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To Whom It May Concern

Submission on consultation paper - greater transparency of proxy advice

Arnold Bloch Leibler (**ABL**) is pleased to provide this submission in response to the consultation paper - *Greater transparency of proxy advice*, dated April 2021 (**Consultation Paper**).

ABL has campaigned on the inherent failures of the current regulatory approach to proxy advisers for several years, both publicly and through correspondence with relevant regulators and policy makers.

In 2016, in a letter to ASIC (copy attached), we raised concerns about the disproportionate impact proxy advisers were having on the Australian market and outlined the need for greater regulatory oversight.

In that context, we welcome the opportunity provided by The Treasury to reinforce our advocacy on this important issue.

While there is a role for proxy advisers in our market, insufficient regulatory oversight allows them to exert a destabilising level of power and influence. As advisers to both ASX listed companies and shareholder activists, we observe the market intervention of proxy advisers creating a perverse incentive for directors to focus on tick-box targets ahead of the medium to long term interests of shareholders.

ABL has long advocated for several of the recommendations included in the Consultation Paper, which would help address the justifiable concerns about proxy advisers that have triggered this consultation.

This submission focuses on three areas of blatantly much-needed reform.

1 Independence, governance, and licensing

Recommendation

Rather than trying to shoehorn proxy advisers into existing regimes that are not fit for purpose, specific regulation should be developed that reflects the unique role they play in the Australian market.

A good example of the current regulatory mismatch is the requirement for proxy advisers to hold Australian Financial Services Licences. The reality is that most of the work undertaken by proxy firms is not classified as providing financial services. In effect, they are licensed for only a small, relatively inconsequential portion of their services and otherwise operate without oversight.

A more appropriately designed licensing system for proxy advisers could operate as an expansion of the existing AFSL regime.

To meet the new licensing requirements, proxy advisers should be required to show evidence that they are independent from the superannuation funds and institutional investors who form their customer base, and that they have sufficient resources, qualifications and expertise to advise investors in the Australian market.

Background and observations

We have witnessed numerous examples over the years of advice provided by proxy firms which contains factual errors, offers little more than a box-ticking approach to recommendations and an obstinate refusal to engage with the companies, who are the subject of their reports.

Of particular concern is the inherent conflict of interest, whereby proxy advisory firms provide corporate consulting services to companies at the same time as advising shareholders how to vote or those same companies in relation to structuring their remuneration reports.

Proxy firms should be obligated to disclose whom they are advising, how many staff they employ, their expertise and where staff are located.

If proxy firms cannot prove they have the resources and expertise to consider the unique nature of a company, the industry in which they operate and the Australian market overall when producing voting recommendations, they should not be holding themselves out as the purveyors of expert voting advice.

Take, for example, proxy advisers' recommendations to block the re-election of Mortgage Choice co-founder Rodney Higgins to the board in 2016, because he had been with the company for too long. This nonsensical recommendation highlights the inability of proxy advisers to consider each company's unique situation on its merits.

There are other examples of votes that went against directors because they did not fit within the proxy advisers' ideal limit on directorships, or because the proxy firm followed a tick-the-box policy of pressuring companies to appoint greater numbers of independent directors.

There are also many examples of protest votes against remuneration reports, which are often encouraged by proxy firms as a method to punish directors on issues that are separate to remuneration, or because the advisers fundamentally misunderstand the industry in which the company operates.

As advisors to ASX-listed companies, we see this issue being contemplated well before it reaches the floor of the AGM. Our clients are conscious of proxy advisors' sensitivity to remuneration and the power they can wield with a recommendation to vote down executive remuneration policies.

Australia is a small, competitive market. Companies in the ASX300 cast their net wide to hire senior executives from the US or UK and need to structure remuneration to entice the best executives from these markets, where remuneration structures are more complex and lucrative than in Australia.

However, there is a real sense that internationally competitive executive remuneration structures are not palatable because of the tick-the-box approach of proxy advisors who are likely to vote down anything considered out of market.

