MARKET FORCES

"Superannuation Fund Trustee Duties and Climate Change Risk"

MEMORANDUM OF OPINION

15 June 2017

ENVIRONMENTAL JUSTICE AUSTRALIA, Solicitors
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Vic 3053

Mr Noel Hutley

and

Mr James Mack

Memorandum of Opinion

A Background

1. Our client, Market Forces, is an affiliate project of Friends of the Earth who are a non-profit organisation. Market Forces seeks our opinion on the breadth of superannuation fund trustee duties and climate change risk. We have been briefed with a Memorandum of Opinion dated 7 October 2016 titled "Climate Change and Directors' Duties" ("**the October Memorandum**"). The October Memorandum is limited to whether s 180(1) of the *Corporations Act 2001* (Cth) ("**the Corporations Act**") permitted or required Australian company directors to respond to climate change risks. As such, the October Memorandum does not consider the position of directors of corporate trustees under the *Superannuation Industry (Supervision) Act 1993* (Cth) ("**the SIS Act**") in relation to climate change risks.

2. The *SIS Act* regulates individual trustees, groups of individual trustees, corporate trustees and directors of corporate trustees (trustee directors). This Memorandum is confined to the law as it relates to trustee directors of registrable superannuation entities.[1] We should not be understood as providing legal advice tailored to any particular trustee director. We are instructed to advise on:

   2.1. whether, and to what extent, do trustee directors of registrable superannuation entities have duties to consider climate change risks;

   2.2. having regard to 2.1 whether, and in what way, the considerations of climate change risks by trustee directors differ under the *SIS Act* as compared to that of director under a s 180(1) of the *Corporations Act*; and

   2.3. what actions might prudent trustee directors take to ensure compliance with such a duty.

B Summary of opinion

3. In summary, we reach the following conclusions:

   3.1. climate change risks can and should be considered by trustee directors to the extent that those risks intersect with the financial interests of a beneficiary of a registrable superannuation entity – see Part D.

[1] It does not extend to the law in relation to self managed super funds.

3.2. the differing functions of a company and a trust are such that considerations of climate change risk may result in differing emphasis and outcomes – see Part E.

3.3. trustee directors should source, consider and weigh relevant information relating to climate change risk and record their decision making processes, including any considerations of climate change risks – See Part F.

C The SIS Act

4. Our instructions use the phrase "registrable superannuation entity" as such it is necessary to say something about the term. To attract the provisions of the SIS Act that bear upon this Memorandum, a fund must be a "superannuation fund" (s 10), the superannuation fund must have a corporate trustee (s 19(2)) and the corporate trustee must have elected that the SIS Act apply in relation to the superannuation fund (s 19(4)). Upon election, the fund meets the definition of a "regulated superannuation fund" (s 19(1)) and in turn falls within the meaning of "registrable superannuation entity" (s 10). To operate a registrable superannuation entity a corporate trustee must have been granted an "RSE licence." An "RSE licensee" must register a registrable superannuation entity (s 29E(1)(d)), must comply with the provisions of the SIS Act relating to RSE licensee and must comply with regulatory regime overseen and maintained by the Australian Prudential Regulation Authority (**APRA**) (s 34C(1)(a)).

5. A trustee director must act in the best interest of "beneficiaries" (s 52A(2)(c)), must exercise due care, skill and diligence in relation to all matters affecting a registrable superannuation entity (s 52A(2)(b)) and must comply with the "enhanced director obligations" obligations in relation to MySuper products (s 29VO).[2] A corporate trustee must adhere to the "investment covenants" and a trustee director must exercise a reasonable degree of care and diligence to ensure that a corporate trustee carries out the s 52 covenants, which relevantly includes the "investment covenants" (s 52A(2)(f)). As the RSE licensing regime is a matter affecting a registrable superannuation entity, a trustee director must exercise the requisite degree of care, skill and diligence in relation to ensuring compliance with the RSE licensing regime (s 52A(2)(b)).

6. The authoritative general law statement in relation to beneficiary's best interest is as follows:

[2] The enhanced obligations in relation to MySuper products are not considered in this opinion because there is no reason to think they would change any of our conclusions in relation to climate change risk.

