STRENGTHENING EFFECTIVE STEWARDSHIP IN AUSTRALIA

UNDERSTANDING BARRIERS AND OPPORTUNTIES FOR INVESTOR STEWARDSHIP ON SUSTAINABILITY OUTCOMES

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CONTENTS

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EXECUTIVE SUMMARY

Stewardship, also referred to as active ownership, 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.[1] Increasingly, investors are undertaking effective stewardship with the explicit objective of achieving positive sustainability outcomes that deliver real benefits for investors and society as a whole.[2]

Such an approach is now widely seen as necessary to help mitigate system-level risks (such as those derived from climate change, biodiversity loss, rising social inequality and human rights violations) that threaten the health and stability of economies and investors long term returns. Many beneficiaries and clients are now demanding that those investing on their behalf take effective action on these issues.

Building on the findings and recommendations in recent reports, A Legal Framework for Impact, Legal Framework for Impact: Australia, and the Stewardship Policy Toolkit, this report sets out the findings of research into how Australian institutional investors conduct stewardship and identifies barriers that limit how effectively they use stewardship to shape sustainability outcomes.

IDENTIFIED BARRIERS TO EFFECTIVE STEWARDSHIP

- Hesitancy about using escalatory measures
- Challenges reporting on the effectiveness of stewardship activities
- Inadequate disclosures of corporate sustainability performance
- Limited resources and capabilities to undertake stewardship functions
- Unclear regulatory guidance on investor duties
- Limited regulation of effective stewardship activities
- Confusion on acting in concert rules
- Cumbersome processes for filing shareholder proposals

Drawing on examples of a number of other jurisdictions that are introducing laws, regulations, and stewardship codes to promote effective stewardship, the report then provides initial proposals for policy developments that could be considered to help overcome the identified barriers.

These proposals include: clarifying investor duties and expectations for effective stewardship; providing guidance on acting in concert rules, stewardship resourcing allocation, and tracking and disclosing stewardship outcomes; investigating opportunities to streamline shareholder resolution processes; and adopting a comprehensive corporate sustainability reporting framework.

Policymakers can play an important role in establishing regulatory frameworks for effective stewardship and ensuring that existing policies do not inhibit the ability of investors to discharge their duties to clients and beneficiaries. Facilitating effective stewardship can also support investors to meet expectations set for them in global sustainability agreements.[3]

[1] PRI, World Bank Group (2020), How Policy Makers Can Implement Reforms for a Sustainable Financial System: A Toolkit for Sustainable Investment Policy and Regulation (p.4)
[2] PRI (2022), A Legal Framework for Impact: Australia (p. 10).
[3] PRI, World Bank Group and Chronos (2023), How Policy Makers Can Implement Reforms for a Sustainable Financial System: Implementation Guide for Sustainable Investment Policy and Regulation Tools – Stewardship (p.6-9).

WHAT IS EFFECTIVE STEWARDSHIP?

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, which affect financial returns and the realisation of clients' and beneficiaries' non-financial interests. It encompasses a multitude of tools and activities split between investee stewardship and broader stewardship (Table 1). Investors may choose to combine a variety of these methods depending on the asset class, geography, and investment strategy.

Table 1: Tools and activities for investee and broader stewardship

Investee Stewardship	Broader Stewardship
■ Voting at shareholder meetings ■ Engagement with investees (both current and potential) ■ Filing, co-filing or submitting shareholder resolutions or proposals ■ Nomination of directors to the board ■ Leveraging roles on the board, or on board committees ■ Direct oversight of portfolio companies or assets ■ Litigation	■ Policy engagement ■ Engagement with standard setters ■ Engagement with industry groups ■ Negotiation with and monitoring of the stewardship action of intermediaries in the investment chain (e.g., asset owners engaging external managers, limited partners engaging general partners) ■ Engagement with other stakeholders (e.g., NGOs, workers, communities and other rights-holders) ■ Contributions to public goods (e.g., publicly available research) or to public disclosure (e.g., through the media) that supports stewardship goals

Broadly, stewardship creates value for investors by:[4]

- Addressing system-level risks that are, by definition, undiversifiable, and which affect investors' entire portfolios;
- Enhancing asset-level returns by monitoring idiosyncratic risks and driving improved performance;[5]
- Supporting investors' efforts to pursue positive sustainability outcomes and contribute to the transition towards more sustainable economies;
- Improving the governance of investees and strengthening their accountability to investors; and
- Helping to manage greenwashing-related risks.

[4] PRI, World Bank Group and Chronos (2023), How Policy Makers Can Implement Reforms for a Sustainable Financial System: Implementation Guide for Sustainable Investment Policy and Regulation Tools – Stewardship (p.5).
[5] See, for example, the data presented in Elroy Dimson, Oğuzhan Karakaş, and Xi Li, "Active Ownership" (2015) 28(12) *The Review of Financial Studies 3225-3268* and Elroy Dimson, Oğuzhan Karakaş, and Xi Li "Local Leads, Backed by Global Scale: The Drivers of Successful Engagement" (2017) 12 *RI Quarterly 14-16*.

ACTIVE OWNERSHIP 2.0: AN EVOLUTION IN STEWARDSHIP

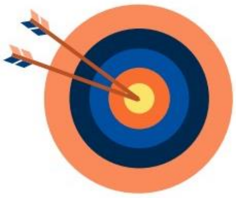
Underpinned by an increase in ambition and assertiveness, investors are increasingly undertaking effective stewardship activities with the explicit objective of pursuing real world sustainability outcomes that deliver real benefits for investors and society as a whole.[6] Such an approach is now widely seen as necessary to help mitigate system-level risks (such as those derived from climate change, biodiversity loss, inequitable social structures and human rights violations) that threaten the health and stability of economies on which institutional investors' diversified portfolios depend upon. Increasingly, beneficiaries and clients are also demanding such an approach.

PRI's Active Ownership 2.0 programme seeks to support this evolution in stewardship practices and ambition, and position investors to more effectively contribute to positive real world sustainability outcomes. Greater support of such an approach will be an essential component of strategy to achieve a sustainable economy and financial system. The three central elements to an effective stewardship approach adopting Active Ownership 2.0 are set out below.

