



THE LAW SOCIETY
OF NEW SOUTH WALES

Our ref: BusLaw: PWb1265673

14 March 2017

Housing Unit Manager
Society Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: socialimpactinvesting@treasury.gov.au

Dear Sir/Madam,

Social Impact Investing Discussion Paper

The Law Society of NSW appreciates the opportunity to comment on the Discussion Paper, *Social Impact Investing*. The Law Society's Business Law Committee contributed to this submission.

1. What do you see as the main barriers to the growth of the social impact investing market in Australia? How do these barriers differ from the perspective of investors, service providers and intermediaries?

We consider that the main barrier for investors is the risk and return profile of social impact investments. Investors willing to bear increased risk until a service proposition is proven, and prepared to sacrifice return on the same basis would comprise a small segment of potential investors. The requirements or obligations of the majority of investors, particularly managed investment and superannuation trustees, is to act in the best interests of the members of the fund. This may constrain their willingness to make such investments without a proven track record of appropriate earnings and acceptable risk.

In our view, the main barrier for service providers is the ability to deliver outcomes for the costs forecast, and to convince investors that they can do so. Intermediaries would need to be able to validate the forecast of service providers and then convince investors that the investment proposed is acceptable based on the investor's risk and return profile requirements.

2. What do you see as the future for social impact investing in Australia: for example, can you foresee the development of new structures for social impact investing?

Social impact investing, as described in the Discussion Paper, to facilitate funding of government services through private sources could become a burgeoning area if the risks and returns are managed appropriately. The sector data should be maintained and analysed in accordance with principles applied to any other investment sectors.

3. Are there any Australian Government legislative or regulatory barriers constraining the growth of the social impact investing market?

The duties of trustees in relation to investments under the *Superannuation Industry (Supervision) Act 1993* ("SIS") regime require the best interests of members of the fund to be of paramount importance, as is also the case under the law relating to trusts. Until the risk and return profile of social impact investing becomes a mainstream investment option, it will be challenging for superannuation fund trustees to make social impact investments, other than perhaps some specific member investment choice opportunities, wherever members demand such investments be made available.

Expansion of the concessional tax treatment for entities through which social impact investments are made would also assist in removing current constraints to the availability of these investments.

4. What do you see as the role of the Australian Government in developing the social impact investing market?

While existing structures under Australian law allow for social impact investing, the legal obligations and tax qualifications imposed on entities act as constraints and increase cost. As with superannuation trustee companies, it may be worth providing for a purpose built legal entity with a template constitution, automatic tax qualification and simplified reporting to make social justice investment entities easier to set up. This will also facilitate participation by less wealthy individuals and corporate investors.

5. Do you see different roles for different levels of government in the Australian social impact investing market? For example, the Australian Government as co-funder with State and Territory Governments continuing to take the lead in developing social impact investments?

The opportunities for social impact investing should relate to the level of government from which the service is provided. A pooled intermediary for services provided across different jurisdictions could also be established, for example for the provision of legal services for the disadvantaged.

6. Are there areas where funding through a social investment framework may generate more effective and efficient policy outcomes than direct grant funding?

Funding through a social impact investing framework distances the service provider from the government by including requirements of an intermediary/investor more akin to commercial relationships. In circumstances where a government wishes to maintain robust control over services providers, grants may prove a more appropriate method for funding.

7. What Australian Government policy or service delivery areas hold the most potential for social impact investing? Are there any specific opportunities you are aware of?

The Discussion Paper and Media Release note public housing as a relevant example.¹ The outsourcing of social services functions has also proved successful though social justice bond issues. Given that legal services for the underprivileged are funded through Legal Aid, and governments provide grant funding to other legal services such as community legal centres, an opportunity may exist for social impacting investing in the legal services area.

8. Are there opportunities for the Australian Government to collaborate with State and Territory Governments to develop or support joint social impact investments?

There should be opportunities for any government services provided by both Federal and State/Territory governments to develop or support joint social impact investments.

9. What are the biggest challenges for the implementing the Australian Government's public data policy in the social impact investing market? What can the Australian Government do to address these challenges?

The collation, maintenance and analysis of data from many different sources will be challenging. This data will be required by investors to provide historical and ongoing performance viability evidence for social impact investments risk and return.

10. Are there opportunities for the Australian Government to form data sharing partnerships with State and Territory Governments, intermediaries and/or service providers?

Any data sharing partnerships should include the Australian Government together with State and Territory Governments.

