move away from quarterly reports – Legal & General Investment Management, in ESG Magazine.
- The Generation Foundation report of November 2015 puts forward the idea that earnings guidance should be replaced with “Integrated Guidance” and also offers a framework for communicating value-relevant information in its place.

Recommended regulatory, policy and/or industry change for Australia:

- Communicate clearly to companies a statement that outlines the desired focus areas for corporate reporting, that being a stronger focus on the delivery of long term strategy over short term reporting
- Encourage the sell-side to produce research to inform long term decision making for investors.

“Issuing earnings guidance, a McKinsey survey found, has no impact on shareholder returns but can be a powerful incentive for management to focus excessive attention on the short term and, in some cases, to manage earnings inappropriately from quarter to quarter to create the illusion of stability.”

The Misguided Practice of Earnings Guidance, McKinsey and Company, 2006

“78% of managers will actually reject an NPV-positive project if it will lower quarterly earnings below consensus expectations”

John R Graham, Campbell R Harvey and Shiva Rajgopal in the Journal of Accounting and Economics, referenced in Generation Foundation, Sustainable Capitalism

1.2 Establishing Stewardship Principles for Institutional Investors

Proposal: The establishment of stewardship principles under which all investors should operate on a comply or explain basis

Detail: Industry guidelines published by regulatory bodies (such as ASIC), industry bodies (such as FSC) or governmental organisations (such as the OECD) can play a role in shifting behaviour, without the challenges of adopting legislation. Specific stewardship principles have been proposed by many bodies globally with a view to ensuring investors become active responsible owners of their investee companies, as opposed to “absent landlords”.

Key Sources: The UK has implemented the UK Stewardship Code which “*aims to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders*”. The code applies to all UK investment managers. To date, similar codes have been put in place in several countries including Canada, EU, Italy, Japan, Malaysia, Netherlands and South Africa in addition to the UK.

Equally, the recent UNEP FI report, *The Financial System We Need*, recommended similarly codes on investor duties.

Recommended regulatory, policy and/or industry change for Australia:

- Establish a stewardship code in Australia similar to the UK Stewardship Code for institutional investors who have voting rights in Australian listed companies. This is being progressed in Australia by the FSC in some form currently.

1.3 Clarifying Key Terms in Statutes in the Context of ESG and Responsible Investing

Proposal: Clarifying fiduciary duty, sole purposes and best interest as it applies to Trustees to address any uncertainties and misunderstandings in light of current evidence on the important impact ESG factors are having on investment outcomes.

Detail: Without the broad acceptance that a positive duty exists to take into account ESG issues in investment decision making, it is likely that many investors will not systematically take into account such issues. A recent report by the UN PRI² has identified that some investors do not consider taking account of ESG issues (which are often fundamentally long term in nature) to be part of their fiduciary duty. This is typically underpinned by the assumption that ESG performance involves a trade-off with financial performance, which has been disproven in a number of studies and meta-analyses in recent years. In the absence of case law in Australia on the extent to which maximising financial benefit is consistent with ESG integration, there is a need for a regulator or policy maker to clarify that investors are required to consider ESG issues as part of their fiduciary duty.

² United Nations Global Compact et al (2015) Fiduciary Duty in the 21st Century available at <http://2ximlj8428u1a2k5o34l1m71.wpengine.netdna-cdn.com/wp-content/uploads/Fiduciary-duty-21st-century.pdf> (accessed 18/11/2015)

This may also be worth pursuing as it relates to company directors to consider long term issues, ESG as well as reputation issues.

Note that is also required in the Australasian context on “best interest duty” which impacts responsible financial advisers when eliciting and responding to client’s ESG, ethical or values lens to investments. In Australia for example, recent changes to Corporations Amendment Act 2012 (FOFA suite of reforms) and product switching throws uncertainty over financial adviser obligations regarding “best interest duty” which may go against the strategic intent of having more capital flow to responsible investments underpinning a sustainable financial system and strong financial returns.

Furthermore, according to the UN PRI³ “in prescribing the ‘sole purpose’ as being to provide benefits to members upon their retirement, Section 62 of the Superannuation Industry (Supervision) Act 1993 is widely accepted as precluding trustees from investing assets for other purposes such as bringing about social change, or in consideration of ESG factors. This is reinforced by the traditional interpretation of the ‘best interests test’ as requiring trustees to exercise their functions and powers in the best financial interests of beneficiaries. This does not, however, prohibit ‘incidental advantages’ that may flow from properly considered and soundly-based investments. The best interests test cannot be considered without reference to risks posed to the fund and its investments by ESG issues, but there is a lack of clarity around the extent to which best financial interests requires asset owners to take account of ESG issues in their investment processes. There is also a lack of clarity on the timeframes over which these interests are to be assessed, other than the general expectation that investors would be expected to account for beneficiaries’ proximity to retirement.”