OUTCOMES, NOT INPUTS OR PROCESSES

Active ownership 2.0 prioritises the pursuit and achievement of positive real-world goals. While resources, activity metrics and intermediate goals are among the levers available to investors, these are neither sufficient nor universally relevant in the delivery of outcomes.

COMMON GOALS



System-level risks require a deliberate focus on and prioritisation of outcomes at the economy- or society-wide scale. This means stewardship that is less focused on the risks and returns of individual holdings, and more on addressing system-level or 'beta' issues such as climate change and corruption. It means prioritising the long-term, absolute returns for universal owners, including real-term financial[7] and welfare outcomes for beneficiaries[8] more broadly.

COLLABORATIVE ACTION

Focusing on collective goals and the delivery of positive real-world outcomes is possible only through enhanced collaboration among investors, service providers and other broader stakeholders. Challenges inherent in addressing collective system-level risks, such as the free-rider problem (i.e., where some avoid the costs of addressing collective problems, while reaping the benefits), result in weaker pursuit of collective goals relative to those where the distribution of costs and benefits is more equitable.[9]

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[6] PRI, World Bank Group and Chronos (2023), How Policy Makers Can Implement Reforms for a Sustainable Financial System: Implementation Guide for Sustainable Investment Policy and Regulation Tools – Stewardship (p.5).
[7] That is, the adjusted spending power of beneficiaries' funds once ESG impacts are included; for example, increases in insurance premiums due to risks of floods or forest fire.
[8] For example, a physically liveable climate or respect for human rights.
[9] For example, a portfolio manager of an actively managed listed equity fund meeting with the CEO of a company to get a sense of the organisation's culture, then deciding to change their level of investment in the company on the basis of that meeting.

METHODOLOGY

The purpose of this report is to understand the challenges for investors carrying out effective stewardship that is aligned with PRI's Active Ownership 2.0 programme, and to identify what policies, mechanisms, or tools would help overcome the identified barriers.

The scope of the research includes Australian asset owners and asset managers investing in listed and private equities, fixed-income investments, and real estate, infrastructure or other real assets. The research builds on the findings and recommendations in the PRI's A Legal Framework for Impact and Legal Framework for Impact: Australia reports, the PRI and World Bank's, and Chronos' stewardship policy toolkit, and the Responsible Investment Association Australia's (RIAA) report, Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022.

The research consists of three key components:

1. A comprehensive literature review of Australia's relevant legal and regulatory framework, academic research papers, and stewardship and broader sustainable finance policies applicable to the Australian market (the Literature Review).
2. A desktop market review of the annual reports of 42 investors operating in Australia, representing over $6.9tn in Assets Under Management, to understand the maturity of stewardship reporting (Box 1) (the Desktop Market Review).
3. Consultation with 27 institutional investors at a PRI Signatory Roundtable on effective stewardship (the Signatory Roundtable).

Box 1: Desktop Market Review methodology

To provide a representative market sample, 42 investors operating in Australia were reviewed. The analysis included 31 PRI signatories and 11 other institutional investors. General investment managers, superannuation funds, property funds, insurers and a government-owned investment manager were analysed (Figure 1).

For the purpose of this research, and to maintain the privacy of the investors analysed, the Desktop Market Review findings have been aggregated, summarised and deidentified.

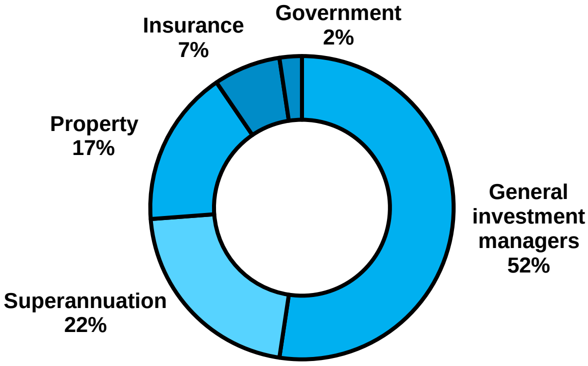


Figure 1: Proportion of investors analysed by type of organisations

STEWARDSHIP IN AUSTRALIA

LEGAL AND REGULATORY SETTING

The definition and scope of stewardship is continually evolving. Internationally, jurisdictions are increasingly introducing an array of hard and soft laws[10] to support effective stewardship.

In Australia, approaches to stewardship have evolved organically over time, as a result of a mix of industry developed interventions and policy guidance notes. These include the following discrete laws and regulatory standards relating to governance, strategy, risk management, remuneration and collective action:

- *Corporations Act 2001* (Cth) (the Corporations Act)
- *ASIC Act 2001* (Cth)
- *Superannuation Industry (Supervision) Act 1993* (Cth) (the SIS Act)
- SPS/SPG 530: Investment Governance
- SPS/SPG 220 & CPS/CPG 220: Risk Management
- RG 128: Collective Action by Investors
- SPS/SPG 515: Strategic Planning and Member Outcomes
- CPG 229: Climate Change Financial Risks
- CPS 511: Remuneration
- CPS 510 & SPS 510: Governance
- Superannuation Circular No.III.A.4: Sole Purpose Test Guidance
- APS 110 and GPS 110: Capital Adequacy

As explored later in this report, this patchwork of approaches provides limited guidance on whether and how investors should integrate stewardship into their governance, risk management and investment processes. In particular, compared to other markets, there is a noteable lack of guidance on whether and how investors should use stewardship to mitigate system-level risks, respond to beneficiaries' sustainability objectives, or align with public policy goals on sustainability matters (national sustainability goals).

Industry associations, like the Financial Services Council (FSC) and Australian Council for Superannuation Investors (ACSI) have developed supplementary guidance on asset stewardship and a signatory-based stewardship code respectively. However, these are voluntary and do not explicitly set expectations or provide guidance for institutional investors on how to to consider or proactively shape sustainability outcomes through stewardship practices.

[10] 'Hard law' primarily consists of investors' legal duties and reporting requirements, whereas 'soft law' pertains to regulatory guidance or voluntary frameworks, such as stewardship codes.

