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ESG RISKS AND SUPERANNUATION TRUSTEES: A LEGAL PERSPECTIVE

Jonathan Steffanoni

The responsibility of superannuation trustees is greater than that of typical businesses – holding an important economic and public policy role to Australian society to provide income in retirement. What duty or responsibility do superannuation trustees have towards environmental, risk, and governance factors?

There has been gradual shift in focus over the past decade from sustainability and socially responsible investments towards ESG risk. This change intersects with the law regulating superannuation fund trustees and is an area clouded by some confusion. Bearing this in mind, I intend on covering a few main themes:

- Clarifying the distinction between the terminology which is frequently confused;
- Taking a closer look at what ESG factors and indicators actually are;
- Focusing on some global trends which are likely to be influential in Australia; and
- Looking at specific legal issues which arise in relation to these global trends.

Putting ESG in Context

Upfront, there needs to be a clear distinction between ESG factors as tactical indicators relevant for selecting and timing decisions about specific investment opportunities; and investment strategies which are conditioned by proscription or prescription of certain non-financial outcomes (such as avoiding tobacco, armaments or fossil fuels or investing in renewable energy technology).

Inclusion of ESG factors differs significantly from divestment or negative screening of assets involved in certain activities. We're also not talking about impact investing in assets intended to achieve a non-financial outcome. Equally, we aren't focused on investing in assets with the intention of controlling or influencing towards non-financial objectives. We are talking about the inclusion of ESG factors as relevant financial considerations informing investment decisions about particular opportunities.

There is too-frequent confusion between the process focused consideration of ESG factors with the outcome focused (to varying degrees) ethical, sustainable or responsible investing. In some ways, the awkward acronym "ESG" itself may have contributed to the confusion. The E and S relate to particular groups of non-financial outcomes, while the G relates to process.

Sustainable, responsible or ethical conditions on investing typically require that the trustee's duties are conditioned by consent of the beneficiary. ESG factors relate more specifically to the active exercise of investment powers where there has been no conditioning of the financial objective and therefore investment strategy.

When we hear or use the term ESG, it can be easy to oversimplify the detail of what is a broad and diverse range of non-financial indicators. Typically, risk factors are those things which may result in financial detriment to the value or income generating capacity of an asset. These risk factors are then reflected in risk indicators, which are can be analysed by investors to inform decision making, and possibly create alpha for managers.

The other important aspect of ESG risk factors and indicators is the role of complex supply chains. Exposure to ESG risks isn't constrained to direct investments, and flow though very complex supply chains of investment management, goods and services. These have traditionally been tricky to monitor, however advances in technology are making this kind of deep analysis possible. Let's just take a quick look at what makes up the E, S and G.

Environmental risk factors

Most of us have a general understanding of what environmental risk factors are, but there's value in taking a closer look. Table 1 includes typical environmental events, factors and indicators. Many of the environmental risk factors are the result of regulation by governments to protect against environmental damage. There are also macro risk factors which relate to the depletion or damage to the resources required to produce and supply.

Table 1.

Risk events	Risk factors	Risk indicators
Chemical release	Production disruptions	Track record of environmental incidents
Degradation of agricultural land	Capital costs of remediation	Environmental management policies and systems
Oil spills	Compensation costs	Environmental data
Climate change	Regulatory or social license costs	Direct and indirect carbon emissions
Natural resource depletion	Regulatory Fines & Penalties	Measures to address climate change direct impact
Waste contamination		
Nuclear mishaps		
Biodiversity		

Sources: ISO 14001 & FSC/ACSI ESG Reporting Guide for Australian Companies

Environmental risk events harm operational activities (or risk factors) within a company's supply chain and potentially have an impact on a company's financial performance and therefore shareholder performance. Inclusion and monitoring of such risk indicators in investment decision making is not uncommon as a financial indicator, and is broadly used by active managers.

Social risk factors

In a similar fashion to the grouping of environmental factors, there are also social risk events, factors and indicators (Table 2). These risk factors are again related to the possibility of the events having a detrimental impact of the financial performance of investing in certain companies or assets.

Table 2.

