

MCDproxyadvice@treasury.gov.au
Market Conduct Division
The Treasury
Langton Crescent
PARKES ACT 2600

4 June 2021

Via Electronic Submission

Re: Greater transparency of proxy advice

Dear Market Conduct Division,

We welcomed the Australian Treasury's review and support its efforts to strengthen the transparency and accountability of proxy advice. We appreciate the opportunity to provide input to that process.

I. About EOS at Federated Hermes

Federated Hermes is a global leader in active, responsible investment. We are guided by the conviction that responsible investing is the best way to create long-term wealth. We provide specialized capabilities across equity, fixed income and private markets, in addition to multi-asset strategies and proven liquidity-management solutions. Through our world-leading stewardship services, we engage companies on strategic and sustainability concerns to promote investors' long-term performance and fiduciary interests. Our goals are to help individuals invest and retire better, to help clients achieve better risk adjusted returns, and where possible, to contribute to positive outcomes in the wider world.

Hermes Investment Management and Federated Investors rebranded as Federated Hermes in February 2020. All activities previously carried out by Hermes Investment Management now form the international business of Federated Hermes.

EOS at Federated Hermes ("EOS") is a leading stewardship provider advising on USD1.3 trillion (AUD 1.68 trillion) as at 31st December 2020. Our engagement activities enable long-term institutional investors to be more active owners of their assets, through dialogue with companies on environmental, social and governance issues. We believe this is essential to build a global financial system that delivers improved long-term returns for investors, as well as better, more sustainable outcomes for society. EOS conducts proactive and reactive engagement with the companies in which its clients invest on a regular basis on environmental, social, governance, strategy, risk and communications concerns. Our team engages in active stewardship on behalf of clients, voting at

annual meetings and other shareholder gatherings to achieve our clients' responsible ownership aims and fulfil their fiduciary duty to be active owners. EOS is a stewardship services provider and does not carry out registered activity.

The views expressed in this communication are those of EOS at Federated Hermes and do not necessarily represent the views of all clients. Our response to this consultation is explicitly supported by PNO Media (the Netherlands).

II. Stewardship and Corporate Engagement

There is a consensus among global regulators in major economies, academics, and key participants in financial markets that institutional investors can and should play an important role in the governance of corporations by purposefully voting shares and engaging with executives and boards at the companies that they own. Active involvement of institutional investors in corporate governance is recognized by the 2015 G20/OECD Principles of Corporate Governance as an effective pathway to improved corporate governance, and long-term institutional investor engagement at a corporate level is a practical way to enhance company performance and foster economic growth. These activities, now often referred to as “stewardship,” have been shown to protect and enhance the value of corporate enterprises, thus contributing to long-term sustainable wealth creation and economic welfare benefiting directly and indirectly hundreds of millions of investors and other stakeholders, particularly workers saving for retirement.

Consequently, policymakers, regulators, corporate governing boards, and institutional investors all increasingly agree that shareholder engagement should encompass much more than corporate governance discussions related to resolutions at shareholder meetings and proxy advisor research and recommendations. Proxy voting can be supplemented through the practice of engaged stewardship to help improve corporate performance over the long-term. Unlike rote voting based on the generic research and recommendations of proxy advisory firms, shareholder engagement involves a meaningful, long-term, and constructive dialogue between companies and institutional investors that provides advantages to companies and investors alike, as institutional investors “help achieve long-term sustainable value” and to “help curb excessive risk taking.”

These are laudable goals, and they conform to the widely recognized fiduciary obligations of institutional investors and investment advisers not only to ensure that proxies are voted on a timely basis as a procedural matter, but also more broadly to ensure that ownership rights are exercised in a prudent and constructive manner in the interests of plan participants, fund shareholders, and other beneficial owners for whom institutional investors act as fiduciaries. Rather than introducing burdensome procedural requirements on periodic shareholder votes, we propose instead that the Treasury should promote constructive, long-term engagement between companies and institutional investors that is not limited to the narrow framework of proxy voting. We have suggested alternative solutions in our response.