AUSTRALIAN INVESTORS APPROACH TO STEWARDSHIP

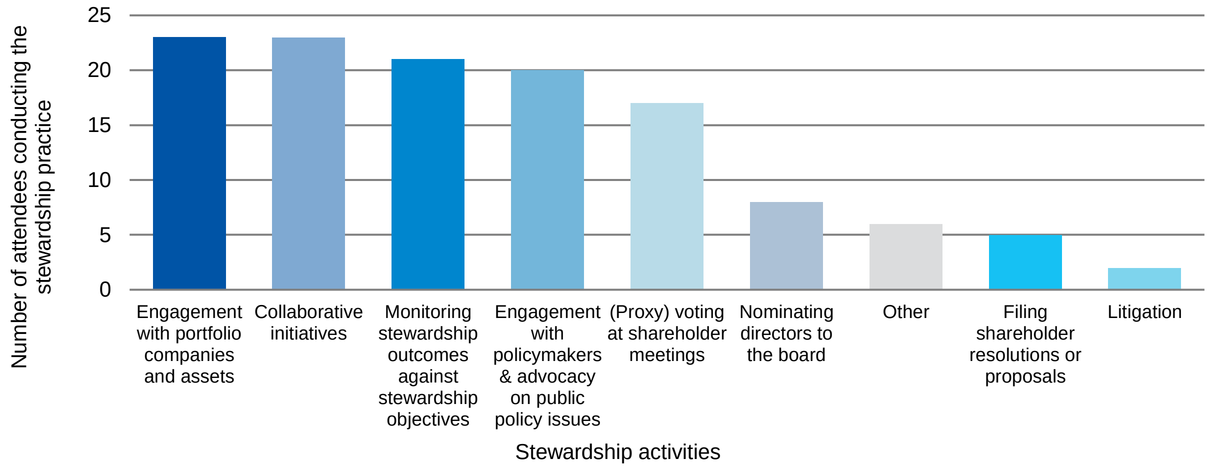
Stewardship is an increasingly important tool for responsible investment in Australia. RIAA's Responsible Investment Benchmark Report Australia 2022 found the application of corporate engagement and shareholder action[11] increased by 54% to $726 billion from $471 billion assets under management to become the second most popular responsible investment approach.[12]

For a long time, Australian investors have conducted stewardship with investees, policymakers, service providers and other stakeholders to maximise the overall long-term value of investments. More recently, such stewardship activities have increasingly focused on addressing sustainability outcomes in line with the stewardship approached described in Active Ownership 2.0. This is illustrated by the findings of RIAA's Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022 report, which analysed stewardship practices by investors across Australia and Aotearoa New Zealand:

- Half of investment managers and asset owners have adopted a stewardship code;
- 85% of investors surveyed publish stewardship policies;
- 82% of investors surveyed collaborated with others to achieve better sustainability outcomes, and 71% engaged or advocated on public policy issues; and
- Climate change; human rights; and diversity, equity and inclusion were the top three sustainability topics investors engaged on with investees.[13]

Findings from the Signatory Roundtable indicated Australian investors generally favour collaborative activities, policy advocacy, or direct engagements with investees, as opposed to filing shareholder resolutions (Figure 2).[14]

Figure 2: Types of stewardship activities practiced by investors attending PRI's Signatory Roundtable on outcomes-focused stewardship.[15]



[11] RIAA's definition of "corporate engagement and shareholder action" is narrower than the tools and activities the PRI considers are available for investee and broader stewardship. According to RIAA, it includes "*executing shareholder rights and fulfilling fiduciary duties to signal desired corporate behaviours – including corporate engagement and filing or co-filing shareholder proposals, and proxy voting guided by comprehensive ESG guidelines*".
[12] Assets under management (AUM) based on 140 investment managers (including asset owners with sufficient internal management of assets) domiciled in Australia or domiciled elsewhere yet managing significant AUM on behalf of Australian investors. See RIAA (2022), Responsible Investment Benchmark Report Australia 2022 (p.16).
[13] RIAA (2022), Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022 (p.6).
[14] Ibid; and discussions with investors during PRI Signatory Roundtable on effective stewardship.
[15] Please note, several of the response options (e.g., voting, filing proposals, or nominating directors to the board) were not applicable to all attendees, for example those without listed equities.

These findings are supported by research from the Australasian Centre for Corporate Responsibility (ACCR) which demonstrated the relative rarity of shareholder resolutions in Australia compared to other jurisdictions, such as the US.[16] More recent data from the PRI's shareholder resolution database shows that, in 2022, only 27 ESG-related shareholder resolutions were filed by Australia compared to 503 that were filed in the US.[17]

Intermediaries also play a central role in investor stewardship in Australia.[18] For example, ACSI, FSC, Investor Group on Climate Change, PRI, RIAA, and other proxy and service providers channel collective influence[19] and conduct direct bilateral engagement with companies on behalf of their member investors.[20]

MATURITY OF STEWARDSHIP REPORTING

There has been significant growth in the number of Australian investors reporting their stewardship activities and associated results; increasing to 45% of investment managers in 2021 from 31% in 2020 and 21% in 2019, according to research conducted by RIAA.[21]

Other desktop research found 73% of the 41 investors analysed are reporting their stewardship activities, but only 36% are also reporting outcomes associated with these activities. A greater proportion of PRI signatories reported their stewardship activities compared to non-PRI signatories. Almost all the investors reporting their stewardship activities and outcomes used investee-specific case studies, while only one investor reported stewardship outcomes and progress toward desired sustainability outcomes at an aggregated or portfolio-level.

Case studies can help investors communicate how they conduct stewardship in line with their duties and link engagements to a particular outcome. They may also provide transparency on the investor's position on high profile or topical issues. However, they do not provide a comprehensive view of how stewardship is conducted for the entire portfolio or how it may be contributing to sustainability outcomes.

"When we set a system-level goal publicly, like deforestation, as short term success is difficult to measure, we work back from the end goal and develop interim indicators of success across our hypothesised goal pathway." - PRI Signatory

Some Australian investors have also adopted common principles of impact investing, such as estimating potential investor influence from contextual factors. Australian investors also noted applying the Global Impact Investing Network (GIIN) guidance to support transparency around attribution of outcomes to their stewardship activities.

"To support transparency, particularly to support the social logic model, we align to the GIIN IRIS+ metrics and consider aspects such as the duration, quality, and the purpose of the engagement." - PRI Signatory

However, many investors remain cautious of attributing an outcome as the result of their individual engagement activities, given outcomes are usually driven by multiple factors.