Risk Events	Risk Factors	Risk Indicators
Industrial disputes	Consumer boycott	OH&S Policies, Systems & incidents
Human rights abuses	Brain drain	Voluntary staff turnover
Workplace accidents	Poor productivity	Employee satisfaction/ engagement
Criminal charges	Compensation costs	Gender diversity indicators
Consumer protection	Legal costs & litigation	Whistleblower policies
Money laundering	Customer and supplier social license (reputational and relationship risk)	Supply chain audits
Exposure of tax avoidance or minimisation	Increased regulation	Tax optimisation practices

Sources: UN Global Reporting Initiative: Labour Practices; FSC/ACSI ESG Reporting Guide for Australian Companies

Social risk events are similar to environmental events in potentially harming operational activities (or risk factors) within a company's supply chain and therefore impacting a company's financial performance. Inclusion of monitoring of such risk indicators in investment decision making is also growing.

Governance themes

Governance is a little different to environmental and social risk factors. The corporate governance themes are more general in nature, although there are some direct financial costs which can result from poor corporate governance.

Indicators of corporate governance practices are intended to provide insight into the quality of management in the company, and the quality of risk oversight by the board who are the representatives of shareholders (Table 3). Failure of the board to address these issues has contributed to many of the high profile corporate collapses over the past decade. Investors often desire reporting on corporate governance to better understand the framework, policies, and incentives in place to ensure best performance by the company.

Table 3.

Risk Themes
Anti-competitive behaviour
Bribery & corruption
Business ethics and conduct
Executive remuneration
Market conduct
Regulatory compliance
Reporting & disclosure
Supply chain assurance
Tax payment
Transparency

Sources: The ASX Corporate Governance Principles and Recommendations supplement black letter law in the Corporations Act in Australia; The Australian Council of Superannuation Investors publish Governance guidelines for listed company boards.

There are some good resources available in relation to governance themes. The ASX Corporate Governance Principles and Recommendations supplement black letter law in the Corporations Act in Australia, and the Australian Council of Superannuation Investors publish governance guidelines for listed company boards. Equipped with a better understanding of ESG risk factors, here are some international developments.

International developments

International developments don't directly impact Australian law, yet we live in a globalised world with strong global connections with international flows of capital, services and information. There are two influential trends worth considering:

- An increasing acceptance of ESG factors as important long term financial indicators; and
- Growing sentiment to challenge institutions which aren't considering ESG factors in making investment decisions.

EU IORP II Directive

EU policymakers have recently agreed a European law, the IORP II Directive (Prudential Regulator of Institutions for Occupational Retirement Provision), which requires pension funds to consider the "use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change."

The EU directive is mandatory for ratification by member states. When it comes into effect, it will be the first time a European law has regulated this kind of risk, reflecting a significant change in the planet's largest economic block. The recital—a preamble to the directive itself—also employs the UN-backed Principles for Responsible Investment (PRI) as a benchmark for EU member states to note when transposing the law.

Many investment managers who supply services to European pension systems also service our superannuation system, and will be required to develop mechanisms and processes to ensure that ESG risk factors are considered in investment decision making. This is likely to have some flow through effect to any Australian superannuation fund clients.

UK Law Commission

The common origin of our legal systems make UK law particularly influential in Australia. In 2014, the UK Government released their recommendations on reforming the law related to ESG considerations in pension fund management.

The commission recommended amending regulations to ensure that pension fund trustees' should take account of environmental, social and governance (ESG) issues where these are financially material (or may become so), and may consider wider ethical factors under certain circumstances.

This wasn't particularly important pre-Brexit…however, it may become more relevant with the short and mid-term uncertainty. Given the closer influence that the UK legal system has on Australian law reform, this may be a relevant influence in the future if it is adopted. There are also a couple of examples of the growing social sentiment to challenge institutions which aren't considering ESG factors in making investment decisions.

Client Earth

Last year, UK based public interest law firm Client Earth revealed that it is preparing to launch an action against the trustees of a large UK pension fund for their failure to manage the financial risks to their investments from climate change. The claim is said to be issued on behalf of the members of the fund, which is identified only as a 'laggard' near the bottom of climate change risk management 'league tables' published by the Asset Owners' Disclosure Project. If this litigation was to proceed, it would be the first publicly commenced case to argue that a trustee had failed in its duty to consider climate change as a material financial issue.

It is not clear whether the Client Earth litigation will eventuate, nor how it will be framed (i.e. as a breach of duty case or a misrepresentation case). However, irrespective of how it is framed, it has the potential to give rise to similar actions against trustees (and their directors) in Australia. It may be that the media attention given to such a court case is itself the desired outcome of the litigation rather than the award of damages or other legal remedy.

