

# PRI RESPONSE

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## APRA CONSULTATION ON DRAFT PRUDENTIAL PRACTICE GUIDE SPG 530: INVESTMENT GOVERNANCE

17 March 2023

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To inform this briefing, the following investor group has been consulted: PRI Regional Policy Reference Group for Australia. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing.

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# ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Australian Prudential Regulation Authority's (APRA) call for feedback on its draft update to its superannuation prudential practice guide SPG 530: Investment Governance.

# ABOUT THIS CONSULTATION

On 17 November 2022, APRA released a draft revision to its guidance on investment governance and valuation practices for registrable superannuation entity (RSE) licensees, [Superannuation Prudential Guide 530: Investment Governance](#) (SPG 530). The proposed amendments to SPG 530 come after APRA consulted on and updated [Superannuation Prudential Standard 530: Investment Governance](#) (SPS 530) on 19 July 2022.

The PRI [responded](#) to APRA's calls for feedback on SPS 530 recommending that it better reflect RSE licensee's obligations to consider and mitigate system-level risks, including sustainability-related risks and that better guidance be provided in either SPS 530 or SPG 530 on how funds can mitigate both sustainability-related idiosyncratic and system-level risks. APRA [recognised](#) the increasing significance and materiality of ESG financial risks factors and that it intended to issue draft guidance on how to reflect those considerations in the investment strategy.

The draft update to SPG 530 attempts to articulate the outcomes that APRA is looking to achieve through SPS 530. Among other things, the proposed amendments seek to outline how APRA expects RSE licensees will consider material ESG risk factors as part of their overall investment risk management.

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# KEY RECOMMENDATIONS

The PRI welcomes APRA's proposal to update SPG 530 and, in doing so, to clarify its expectations about how RSE licensees address environmental, social and governance (ESG) factors. We consider that the proposed amendments attempt to provide a much-needed update to the previous version of SPG 530 and better reflect current and emerging market practice, particularly in relation to the integration of ESG factors into idiosyncratic risk analysis and management. Direct reference to the need for RSE licensees to consider market-wide (system-level) risks, including climate change, in their stress testing program is also welcome.

However, in order to more comprehensively align with current market practice and to support RSE licensees to discharge their legal duties and meet their beneficiaries' expectations, greater clarity and guidance should be provided about the need for RSE licensees to embed the consideration of ESG-related risks and impacts throughout the process of formulating, giving effect to, monitoring and reviewing their investment strategy. This should include explicit reference to the need for RSE licensees to consider and take into account system-level (market-wide) ESG-related risks and the provision of guidance on the types of investment and stewardship activities needed in order to do so, including through the intentional pursuit of sustainability-related outcomes that are instrumental to financial return objectives.

Relatedly, greater clarification within SPG 530 is needed regarding the role of stewardship in helping to meet investment objectives, including through the pursuit of sustainability-related outcomes. Further clarification and consistent usage of ESG-related terminology within SPG 530 is also necessary to ensure useability of the guidance. Clear guidance should also be provided on how RSE licensees should assess and integrate their members' sustainability objectives into their investment governance processes. Further discussion about these points is set out below, followed by our key recommendations to address them.

## **Clear and consistent use of ESG-related terminology**

Currently, usage of ESG-related terminology within the updated draft SPG 530 is inconsistent and lacks clarity. Specifically, while the glossary provides a definition of the term 'ESG factors', the term is only used on two occasions throughout the guidance. Instead, the guidance uses varying terms such as ESG, ESG risk factors, ESG risks, ESG risk considerations, ESG investment opportunities, ESG considerations, and ESG impacts. We further note that the guidance uses the terms market risk, market-wide risks, and systemic risks seemingly interchangeably. Clearer and more consistent usage of these terms within SPG 530 and across the broader regulatory framework would improve useability and limit risks of market confusion.

## **Clarification and guidance on system-level (market-wide) risks and sustainability outcomes**

The updated draft SPG 530 includes an increased expectation about the need for RSE licensees to demonstrate an understanding of risks and opportunities presented by ESG factors, the definition of which includes a consideration of impacts on markets. This is a welcome improvement, yet it does not adequately emphasise the need for RSE licensees to take into account system-level (market-wide) ESG-related risks throughout the process of formulating, giving effect to, monitoring and reviewing their investment strategy. In this respect, the updated draft guidance is not yet well-aligned with recent interpretations of RSE licensees' legal duties or current market practice.