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[16] ACCR (2014), Shareholder Resolutions at Listed Public Companies in Major English-Speaking Countries: Comparative Arrangements.
[17] For more information, see the PRI's Resolution Database.
[18] Tim Bowley and Jennifer G. Hill, "Stewardship and Collective Action: The Australian Experience" (2020) *European Corporate Governance Institute - Law Working Paper No. 491/2020*.
[19] Ibid.
[20] Ibid.
[21] RIAA (2022), Responsible Investment Benchmark Report Australia 2022 (p.18).

IDENTIFIED BARRIERS TO EFFECTIVE STEWARDSHIP IN AUSTRALIA

Based on the research of stewardship approaches in Australia detailed in the above section, there are several barriers to achieving the central elements of effective stewardship outlined in Active Ownership 2.0:

1. Pursuit and achievement of outcomes
2. Common goals
3. Collaborative action

These barriers are related to both the legal and regulatory framework, as well as preferred market practices. We have explored these barriers in further detail below.

BARRIERS TO THE PURSUIT AND ACHIEVEMENT OF OUTCOMES

HESITANCY ABOUT USING ESCALATORY MEASURES

Historically, Australian investors have been somewhat reluctant to leverage the full range of stewardship measures, particularly shareholder resolutions and proxy voting, as a tool for influencing investees to improve their sustainability performance.

While direct engagement is one avenue for influencing the achievement of sustainability outcomes, alternative stewardship actions may need to be considered if progress stalls or is otherwise insufficient. Further escalatory measures that may be more commonly used in other markets, include, filing and/or voting for shareholder resolutions, voting against board-led resolutions (e.g., the (re-) election of board members or approval of annual reports), proposing directors for election, litigation and (in certain circumstances) divestment.[22]

In comparison to other jurisdictions, in Australia there has been a tendency in practice to favour reaching agreement for change through direct bilateral engagement,[23] with investors, in some cases, viewing shareholder resolutions and proxy voting as hostile and potentially detrimental to their relationships with portfolio companies. In this respect, some investors may place more weight on maintaining collegiate relationships rather than prioritising sustainability outcomes and using their investor rights to discharge their duty to mitigate system-level risks and support beneficiaries' sustainability preferences.

"The construct of shareholder resolutions is certainly a barrier. In the Australian context, it is seen as quite an antagonistic way to drive change, and a last resort option" – PRI Signatory

"[Lodging a shareholder resolution] would be seen as a very antagonistic move, and could be detrimental to our relationships with portfolio companies" – PRI Signatory

In more recent years, there has been evidence of successful escalatory measures being used, albeit to a limited extent, such as recent collaborative action to elect shareholder nominated directors to an energy company board to address climate change strategy-related concerns.[24]

[22] PRI (2021), Making Voting Count; PRI (2022), Discussing Divestment; PRI (2023), A Guide to Filing Impactful Shareholder Proposals.
[23] ACSI (2017), Shareholder Resolutions in Australia: Is There a Better Way?
[24] Mark Ludlow and Elouise Fowler, 'AGL Board Must Work as One, Warns McKenzie', *Australian Financial Review* (online, 15 November 2022)

CHALLENGES REPORTING ON THE EFFECTIVENESS OF STEWARDSHIP ACTIVITIES

Currently, investors face significant challenges to report on the investee-level changes that result from their stewardship activites. Organisational decision-making and governance are influenced by a multitude of internal and external factors and it is hard to establish which changes are due to investor stewardship efforts. Fears of perceived greenwashing contribute to a reluctance to report on the results of stewardship as investors want to avoid making claims or overstating the level of influence their stewardship activities had in relation to shaping sustainability outcomes.

"It is really challenging to know how we can claim that this is our outcome, when most of the outcomes are partially us, partially others, partially increased regulatory pressure and so on. Especially with the risk of greenwashing we don't want to overstate something publicly." – PRI Signatory

These concerns are potentially compounded where there has been increased scrutiny by regulators on greenwashing, yet minimal guidance from regulators on useful reporting indicators or approaches that investors can use to track and disclose their progress and the results of effective stewardship.

ASIC, for example, is concerned with potential misleading statements around stewardship. Specifically, it has signalled its interest in investigating funds that claim to use their influence to transition their investees on climate-related issues, but their voting records are misaligned. ASIC expects investors to demonstrate how they use their influence and how such influence was effective.[25] However, the Federal Government and financial regulators have not set minimum expectations or provided guidance on best practice for disclosing the outcomes of such influence, and existing requirements for superannuation funds to summarise how they exercise their voting rights fall short of providing the necessary direction.[26]

Limited data availability, the prolonged time taken for stewardship targets to change their behaviour, and the iterative nature of stewardship activities also present challenges to reliable disclosures on effective stewardship. For instance, investors may engage companies over several years before any tangible outcome can be reported, making it challenging to communicate to stakeholders the effectiveness of their stewardship activities in the interim.

"One main barrier is that we are looking at huge, systemic problems and trying to track small or fluid progress" – PRI Signatory

"Achieving the final outcome can take years and reporting on progress is a challenge." – PRI Signatory

These barriers to reporting stewardship outcomes are experienced by investors internationally. For example, in its 2021 review of reporting against the UK Stewardship Code, the FRC found many organisations failed to consistently report outcomes of their activities and as a result did not achieve the standard expected by the code.[27] While the FRC Review of Stewardship Reporting 2022 found improvements in outcome reporting for engagement, hope for improvement was noted with respect to more effective activities and outcomes reporting, using both quantitative and qualitative evidence.[28]

[25] Hannah Wootton, 'ASIC Pursues 'Several' Super Funds for Greenwashing, Expects Court Action', *Australian Financial Review* (online, 13 March 2023).
[26] *Superannuation Industry (Supervision) Regulations 1994* (Cth) r 2.38(o).
[27] FRC (2021), FRC Effective Stewardship Reporting Review November 2021 (p.42).
[28] FRC (2022), Review of Stewardship Reporting 2022.