Urgenda Foundation v The State of the Netherlands

While it didn't relate to the investment related duties of fiduciaries, this case demonstrates the changing appetite for legal action in pursuit of environmental objectives. Environmental group, the Urgenda Foundation filed a lawsuit against the Dutch Ministry of Infrastructure and Environment on behalf of nearly 900 Dutch citizens. The district court in Den Haag ordered the Dutch government to ensure that the Netherlands reduce greenhouse gas emissions at a faster rate than currently targeted.

Having much of a country below sea level may not carry much legal weight, but maybe this played on the mind of the judiciary in this case. The Dutch government has announced its intention to appeal the decision, expected to occur later this year.

What these examples demonstrate is that there is a growing appetite to legally challenge environmental issues in particular. Superannuation trustees aren't immune from this environment, and there are some aspects of the law related to superannuation trustee duties which warrant some attention.

Legal issues

There are two groups of legal issues which relate to the growing adoption of ESG factors in investment decision making: trustee duty related issues, and disclosure issues.

Concerning the potential breach of a trustee's duties, there are two distinct angles which should be considered. First, can trustees consider ESG factors in making investment decisions without member consent? Secondly, might a failure by a trustee to consider ESG factors result in a breach of fiduciary duties?

There are also potential issues related to product disclosure. First, does consideration of ESG factors by a trustee or investment manager need to be disclosed under current product disclosure laws? Secondly, does being a UN PRI signatory (or similar membership) require disclosure under product disclosure laws?

Trustee duties

There are two aspects in relation to the making of investment decisions which resonate with the questions just posed. First, the question of whether trustee investment decisions are made for proper purpose is particularly pertinent when we consider whether trustees are at risk

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of being in breach of fiduciary and statutory duties by considering ESG factors in making investment decisions. Second, the standard of care required of trustees in making investment decisions is relevant is assessing whether Trustees may be at risk of breaching fiduciary and statutory duties if they are not considering ESG factors when making investment decisions. Let's take a closer look at proper purpose.

Proper purpose

The relevant law that finds three key aspects to the proper exercise of investment powers arising from statute and general law.

1. The sole purpose test under section 62 of the SIS Act;
2. Trustee's duty to act in the beneficiaries' best interests; and
3. The doctrine of powers in general law.

It's worth focusing on each of these aspects briefly, considering whether the inclusion of ESG factors into decision making is permitted under these aspects of the law. But before we look at the sole purpose test, we should be clear that there is an overarching caveat that the law may be conditioned by express and informed consent of members or beneficiaries to invest towards non-financial objectives. The following analysis assumes this is not the case.

Sole purpose test

While we might be familiar with section 62 of the SIS Act, in general terms it requires trustees to maintain a fund solely for one or more of a set of specified core purposes (the provision of benefits upon the retirement or passing of a member) or core and ancillary purposes which include ill health and termination of employment. This was interpreted by Associate Justice Hallen in the SMSF case of Sutherland v Woods as ensuring that the paramount consideration of superannuation investment was retirement income.

While the paramount importance of retirement incomes is clear, it is critical that the correct test is one of the dominant purpose rather than the sole purpose. In support of the interpretation of the dominant purpose test, APRA has documented this approach in Circular No.III.A.4. The law entrenches an all-encompassing dominance of retirement income provision over any other incidental outcomes and therefore matters considered.

Therefore, concerning ESG factors, there may well be decisions made which result in desirable outcomes related to the natural environment or social issues, however these outcomes must not override or prejudice the dominant consideration of retirement income provision.

Best interests of beneficiaries

Subsection 52(2)(c) echoes the general law principle most famously articulated in the 1985 British case Cowen v Scargill, by inserting the covenant expressly in trust instruments that trustee duties and powers are performed and exercised in the best interests of beneficiaries. Importantly, for the interpretation of subsection 52(2), in Cowen v Scargill, Sir Robert Megarry went to define best interests in a pension or superannuation context as being financial best interests:

"The starting point is the duty of trustee to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty…is paramount. They must, of course, obey the law; but subject to that, they must put the interest of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries…the best interests of the beneficiaries are normally their best financial interests."

This standard is further lifted for trustees of default MySuper products. Subsection 29VN(a) specifically requires the promotion of the net financial performance of interests of MySuper members. The specification of best interests meaning financial best interests is important in considering whether the inclusion of environmental or social factors (such as minimising carbon emissions or child labour) in making investment decisions is consistent with the financial retirement income interests of beneficiaries.