We have seen examples of institutional shareholders telling companies that while they understand the rationale for such remuneration packages, they feel compelled to vote against them, in line with proxy advice. These institutions are often frustrated by the situation but simply don't have resources themselves to justify a vote which is out of line with the proxy advice.

The resolution to many of these issues is a more robust licensing system that is fit for purpose for the proxy industry, so that regulators are not left standing idly by as proxy firms hijack our markets with undue power and influence.

While there was some discussion of an opt-in code of conduct for proxy firms in 2017, a recent review of the websites of the four largest proxy advisors in Australia - ISS, CGI Glass Lewis, ACSI and Ownership Matters - found that not one of them references a code of practice or conduct.

Ownership Matters actually has a manifesto on its website decrying the need for regulation, stating that the firm "doesn't believe that there is any need to establish a 'Code of Conduct' for proxy advisors in Australia".[1]

It is clear that nothing less than a mandated regulatory regime is required to inject a sense of humility and responsibility into the sector.

2 Improved disclosure of trustee voting

Recommendation

We agree with a greater focus on transparency of voting practices. However, this focus should apply, not only to superannuation funds, but to other institutional shareholders who have a significant impact on our markets due to their relative shareholdings.

A new regulatory regime should make it clear that institutional investors and superannuation funds have a fiduciary duty to their investors and should be focused on investors' best financial interests.

This is also why super funds and institutional investors should be required to provide evidence they exercise independent judgement when voting. It is legitimate to rely on external independent advice, as long they exercise their own judgement having regard to their investors' particular circumstances.

To aid with this, institutional investors and superannuation funds should be required to disclose the proxy reports they relied upon when casting votes and a comparison of how they were *advised* to vote against how they *did* vote.

Where there are no, or very few, examples of funds departing from proxy advice, those funds should explain why.

[1] Ownership Matters, *Regulation of Proxy Advisors – Our View,* <http://www.ownershipmatters.com.au/research-news/issues/>.

We recognise this increases the burden on institutional investors and superannuation funds and will further stretch their resources, but if they are going to hold shares in hundreds of ASX listed companies, it is only appropriate that they should be expected to have this capability.

Background and observations

Institutional investors can receive voting materials from up to 300 companies each year, and are required to review those materials and decide how to cast their votes within a two-month AGM season. At the peak of the season there may be more than 30 meetings in a week.[2]

The Australian Institute of Company Directors has highlighted that this high volume of materials, and the need to review them in a time pressured environment, creates a strong incentive for institutional investors to outsource their voting to proxy advisory firms for cost and efficiency gains.[3]

In a recent study considering whether institutional investors in Australia use their shareholding positions to engage with investee companies, Professor Jennifer Hill found Australian institutional investors are more reliant on proxy advisers than their US/UK counterparts.

Noting Australia's takeover laws which are designed to prevent the formation of voting blocks, Professor Hill suggested that ASIC should consider "whether the emergence of proxy advisers may have contributed to a degree of standardisation in institutions' voting practices, negating the need for institutions to coordinate their voting directly"[4].

The Productivity Commission has raised the prevailing concern that institutional investors follow proxy advisers' recommendations without question[5]. Allens Linklaters' clients expressed a similar concern, with one commenting that "proxy advisory firms are effectively dictating to company boards, indicating an underlying concern as to what degree of independent judgement some shareholders were exercising on key issues".[6]

Former Chief Justice of the NSW Supreme Court James Spigelman, speaking extra-curially, also referred to institutional investors' use of proxy advisors, noting that "this is an area fraught with difficulty, not least because of the absence of effective quality controls on the advisers or on the advice provided". Chief Justice Spigelman went on to note that there is "a discernible element of mechanical compliance with what is perceived to be an obligation on the part of institutional shareholders to seek advice on such matters".[7]

Our clients have expressed similar concerns to us, particularly when discussing how best to liaise with proxy advisers during heated shareholder disputes that involve contested director nominations. What we witness as advisors is how decision making is impacted at the board level out of fear that proxy advisors won't understand a decision or won't understand the unique circumstances the company is facing.