As identified in detailed legal analysis recently published by the PRI and other partners, RSE licensees' duty to act in their beneficiaries' best financial interests requires them to maintain and

improve long-term financial performance by addressing both current and anticipated system-level risks.<sup>1</sup> As predominately universal owners, RSE licensees' returns are dependent on economic growth over the long term, which itself is threatened by the deterioration and potential collapse of environmental and social systems.<sup>2</sup>

Accordingly, to comply with their legal duties, RSE licensees must consider the various sustainability-related system-level risks that threaten the financial interests of their beneficiaries over the long term. Where those risks are identified, RSE licensees should take steps to mitigate them by shaping sustainability outcomes that support the stability of environmental and social systems.<sup>3</sup> Investors globally and in Australia, including many RSE licensees, are already taking such steps, for example, by setting strategic goals to align their portfolios with the Paris Agreement and Sustainable Development Goals (SDGs) through capital allocation, stewardship activities and public policy engagement.<sup>4</sup>

Failure to provide clarity about the need for RSE licensees to integrate the consideration of system-level (market-wide) ESG-related risks into investment and stewardship strategies, including guidance on how they should do so, will expose them to increased legal risks, delay actions needed to protect market stability and beneficiaries best financial interests and exacerbate potential free-rider problems.

#### **Clarification about the role of stewardship in meeting investment objectives**

The updated draft SPG 530 includes a brief mention of the role of stewardship under the heading of 'additional ESG impacts' and introduces certain expectations. This does not adequately reflect the importance of stewardship in achieving investment objectives or current market practice. It may also impose undue burdens on RSE Licensees in relation to their stewardship practices.

Effective investor stewardship is a fundamental component of investor risk management and corporate governance oversight and accountability in Australia.<sup>5</sup> It is also one of the most effective tools available to RSE licensees to address both idiosyncratic and system-level (market-wide) ESG-related risks,<sup>6</sup> Australian investors have been actively carrying out stewardship in relation to ESG issues for over two decades.<sup>7</sup> As the exercise of an RSE licensee's duty of care, skill, and diligence is determined against the standard of a *prudent superannuation entity director*,<sup>8</sup> the longstanding practice of stewardship in the industry strongly suggests that stewardship is an integral component of exercising their duties.<sup>9</sup>

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<sup>1</sup> Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), [A Legal Framework for Impact: Sustainability impact in investor decision-making](#), PRI (2022), [A Legal Framework for Impact: Australia](#).

<sup>2</sup> With regards to the economic impacts of climate change, see: IPCC (2022), [Climate Change 2022: Impacts, Adaption and Vulnerability – Technical Summary](#).

<sup>3</sup> Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), [A Legal Framework for Impact: Sustainability impact in investor decision-making](#), PRI (2022), [A Legal Framework for Impact: Australia](#).

<sup>4</sup> See, eg., IGCC (2023), [The State of Net Zero Investment in Australia](#).

<sup>5</sup> Parliamentary Joint Committee on Corporations and Financial Services (2008), [Better Shareholders – Better Company: Shareholder Engagement and Participation in Australia](#) (p.5); ASX Corporate Governance Council (2019), [Corporate Governance Principles and Recommendations](#) (p.23); Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.

<sup>6</sup> PRI (2022), [Australia: Integrating Sustainability Goals across the Investment Industry](#) (p.13).

<sup>7</sup> GP Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon Press, 1996); Benedict Sheehy, Howard Pender and Ben Jacobsen, 'Corporate social responsibility/ESG shareholder activism in Australia: A case study of the Australasian Centre for Corporate Responsibility' (2021) 36 *Australian Journal of Corporate Law* 156, 162.

<sup>8</sup> *Superannuation Industry (Supervision) Act 1993* (Cth) s 52A(2)(b).

<sup>9</sup> Geof Stapledon, Sandy Easterbrook, Pru Bennett, and Ian Ramsay (2000), [Proxy Voting in Australia's Largest Companies](#); UNEP FI and PRI (2019), [Fiduciary Duty in the 21<sup>st</sup> Century: Final Report](#).

Nevertheless, rather than clarifying the role of stewardship as an important component of a RSE's pursuit of their investment objectives, the current wording in paragraph 75(a)-(d) of the updated draft SPG 530 is overly prescriptive and adds unnecessary requirements that may confuse RSE licensees about their obligations. Where stewardship functions are already largely under resourced, these requirements could add unwarranted expenditure for RSE licensees at the expense of members' interests.

