IMPACT
INVESTMENT
GROUP

Certified B Corporation

31 March 2015

Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: fsi@treasury.gov.au

Re: Financial System Inquiry Final Report

Dear Sir/Madam,

Impact Investment Group is pleased to offer a submission in response to the Financial System Inquiry's final report. Our submission focuses on the significant matter of Impact Investment in Appendix 1.

About Impact Investment Group
The Impact Investment Group (IIG) seeks to create impact investment opportunities that generate attractive financial returns to investors and deliver meaningful change for society.

We believe in the power of commercial capital, intentionally focused on impact, to create real and measurable progress globally. Ultimately our vision is to build a fairer and more equitable world. IIG is the first Australian fund manager to become a certified B Corporation, further explained below.

IIG has approximately $167 million in assets under management. It is owned by Chris Lock (Chief Executive Officer) and Small Giants, the family office of Daniel Almagor and Berry Liberman. IIG is an active and ethical manager that benchmarks its fees to the long term performance of its assets.

Impact Investing and the Financial Systems Inquiry Recommendations
IIG thoroughly endorses Recommendation 32 of the Inquiry.

Recommendation 32 reads as follows:

a) Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery.
b) Provide guidance to superannuation trustees on the appropriateness of impact investment.
c) Support law reform to classify a private ancillary fund as a 'sophisticated' or 'professional' investor, where the founder of the fund meets those definitions.

As an initial comment, IIG congratulates the Inquiry for using the term 'impact investment', rather than 'social impact investment' and encourages the Government to do the same. Impact investment describes opportunities that offer social and/or environmental and financial returns, so it is best to not include the word 'social'.

IIG provides detailed comments on each of these recommendations below.

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(a) Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery.

The body of the Final Report states as follows:

> "The Inquiry sees merit in Government facilitating the impact investment market. Government's involvement should include coordinating interested private sector parties, providing expertise on social service delivery and performance measurement and offering explicit public endorsement for the significant private sector interest in this emerging market."

IIG believes Government should take an even more active role than suggested in the Final Report to help overcome the barriers to impact investment that were outlined in the Interim Report. Impact investment can play an important role in bringing additional private capital to help address issues that have traditionally been predominantly Government funded and in an era of declining government revenues, this should be of significant interest to Government.

Catalytic role

Government can play a catalytic role in relation to specific actions to trigger the development of the market, such as providing risk capital.

Providing risk capital will serve to de-risk impact investments for investors and encourage more impact investments, especially from investors who have limited experience with impact investments or have a more conservative approach. Several mechanisms can be implemented to minimise the risk of impact investments. Catalytic first-loss capital can be used to mitigate risk to the investor by absorbing a set amount of losses before the investor does. This first-loss capital is called catalytic because it attracts the participation of commercial investment that would otherwise not be there. This protective layer is often funded by organisations that are strongly aligned with the investee's social and/or environmental goals, but Government funds can also be used in this catalytic way.

Another way to de-risk impact investments is for Government to leverage its balance sheet by underwriting investments or providing capital guarantees on loans provided to impact transactions. This low-cost approach is also catalytic in its ability to leverage private capital that would otherwise perceive such investments as too risky. In reducing risk to lenders, such guarantees can also help reduce the cost of capital, which in turn can make the opportunities more attractive to equity investors.

Examining tax incentives

Government should consider various tax incentives to facilitate development of the impact investment market. Even though Treasury has stated that tax matters will be considered under the Tax White Paper process, impact investment was not highlighted as a tax matter so may not be picked up in the scope of the Tax White Paper, so some suggestions are included here.

The March 2013 Report, *The Role of Tax Incentives in Encouraging Social Investment,* published by the City of London and Big Society Capital, is a useful resource that should be reviewed by Government. The study discusses the implications of providing tax incentives specifically for social investments.[1] The major challenge in the market was identified as the funding gap between investors and social enterprises. The report emphasises that growing the social investment market requires a move away from the provision of grants and subsidies that reinforce a culture of reliance and dependence. The report found that tax relief for social investment would be most likely to be utilised by high net worth individuals who are interested in social investment. Those individuals indicated that the lack of tax incentives acted as a barrier to making such investments.