INADEQUATE DISCLOSURES OF CORPORATE SUSTAINABILITY PERFORMANCE

Investors require high-quality, comprehensive disclosures by companies on their sustainability performance to inform and reduce the cost of stewardship. However, despite APRA and ASIC increasingly encouraging climate-related risk disclosures, there are still no mandatory requirements for companies to publicly disclose their sustainability performance broadly. Similarly, there are generally no mandatory requirements in investment management agreements for asset managers to monitor and disclose how they are shaping sustainability outcomes.

This results in a significant information gap for investors, who must instead rely on limited, voluntary disclosures[29] or request that information from companies or investment managers. Stewardship practices may therefore prioritise attaining this information either before or instead of shaping sustainability outcomes. In turn, this increases the cost of stewardship for already resource constrained investors and may dilute effectiveness.

Welcomely, the Federal Government intends to introduce mandatory climate-related risk disclosures and is co-developing an Australian Sustainable Finance Taxonomy. These initiatives, coupled with existing requirements for Australia's largest greenhouse gas emitters, energy consumers and producers under the National Greenhouse and Energy Reporting (NGER) scheme,[30] will provide investors with valuable data to evaluate their investees' emissions and business risks.

Nevertheless, without clear, comprehensive, and mandatory corporate disclosure requirements on wider sustainability issues, there will continue to be significant data gaps in areas that are less mature than climate but that are nonetheless material concerns for investors (i.e., biodiversity loss and broader social issues).

LIMITED RESOURCES AND CAPABILITIES TO UNDERTAKE STEWARDSHIP FUNCTIONS

Effective stewardship requires sufficient quantity and quality of resources with relevant sustainability related skills and knowledge.[31] Further, consistent, and clear messaging with investee companies can lead to better outcomes. However, stewardship functions are often under resourced, meaning investors do not have capacity to manage regular engagements, monitor data and disclose outcomes.[32]

Barriers to adequate resourcing for stewardship functions include:

- cost-cutting efforts and lack of financial resources;
- no regulatory guidance or market standard regarding what good stewardship resourcing looks like;
- employees are generally financially trained and lack technical stewardship competency;[33] and

[29] IGCC, CDP & PRI (2021), Confusion to Clarity (p.4-5).
[30] The NGER scheme provides a single national framework for reporting and disseminating company information about greenhouse gas emissions, energy production and energy consumption. This provides investors standardised metrics to evaluate the climate change related performance of their assets over time and understand whether their stewardship activities are having an impact. However, NGER reporting requirements are limited to the nation's largest greenhouse gas emitters, energy consumers and energy producers.
[31] Australian Sustainable Finance Initiative (2020), Australian Sustainable Finance Roadmap: A Plan for Aligning Australia's Financial System with a Sustainable, Resilient and Prosperous Future for All Australians; RIAA (2022), Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022.
[32] PRI (2023), Why We Need to Talk About Resourcing Stewardship.
[33] RIAA (2022), Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022 (p.5, 20-21).

- challenges in finding new resources with the necessary capabilities to conduct effective and persuasive engagement on system-level sustainability issues.[34]

"One key barrier we face is having the technical competence within the investment teams, to ensure we are asking the right questions, and are able to push and challenge these companies" – PRI Signatory

Resourcing constraints create a significant barrier to effective stewardship and exacerbate many of the other barriers discussed throughout this paper.[35] These barriers are likely greater for small investors, which may face disproportionately higher costs to undertake effective stewardship due to access to less resources and lower levels of influence.

BARRIERS TO COMMON GOALS

UNCLEAR REGULATORY GUIDANCE ON INVESTOR DUTIES

Historically, a narrow interpretation of fiduciary duties hindered the incorporation of environmental, social and governance (ESG) considerations into investment activities, including stewardship and capital allocation decisions.[36] There is now clear evidence that incorporating ESG considerations can deliver positive financial outcomes for companies and investors, while failure to do so creates material risks.[37]

Authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, United Nations Environment Programme Financial Initiative, and the Generation Foundation, the report, A Legal Framework for Impact, concludes that Australian investors are broadly permitted to consider shaping sustainability outcomes where doing so would support their financial return objectives. Yet despite these findings, many investors remain uncertain about the extent to which they are required or permitted to do so, in part because relevant legislation and standards generally fail to explicitly identify sustainability-related system-level risks as relevant considerations.[38]

More broadly, there is currently limited, direct acknowledgement of investors' rights and responsibilities to shape sustainability outcomes as a means of responding to beneficiaries' sustainability objectives or to meet the expectations for financial institutions set out in global sustainability agreements.[39]

"There is a need for more clarity in the policy space, particularly in pursuing system-level outcomes" – *PRI Signatory*

PRI signatories acknowledged unclear regulatory guidance on fiduciary duties as a barrier to effective outcomes-focused stewardship.[40] They highlighted the need for clearer expectations for investors to consider sustainability related issues within their fiduciary duty.

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[34] Discussions with investors at the PRI Signatory Roundtable.
[35] Resourcing constraints was one of the primary barriers raised by investors at the PRI Signatory Roundtable.
[36] Benjamin J. Richardson, "Keeping Ethical Investment Ethical: Regulatory Issues for Investing in Sustainability" (2009) 87(4) *Journal of Business Ethics* 555-572; Joakim Sandberg, "Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective" (2011) 101(1) *Journal of Business Ethics* 143-162; UK Law Commission (2014), Fiduciary Duties of Investment Intermediaries.
[37] Mozaffar Khan, George Serafeim and Aaron Yoon, "Corporate sustainability: First evidence on materiality" (2015) 91(6) *The Accounting Review 1697-1724*; Zoltán Nagy, Altaf Kassam, and Linda-Eling Lee, "Can ESG add alpha? An analysis of ESG tilt and momentum strategies" (2016) 25(2) *The Journal of Investing 113-124*; Witold J. Henisz and James McGlinch, "ESG, material credit events, and credit risk" (2019) 31(2) *Journal of Applied Corporate Finance 105-117*; Erik Landry, Mariana Castillo-Lazaro and Anna Lee (2017), Connecting ESG and Corporate Bond Performance; Sung C. Bae, Kiyoung Chang and Ha-Chin Yi, "The impact of corporate social responsibility activities on corporate financing: A case of bank loan covenants" (2016) 23(17) *Applied Economics Letters 1234-1237*
[38] The following regulatory guidance materials on organisational governance and risk management standards omit reference or effectively embed consideration of ESG system-level risks: RG128: Collective Action by Investors; SPS/SPG515: Strategic Planning and Member Outcomes; SPS530 and SPG530: Investment Governance; SPS/SPG220 & CPS/CPG220: Risk Management; APS110 and GPS110: Capital Adequacy; CPS 511: Remuneration; CPS 510 & SPS510: Governance; and Superannuation Circular No.III.A.4: Sole Purpose Test Guidance.
[39] See, for example, Paris Agreement article 2.1(c) and Kunming-Montreal Biodiversity Framework target 14.
[40] Corroborated during discussions with investors at the PRI Signatory Roundtable.