### **Guidance related to members' sustainability objectives**

Increasingly, there are strong expectations from superannuation funds members regarding the sustainability impacts of their investments. Recent evidence from the Responsible Investment Association Australasia (RIAA) shows that 80% of Australians expect their investments to have a positive impact on the world.<sup>10</sup> Broader surveys have found that more than 50% of individual Australian investors are interested in realising positive change through their investments.<sup>11</sup> In this context, APRA should consider how to provide better guidance to RSE licensees on how these objectives can be taken into account and integrated into investment governance.

### **Recommendations**

Accordingly, the PRI recommends that:

- SPG 530 is refined so that ESG-related terms and terms related to system-level (market wide) risks are used consistently. A definition for ESG impacts, ESG risks and system-level (market-wide) risks should also be included within the glossary.
- SPG 530 explicitly clarifies the need for RSE licensees to consider system-level (market-wide) ESG-related risks when formulating, giving effect to, monitoring and reviewing their investment strategy. Guidance should be provided on how RSE licensees can do so by setting and pursuing sustainability outcomes goals, in beneficiaries best financial interests, through their investment decisions, stewardship, and public policy engagement.
- SPG 530 clarify that effective investor stewardship is an integral component of RSE licensees' duties to act in the best financial interests of their beneficiaries. A definition of stewardship should be included in the glossary and expectations should be set on the manner in which stewardship is conducted, including that that the consideration of ESG-related risks and impacts should be incorporated into stewardship processes and decisions. Potentially disproportionate expectations to justify the cost-effectiveness of stewardship should not be imposed but instead refer to the existing duty for RSE licensees to act in the best financial interests of members.
- APRA's regulatory framework should (e.g., either SPG 530, SPS 515, SPG 515 or elsewhere) provides better guidance on how RSE licensees can assess their members' sustainability objectives to determine any additional environmental and social objectives a fund should pursue beyond those necessary to mitigate system-level risks.

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<sup>10</sup> These expectations can drive investment behaviours with 61% of Australians stating they would save and invest more if they knew their savings made a positive difference in the world. See Responsible Investment Association Australasia (2022), [From Values to Riches 2022: Charting consumer demand for responsible investing in Australia](#)

<sup>11</sup> Fidelity International (2022). [Fidelity survey: APAC investors' strong interest in sustainable investing continues, with a confidence challenge still to tackle](#)

# DETAILED RESPONSE

## CONSISTENCY OF LANGUAGE

### ESG TERMINOLOGY: ESG FACTORS, RISKS & IMPACTS

SPG 530 should be amended to provide consistency with the use of ESG-related terms. APRA should also consider providing definitions for the terms used in SPG 530 beyond ESG factors, specifically ESG risks and ESG impacts.

The updated draft SPG 530 defines ESG factors as: “*either qualitative or quantitative Environmental, Social and Governance factors that may affect the risk-return profile of investments through their impacts on assets, companies, industries, or markets generally.*” We welcome APRA’s revised recognition of ESG factors as relevant to risks and issues beyond ethical considerations. However, we note that the term is only used on two occasions at paragraphs 47 and 48 under the heading “*ESG risk factors*”. ESG factors is also used alongside the terms “*ESG risk considerations*” and “*ESG risks*” at paragraphs 48 and 49 while “*ESG*” is subsequently used to caveat investment risk factors at paragraphs 61(b).

In this respect, RSE licensees may incorrectly consider that the definition of ESG factors used by APRA is synonymous with and confined to ESG risks. This may lead to confusion in circumstances where the following terms are used without inclusion in the glossary:

- “*ESG considerations*” used at paragraph 27 in relation to APRA’s expectations on how ESG factors inform the investment philosophy and at paragraph 61(a)(ii) in relation to how RSE licensees demonstrates its due diligence process for investments; and
- “*ESG investment opportunities*” used at paragraph 60 in relation to how RSE licensees conduct due diligence on expected returns; and
- “*Additional ESG Impacts*” and “*environmental or social impact*” used at paragraphs 73 and 74 in relation to the pursuit of additional objectives.