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[1] Worthstone 2013, *The Role of Tax Incentives in Encouraging Social Investment*. Available at: <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/the-role-of-tax-incentives-in-encouraging-social-investment-WebPDF.pdf>

This paper greatly influenced the creation of the Social Investment Tax Relief Scheme (SITR) in the UK. Under the SITR scheme, announced in 2014, investors are able to deduct 30% of the cost of an eligible investment, with a minimum investment period and a maximum investment amount imposed.[2] There are certain eligibility requirements for the investment, for the investor, and for the social enterprise invested in.

Under the United Kingdom's *Finance Act 2014*, tax relief is provided for investments in charities, community interest companies and community benefit societies, and in certain types of social impact bonds.

Clarifying whether discounted returns can count towards minimum distribution requirements for Private Ancillary Funds, and allowing Public Ancillary Funds and Private Ancillary Funds to provide loans guarantees using their corpus

Some Private Ancillary Funds are unclear whether they may count discounted financial returns towards minimum distribution requirements.

Rule 19.3 in the *Public Ancillary Fund Guidelines 2011* (Cth) provides guidance as to this concern for Public Ancillary Funds (PuAFs). Example 3 under rule 19.3 in the *PuAF Guidelines* states:

> "If a public ancillary fund invests in a social impact bond issued by a deductible gift recipient with a return that is less than the market rate of return on a similar corporate bond issue, the fund is providing a benefit whose market value is equal to the interest saved by the deductible gift recipient from issuing the bond at a discounted rate of return."[3]

Currently, the *Private Ancillary Fund Guidelines 2009* (Cth) do not replicate this provision. Despite this, some trustees assume that this arrangement applies in the context of PAFs. Therefore, the Government should replicate this provision in the PAF Guidelines in order to remove the current uncertainty and clarify the position of PAF trustees. The Government should clearly specify the criteria, if any, that an investment must meet before its discounted returns can count towards a PAF or PuAF's minimum distribution requirements.

In the United States, program-related investments can be counted towards a foundation's 5% minimum annual distribution. A program-related investment (PRI) is a type of mission or social investment that foundations make in order to achieve their philanthropic goals. PRIs can employ a wide variety of financing methods, such as loans (senior and subordinated), loan guarantees, lines of credit, linked deposits, cash deposits, bonds, equity investments, and other transactions designed to help charitable organisations and social enterprises access capital funding. PRIs are expected to be repaid, often with a modest rate of return. Loan guarantees are an especially common form of PRIs.

According to the US Internal Revenue Code, to qualify as a PRI:

1. The primary purpose of the investment must be to accomplish one or more of the charitable, religious, scientific, literary, educational and other exempt purposes described in the Code;[4]
2. No significant purpose of the investment should be the production of income or the appreciation of property; and
3. The investment must not have any political purposes.[5]

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[2] UK Government – Cabinet Office, *Social Investment Tax Relief*. Available at: <https://www.gov.uk/government/publications/social-investment-tax-relief-factsheet/social-investment-tax-relief> [6 April 2014].

[3] PuAF Guidelines r 19.3.

[4] The exempt purposes are described in s170(c)(2)(B) of the Internal Revenue Code.

[5] Mission Investors Exchange, Linklaters, TrustLaw, *Strategies to maximize your philanthropic capital: a guide to program related investments*, April 2012.

At the time the investment is made, the rate of return must be expected to be below prevailing market rates on a risk-adjusted basis in order for the investment to qualify as a PRI for tax purposes. Once repaid, these funds can be used for subsequent charitable investments. Arguably, the position should be similar in Australia. By clearly allowing PRIs, PAFs would be able to leverage their financial resources more effectively, and deliver more community benefit.