11. We are seeking your feedback on the four proposed Principles for social impact investing.

The Principles aim to encourage the involvement of the community and the private sector into social impact investing by achieving the objectives set out on page 18 of the Discussion Paper.

Value for money

It is fundamental that a social impact investment funding alternative will only be undertaken by government for a service where delivery improvements and cost reductions to government will result.

The government should consider the available research, such as the Productivity Commission's findings in relation to the economics and efficiencies of funding Legal

¹ See also the scheme provided by Defence Housing Australia:
<https://www.dha.gov.au/investing/buy-a-dha-investment-property/who-is-eligible-to-buy-a-dha-property>

Aid Commissions and Community Legal Centres², as well as the work conducted by the Law and Justice Foundation referred to below.

Outcomes based measurement and evaluation

The requirements and methodologies described in the Discussion Paper are appropriate and necessary to produce robust data for evidence based decision making. The Law and Justice Foundation of NSW already undertakes similar processes in its work producing legal needs based data and in providing grants.

Fair sharing of risk and return

Investor expectation is the most important element in decision making by investors on willingness to make social impact investments. Consequently the risk of under delivery, resulting in under earnings, will need to be clearly articulated in disclosure materials to investors and included in contractual services delivery agreements with services providers and government. Given the innovative character of social impact investments initially, any lack of forecast delivery of services or earnings could have a major negative impact on future willingness of investors.

Deliverable and relevant social outcome

The matters to be considered by government when assessing suitable service providers set out on pages 23 and 24 of the Discussion Paper are appropriate, namely:

- the governance arrangements;
- the capability of the management team;
- the sustainability of the business model;
- service delivery and relationship management experience;
- the ability to adjust the delivery of the intervention in response to data about performance; and
- whether the proposed intervention is supported by the existing evidence base.

Government agencies should ensure they have the internal capability to manage a social impact investment, including:

- management capability;
- contract and relationship management skills; and
- access to the required data.

It is imperative that service delivery forecasts be met or exceeded in order for future social impact investments to be perceived as acceptable to investors.

12. Are there any issues other than those identified relating to control that would suggest the options presented will not be sufficient to solve the problem?

The options set out in the Discussion Paper only relate to private ancillary funds ("PAFs") qualifying as sophisticated investors under the *Corporations Act 2001* (Cth). These allow PAFs to qualify for disclosure exemptions for social impact investment

² See, for example, Productivity Commission, Australian Government, *Access to Justice Arrangements Inquiry*, Report No 72 (2014) 703.

opportunities, if only high net wealth individuals or investing corporations or entities are anticipated to invest.

We note that the Discussion Paper does not look at public ancillary funding. If less wealthy individuals wish to be involved in such investments, they would need to access the investments through such public entities, or through their superannuation fund's member investment choice regime.

14. Do the options canvassed provide sufficient certainty around when a PAF is controlled by a sophisticated investor? Are there better options that are not discussed?

The options in the Discussion Paper for identification and qualification of sophisticated investors should be adequate to PAFs that meet the suggested investor criteria, and should provide certainty. We note that the same criteria are used under the Australian Financial Services regime.

15. How could these options be best incorporated within the appropriate legislation?

The Australian Securities and Investments Commission ("ASIC") could provide relief from the requirements for PAFs that meet the suggested criteria.

16. Is a written statement from the board of directors of the PAF sufficient evidence of the status of the trust as a sophisticated investor, or should a letter from an independent third party be required?

It would be preferable, for good governance purposes, for an independent third party such as an accountant to provide certification.

17. What qualifications should the independent third party person be required to hold?

A certificate that the investor meets the definition requirements of a sophisticated investor, from the investor's accountant, as is the case currently under the *Corporations Act 2001* (Cth), should be sufficient.

18. Is it common for a natural person involved with a PAF to meet the professional investor test, but not the sophisticated investor test, or vice versa?

While this is possible, it is not common as professional investors are generally sophisticated.

19. Does this lack of control provision restrict PAFs established by professional investors from investing in impact investment products?

The lack of control provision does not prevent a PAF of professional investors from making such investments. It would, however, require costly and detailed disclosure materials.

20. Are there any similar issues about the application of the sophisticated investor test and/or professional investor test for investment by PAFs in financial products other than securities that are structured as impact investment products?

Any social impact investment, whether utilising a PAF or through a social justice bond, must meet the requirements for the issue of investment interests under the *Corporations Act 2001* (Cth). As such, the investment should offer the protection of that regime, and the exemptions available from disclosure to sophisticated investors and, if ASIC provides relief, for professional investors.