ESG factors not only relate to idiosyncratic and system-level risks but to opportunities and impacts. The PRI defines ESG factors as “*environmental, social and governance issues that are identified or assessed in responsible investment processes.*”<sup>12</sup> Environmental factors are issues relating to the quality and functioning of the natural environmental and natural systems. Social factors are issues relating to the rights, well-being and interests of people and communities. Governance factors are issues relating to the governance of companies and other investee companies. Although there is currently no standardised meaning of ESG-related terminology, we note that the PRI, together with the CFA Institute and the Global Sustainable Investment Alliance, have launched a global collaboration to align and refine ESG terminology used by these organisations.<sup>13</sup>

We encourage APRA to consider the definitions of ESG and sustainability used globally and within the Australian market to inform how it defines the terminology within SPG. In particular, we encourage APRA to define ESG impacts – what the PRI refers to as “*sustainability outcomes*” – in a manner that reflects the real-world effects of investment activities on people and/or the planet.

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<sup>12</sup> See PRI (2023) [Reporting Framework glossary](#) which sets out the key definitions that signatories use to prepare their annual PRI report.

<sup>13</sup> RIAA (2022), [Global Collaboration on Terminology Announced](#).

## SYSTEM-LEVEL RISKS: MARKET, MARKET-WIDE, & SYSTEMIC RISKS

SPG 530 should be refined to include only one term that covers the various definitions currently being used to describe what the PRI defines as system-level risks. A definition of the term should also be provided within the glossary. Additionally, paragraphs 45 to 49 should make it explicit that RSE licensees should demonstrate their understanding of the system-level risks presented by ESG factors while providing clearer guidance on how such risks can be addressed through the pursuit of sustainability outcomes.

The updated draft SPG 530 sets out APRA's expectations at paragraph 79 that RSE licensees will consider a range of scenarios across "*systemic/market-wide risks*" when undertaking stress testing. Welcomely, it provides an ESG factor (i.e., climate change) alongside liquidity as an example of a systemic/market-wide risk. However, we note that somewhat confusingly paragraph 45 sets out a range of investment risks that an RSE licensee should consider including "*market risk*" and separately liquidity risk and climate risk. For coherency, we recommend APRA use one term consistently.

Regardless of the final term used to cover these system-level risks, we recommend that it be defined in the glossary with examples of ESG factors that could constitute such risk. The PRI, for example, defines system-level risk as "*a catch-all term for systematic and systemic risk, both of which have implications for investment performance*" where:

- Systematic risk means "*risk transmitted through financial markets and economies, that affects aggregate outcomes, such as broad market returns. The term is interchangeable with "market risk" or "market-wide risk". Because systematic risk occurs at a scale greater than a single company, sector or geography, it cannot be hedged or mitigated through diversification. One example of a sustainability-related systematic risk is the risk of reduced global economic growth due to sustained physical impacts of climate disruption; another is the opportunity cost associated with failing to meet the SDGs.*"
- Systemic risk means "*the risk that an event at a particular point in time or a chronic economic condition destabilises the financial system or leads to its collapse. An example of a systemic risk materialising would be a number of "too-big-to-fail" financial institutions defaulting on obligations to their creditors or investors. An example of a sustainability-related systemic risk would be a sudden repricing of assets across the fossil fuel sector, resulting in cascading defaults that destabilise financial markets – this is sometimes referred to as a potential "climate Minsky moment"*".

In addition, we welcome the direction at paragraphs 45 and 46 that RSE licensees consider how system-level risks can manifest through their chosen investment strategy, how it can affect investment outcomes for members and the extent to which it can be managed as well as demonstrate how it informs the investment strategy. As further discussed below, the nature of system-level risks means that RSE licensees cannot diversify away from these risks. Accordingly, we consider the section heading "*Diversification*" may mislead RSE licensees on how to manage these risks. Instead, we encourage APRA to label this section "*Risk Management*" and provide guidance on how RSE licensees can manage sustainability-related system-level risks (i.e., those risks resulting from ESG factors) through setting sustainability outcomes goals and taking actions such as investment decisions, stewardship, and public policy engagement to pursue those goals.

Finally, in refining ESG-terminology, we encourage APRA to ensure that paragraph 47 to 49 more clearly reflects that ESG factors can present system-level risks that may affect financial returns.

# SUSTAINABILITY OUTCOMES AND ESG IMPACTS

## ADDRESSING SYSTEM-LEVEL RISKS

As mentioned above, in order to more comprehensively align with current market practice and to support RSE licensees to discharge their legal duties and meet their beneficiaries' expectations, SPG 530 should explicitly clarify the need for RSE licensees to consider system-level (market-wide) ESG-related risks when formulating, giving effect to, monitoring and reviewing their investment strategy. Guidance should be provided on how RSE licensees can do so by pursuing sustainability outcomes goals through their investment decisions, stewardship, and policy engagement.