III. The Market for Proxy Advisory Services

Proxy advisory firms play a useful role in facilitating voting and related engagement activities of institutional investors, many of whom have invested in thousands of companies around the world. Proxy advisory firms owe express obligations to their clients in exchange for fees under detailed contracts. These services are generally provided to institutional investors, ultimately for the benefit of their beneficiaries. It is our view that these beneficiaries are the true main street investors. In our experience, institutional investors are generally satisfied with the services provided by proxy advisory firms, and critically, it is our understanding that investors very rarely find factual errors in the research provided by proxy advisory firms. In fact, the Australian securities regulator ASIC undertook a review¹ of proxy advisers in Australia after concerns had been voiced regarding engagement practices of proxy advisers. Empirical data reviewed by ASIC suggested that concerns regarding the extent of influence of proxy adviser recommendations on the voting outcomes of company resolutions is overstated. The policies of the four major proxy advisers in Australia appeared to reflect: (i) a willingness to engage with companies and make a copy of their report available to companies either prior to or after publication, (ii) a desire to ensure independence from the companies that are the subject of their reports and (iii) a willingness to receive feedback from companies in relation to potential factual errors and to correct material factual errors.

We are concerned that some of the Treasury's proposals would disrupt proxy advisory relationships that have developed into an effective process, underpinning the stewardship ecosystem that has developed since the Global Financial Crisis. These risks include inefficiencies in the delivery of services and compromised independence of proxy advisory firms. We also expect that, if adopted, some of the proposals would result in reduced competition from the likely withdrawal of the remaining smaller proxy advisory firms from the market.

IV. Our views on the options being considered

Our responses on the options are as follows:

Ensuring independence between superannuation funds and proxy advice

- **Option 1: Improved disclosure of trustee voting.** Under this option, superannuation funds would be required to disclose more detailed information in relation to their voting policies and actions for each financial year. The details to be disclosed could include how votes were exercised, whether any advice was received from a proxy adviser and who provided the advice.

If proxy advice is received, disclosure could include whether the voting actions taken were consistent with the proxy advice.

¹ <https://www.asic.gov.au/media/4778954/rep578-published-27-june-2018.pdf>

We do not fully understand what problem this proposal seeks to address and how it would work. Disclosure of voting records is a practice that is already established in many jurisdictions, including in Australia. However, public disclosure of advice from proxy advisers is not mandatory and we do not understand what purpose this will serve. Indeed, such data can be interpreted in several ways and we do not view it as a meaningful indicator. Investors will often use the services of more than one proxy advisory firm. They can also request customised research and recommendations that is tailored to their unique policy. In some cases, an investor will apply the vote recommendation of its proxy adviser(s) because several factors led it to decide that application of its voting policy was appropriate. In other cases, it will decide to differ from it. Each of these decisions will be the result of factors such as a direct and constructive dialogue with the company in question or the views of internal investment teams. Proxy advice is only one of several inputs in the voting decision process. As a result, we do not believe that data showing whether the ultimate vote decision was consistent with the initial vote recommendation is a particularly meaningful indicator on its own.

Other jurisdictions have developed proxy voting disclosure requirements allowing investors to choose how to present the information so that it is done in a meaningful way. The UK Stewardship Code² for example now comprises a set of 12 ‘apply and explain’ Principles for asset managers and asset owners, with a separate set of six Principles for service providers. It requires investor signatories to disclose their voting records and voting policies, and to describe the extent to which they use vote recommendations of proxy advisers and how they monitor their service providers. Other alternative solutions include enhanced disclosure requirements for shareholder voting research through best practice guidelines. This can be accomplished via industry groups such as the Best Practice Principles Group (BPPG)³ which developed Best Practice Principles for Shareholder Voting Research, or transparency obligations such as those required by the European Shareholder Rights Directive⁴ on conduct, conflicts of interest and methodology for proxy advisers.