Compounding these concerns is the question at law as to whether fund managers owe their investors a fiduciary duty. Management agreements routinely seek to exclude

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[2] Australian Institute of Company Directors report, *'Institutional Share Voting and Engagement – Exploring the link between directors, institutional shareholders and proxy advisors'* (September 2011) 71.
[3] Ibid, 3.
[4] Tim Bowley, Jennifer G. Hill 'Stewardship and Collective Action: The Australian Experience' (Law Working Paper No.491/2020 ECGI Working Paper Series in Law, April 2020) 17.
[5] Productivity Commission report, '*Executive Remuneration in Australia*' (4 January 2010), 313-314.
[6] Allens Linklaters, '*Allens Listed Client Survey CAMAC Review of Annual General Meetings*' (2012).
[7] Chief Justice James Spigelman, 'Institutional shareholders and corporate governance', (2010) 28 *Company and Securities Law Journal* 235, 239.

fiduciary duties, but it has been suggested that such provisions are not conclusive and the contract as a whole may create a fiduciary relationship.[8]

In practice, trustees and managers of institutional investor funds will almost always owe duties of a fiduciary nature to fund beneficiaries, specifically to act in their best interests, including when exercising voting power.[9]

Where institutional investors delegate (whether formally or in practice) voting decisions to proxy advisory firms, their compliance with their fiduciary duties is called into question. Abdicating those duties by delegating decision making to a proxy firm may not be sufficient, which creates a situation where institutional investors are routinely breaching their fiduciary duties.

3 Engagement, transparency, and accessible materials

Recommendation

Just as companies must comply with continuous disclosure obligations to ensure they do not mislead the market, proxy advisers should also be held to a standard that aligns with the influence they have on shareholder votes.

Proxy advisers should be required to provide draft reports to a target company prior to public release, so that the company has an opportunity to rebut or amend factual inaccuracies.

Although the proxy adviser may retain the discretion as to whether they amend the report, a copy of the company's full response should be provided to recipients for transparency. This ensures steps are taken to prevent factual inaccuracies, and to counteract misleading or deceptive statements.

In our experience, proxy firms tend to support the incumbent board when a shareholder is advocating for change, without regard to the particular circumstances of the company. In our view, where a shareholder has requisitioned a shareholder meeting and a proxy firm is advising other shareholders how to vote on a proposed resolution, such advice should be provided to the relevant shareholder, so they have the same opportunity to respond and correct any inaccuracies.

Background and observations

The proxy advisory industry has claimed the Consultation Paper is a solution looking for a problem that does not exist. This self-serving criticism ignores the issues we have identified in this submission, including the lack of transparency and consultation, the box-ticking approach and the disproportionate influence advisors wield in our market.

Proxy advisors' concern about the consultation process is to be expected as any form of regulation will be a threat to the viability of a business model that is founded on keeping the market in the dark.

Ownership Matters all but admits this in its argument against regulation, noting that a requirement to provide draft reports to companies before publication "would propose a higher operating standard (and cost) on proxy research than any other form of investment research". [10]

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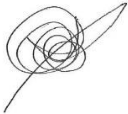
[8] JD Heydon, MJ Leeming, PG Turney, *Meagher, Gummow and Lehane's Equity: Doctrines and Remedies* (Lexis Nexis Butterworths, 5th ed. 2015), 146.
[9] JD Heydon and MJ Leeming, *Jacobs' Law of Trusts in Australia* (LexisNexis Butterworths, 8th ed, 2016), 487 at [20-51].
[10] Ownership Matters, above n 1.

> This is the point. With proxy advisors wielding such influence on the Australian market, more than any other category of researcher, they should be held to a high standard – whether they like it or not.

ABL welcomes the opportunity to provide further submissions and participate in any discussion on the Consultation Paper and subsequent recommendations.

Yours sincerely



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