Considering new legal structures for social enterprises

The B Corporation certification is given to companies that meet rigorous standards of social and environmental performance, accountability, and transparency and are committed to leveraging their business model as a force for good. The mission of the non-profit B Lab is to use the power of business to solve social and environmental problems. Currently, B Corporations exist across a wide range of industries and over 1,200 companies worldwide have achieved the certification.

The 'benefit corporation' is a for-profit legal structure that has now been adopted in 26 US states and one district. It removes the reluctance of directors to take into account the interests of non-financial stakeholders by creating a new statutory entity, the 'benefit corporation,' that requires companies to provide a public social benefit. In other words, the directors are required to consider the impact of decisions on all stakeholders, rather than shareholders alone, as assessed against a third party standard.

Maryland was the first US state to pass benefit corporation legislation in 2010. In just five short years, 27 laws have been passed and a further 14 states are reportedly working on it. There are now more benefit corporations than there are companies with B Corporation certification. The Model Benefit Corporation Legislation was drafted by William Clark, a partner at law firm Drinker Biddle & Reath.

The benefit corporation differs from other forms of hybrid companies. It is more rigid than a Low-Profit Limited Liability Company (L3C) and is subject to greater review. California offers another alternative, the Flexible Purpose Corporation, through its *Corporate Flexibility Act 2011* which allows corporations to function as a normal business with an added special purpose. In contrast to benefit corporations, flexible purpose corporations are not required to assess or report against a third party standard and need not pursue a general public interest purpose. The benefit corporation also differs from the UK's Community Interest Company in that it is not subject to government regulation of its purposes or activities.

The legislation addresses two main problems in the US corporations law sphere, arguably both of which also apply in Australia:

1. The hesitancy of directors to take into account the interests of all stakeholders, not just shareholders when making decisions, for fear of not fulfilling their fiduciary duty of maximising profit to shareholders; and
2. The lack of distinction between an ethical (a truly 'good') company and good marketing.[6]

IIG recommends that the Government should consider creating the benefit corporation legal structure in Australia.

Capacity building social enterprises

Programs that assist entrepreneurs in launching and scaling socially-minded businesses would enhance social enterprises' investment readiness and therefore increase investment options available to impact investors. For example, GoodCompany Group, the US's first accelerator

[6] Westaway, W, Sampselle, D, 'The Benefit Corporation: An Economic Analysis with Recommendations to Courts, Boards, and Legislatures' (2013) 62: 999 *Emory Law Journal.*

program exclusively focused on social entrepreneurs,[7] supports businesses with innovative ideas that tackle unmet social and environmental needs. It provides workspace, mentoring, and access to a network of sources of capital. Companies that have graduated from the program have raised US$50m in private capital to date, and 300 jobs were created in 2013.[8]

The Investment Contract Readiness Fund (ICRF) in the UK provides an interesting model for Australia. The Office of Civil Society launched the ICRF in 2012 for the purpose of supporting social ventures to build their capacity to secure new forms of investment and compete for public service contracts.[9] The rationale behind the establishment of the ICRF was that social ventures are often run by management teams with enthusiasm and expertise in the social sector, but they lack commercial skill and experience.[10] Social ventures must fulfil certain criteria in order to apply, and the ICRF Investors Panel awards the grants. A prerequisite is that social ventures must partner up with ICRF Approved Providers, generally firms and organisations that provide professional investment and contract readiness support such as developing a sustainable business model, training in financial management skills and making cash flow projections. The ICRF requires the grant money to be principally used to pay for such business advisory services. The program was launched as a three year program with £10 million, which was initially only distributed as grants. However, the ICRF Investors Panel now reserves the right to offer partially repayable grants depending on successfully raising capital in the future.[11] From 1 April 2013, all investment readiness awards over £75,000 are subject to repayment clauses, to help extend the sustainability of the fund.

Creating an investment readiness fund in Australia, supported by Government, was one of the four key recommendations to catalyse the impact investing market suggested by Impact Investing Australia following their sector consultation.[12] NAB has committed $1m to seed the NAB Investment Readiness Fund, but ideally this would reach $10-20m with the support of Government.