Currently, the draft updated SPG 530 implicitly recognises that system-level (market-wide) risks can adversely affect the best financial interests of beneficiaries. Although it sets out APRA's expectation that RSE licensees undertake stress testing and assessments to identify risk mitigation strategies, it provides no guidance on how to manage such risks. This is in contrast to APRA's approach to idiosyncratic risks where it sets out expectations that RSE licensees diversify each investment option and demonstrates how asset allocation achieves appropriate diversification targets (see paragraphs 44 and 50 to 53).

### Impact of system-level risks on economic and financial stability

As is the case for many large institutional investors with highly diversified portfolios, investment returns are largely driven by the performance of whole sectors and markets. Accordingly, their beneficiaries' best financial interests are dependent on economic growth over the long term, which is inextricably linked to the stability and viability of the environmental and social systems that the economy relies on.<sup>14</sup>

However, these systems are threatened by inaction on issues like climate change, biodiversity loss, social inequality and human rights violations, and the cost-of-living crises.<sup>15</sup> Unmitigated climate change, for example, has been estimated to cause a \$3.4 trillion loss in Australia's GDP by 2070. The 6<sup>th</sup> IPCC report concluded that the climate impacts from warming above 1.5°C will pose significant risks to financial markets if they are incompletely internalised, which will lead to adverse implications for market stability.<sup>16</sup> Biodiversity loss and environmental degradation also severely threaten economic stability<sup>17</sup> with 49.3% of Australia's GDP – or \$892.8 billion – moderately to very highly dependent on the services that nature provides.<sup>18</sup>

### Measures to mitigate system-level risks

As these issues affect the stability of the economy as a whole, they cannot be managed by divesting from individual assets in the first instance.<sup>19</sup> RSE licenses can, however, seek to address system-level risks by using their investment powers to bring about assessable changes in the behaviour of

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<sup>14</sup> Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), [A Legal Framework for Impact: Sustainability impact in investor decision-making](#), PRI (2022), [A Legal Framework for Impact: Australia](#).

<sup>15</sup> World Economic Forum (2023), The [Global Risks Report 2023](#); International Corporate Governance Network (June 2019), [Investor Frameworks for Addressing Systemic Risks](#).

<sup>16</sup> IPCC (2022), [Climate Change 2022: Impacts, Adaption and Vulnerability – Technical Summary](#) (p.66).

<sup>17</sup> De Nederlandsche Bank (2020), [Indebted to nature: Exploring biodiversity risks for the Dutch financial sector](#); World Economic Forum (2020), [Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy](#); NGFS (2022), [Statement on Nature-Related Financial Risks](#).

<sup>18</sup> Australian Conservation Foundation, Pollination, & Australian Ethical (2022), [The Nature-Based Economy: How Australia's Prosperity Depends on Nature](#).

<sup>19</sup> PRI (2022), [Discussing Divestment: Developing an Approach when Pursuing Sustainability Outcomes in Listed Equities](#).

their investee companies and other assets as well as in the systems in which companies and investors operate, in line with global sustainability goals.

Common practices involved in pursuing sustainability outcomes involve (1) setting specific goals and targets to reduce the negative and increase the positive impacts of investments, (2) using a combination of investment decisions, stewardship and policy engagement to pursue those set goals, and (3) monitoring and assessing the changes and achievement of such goals.<sup>20</sup>

Such actions are in line with increasing expectations from superannuation funds members where evidence by the Responsible Investment Association Australasia (RIAA) shows that 80% of Australians expect their investments to have a positive impact on the world.<sup>21</sup> Broader surveys have found that more than 50% of individual Australian investors are interested in realising positive change through their investments.<sup>22</sup>

### **Current practices on sustainability outcomes**

Accordingly, many institutional investors globally, as well as in Australia, are recognising this reality and are increasingly seeking to mitigate system-level risks by setting real-world sustainability goals and integrating the pursuit of these goals into their risk management, objective setting and investment decision-making frameworks.<sup>23</sup> By way of example, in PRI's 2021 annual reporting & assessment of signatories, 82 Australian signatories responded to an optional question on sustainability outcomes and of that number, 63 respondents (77%) stated that their organisation had chosen to shape sustainability outcomes in some way. A recent review of institutional investors in Australia, managing \$2.1 trillion found that 70% of respondents have now set net zero targets for 2050.<sup>24</sup>