Key Sources: The report by the UN PRI recommended the following actions should be undertaken by regulators and policy makers:

- Clarify that fiduciary duty requires investors to take account of ESG issues in their investment processes, in their active ownership activities, and in their public policy engagement. Also clarify that fiduciary duty requires that investors pay attention to long-term investment value drivers, including ESG issues. In Australia, APRA is likely to be the relevant regulatory authority.
- Australian regulators should clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement.

Notably, the Kay Report favoured clear and specific guidance in the form of principles as opposed to specific regulation.

- Support efforts to harmonise legislation and policy instruments on responsible investment globally, with an international statement or agreement on the duties that fiduciaries owe to their beneficiaries. This statement should reinforce the core duties of loyalty and prudence, and should stress that investors must pay attention to long-term investment value drivers, including ESG issues, in their investment processes, in their active ownership activities, and in their public policy engagement.

³ United Nations Global Compact et al (2015) Fiduciary Duty in the 21st Century available at <http://2xjmlj8428u1a2k5o34l1m71.wpengine.netdna-cdn.com/wp-content/uploads/Fiduciary-duty-21st-century.pdf> (accessed 18/11/2015)

The UK government has progressed with recommendations of the Kay Review, most notably by requiring the UK Law Commission to undertake a review of fiduciary duties, which has provided useful clarity on this topic. The UK Government has recently decided not to progress with any amendments to the Investment Regulations which has disappointed responsible investment organisations in the UK who deem it essential to translate the clarity confirmed by the Law Commission into law.

South Africa's Regulation 28 defines the obligation on pension trustees to consider all factors that "may materially affect sustainable long-term performance". The regulation explicitly states that prudent investing should take into account all factors that could materially affect an investment, including ESG issues.

Recommended regulatory, policy and/or industry change for Australia:

- As noted, the report by the PRI recommended that:
 - The Australian Prudential Regulation Authority (APRA) should clarify that fiduciary duty requires asset owners to pay attention to long-term factors (including ESG factors) in their decision-making and in the decision-making of their agents. At a minimum this relates to:
 - o fiduciary duty obligations in the Corporations Act 2001;
 - o APRA's Prudential Practice Guide on Investment Governance (SPG 530), issued in 2013, ensuring the guidance is not limited to the offer of "ethical investment options"; and
 - o Sole Purpose Test in the Superannuation Industry (Supervision) Act 1993.
 - For financial advisers, seek clarification from relevant governing bodies (e.g. APRA) that best interest duty requires financial advisers to consider ESG issues in their Fact Find and provision of financial services advice, especially with respect to:
 - o Best Interest Duty as part of the Corporations Amendment (Future of Financial Advice) Act 2012; and
 - o Corporations Amendment (Further Future Financial Advice Measures) Act 2012; as well as
 - o Corporations Amendment (Streamlining of Future Financial Advice) Bill 2014 which impacts best interest duty as it relates to scaled advice.

1.4 Supporting Longer Term Investment Holdings via Tax Law

Proposal: Taxation law has the potential to be an effective means of encouraging long term investment through incentives for both institutional shareholders and individual shareholders, as well as disincentives for short term trading. Although we deem this a tool of last resort, we believe there is merit in considering the vast array of options that sit within taxation to ensure capital is focused on contributing to socially useful activities and supports rather than hinders capital allocation to the real economy.

Detail: Numerous proposals have been canvassed that use the taxation system to direct capital towards long term productive assets. These include the Cox review that proposed that taxation regulation should be amended to attract long-term equity investors and incentivise long term shareholdings. It made specific reference to tapering capital gains tax (e.g. Capital Gains Tax on shares could be tapered in a series of yearly step, from a rate of 50% in year one to 10% after year 10 to encourage longer periods of share ownership.). However, Kay noted that capital gains tax is only paid by a small proportion of holders of UK shares. It also suggested reducing the liability on dividends (e.g. in a series of yearly steps, from the prevailing rate of income tax in year one to 0% after year 10). A financial transactions tax has also been suggested to increase the transaction costs of short term, high turnover investment strategies (including high frequency trading).