(b) Provide guidance to superannuation trustees on the appropriateness of impact investment.

IIG strongly supports this recommendation. IIG also suggests that this recommendation be broadened to include philanthropic trustees. As stated in the Interim Report, some superannuation and philanthropic trustees consider their fiduciary duties to be a barrier to impact investment. This was discussed in the recently released *Impact Investing: Perspectives for Charitable Trusts and Foundations* report[13] and a similar report in relation to superannuation funds.

As Social Ventures Australia pointed out in their submission to the Financial Systems Inquiry, trust law across Australia requires all trustees, including trustees of private ancillary funds, to act on

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[7] Collins, S 2012, 'Purpose Meets Profit: Free Summer Incubator for Social Enterprises at GoodCompany Ventures', *Generocity* 16 May 2012. Available at: <http://www.generocity.org/purpose-meets-profit-free-summer-incubator-for-social-enterprises-at-goodcompany-ventures/> [Accessed 27 May 2014].

[8] Good Company Ventures, *Results and Impact.* Available at http://goodcompanyventures.org/about#results.

[9] Investment and Contract Readiness Fund, *About the Fund.* Available at: <http://www.beinvestmentready.org.uk/offer/>. [Accessed 28 May 2014].

[10] Brown, Adrian and Swersky, Adam 2012, 'The First Billion' *The Boston Consulting Group* <https://www.bcg.com/documents/file115598.pdf>

[11] The Social Investment Business, *Frequently Asked Questions* http://www.beinvestmentready.org.uk/fileadmin/tsib_users/Our_Funds/ICRF/Investment_and_Contract_Readiness_Fund_-_FAQs_v4__no_retail_repayable_.pdf [Accessed 18 May 2012].

[12] Impact Investing Australia, *Sector Consultation*. Available at: <http://impactinvestingaustralia.com/sector-consultation/> [Accessed 6 Aug 2014].

[13] Charlton, K, Donald, S, Ormiston, J and Seymour, R 2014, *Impact Investments: Perspectives for Australian Charitable Trusts and Foundations.* Available at: <http://sydney.edu.au/business/__data/assets/pdf_file/0004/199768/BUS10008_Impact_Investments_web_sml_3.pdf>

behalf of beneficiaries without the flexibility of taking into account any social or community impact of an investment.

When investing trust money, case law indicates that the trustee *must be primarily concerned with the financial advantage of the trust*.[14] If there is no contrary direction in the trust instrument, a trustee must duly and promptly invest all trust money for this purpose.[15] Should the trustee not invest trust money in this manner or in accordance with another direction of the trust instrument, then the trustee/s has committed a breach of trust and is liable for any consequent loss.[16]

The concern is that those trusts and funds that possess ambiguity in their trust instrument as to the priority that is to be given between investing for social impact and financial gain place the trustee in a vulnerable position. Given the above authority, there is a risk that a trustee who invests for social impact and sacrifices financial return may become personally liable to the trust. While it is true that a trustee must have regard to the purposes of the trust and the needs and circumstances of the beneficiaries, which enables the trustee to accommodate the purpose of the trust, arguably this offers only meagre protection.[17]

It is interesting to examine the situation in other jurisdictions. The legal position in the United Kingdom is particularly insightful. In the UK, trustees of any charity can decide to invest ethically even if the investment may result in a lower return than an alternate investment. Here an ethical investment is understood as an investment that reflects the charity's mission. The law does require, however, justification from the trustee as to why it is in the best interest of the charity to invest in this way. The law permits the following reasons:

- a particular investment conflicts with the aims of the charity; or
- the charity might lose supporters or beneficiaries if it does not invest ethically; or
- there is no significant financial detriment.[18]

In summary, providing guidance to philanthropic and superannuation trustees that impact investing is permitted is desirable so trustees are able to confidently make impact investments without worrying that they are breaching their fiduciary duties. As at 31 March 2014, there was $1.8 trillion invested in Australian superannuation funds.[19] Given the scale of funds that these institutions manage, even a small allocation would give the impact investing industry a large boost in funds available for investment. Likewise, foundations represent large pools of capital that could be put towards impact investing.