"It gets difficult in the social space around fiduciary duty and more work is to be done on operationalising that as a concept within our duty" – PRI Signatory

"We need more guidance to remove ambiguity and provide clarity on the interpretation of best financial interests, particularly in terms of the short vs long term challenges" – PRI Signatory

LIMITED REGULATION OF EFFECTIVE STEWARDSHIP ACTIVITIES

Internationally, jurisdictions are introducing regulations that clarify stewardship expectations[41], as well as regulator supported stewardship codes[42], which can help drive significant changes in market attitudes and incentivise effective stewardship activities.

Australia's regulatory framework provides limited clarity over expectations for investors to exercise stewardship. Where stewardship is referenced in Australia's regulatory framework, it is incidental and provides limited direction or support to engage in stewardship generally or to shape sustainability outcomes.

For example, APRA's Draft Prudential Practice Guide SPG 530: Investment Governance in Superannuation, briefly mentions permissions for superannuation funds to consider stewardship and introduces certain expectations. Yet it makes limited reference to stewardship as a tool for driving long-term sustainable value creation and does not recognise effective stewardship as a fundamental component of exercising trustee duties.

In addition, no regulator supported stewardship code exists in Australia. Instead, industry associations such as the FSC and ACSI have developed guidance on asset stewardship and signatory-based stewardship codes respectively. The FSC issued FSC Standard 23: Principles of Internal Governance and Asset Stewardship in July 2017 (FSC Code) to encourage higher standards of internal governance and stewardship practices amongst asset managers.[43] ACSI published the Australian Asset Owner Stewardship Code in May 2018 (ACSI Code) to increase transparency and encourage consistent stewardship approaches amongst asset owners.[44]

The FSC and ACSI codes are voluntary, and neither explicitly set expectations or provide guidance on how institutional investors should consider or pursue sustainability outcomes through stewardship practices. Further, the existence of two codes covering different types of investors within the Australian market has contributed to variations in stewardship approaches. As a result, there have been calls for a revised approach to stewardship codes in Australia.[45] In 2019, ACSI published a discussion paper calling for reform to Australia's approach to stewardship and recommended a stewardship code be developed that is applicable to all institutional investors and sits within an appropriate regulatory framework, rather than be an industry-led initiative.[46]

RIAA's Responsible Investment Benchmark Survey 2022 found half of Australasian asset managers and asset owners have adopted a stewardship code.[47] However, a broad range of voluntary codes have been adopted, creating inconsistent stewardship approaches within the Australian market.[48] Investors

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[41] For example, in South Africa Regulation 28 of the Pension Funds Act No. 24 of 1956 regulates how pension funds should invest their assets. In 2019, it was clarified that to comply with the regulation funds should have an active ownership policy in its investment policy statement. Source: Financial Sector Conduct Authority (2019), Guidance Notice 1.

[42] For example; the UK Stewardship Code (Box 2); the Code for Responsible Investment in South Africa (CRISA); and India's Pension Fund Regulatory and Development Authority (PFRDA) Common Stewardship Code, Insurance Regulatory and Development Authority of India (IRDAI) Guidelines on Stewardship Code for Insurers, and Securities and Exchange Board of India (SEBI) Stewardship Code.

[43] Financial Services Council (2017), FSC Standards: Standard No. 23: Principles of Internal Governance and Asset Stewardship.

[44] Australian Council for Superannuation Investors (2018), Australian Asset Owner Stewardship Code.

[45] Tim Bowley and Jennifer G. Hill, "Stewardship and Collective Action: The Australian Experience" (2020) *European Corporate Governance Institute - Law Working Paper No. 491/2020*

[46] ACSI (2019), Towards Stronger Investment Stewardship

[47] RIAA (2022), Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022 (p.5-7).

[48] RIAA (2022), Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022 (p.8-9).

believe a formal Australian stewardship code could help clarify investor responsibilities and encourage better disclosure of engagement outcomes.

"A formal stewardship code supports investors' understanding and supports a forum for learning within one's own organisation" – PRI Signatory

Box 2: International insights into UK Stewardship Code

The UK Stewardship Code, developed by the Financial Reporting Council (FRC) in 2010 and updated in 2020, is recognised by both UK and non-UK investors as the gold standard for stewardship globally.[49]

The UK Stewardship Code now explicitly defines stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for '*the economy, the environment and society*'.[50] The update has raised the bar in terms of what is expected from asset owners by explicitly setting out a raft of new expectations to be fulfilled in relation to how asset owners should engage with asset managers to enforce stewardship responsibilities.[51]

The 2020 updates also explicitly recognises that asset owners and asset managers play an important role in working to minimise systemic risks and places greater focus on reporting stewardship outcomes.[52] Research by the FRC into the influence of these updates noted the most notable benefit of the revised code has been the emphasis on reporting the activities and outcomes of stewardship, which has prompted a major change in behaviour.[53]

With that said, effective stewardship in the UK is not driven solely by the code. Stewardship practices are also promoted through other relevant policies, including the FCA regulation mandates that investors disclose their commitment to meeting the UK Stewardship Code, or explain otherwise.[54]

To improve shareholder engagement and increase stewardship transparency, the FCA also developed Policy Statement PS19/13 and set requirements for asset managers and life insurers to publicly disclose their policies on how they engage and the companies they invest in.[55] Additionally, updates to the Occupational Pension Scheme regulations now require all schemes to publicly disclose details regarding their investment strategy and arrangement with their asset manager in the Statement of Investment Principles, including information on voting behaviour and engagement policy.[56]