Key Sources: Laurence Fink , the CEO and Chair of Blackrock, among others, has advocated for lengthening the time period for reducing capital gains tax rate from one year to three, as well as placing a higher taxation rate on capital gains for shares held for less than six months. Also a financial transactions tax has been promoted in the EU aiming to discourage rapid turnover of share portfolio's that contributes to short termism. The proposal would implement a tax of 0.1% on the exchange of shares and bonds and 0.01% across derivative contracts. UBS goes further and suggests that special franking credits could be used to encourage specific "impact investments" ⁴

Recommended regulatory, policy and/or industry change for Australia:

We believe these options are worth considering as potential tools to direct capital to more long term and productive applications:

- Tapering of capital gains tax over time
- Tapering of income tax on dividends over time
- Introducing a Financial Transaction Tax, as is promoted by the EU
- Require investors to provide advance notice before selling listed equities to prevent instant buying and selling⁵
- Use of franking credits to encourage investment in specific "impact" projects.

⁴ UBS (2015) The Investment Drought Whitepaper

⁵ First State Stewart, *Alice in FinanceLand*, May 2014

2. Investor Tools

“The 14% hurdle for discount rates that was considered a minimum in the late 1990s, for example, halves the future value of a dollar every 5 years, so that in 10 years today’s dollar is worth 25¢; in 20 years 6¢; and in 50 years one tenth of one cent! It is hardly surprising that any event out that far is ignored.... Seen through a corporate discount rate lens, our grandchildren really do have no value”

Jeremy Grantham, GMO Quarterly Letter, February 2012

There is no dearth of investor tools to deliver value over appropriate time horizons; an example being well structured investment mandates. Although considered a day-to-day part of investment supply chain management, investor tools were not selected as RIAA priorities for 2016 - 2018. Refer to Appendix 1 for more detail on Investor Tools.

3. Culture

3.1 Creating Appropriate and Aligned Incentives

Proposal: **Performance incentives for corporate executives should be aligned with long term sustainable value creation**

Detail: Setting appropriate incentive structures that align with long term value creation is key for focusing executives on those objectives. Many suggestions have been made to this effect, including ensuring a “meaningful proportion of executive remuneration” is based on long term performance, requiring executives to hold a meaningful amount of equity in the company, incorporating significant vesting periods for incentive compensation among others (AICD)

Key Sources: This issue has been thoroughly discussed by groups including the AICD, Generation Foundation, The Cox Review and the Kay Review.

Recommended regulatory, policy and/or industry change for Australia:

- This matter requires industry change at the company level, and would require a concerted and coordinated push from the long term investment community to encourage ASX listed companies to adopt appropriate incentive structures based on some universally developed principles.
- Strengthen and communicate expectations by investors that REM needs to be tied to long term value and the sound management of material ESG factors.

3.2 Strengthening Asset Owner Competency and Capability

Proposal **Strengthen asset owner competencies and capability on long term issues including ESG issues**

Detail: Trustees are now having to navigate a much more complex set of drivers of investment value including many systemic risks and megatrends that their traditional training is not set up to help them to navigate. In a world where there is an increasing view that to not consider ESG issues such as climate risk is to breach your fiduciary duties, asset owners, and specifically trustees, need to be properly equipped and trained in these issues.

Key Sources: Generation Foundation recommended for example integrating sustainability into business education at all levels. Equally, this could apply to ensuring appropriate training for many elements of the finance industry, and was recently suggested by President and Chief Executive of CFA Institute Paul Smith, that ASIC needs to set tougher standards of training and education for finance professionals.⁶

⁶ AFR, *World of Finance in need of Cultural Change*, 13 October 2015

Recommended regulatory, policy and/or industry change for Australia:

- Incorporate appropriate training in ESG issues, risks and opportunities as part of the trustee training through ASFA and AIST (such as the PRI Academy training in responsible investment)
- Require superfund boards have an appropriate diversity (skills, as well as gender, age and other) to ensure stronger competency
- Toughen education standards imposed by ASIC for investment professionals, that includes education on ESG and other long term issues.