Although leading RSE licensees with strong responsible investment practices are beginning to consider system-level risks and incorporate sustainability goals in their decision-making, broader market practice remains inconsistent. While many RSE licensees are increasingly considering environmental, social, and governance (ESG) factors, their approach is often limited to addressing ESG risks only at a narrower company or portfolio-specific level, rather than at a broader system-level. Failure to provide clarity about the need for RSE licensees to integrate the consideration of system-level (market-wide) ESG-related risks into investment and stewardship strategies, including guidance on how they should do so, will expose them to increased legal risks, delay actions needed to protect market stability and beneficiaries best financial interests and exacerbate potential free-rider problems.

### **Recommendations**

APRA should therefore level the playing field amongst RSE licensees by clearly signalling in SPG 530 permission for RSE licensees to set and pursue sustainability goals to mitigate system-level risks. Such guidance would be in line with APRA's mandate to develop standards in relation to conduct by

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<sup>20</sup> Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), [A Legal Framework for Impact: Sustainability impact in investor decision-making](#) (p.22-33); PRI (2022), [A Legal Framework for Impact: Australia](#) (p.10).

<sup>21</sup> These expectations can drive investment behaviours with 61% of Australians stating they would save and invest more if they knew their savings made a positive difference in the world. See Responsible Investment Association Australasia (2022), [From Values to Riches 2022: Charting consumer demand for responsible investing in Australia](#)

<sup>22</sup> Fidelity International (2022). [Fidelity survey: APAC investors' strong interest in sustainable investing continues, with a confidence challenge still to tackle](#)

<sup>23</sup> Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), [A Legal Framework for Impact: Sustainability impact in investor decision-making](#), Australia Annex (p.163-165; 175-176).

<sup>24</sup> See, eg., IGCC (2023), [The State of Net Zero Investment in Australia](#).

RSE licensees to protect the interests of beneficiaries and meet their reasonable expectations as well as to ensure RSE licensees do not cause or promote instability in the Australian financial system.<sup>25</sup>

## ADDITIONAL ESG IMPACTS

It is our understanding that when addressing “*Additional ESG impacts*” in paragraphs 73 and 74, APRA is referring to the circumstances where an RSE licensee may pursue real world sustainability outcomes separate to where such action is necessary to mitigate system-level risks (e.g., where such action reflects members’ broader sustainability objectives). We welcome APRA’s recognition that RSE licensees are permitted to pursue environmental and social impacts in these additional circumstances. As this permission relates to the objectives an RSE licensee can set as part of its investment strategy, we recommend APRA reallocate paragraphs 73 and 74 to the section “*Formulating the investment strategy*” below paragraph 49.

In line with our recommendations to APRA in response to its consultation on SPS 515, we encourage APRA to consider providing separate support or guidance to enable RSE licensees to assess their members’ sustainability objectives to determine what additional environmental and social impacts a fund should pursue beyond those necessary to mitigate system-level risk.<sup>26</sup>

## STEWARDSHIP

SPG 530 should be amended to clarify the role of stewardship as an important component of RSE licensees’ pursuit of their investment objectives. We also recommend APRA further refine SPG 530 using a clear definition of stewardship with recognition of the various activities it covers.

### **Stewardship is an integral tool to meet RSE licensees’ fiduciary duties**

Stewardship is the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients’ and beneficiaries’ interests depend.<sup>27</sup> It is broadly recognised as a fundamental component of investor risk management and corporate governance.<sup>28</sup> For example, an inquiry by the Parliamentary Joint Committee on Corporations and Financial Services into engagement by shareholders into the governance of their investee companies noted that engagement between shareholders and company boards is critical to decision-making and accountability measures and ineffectual shareholder engagement increases investment risk.<sup>29</sup> Similarly, one of the key lessons from the 2008 financial crisis was that institutional investors should act as responsible shareholders of public companies to restrain excessive risk-taking and short-termism.<sup>30</sup>

When used effectively, stewardship can help mitigate both idiosyncratic and system-level risks by encouraging appropriate corporate governance that minimises the risky behaviour of an investee company or other assets and their impacts on relevant environmental and social factors.