BARRIERS TO COLLABORATIVE ACTION

CONFUSION ON ACTING IN CONCERT RULES

Collaborative action amongst investors can significantly help increase the efficiency and effectiveness of stewardship activities, but there are hesitations amongst some investors about engaging in such action due to a perceived risk of triggering anti-competition restrictions. ASIC's regulatory guidance RG 128: Collective action by investors, aims to facilitate collaborative action while clarifying when investors

[49] Financial Reporting Council (2022), The Influence of the UK Stewardship Code 2020 on Practice and Reporting
[50] Ibid.
[51] EY (2020), Meeting Great Expectations: Analysis and Insights of Stewardship Engagement and Outcomes for Asset Owners.
[52] Ibid
[53] Financial Reporting Council (2022), The Influence of the UK Stewardship Code 2020 on Practice and Reporting.
[54] The Financial Conduct Authority Handbook Conduct of Business Sourcebook (COBS) section *2.2 Information disclosure before providing services* requires firms, other than a venture capital firm, which is managing investments for a professional client that is not a natural person must disclose clearly on its website, or if it does not have a website in another accessible form; (1) the nature of its commitment to the Financial Reporting Council's Stewardship Code; or (2) where it does not commit to the code, its alternative investment strategy.
[55] Financial Conduct Authority (2019) PS19/13: Improving Shareholder Engagement and Increasing Transparency around Stewardship.
[56] UK Government (2019) The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019.

can expect certain conduct to trigger takeover and substantial holding provisions under the Corporations Act.

RG 128 notes that while in some instances it can be clear whether conduct falls within or outside the scope of the legal provisions, due to the nature of concepts like ‘relevant agreement’ and ‘associate’, there can be uncertainty about their application to a variety of conducts.[57] As a result of this uncertainty, there remains a perceived risk that certain collaborative stewardship activities may trigger takeover and substantial holding provisions. This is particularly the case for larger investors that may trigger substantial holding provisions due to the size of their funds.

“RG128 is front and centre for us. Even if we, as a fund, wanted to participate in co-filing a shareholder resolution, we are constrained as we don’t have legal buy in at fund level. We have to follow internal advice not to take the acting in concert risk.” – PRI Signatory

Investors also noted that the uncertainty prevents internal legal functions from developing a clear internal interpretation of RG 128, contributing toward the perception of this risk arising and disincentivising collaborative action.

“The different responses to RG128 are a function of different types of investors and the different amount of work that legal functions are willing to put into it to get the right interpretation. [We need] guidance to support overworked legal functions” – PRI Signatory

ASIC states in RG 128 notes that it will generally grant relief if the nature of collective action is not concerned with the acquisition of a substantial interest or control over the entity.[58] However, investors identified that clearer guidance on the types of conduct that would lead investors to becoming associates or that would trigger the takeover and substantial holding provisions would alleviate the perceived risk.

“RG128, the resolution process, and the policy environment are definitely a real barrier, stopping people from using these [collaborative stewardship activities] and escalation where necessary” – PRI Signatory

Box 3: International insights into acting in concert rules

Acting in concert rules aim to prevent undue accumulation of voting power by triggering takeover regulations. While regulators tend to note that these should not unnecessarily encumber investor collaboration, there is an issue of perceived threat of non-compliance in many jurisdictions globally. [59]

For example, Japan’s Financial Services Agency’s published view is that normal stewardship activities, which do not involve agreement on exercising rights with other investors, do not comprise acting in concert. However, the Legal Framework for Impact report found several issues with the regulation, that may raise sufficient concern to deter investor collaboration nonetheless.[60]

In addition, the UK's Competition and Markets Authority’s (CMA) draft guidance on competition rules to environmental sustainability agreements includes an example that joint lobbying on climate change pricing is unlikely to affect the main parameters of competition.[61]

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[57] ASIC (2015), Regulatory Guide 128: Collective Action by Investors.
[58] Ibid.
[59] Tim Bowley and Jennifer G. Hill, “Stewardship and Collective Action: The Australian Experience” (2020) *European Corporate Governance Institute - Law Working Paper No. 491/2020*; Freshfields Bruckhaus Deringer, PRI, UNEP FI, and The Generation Foundation (2021), A Legal Framework for Impact: Sustainability Impact in Investor Decision Making.
[60] Freshfields Bruckhaus Deringer, PRI, UNEP FI, and The Generation Foundation (2021), A Legal Framework for Impact: Sustainability Impact in Investor Decision Making.
[61] UK Competition and Markets Authority (2023) Draft Guidance on the Application Of The Chapter I Prohibition In The Competition Act 1998 To Environmental Sustainability Agreements (p.9).

CUMBERSOME PROCESS FOR FILING SHAREHOLDER RESOLUTIONS OR PROPOSALS

Shareholder-requisitioned meetings are one of the few mechanisms shareholders have to effect significant timely change in the management and direction of their company.[62] However, filing shareholder resolutions or proposals is one of the least common stewardship activities practiced by Australian investors.[63]

To raise an advisory resolution in Australia, investors are first required to pass an amendment to the company constitution permitting such resolutions.[64] Constitutional amendments can be contentious, with votes often falling short of the requisite standard and level of support for the related advisory resolution.[65]

"I do think that the fact that there is a requirement to amend the constitution does scare some investors from voting" – PRI Signatory

The requirement to pass an amendment to the company's constitution renders the Australian resolution framework relatively restrictive,[66] particularly in comparison to jurisdictions such as Canada, the UK, the US and South Africa which offer mechanisms such as non-binding advisory votes and resolutions.[67] In these more flexible jurisdictions, shareholders have clearer rights to submit proposals and greater liberty to present a matter to the board.[68]

Consequently, difficulty in raising shareholder resolutions limits a key mechanism for investors to effect influence.

Box 4: International insights into filing shareholder resolutions

In 2014 and 2015, reports comparing the shareholder resolution process across various jurisdictions indicated that relative to Australia, resolutions were more common in other jurisdictions such as the USA.[69] It suggested that in other jurisdictions such as the US, relevant legislation was clearer, less burdensome, and less curtailing, and that shareholder rights to raise resolutions were stronger and more clearly defined.