While I'm unaware of the issue being specifically tested in Australian courts, a reasonable application of the best interests duty to the inclusion of ESG factors in investment decision making would see that Trustees can consider ESG factors in assessing financial prospects of investments, and furthermore can make investments which are coupled with the potential of an environmental or social benefit, so long as they can demonstrate that there is no prejudice to the financial interest of members.

Doctrine of powers

It's also worth mentioning the doctrine of powers in general law—as it applies to the consideration of ESG factors in investment decision making. The relationship between the statutory duties of trustees and those derived from general law principles is a topic of much debate. Indeed, there are resonances between the general law and sections 52, 62 and 29VN(a).

The general law provides that the trustee must exercise its powers for proper purpose, which is defined as being the purpose for which the power was granted. Any exercise of power for a purpose other than that for which it was granted is voidable as a fraud on the power. Cowen v Scargill is relevant here again in interpreting what the purpose may be—the best financial retirement income interests of members.

So then, how should we treat the potential of there being an ancillary or subsidiary purpose such as minimising pollution or graft and corruption?

We can find guidance in the general law, with the courts holding that the presence of potential incidental or collateral benefits not necessarily tainting the exercise of a power. To quote Lord Justice Parker in the old British case of Vatcher v Paull:

"It is not enough that an appointer or some person not an object of a power may conceivably derive some benefit."

This reasoning was picked up and applied in the Australian courts to a superannuation fund in Invesys Super v Austrac Investments, where Justice Byrne was not prepared to void the trustee's distribution of a surplus which benefited an employer, so long as the other relevant duties and obligations under the trust were met.

What does this mean for ESG factors? Can Trustees proceed with confidence? In my view yes, however it remains important that the adoption of ESG factors (and resulting non-financial outcomes) does not prejudice the financial retirement income interests of beneficiaries.

Now then, if we take this further—a more interesting question relates to whether the failure to include ESG factors in investment decision making might result in a trustee breaching the required standard of care in managing investment related risks?

Standard of care

Trustees of superannuation funds are required to adopt a certain standard of care in making decisions and exercising their duties, such as investing the assets of the fund. A good starting point to understand the required standard of care is the general law principle in Whitely, that trustees must:

"Take such care as the ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound."

We have however set a higher standard of care for superannuation trustees in statute, with the standard being that of the prudent superannuation trustee rather than the ordinary prudent man. It was explicit in the explanatory memorandum of the Act which amended the SIS Act to define a prudent superannuation trustee over a prudent ordinary person that the intention was to raise the standard of care to reflect the importance and scale of the responsibility which was in the hands of superannuation trustees.

Subsection 52(2)(b) of the SIS Act imposes a covenant on trustees to:

"Exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments."

The prudent superannuation trustee is expected to be held to a high standard of care in managing risks related to investments and due diligence. This then raises the obvious question or what is meant by "care" in the context of making investment decisions. Does it include the consideration of risks such as those posed by environmental, social and governance factors? There are two aspects to the standard of care which are relevant:

1. The assumption of investment risk; and
2. The elimination of due diligence risk.

The assumption of investment risk by superannuation trustees is addressed under subsection 52(6)(a), which requires trustees:

"Formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity, including, but not limited to the following:

(1) The risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and is expected cash flow requirements…"

The statutory requirement of consideration of the whole circumstances of the entity is broader than managing trust affairs, which exists in general law. This may open the door (ever so slightly) to the possibility of a challenge to the omission of considering ESG risk factors in the making of investment decisions.

The statutory requirements under subsection 52(6)(a) relate to the investment strategy, and provide for the formulation, review and implementation with regard to certain factors which can be considered to reflect due diligence, relevantly s52(6)(a)(i) concerns the risk and return of investments, measured against investment objectives; and s52(6)(a)(viii) is a catch all for any other relevant matters.

Might any of these due diligence requirements be interpreted to relate specifically to ESG risk factors? While there's no specific precedent, it is reasonable to see that the long term horizon of investment objectives and progressive normalization of including ESG factors in investment decision making within the sector might open the way for such an argument.

The increasing adoption of ESG risk factors in investment decision making may prove persuasive in setting judicial expectations of what a prudent superannuation trustee should consider in assessing the risks associated with investment decisions. We now know that up to 70% of investment managers are including ESG analysis information in making investment decisions.