> 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.[3]

Courts have adopted the focus on best *financial* interests for the purposes of beneficiaries under the SIS Act.[4] It follows that a trustee director should perform their duties and exercise their powers in the best *financial* interests of beneficiaries.

7. In relation to the *standard* of due care, skill and diligence to which a trustee director is held, s 52A(2)(b) provides it is that of a prudent "superannuation entity director"[5] that makes investments on behalf of beneficiaries. The standard was introduced by amendments to the SIS Act in 2013. Prior to the amendments the standard applicable to a corporate trustee was that of an "ordinary prudent person" which was considered to be equivalent to the standard required by the general law.[6] The Explanatory Memorandum to the 2013 changes described the new standard as a "heightened" standard, which corresponded to existing State and Territory trustee legislation applying to professional trustees.[7] The precise scope of the heightened duty on trustee directors has not been the subject of judicial consideration.

8. The "investment covenants" which apply to a corporate trustee by force of s 52(6) require a corporate trustee to regularly review and give effect to an "investment strategy." In doing so they must have regard to factors, which include, the level of risk, likely return, diversification, the availability of reliable information and any other relevant matters (s 52(6)). What is required of a corporate trustee to satisfy the investment covenants has not been the subject of judicial consideration. What *does* inform the "investment covenants" is APRA's prudential standard "SPS 530 Investment Governance." The effect of SPS 530 is to mandate the investment governance framework required of an RSE licensee.

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[3] *Cowan v Scargill* [1985] 1 Ch 270 at 286-7.

[4] see *Manglicmot v Commonwealth Bank Officers Superannuation Corporation Pty Ltd* [2011] NSWCA 204; 282 ALR 167 at 121 per Giles JA with whom Young and Whealy JJA agreed, stated (in relation to the covenant concerning corporate trustees) that s 52(2)(c) does not materially add to the general law duty of the trustees to act in the best interests of the fund; *Commonwealth Bank Officers Superannuation Corporation Pty Ltd & Anor v Beck & Anor* [2016] NSWCA 218; 334 ALR 692 [136] (Bathurst CJ, Macfarlan JA, Gleeson JA).

[5] s 10 and s 29VO(3) defines a "superannuation entity director" as a person whose profession, business or employment is or includes acting as director of a corporate trustee of a superannuation entity and investing money on behalf of beneficiaries of the superannuation entity.

[6] *Manglicmot v Commonwealth Bank Officers Superannuation Corporation Pty Ltd* [2011] NSWCA 204; 282 ALR 167 at 120 per Giles JA.

[7] *Superannuation Legislation Amendment (Trustee Obligations and Prduential Standards) Bill 2012,* Explanatory Memorandum at 1.46, 1.62 and 1.129 (in relation to trustee directors.

D Analysis: climate change risks and duties of trustee directors

9. The Financial Stability Board's Task Force on Climate-Related Financial Disclosure draws a useful distinction between the *transition risks* and *physical risks* associated with climate change.[8] The *physical risks* relate to the financial implications caused by direct damage to assets and indirect impacts from supply chain disruption.[9] The *transition risks* are those risks associated with developments that may (or may not) occur in the transition to a lower-carbon economy precipitated by changes in policy, law, technology and markets.[10] For the purposes of this Memorandum, "climate change risk" should be understood to encompass both the transition risks and the physical risks associated with climate change.

10. In our opinion, there is an inherent harmony between the *financial* effect associated with climate change risks and the cardinal requirement of a trustee to act in the best *financial* interests of beneficiary. It follows that climate change risks can and should be considered by trustee directors to the extent that those risks may intersect with the financial interests of a beneficiary of a superannuation fund. This situation is most likely to arise if a trustee director is making a significant decision related to investments that are exposed to climate change risk. In our opinion, it is incumbent upon a trustee director, in an appropriate case, to consider the climate change risk in order to satisfy the requirements at s 52A(2)(b) in relation to due care, skill and diligence, s 52A(2)(c) in relation to the best interests of beneficiaries and at s 52A(2)(f) in relation to ensuring a corporate trustee carries out the s 52 covenants.