Research performed by ACSI in 2017 proposed the relative frequency of resolutions in the US was a result of regulatory gaps and differences in engagement culture.[70] The research suggested that Australian investors had a more developed culture of investor engagement, preferencing direct bilateral engagements to resolve issues, and that US investors used resolutions to overcome regulatory framework gaps relating to rights available to Australian shareholders (e.g., proxy access).

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62 ASIC (2017), Report 512 - Regulation of Corporate Finance: July to December 2016.
63 RIAA (2022), Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022 (p.12).
64 *Corporations Act 2001* (Cth), s 249N.
65 Lloyd Freeburn, and Ian Ramsay "An Analysis of ESG Shareholder Resolutions in Australia" (2021) 44(3), *University of New South Wales Law Journal*; PRI (2023), Filing a Shareholder Proposal in Australia.
66 Ibid.
67 PRI (2023), A Guide to Filing Impactful Shareholder Resolutions; ACCR (2015), Shareholder Resolutions on ESG Issues at Listed Public Companies: Comparative Practice in Australia, the US & the UK; ACCR (2014), Shareholder Resolutions at Listed Public Companies in Major English-speaking Countries: Comparative Arrangements.
68 Ibid
69 ACCR (2015), Shareholder Resolutions on ESG Issues at Listed Public Companies: Comparative Practice in Australia, the US & the UK; ACCR (2014), Shareholder Resolutions at Listed Public Companies in Major English-speaking Countries: Comparative Arrangements.
70 ACSI (2017), Shareholder Resolutions in Australia: Is There a Better Way?

INITIAL PUBLIC POLICY CONSIDERATIONS

Overcoming the identified barriers to effective stewardship in Australia is not insurmountable but will require coordinated effort across government, regulators, and key stakeholders within the investment industry.

The following areas for possible policy consideration have been developed based on the research undertaken and barriers identified. The areas for possible policy consideration aim to support the three central elements of effective stewardship in Australia are outlined in Table 2, relating to common goals, collaborative action and pursuit and achievement of outcomes.

Table 2: Potential policy areas for consideration to overcome barriers to effective stewardship in Australia

No.	Barriers to effective stewardship	Policy areas for further consideration
1.	Unclear regulatory guidance on investor duties	**Clarify investor duties to address sustainability-related system-level risks** The Federal Government and financial regulators should update legislation and regulatory standards to clarify that investor duties require them to address sustainability-related system-level risks by shaping sustainability outcomes. Requirements to consider and address sustainability-related system-level risks could be embedded within governance, strategy, risk management and remuneration structures.
2.	Limited regulation of effective stewardship activities	**Clarify expectations for effective stewardship** The Federal Government and financial regulators should review and update the network of legislation and regulatory guidance with a view to streamline the stewardship policy framework, enhance effectiveness and accountability of investor stewardship, and guide stewardship practices towards driving positive sustainability outcomes. This could include: ■ communicating expectations for effective stewardship to support investors to mitigate system-level risks, beneficiary preferences, and to meet the expectations on financial institutions set out in global sustainability agreements; and ■ addressing investor rights, duties, and implementation mechanisms to better encourage, require, and/or scale up effective stewardship; and ■ introducing a cross-industry stewardship code that builds off of international best practice.[71]

[71] See for example, Financial Reporting Council (2020), UK Stewardship Code; Aotearoa New Zealand (2022), Stewardship Code.

No.	Barriers to effective stewardship	Policy areas for further consideration
3.	Confusion on acting in concert rules	**Provide additional guidance and clarification on acting in concert rules** ASIC could provide additional guidance and clarity on activities that are permitted within the scope of investor stewardship, particularly for large funds that are likely to be most concerned about triggering takeover and substantial holding provisions. For example, RG 128 could be updated to clarify permissions for both investor collaboration and other specific stewardship actions.
4.	Limited resources and capabilities to undertake stewardship functions	**Investigate how to encourage greater resourcing allocation** The Federal Government and financial regulators could examine how it could support and encourage investors to allocate greater resourcing for effective stewardship measures through guidance, standards, and disclosure expectations.
5.	Hesitancy about using escalatory measures	**Signal support for effective stewardship** The Federal Government could publicly recognise the importance of effective stewardship in its national sustainable finance strategy and signal support for investors to use the full range of stewardship measures at their disposal, including shareholder resolutions and voting, when appropriate.
6.	Challenges reporting on the effectiveness of stewardship activities	**Provide guidance for tracking and disclosing stewardship outcomes** The Federal Government and financial regulators could set expectations that investors disclose the processes, practice, and most importantly the results of their effective stewardship, as well as provide guidance on best practice.
7.	Cumbersome processes for filing shareholder proposals	**Investigate opportunities to simplify and streamline the shareholder resolution process** The Federal Government and financial regulators could investigate opportunities to simplify and streamline the shareholder resolution process, to support greater opportunities for dialogue.

No.	Barriers to effective stewardship	Policy areas for future consideration
8.	Voluntary disclosures for corporate sustainability performance	**Adopt a comprehensive corporate sustainability reporting framework** Building on the Federal Government's commitment to introduce mandatory climate-related financial reporting,[72] the Federal Government should introduce legislation requiring corporate disclosure of wider sustainability-related risks and sustainability performance. Australian standards should be based on the ISSB's final IFRS S1 and S2 standards as a minimum baseline. Additional standards, directors, and guidance should be introduced on disclosing corporate sustainability performance.

[72] Australian Government (2022), Climate-Related Financial Disclosure.

APPENDIX A: KEY TERMS

The following key terms are used throughout this report[73]:

- **Sustainability outcomes:** the real-world sustainability outcomes of human activity, which includes actions by investors. Positive sustainability outcomes are those aligned with global sustainability goals, such as the goals of the Paris Agreement and the UN Sustainable Development Goals (SDGs), as well as with the UN Guiding Principles on Business and Human Rights, the International Bill of Human Rights and International Labour Organization conventions.
- **Shaping sustainability outcomes:** an investment approach that involves taking deliberate steps to increase positive sustainability outcomes or reduce negative sustainability outcomes or both, in assessable ways.
- **System-level risks:** a catch-all term for systematic risk and systemic risk, both of which have implications for investment performance.
  - **Systematic risk:** 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:** 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".

[73] PRI (2022), A Legal Framework for Impact: Australia

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