While there is no precedent, it isn't unreasonable to foresee that the standard of care may be interpreted to include the consideration of ESG analysis in making investment decisions. As there is future development in ESG research and analysis in the coming years it will be interesting to see the extent to which aspects of ESG research can be shown to correlate to investment performance. There are also interesting issues related to ESG and product disclosure laws.

Disclosure

There are two questions to address in relation to ESG disclosure and ESG risk factors:

1. Does consideration of ESG factors by trustee or investment manager need to be disclosed?
2. Does being a UN PRI signatory (or similar signatory) require disclosure?

In response to one, amendments to the Corporations Act over a decade ago introduced the requirement shown here, being that:

"A Product Disclosure Statement must include the following statements, and such of the following information as a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product: […]

"If the product has an investment component—the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment."

While it reads relatively clearly, ASIC has provided some principles based guidance in Regulatory Guide 65. There are some interesting aspects which warrant a little consideration:

- The disclosure obligation applies to all product issuers, so that will include the requirement to disclose where such factors are not taken into account at all;
- There is an expectation that the more a product is marketed on the basis of such considerations, the more detail is expected;

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It will be the first time a European law has regulated this kind of risk, reflecting a significant change in the planet's largest economic block.

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It's important that trustees are aware of the approach being adopted by these investment managers and disclose details about this adequately.

- Where it's not actively promoted, disclosure still required;
- Where multiple investment options exist, the approach needs to be disclosed separately for each investment option;
- Distinction between treatment of different asset classes is required;
- Devolved investment decision making—underlying managers practices need to be disclosed (unless additional PDS from product issuer to be provided).

Put simply, where a trustee defines ESG factors as being relevant by way of the trust deed or policy, or where the managers of underlying investments are considering ESG related factors in making investment decisions—this needs to be included in product disclosure.

This can be challenging in an environment where many investment managers are undertaking ESG analysis across much of their business in an effort to exploit market inefficiencies and achieve alpha over competitors. It's important that trustees are aware of the approach being adopted by these investment managers and disclose details about this adequately.

The reasoning for the inclusion of the disclosure requirement is interesting, as it reflects that financial performance improved by considering ESG factors; that it allows more detailed assessment of the opportunities and risks posed by a particular product; and that there is a desire to provide products which match investor views about the type of world in which they want to live.

While the first two reasons relate to the use of ESG factors as indicators of financial performance, the third reason specifically calls in objectives other than financial. This places the requirement in a tricky position. The disclosure laws and guidance apply consistently, irrespective of whether the trustee duty to invest in the best financial interests of beneficiaries is conditioned by member consent.

Indeed, it raised an interesting question of whether mandatory disclosure conditions the previously discussed trustee duties in either instance? Accurate disclosure in compliance with relevant law is likely to result in the trustee duties being conditioned by the consent of the member when applying and commencing membership with a product. The precise wording of disclosures may prove to be quite important and worthy of close scrutiny by trustees.

United Nations Principles of Responsible Investment

It is not uncommon for superannuation funds to participate in initiatives such as the United Nations Principles for Responsible Investment. In Australia, there are currently 34 asset owner signatories (mostly superannuation funds), 71 investment managers and 11 service providers also participating. These signatories typically have transparency reports posted online, detailing the asset owners' progress in implementing the principles.

Where a superannuation trustee is signatory to such an arrangement, it certainly sends a signal to the market that the asset owner intends to act in a particular manner. This would be relevant in setting the level of detail which would be expected to be disclosed in product disclosure documents. In such circumstances, particular care should be taken in ensuring that product disclosure is adequately detailed and consistent with information reported by the UNPRI about the entity.

Something to consider

ESG related questions to consider if you're managing a superannuation fund:

- Are investment decisions being made on behalf of members?
- If so, are ESG risk factors assessed to determine whether they may result in a financial impact?
- Do investment policies and procedures facilitate inclusion of ESG risk factors in investment decision making?
- Do Investment Management Agreements (IMA) address the inclusion of ESG risk factors and are they considered under mandates?
- Do IMAs ensure that any ESG risk data and information is reported to trustees?
- Does the trustee's risk framework cater for the identification, setting of appetite and assessment of ESG risks?
- Are ESG related investment risks monitored and reported to trustee board and investment committee?
- Has disclosure been reviewed to ensure the approach to ESG factors hasn't been misrepresented?
- Is the fund a signatory to the UNPRI or other initiatives which may represent an approach to ESG risks? **FS**