- **Option 2: Demonstrating independence and appropriate governance.** Under this option, proxy advisers would be required to be meaningfully independent from a superannuation fund they are advising to ensure that proxy advice is provided to and used by superannuation funds on an ‘arm’s length’ basis. Trustees could also be required to outline publicly how they implement their existing trustee obligations and duties around independent judgement in the determination of voting positions.

We believe the independent test for proxy advisory firms is that they must be independent from companies *about whom they have been hired to provide independent proxy voting advice*. In our view, the conflicts of interest most commonly faced by proxy advisory firms arise from the corporate consultancy services that are offered by certain proxy firms. A superior and more direct method of

² <https://www.frc.org.uk/investors/uk-stewardship-code>

³ <https://bppgrp.info/>

The compliance Statement of EOS at federated Hermes is available here: <https://bppgrp.info/wp-content/uploads/2021/03/eos-corporate-bpp-compliance-statement-12-2020.pdf>

⁴ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017L0828>

mitigating this primary source of conflicts would be to require proxy advisory firms to cease or separate and insulate their corporate consultancy businesses, if they exist, from the core voting-related advisory work performed for and on behalf of institutional investors, and we ask the Treasury to consider adopting, instead of the existing proposal, rules to enforce such separation (including information barriers). As indicated above, examples of best practice guidelines on conduct and conflicts of interest for proxy advisory firms include the Best Practice Principles Group (BPPG) or the requirements of the European Shareholder Rights Directive.

Small institutional investors have sometimes pooled resources to support the development of a separate stewardship business. This is due to their limited funds and resources which constrain their ability to conduct their own research on company proposals for shareholder meetings. The creation of a separate stewardship business also reduces their dependence on the research and recommendations offered by larger proxy voting advice businesses. We believe this provides healthy competition in an industry characterised by a lack of competition and market share dominance by a duopoly. EOS constitutes a great example because it was established in 2004 in response to requests from pension funds that wanted to be more active owners of the companies they were invested in. These origins and our minority ownership by one of the UK's largest corporate pension schemes, BTPS, along with our partnerships with some of the world's leading institutions have provided us with deep-rooted values for the proper stewardship of assets to represent the long-term interests of ultimate beneficiaries, driving our purpose and our strategy. This insight into the long-term needs of pension fund clients means a culture of fiduciary responsibility is embedded at the heart of our organisation.

Facilitating engagement between companies and proxy advisers

- **Option 3: Facilitate engagement and ensure transparency.** Under this option, proxy advisers would be required to provide their report containing the research and voting recommendations for resolutions at a company's meeting, to the relevant company before distributing the final report to subscribing investors. For example, a period of five days prior to the recommendation being made publicly available would give enough time for both the company and proxy adviser to comment and for the proxy adviser to amend the report in response if warranted.

We have concerns with this proposal and believe that, overall, it will hamper engagement by institutional investors and their investment advisers, rather than "facilitate" it. It will significantly damage the stewardship ecosystem in Australia by making timely delivery of proxy advice to institutional investors impractical and adding significant costs. The proposal could also compromise the independence of proxy advisory firms. Our key concerns are:

- **Disruption of the relationship between institutional investors and their advisers, and likely compromise of independence and quality of advice as a result**

This proposal does not specify to what extent proxy advisers would be required to incorporate comments from a company in their research and voting recommendations. Institutional investors hire proxy advisory firms to provide timely analysis that is independent from companies to help them make informed and prudent decisions regarding companies owned on behalf of their beneficiaries.

A requirement for proxy advisory firms to first provide their advice and analysis to the companies *about whom they have been hired to provide independent proxy voting advice* will disrupt the relationship between institutional investors and their advisers. This is likely to compromise the independence and quality of advice provided by proxy advisory firms to institutional investors.

A requirement for proxy advisers to share their report prior to dissemination to clients presents a detrimental opportunity for companies to object to analysis under the guise of “corrections.” Depending on the obligations imposed on proxy advisers, these objections in turn could create the foreseeable risk that the company will assert that the proxy advisor made material misstatements in proxy voting advice or did not satisfy other requirements. Proxy advisory firms may consciously or unconsciously submit to specious arguments offered by the company and therefore compromise the independence of their analysis.