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<sup>25</sup> *Superannuation Industry (Supervision) Act* s 34C(4).

<sup>26</sup> PRI (2022), [PRI Response to APRA Consultation on Prudential Standard 515: Strategic Planning and Member Outcomes](#) (p.6).

<sup>27</sup> PRI, [An Introduction to Responsible Investment: Stewardship](#).

<sup>28</sup> Michael C Jensen and William H Meckling, ‘Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure’ (1976) 3(4) *Journal of Financial Economics* 305; ASX Corporate Governance Council (2019), [Corporate Governance Principles and Recommendations](#) (p.23).

<sup>29</sup> Parliamentary Joint Committee on Corporations and Financial Services (2008), [Better Shareholders – Better Company: Shareholder Engagement and Participation in Australia](#) (p.4-5);

<sup>30</sup> Kay, J (2012). [Kay Review of UK Equity Markets and Long-term Decision Making](#).

Australian investors have been undertaking stewardship activities on ESG issues for over two decades. In the late 1990s, institutional investors began filing shareholder resolutions to improve governance over financial performance. Stewardship activities have subsequently evolved to address system-level risks that may impact members' returns in the long run.<sup>31</sup> For example, over 700 investors, including Australian superannuation funds, have participated in the Climate Action 100+ initiative to engage with 166 of the world's largest corporate greenhouse gas emitters on climate change. Our analysis of 17 PRI signatories who hold an RSE license shows that 100% of them hold responsible investment or stewardship policies that relate to their stewardship activities, with each of their rationales for undertaking stewardship relating to the need to manage risk and/or derive value for members in the long term. More broadly, RIAA found that in a survey of 70 institutional investors, 85% published stewardship policies.<sup>32</sup>

Accordingly, responsible RSE licensees have been and are continuing to consider and undertake stewardship activities. Where an RSE licensee's duty of care, skill and diligence is determined against that of a *prudent superannuation entity director*, the longstanding practice of proxy voting, company engagement, and (co)filing shareholder resolutions strongly suggests that stewardship is an integral component of an RSE licensee's fiduciary duties. Indeed, the [Fiduciary Duty in the 21<sup>st</sup> Century](#) report argues that it would be a failure of investor duty if institutional investors did not exercise stewardship to encourage high standards of ESG performance in the companies or other entities in which they were invested.<sup>33</sup>

Nevertheless, the draft updated SPG 530 does not adequately recognise the integral nature of stewardship activities – such as proxy voting, engagement, shareholder resolutions, public policy advocacy, and (in certain circumstances) legal recourse – for RSE licensees. Instead, references to stewardship activities in paragraph 75 under the heading “*Additional ESG impacts*” inappropriately confines stewardship as a tool to address members' sustainability objectives. While stewardship can and should be used in these circumstances, APRA should also recognise stewardship as a part of the prudent management of idiosyncratic and system-level risks, including those that relate to ESG and sustainability factors.

### **Resourcing stewardship and members interests**

We also acknowledge APRA's desire to ensure RSE licensees balance their rights and obligations to undertake stewardship against the costs and other interests of members and has sought to address this through the introduction of directions in paragraphs 75(a)-(d). However, we consider that the level of prescription in these requirements may cause confusion amongst RSE licensees, leading to inefficiencies that may conflict with members' long-term interests. The duty imposed on superannuation trustees to act within the best financial interests of the beneficiaries already provides strict requirements on funds to justify the cost-effectiveness and value creation of their activities. Accordingly, there are already appropriate guardrails to guide the way RSE licensees exercise their stewardship activities and with which funds are taking appropriate actions to comply with.

Based on our review of 17 PRI signatories who hold an RSE license, many funds are already taking measures to minimise fees by outsourcing engagement and proxy voting to their investment managers and third-party advisors, such as CGI Glass Lewis, the Australian Council for

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<sup>31</sup> Benedict Sheehy, Howard Pender and Ben Jacobsen, 'Corporate social responsibility/ESG shareholder activism in Australia: A case study of the Australasian Centre for Corporate Responsibility' (2021) 36 *Australian Journal of Corporate Law* 156, 162.

<sup>32</sup> Responsible Investment Association Australasia (2022), [Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022](#).

<sup>33</sup> PRI, UNEP FI and The Generation Foundation (2019), [Fiduciary Duty in the 21<sup>st</sup> Century: Final Report](#).