3.3. Strengthening Industry Culture around Ethics

Proposal **Strengthen industry culture particularly education on ethics**

Detail: It is acknowledged that culture plays a significant role in delivery of responsible financial systems. Even with whistleblowing legislation in place, an organisation's culture — its tone set from the top — determines how laws are operationalised in the workplace. Supervisors play a key role in supporting the ethical and compliance culture of the organisation; incentive structures either reward or discourage ethical conduct in achieving goals. Externally focussed, client communications and disclosures also play a key role ensuring clients are aware of the positive and negative influences on recommendations because risks and limitations differ by organisation and client strategy. In recent times we've seen the growth and strengthening of professional organisations helping raise the standard of individual ethics and compliance by professionals, however many in the industry are not subject to professional codes and some workplaces do little to imbue those standards across whole organisations and their supply chains.

Key Sources: Professional bodies such as CPA, CFA and AIST have and require professionals to abide by an ethical and/or professional code of conduct but their reach over other industry players is limited. ASIC Survey (May 2015) into a number of investment banks to better understand their appetite, attitude and approach to conduct; APRA is monitoring cultural performance in banks.

Recommended regulatory, policy and/or industry change for Australia:

- Consider an ethics audit on financial services industry
- Work with the professional bodies (CPA, CFA, AIST etc.) to step up and focus role-playing dilemmas as part of their entry conditions to those bodies as well as part of ongoing professional development
- Toughen education standards imposed by ASIC for investment professionals, that includes education on ethics.
- Encourage broader uptake of the Banking and Finance Oath

4. Consumers

4.1 Observing Consumer Primacy

***Proposal:* Consumer primacy should be established ensuring that the ultimate beneficiaries are given choice. Better and more effective communications with beneficiaries maximises the likelihood of effective engagement, creating a culture of open dialogue, with a clear understanding of consumer needs and expectations**

Detail: The underlying beneficiary remains far removed from the investment decision being made with their retirement savings. We know how disengaged most are with their superannuation. It has been suggested that there should be a greater prioritisation of engaging those ultimate beneficiaries in the investment decisions by better understanding their values, beliefs and expectations, to ensure the finance system is indeed serving its clients and acting in their best interests. The Kay Review emphasised ensuring better communications to enhance engagement, and creating a culture of open dialogue with beneficiaries.

The options could include mandatory disclosure of all portfolio holdings to enable members to know what they are investing in, encouraging members to vote their own shares, or to undertaking regular surveys of members.

Key Sources: Recommended by Kay Review

Recommended regulatory, policy and/or industry change for Australia:

- Industry-wide efforts to better understand the desires of Australians as to how their retirement savings are invested.
- Strengthen industry-wide and organisation-level information to improve product understanding and inform better consumer choices aligned with their expectations.

4.2 Redefining Default Investment Options

***Proposal:* Default investments for members of the public who do not exercise choice should include a base level of moral and ESG standards consistent with expectations of Australasians**

Detail: Extensive polling has highlighted how the average Australian does have a baseline expectation that their super is invested without doing any harm. This understanding has led to a rapid divestment from around 30 superfunds in the last two years from tobacco, based on an increasingly clear view that the majority of beneficiaries do have some base level expectations as to how they want their retirement savings managed.

For similar reasons, the vast majority of European Pension funds have in place at least one voluntary exclusion, to reflect the expectations of the beneficiaries. Indeed, it was recently reported that the CEO of AMP Capital, Stephen Dunne, suggested all superfund trustees and asset managers should consider putting in place a base moral standard implemented across all investments.⁷

Key Sources: Sources include Essential Media Communications research April 2015, Morgan Stanley Sustainable Signals Research February 2015 and RIAA/Lonergan Research 2013

Recommended regulatory, policy and/or industry change for Australia:

- My Super products should be required to have in place minimum standards of ethical and responsible investment, including base level exclusions and ESG analysis to recognise the expectations of Australians around responsible investment

⁷ The Sydney Morning Herald, *Super Fund Members Lack Ethical Investment Knowledge*, 4 September 2015

APPENDIX 1 – Not-prioritised proposals considered as part of the Policy Roundtable in October 2015