11. In the absence of a factual matrix that bears upon a particular investment decision or investment strategy, it is difficult to speculate when the financial effect of climate change risks may warrant consideration. However, it is possible to make some general remarks based on the investment covenants and the corresponding "Prudential Standard SPS 530 Investment Governance." In our opinion, although SPS 530 does not define risk, it does provide a framework for determining when the financial effect of climate change risks may warrant consideration. As such, when formulating an investment strategy and determining an appropriate level of diversification, the financial effect of climate change risk factors may need to be identified, so too the sources of return with which such factors are associated.[11] Similarly, the due diligence involved in an investment selection process may

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[8] Financial Stability Board "Recommendations of the Task Force on Climate-related Financial Changes" Part B.
[9] Id at p 8.
[10] Id at p 7.
[11] SPS 530 at 18.

need to be commensurate with any financial effect of climate change risks related to an investment.[12]

E The SIS Act and the Corporations Act

12. The differing functions of a company and a trust are such that considerations of climate change risk may result in differing emphasis and outcomes. For example, a trustee director under the SIS Act will be required to consider relevant climate change risks through the prism of an investment portfolio and the best financial interest of a beneficiary *whereas* a company director (for the purposes of the Corporations Act) will be required to consider relevant climate change risks through the prism of the activities of a company and the best interests of that company.[13] As such, if a trustee director came to the view that climate change risk may affect the financial interests of a beneficiary, a resulting decision may cause a change to the composition or diversification of an investment portfolio *whereas* if a company director came to an equivalent conclusion that climate change risk may affect a company's best interest, a resulting decision may cause a change in that company's business model.

F The prudent trustee director

13. Section 55 of the SIS Act governs the liability of a trustee director for loss or damage for breaches of covenants such as those provided at s 52A(2)(a),(b) and (f). A trustee director can avoid liability by establishing a defence that they did, in fact, comply with the relevant covenant (s 55(5)). In our opinion, this "defence" merely requires compliance with the law. Plainly, it imposes a higher standard than the "business judgment rule" provided at s 180(2) of the Corporations Act. Beyond the obvious requirement that a trustee director should comply with the SIS Act, a prudent trustee director should also keep records capable of showing compliance.

14. It has been held that the SIS Act clearly requires that trustee directors "use their own acumen, knowledge and judgment in weighing all relevant factors including professional advice."[14] Such a requirement should be read with s 56(3) SIS Act which renders void any provision in an entity's governing rules that precludes a trustee from being indemnified for obtaining advice. In our opinion, if a trustee director were confronted with a significant

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[12] SPS 530 at 22.

[13] In the event that a trustee director's obligations under relevant sections of the Corporations Act conflict with their duty to act in the best interest of a beneficiary under the SIS Act, the SIS Act duties prevail: s 52A(2)(d) and (3).

[14] *VBN and Australian Prudential and Regulation Authority* (2006) 92 ALD 259; [2006] AATA 710 at [469].

investment decision that involved a substantial exposure to climate change risks, it would be prudent to seek out information in relation to the risk and obtain advice on the risk. It would also be prudent, following a consideration of the relevant materials, for a trustee director to have a record of the consideration of the risk. In particular, it would be prudent to record why a trustee director was satisfied that any investment was in the best interests of beneficiaries notwithstanding the risks.

G Conclusion

15. It appears likely from recent comments of an APRA Member, that APRA will conduct its regulatory functions conferred by the SIS Act on the basis that climate change presents a financial risk.[15] It is the treatment of climate change as a *financial* risk (as distinct from the treatment of climate change as a environmental, social or governance issue) that trustee directors ought consider in an appropriate case when fulfilling the requirements imposed by the SIS Act.

15 June 2017

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[15] see remarks of APRA Member Geoff Summerhayes to the Australian Senate 'Economic References Committee: Carbon risk disclosure' on 8 March 2017, noting in particular remarks at Hansard p 38 "APRA sees climate related risks as distinctly financial in nature and likely to be relevant and important for all APRA regulated entities."