Finally, proxy advisory firms and their counsel are likely to spend substantial time arguing with executives and boards when the proposed advice does not support the position of the executives and the board. This could potentially lead to significant direct and indirect costs in the form of legal fees and lost time that could be spent analysing proxies on behalf of their clients. Such costs could operate as a disincentive to recommend a vote against executives and boards in all cases.

Overall, we believe that the compromised independence of proxy advisory firms would have a greater negative impact on the “reliability” of voting advice than any positive impact that could reasonably be expected from making it mandatory for proxy advisers to provide their report to companies before it is provided to clients.

- **Increased financial and operational burden for proxy advisers, resulting in limited ability for institutional investors to afford proxy voting advice and in reduced competition**

While the magnitude of the increased costs associated with this proposal is difficult to ascertain at this time, we respectfully suggest that the Treasury seeks to quantify both direct and indirect costs imposed on proxy advisory firms as a result of implementation. We believe the costs of the financial and operational burdens associated with an obligation for proxy advisers to provide their reports to companies prior to dissemination to their clients could be significant.

The increased costs on proxy advisory firms to run their businesses will inevitably be passed on to institutional investors in the form of increased fees. As such, it will harm investors, as opposed to protect them, by significantly increasing the costs associated with engaging proxy advisory firms for assistance in considering proposals and potentially limiting their ability to afford proxy voting advice at all.

This is particularly troubling when considered in concert with the fact that small institutional investors tend to rely more heavily on the research and recommendations offered by proxy voting advice businesses due to their limited funds and resources which, in turn, limit their ability to conduct their own independent research on company proposals for shareholder meetings.

We also expect that this would likely result in reduced competition from the likely withdrawal of the remaining smaller proxy advisory firms from the market. It will also create a higher barrier of entry for new market entrants in an industry already under strain from the inability of new and smaller, boutique businesses to effectively compete with the two established proxy advisory firms.

- **Nature of information being shared**

We are not aware of concerns within the investment industry that investors frequently find factual errors in the research provided by proxy advisory firms. To the extent that an obligation for proxy advisory firms to provide their report prior to dissemination to clients is designed to address factual errors, the Treasury could instead propose a rule that requires the sharing of factual information and data used by a proxy advisory firm in preparing proxy research and recommendations, rather than all research and recommendations, which it intends to provide to its clients (which may not include the data and factual information on which the research and recommendations are founded). Another relevant element is that proxy advisory firms often offer custom research and recommendations that vary depending on the voting policy of their clients. Such services mean companies themselves would potentially be receiving hundreds of different versions of voting research and recommendations for each and every shareholder meeting based on the customised voting policies of the more advanced institutional investors. We also believe that, fundamentally, customised policies and associated recommendations represent the intellectual property of institutional investors and therefore should not be disclosed by proxy advisers to companies without the relevant proxy advisor clients' prior consent.

- **Standardisation of both advice and advice delivery models**

The proxy advisory industry is already under strain from the inability of new and smaller, boutique businesses to effectively compete. A review requirement will operate to exclude new entrants from the proxy advisory industry and make the business uneconomical for all but the largest proxy advisory firms. As we alluded to above, companies may be reluctant to receive potentially hundreds of different versions of proxy research and recommendations for each shareholder meeting based on the customised voting policies of institutional investors. Extrapolating this dynamic to the more than two thousand companies listed on the ASX, the management of an enterprise on this scale cannot reasonably be performed by a start-up or boutique business, and naturally lends itself to standardisation of both advice and advice delivery models. As the universe of proxy advisory firms narrows, institutional investors will have access to fewer sources of proxy advice, and consequently access to less diversity and specialisation in proxy advice. Less diversity and specialisation in turn will lead to less

informed proxy voting by institutional investors. The handful of proxy advisory firms that have adequate scale to remain in the proxy advisory industry will (i) need to devote a greater portion of their resources to a new and potentially cumbersome process (and thus less of their resources to providing substantive advice to clients), and (ii) be subject to less competition as competitors flee the industry (and new entrants face high barriers to entry). Relieved of competitive pressures to provide a differentiated service, proxy advisory firms will be inclined to provide more generic advice in a standardised form to reduce costs.