Superannuation Investors, and EOS at Federated Hermes. One fund even highlighted that they outsourced stewardship responsibilities given resource constraints. In our view, RSE licensees are already balancing stewardship costs with their stewardship obligations based on their duty to act in the best financial interest. In circumstances where institutional investors' stewardship functions are commonly under resourced,<sup>34</sup> the requirements in paragraph 75 of SPG 530 would impose additional reporting burdens that could counterproductively constrain practical stewardship activities.

Finally, we highlight that beneficiaries are also increasingly supportive of and expect their superannuation funds to engage in stewardship to address system-level risks and add value in the long-term. In that respect, we refer to the *McVeigh v Rest* litigation which was settled with agreement by Rest to “actively consider all climate change related shareholder resolutions with investee companies and otherwise continue to engage with investee companies and industry associations to promote business plans and government policies to be effective and reflect the climate goals of the Paris Agreement.”<sup>35</sup> International research of over 3,000 pension members found that 70% preferred for their funds to use their collective power to engage with investee companies and prepare them to align with global climate change efforts.<sup>36</sup>

In taking into account the benefits of stewardship to supporting overall portfolio value, we note that investors often need to act where it may be challenging to attribute direct causation from their stewardship activities to changes within the behaviour and actions of their portfolio companies. For example, change to an investee companies' activities may occur due to an RSE licensees' influence alongside other stakeholder and external pressures (i.e., changes in regulation affecting the company's business strategy). Investors also frequently inform the PRI of the need to consider the impacts of stewardship activities over various time horizons where the benefits of activities undertaken today may not come to fruition until the long term. Indeed, RSE licensees often take a multi-year approach to influence certain investee companies and escalate their activities over time. Accordingly, RSE Licensees need to be accorded some flexibility in their approach to and assessment of their stewardship activities, within their overarching duty to act in the best financial interests of their beneficiaries.

## Recommendations

Recognising that stewardship is a fundamental tool to execute an investment strategy in beneficiaries' best financial interests, we recommend APRA separates references to stewardship from its guidance on “Additional ESG impacts”. Rather it should include it as an independent section under the heading “Monitoring investments” and clarify that RSE licensees should exercise stewardship as part of their duty of prudence to members. We further recommend that APRA removes the expectations in paragraph 75(a)-(d). Instead, it should set out expectations for RSE licensees to:

- individually or collaboratively exercise stewardship obligations by:
  - diligently monitoring portfolio companies; and
  - engaging with companies in which they invest or intend to invest, and with other stakeholders;
  - exercising investors' rights, including the right to vote and to file shareholder resolutions; and

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<sup>35</sup> Rest (2020), [Rest reaches settlement with Mark McVeigh](#).

<sup>36</sup> Rolhat Zen-Aloush (2021, June 14), [Majority of savers not aware of net-zero pension goals](#).

- incorporate ESG factors in stewardship processes and decisions to support the long-term value of investments and act in members' best interests.

In clarifying how RSE licensees should exercise stewardship, APRA may wish to consider the approach taken by the US regulator, the Department of Labor (DoL), in relation to stewardship obligations of private pension funds. The DoL has a longstanding position that the *“fiduciary act of managing plan assets that involve shares of corporate stock includes making decisions about voting proxies and exercising shareholder rights.”*

Its 2021 rule on shareholder rights states that pension plans must exercise their shareholder rights, including voting on proxies, unless a fund determines it is not in the plan's best interests (due to significant costs or efforts associated with voting). In particular, it notes that *“prudent fiduciaries should take steps to ensure that the cost and effort associated with voting a proxy is commensurate with the significance of an issue to the plan's financial interests. The solution to proxy-voting costs is not total abstention, but is, instead, for the fiduciary to be prudent in incurring expenses to make proxy decisions and, wherever possible, to rely on efficient structures (e.g., proxy voting guidelines, proxy advisers/managers that act on behalf of large aggregates of investors, etc.).”*<sup>37</sup>

Finally, we recommend that APRA includes a definition of stewardship in the glossary in a manner that recognises stewardship as the use of influence by RSE licensees to maximise overall long-term value (which includes the value of common, economic, social, and environmental assets on which members' interests depend).

*The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of APRA to improve superannuation trustee's stewardship and governance with respect to system-level risks and sustainability impacts in Australia.*

Please send any questions or comments to [REDACTED]

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<sup>37</sup> Employee Benefits Security Administration (2021), [Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights](#);