Ref	Item	Recommended action
Regulation or Policy		
A	Increased rights for long term owners: such as loyalty shares, enhanced voting rights, differentiated loyalty dividends.	Undertake consultation on the views of implementing enhanced rights for loyal shareholders in Australia.
B	Properly pricing externalities: to better account for social and environmental impacts that will be borne by the broader economy and universal owners.	Advocate for the pricing of key externalities, with a focus on carbon pricing as an immediate priority.
C	Governments unlocking opportunities for capital to flow into long term assets: i.e. co-investment through financing vehicles to support long term investing and collaboration based on identified market failures and avoiding crowding out. This could apply to impact investment, infrastructure, start-ups/VC, innovation, low carbon etc.	Engage with governments around opportunities for such public intervention to leverage private capital where market failures exist, including on issues such as infrastructure, low carbon finance, impact investments.
D	Protect shareholder rights: including issues such as putting forward ordinary resolutions and non-binding votes. Ensure shareholder rights are not weakened, including allowing shareholders to put ordinary resolutions.	
Investor Tools		
E	Discounting and long term mandates: valuation tools such as DCF, Cost Benefit Analysis, Due Diligence, and discount rates: acknowledge that much that is value creating is not quantifiable, and long term value should not be heavily discounted.	Investigate ways of shifting the economic and valuation tools used by long term investors to ensure they are based on an assessment to deliver value consistent with the time horizon of the investor. Engage with groups such as CFA to progress this agenda. Allow valuations to consider that some value creation comes from unquantifiable items, many of which are ESG related.

Culture		
F	Assessing Asset manager performance over longer time horizons: extending the duration of mandates and the timeframe for performance measurement of asset managers to align with clients, from monthly/quarterly to annually.	As a cultural matter, this requires leadership from the asset owner community to put in place appropriate reporting and incentive structures for asset managers.
G	Enhancing reporting requirements of asset managers to asset owners: including average length of time a stock is held, explanation for turnover, voting practices, nature and frequency of discussion with management.	This requires leadership from the long term focused, asset owner community.
H	Increasing employee ownership: require executives to hold a meaningful amount of equity in the company.	Asset owner advocacy with corporations.
I	Strengthening direct engagement between asset owners and companies where time horizons are more aligned than asset managers and analysts; establish pre-eminence of asset owners over analysts in setting corporate priorities.	Asset owner advocacy with corporations and better delineation of expectations and task between asset managers and companies.
J	Companies should consult major long term investors over board appointments	Asset owner collaboration and engagement with companies.
Consumers		
K	<p>Aligning with beneficiaries: Asset owners should set mandates that are in line with their beneficiaries' time horizons.</p> <p>In a similar vein to the long term mandates, the Kay Review suggested that asset owners should be aiming to align their investments more closely with the time horizons of their underlying beneficiaries.</p>	

APPENDIX 2 - References

- Australian Institute of Company Directors, Louise Pocock, *Curbing Excessive Short-Termism: A Guide for Boards of Public Companies*, April 2013
- Eurosif, *A Sustainable Capital Markets Union Manifesto*, May 2015
- G20/OECD, *High-Level Principles of Long-Term Investment Financing by Institutional Investors*, September 2013
- Generation Foundation, *Implementing Integrated Guidance: Case studies in communicating value-relevant information*, November 2015
- Generation Foundation, *Allocating Capital for Long-Term Returns: The Strengthened case for sustainable capitalism*, May 2015
- Generation Investment Management, *Sustainable Capitalism*, February 2012
- Harvard Business Review, *Short-Termism: Don't Blame Us*, June 2012
- Institute for Sustainable Futures, *Solutions to short termism in the finance sector*, July 2007
- The Commonwealth Treasury, *Superannuation Legislation Amendment Regulation 2013: My Super and governance reforms*
- *The Kay Review of UK Equity Markets and Long-Term Decision Making*, July 2012
- Sir Michael Cox, *Overcoming Short-Termism Within British Business*, February 2013
- UK Financial Reporting Council, *UK Stewardship Code*, September 2012
- UK Government Response to the Kay Review, *Ensuring Equity Markets Support Long-Term Growth: The Government Response*, November 2012
- Mercer, *Fair Capitalism: A Manifesto for Change*, May 2013
- UNEP FI, *The Financial System We Need: Aligning the Financial System with Sustainable Development*, October 2015
- UNPRI, *Policy Frameworks for Long-Term Responsible Investment: the case for investor engagement in public policy*, November 2014
- UN Global Compact, UNEP FI, and PRI, *Fiduciary Duty in the 21st Century*, September 2015

“If we think long term, we can accomplish things that we couldn’t otherwise accomplish.”

-- Jeff Bezos, CEO of Amazon

We’ve created a gambling culture in which we tune out everything except the most immediate outcomes. If we’re going to meet our commitments to our children and grandchildren, and to society as a whole, we need to open up the lens and start taking a more responsible, longer-term view of the challenges we face.

Laurence Fink is the chairman and CEO of BlackRock



Responsible Investment Association Australasia

www.responsibleinvestment.org