21. If the Government were to amend any of these definitions to provide clarity for PAFs, would there be any consequences for other activities regulated by the Corporations Act, or other Commonwealth legislation?

There should not be any consequences for other activities regulated by the *Corporations Act 2001* (Cth) or other legislation, so long as the relief provided by ASIC is specifically applicable only to PAFs for the purposes of enabling efficient social impact investing.

22. Are there relevant parts of the Corporations law, or other Commonwealth legislation and guidelines, which represent a barrier to PAFs investing in impact investment products?

As far as we are aware, there are no other relevant parts of the Corporations law, or other Commonwealth legislation, that represent a barrier to PAFs investing in social impact investment products.

23. What guidance in particular would provide a desired level of clarity on the fiduciary duty of superannuation trustees on impact investing?

In our view, it may not be appropriate for a regulator or government to provide guidance to a superannuation trustee on its fiduciary obligations to the fund's members, when it comes to decisions on investments. This is because membership constituencies may have very different investment requirements for their differing risk and reward appetites and needs. Equity law, and the codification of it under the provisions of the SIS regime, already provide very clear guidance on the fiduciary obligations of superannuation trustees.

If any guidance is to be provided, it should stipulate that a superannuation fund trustee offering a social impact investment option within its member investment choice range, may do so after appropriate due diligence and disclosure of the forecast returns and risks. This information should be made available to members who demand such investment options due to their altruistic support of social impact investments.

24. To what extent are the current arrangements for program related investments appropriate?

Should changes be made to:

- 24.1. recognise the total loan, rather than only the discount rate between a commercial rate and the concessional loan rate, for the purposes of meeting the ancillary's funds minimum annual distribution; and**

24.2. allow ancillary funds to make program related investments to non DGR organisations?

In our view, the existing formula for program related investment allocation to allowed distributions is acceptable.

In relation to question 24.2, if a program of social impact investing is to be implemented, then it is essential that program related investments can be made to entities other than deductible gift recipient ("DGR") organisations. The alternative option of adding every service provider as a DGR under income tax legislation is not feasible.

To ensure a PAF only utilises funds enabled for social impact investments, the discount should only be allocated to its minimum annual distribution amount. If the total loan amount could be utilised for this purpose, then it could result in the PAF being unable to repay investors should the loans default.

25. What is the level of demand from both DGR and non DGR organisations who could be recipients of program related investments?

We are not able to provide a response to this question.

26. What are the costs of administration for organisations receiving program related investments compared with receiving irrevocable donations?

We are not able to provide a response to this question based on experience. However, the collation of data to verify delivery and forecast benefits of program-related investments, requires additional time and resources by the provider, so must incur additional resource costs.

27. Given the recent changes to the ancillary fund guidelines regarding program related investments, and noting the issues associated with making further changes, are there alternative mechanisms for promoting program related investments outside of ancillary funds?

As with commercial capital raisings, social impact funding could be provided through tranches of social impact bonds, issued when program funding is required and priced to cater for the differing tranche needs.

28. Have you faced a legal impediment as a director of a social enterprise from making a decision in accordance with the mission of the enterprise, rather than maximising financial returns, that only a change in the legal structure could resolve? If so, what amendment to Commonwealth legislation, regulation or ASIC guidance would you consider is needed to address this problem?

We are not able to answer this question from experience.

29. Would making a model constitution for a social enterprise assist in reducing the costs for individuals intending to establish a new entity? What other standard products or other industry led solutions would assist in reducing the costs for individuals intending to establish a social enterprise?

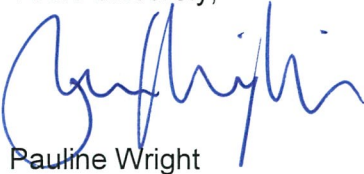
A model constitution (and trust deed) for a social enterprise, would reduce establishment costs. This was the case with the model constitution introduced some

time ago for superannuation fund trustees. By having a standardised document, due diligence could be made simpler and so less costly.

Investment due diligence information could also be standardised to accord with investment consulting due diligence practices. This would curtail the major costs involved with setting up a social enterprise and assessing the appropriateness of proposed social impact investments.

Thank you for the opportunity to provide comments to this review. I would be grateful if questions can be directed at first instance to Liza Booth, Principal Policy Lawyer, by email at liza.booth@lawsociety.com.au or phone (02) 9926 0202.

Yours sincerely,



Pauline Wright
President