(c) Support law reform to classify a private ancillary fund as a 'sophisticated' or 'professional' investor, where the founder of the fund meets those definitions.

IIG strongly supports this recommendation. Many impact investment products, including IIG's own products as well as the NSW Social Benefit Bonds, are only offered to sophisticated or professional investors. PAFs act as a significance source of capital, which could be leveraged to support private sector funding for social and environmental projects. Taking away a source of demand for social investments in turn increases the burden on taxpayers to fund these projects.

From a regulatory standpoint this restriction is logical, however there are a multitude of private ancillary funds (PAFs) that do not clearly meet the thresholds to be considered as sophisticated or

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[14] *Cowan v Scargill* [1985] 1 Ch 270.
[15] *Cann v Cann* (1884) 51 LT 770 at 771; 33 WR 40 per Kaye J (the maximum period for which trust capital can remain uninvested is six months).
[16] *Speight v Gaunt* (1883) 9 App Cas 1 at 19; 50 LT 330 per Lord Blackburn, HL.
[17] For example *Trustee Act 1925* (NSW) s14C (1) (a).
[18] See more at http://www.charitycommission.gov.uk/publications/cc14.aspx#c3
[19] Association of Superannuation Funds of Australia 2014, *Superannuation Statistics - ASFA*. Available at: <http://www.superannuation.asn.au/resources/superannuation-statistics/> [Accessed 6 Aug. 2014].

professional investors, yet are sponsored by individuals that meet the requirements themselves. The average PAF has consistently had assets valued in the $2-3m range,[20] so the definition of sophisticated investors is crucial for many PAFs. Many do not meet the $2.5m threshold themselves, and this has served as an impediment for some PAFs in participating in offerings of social impact investments.

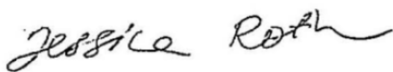
Section 708 of the *Corporations Act 2001* (Cth) states the types of investment offerings in which the issuer is exempt from prospectus requirements. The section 708 requirements in the context of a PAF are ambiguous, causing some PAFs to miss out on investment offerings, simply because a lack of clarity, even if they were legally eligible. Section 708(8) covers an investment offer to 'sophisticated investors'. The section states that a 'sophisticated investor' includes a 'trust that is controlled by a person who meets the requirements of [being a sophisticated investor]'.[21] Although Section 50AA provides some guidance as to the definition of 'control', there is still no clarity as to scope of 'control' in the context of a PAF.

Similar issues have arisen concerning uncertainties relating to the status of Self-managed Super Funds. In response, the Australian Securities and Investments Commission (ASIC) acknowledged the legal uncertainty and provided clarity that the law can see the trustees' in their personal capacities as a wholesale investor, rather than trustees needing to meet the $10 million threshold of net assets in their superannuation fund.[22]

PAFs require similar clarification from ASIC. ASIC may consider clarifying the interpretation of 'control' in section 708(8) of the *Corporations Act 2001* (Cth) as well as other relevant provisions. It is suggested that ASIC should take a stance that acknowledges 'substance over form'. For example, if an investment decision maker, such as the Chief Investment Officer, is considered a sophisticated investor, the underlying PAF should similarly be classified as a sophisticated investor. This would clearly allow the corpus of PAFs to promote positive change through impact investments that are limited to sophisticated or professional investors.

We hope this material assists Treasury. Please do not hesitate to be in touch if you wish to discuss any of the matters raised in this submission further.

Kind Regards,



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[20] McLeod, J, *The PAF Report – Private Ancillary Funds after 12 Years*, August 2014.
[21] Section 708(8)(d)
[22] ASIC, 14-191MR Statement on wholesale and retail investors and SMSFs, 8 August 2014. Available at http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-191mr-statement-on-wholesale-and-retail-investors-and-smsfs/.