If these foreseeable, anti-competitive industry developments do occur, it will make it much more difficult for institutional investors to obtain sophisticated advice and insight to inform their fiduciary obligation to vote proxies in the best interests of their beneficiaries, who are the true main street investors.

- **Truncated amount of time available to investors to review advisory proposals and to undertake meaningful engagement with companies**

A requirement for proxy advisers to provide their report to companies prior to dissemination to clients will meaningfully reduce the time available for investors and/or their investment advisers to consider proposals and hinder the opportunity for substantive, meaningful engagement between investors, their advisers, and companies. Furthermore, having interacted with proxy advisory firms, companies may be less inclined to engage in further discussions with institutional investors once the advice is finally given.

While a requirement to provide the report to companies before dissemination to clients presents a beneficial opportunity to correct factual inaccuracies, we do not believe that it will improve the reliability of the voting advice and will instead inhibit stewardship and engagement by institutional investors and their investment advisers rather than facilitate it. In our view, rules that address the proxy voting process should encourage engagement activities by institutional investors, with the goal that these activities become an integral part of the activities of institutional investors, rather than a periodic consideration prompted by shareholder meetings. More direct and well-informed dialogue between companies and institutional investors and their advisers, in turn, could ensure that each company's specific circumstances are taken into consideration by fiduciaries charged with exercising shareholder rights in the best interests of retirees and other investors. The imposition of burdensome procedural requirements on proxy advisory firms does not advance this purpose, and instead will inhibit effective shareholder engagement.

Consequently, we respectfully recommend that the Treasury does not adopt Option 3 and its proposed requirements to (i) provide the report containing research and vote recommendations before distributing the final report to subscribing investors and (ii) amend the report in response if warranted.

However, if the Treasury chooses to move forward with this proposal, we believe that the following adjustments could mitigate the potential for the damage and unintended consequences discussed above.

- We strongly encourage the Treasury to introduce a safe harbour rule to protect proxy advisory firms from legal risks associated with the provision of subjective analysis, assessments, and judgments regarding proposals. There are significant legal risks and costs associated with providing companies a right to receive proxy advice before dissemination, especially where proxy advisory firms intend to provide recommendations to vote against executives and boards. Of particular importance is the protection of subjective statements that do not purport to convey facts from legal challenges as materially false or misleading statements.
 - We therefore encourage the Treasury to consult closely with both proxy advisory firms and companies to establish mechanics that are both practicable and value adding. There is a risk of significant interruption of a functioning market for proxy advice.
 - The U.S. Securities and Exchange Commission (SEC) adopted a mechanism under which research must be made available free of charge to the company at (or before) the time of dissemination to clients and any written statement made subsequently by the company is communicated to clients. We consider mandatory dissemination shortly after publication to be a more viable option. Encouragingly, on 1st June 2021 the SEC Chair Gary Gensler directed the SEC staff to consider whether to recommend a review of this mechanism⁵.
- **Option 4: Make materials accessible.** Under this option, proxy advisers would be required to notify their clients on how to access the company's response to the report. This could be through providing a website link or instructions on how to access the response elsewhere.

We believe communication by a proxy adviser of a company's response in reaction to a report should be on a best-efforts basis. Companies should establish effective communication channels with their investors and should not rely on proxy advisers for the distribution of information to them. The best place for a company to notify its investors about its response to a report by a proxy advisory firm is via a market announcement or other communication tool such as its website or by sending a letter to its shareholders

V. Alternative Solutions

EOS is encouraged by the Treasury's concern regarding the proxy voting process and investor engagement generally. We appreciate its efforts to ensure the availability of more accurate, transparent, and complete information on which institutional investors and their advisers make their voting decisions. We also support the Treasury's stated goals to strengthen the transparency

⁵ <https://www.sec.gov/news/public-statement/gensler-proxy-2021-06-01>

and accountability of proxy advice in the interest of ultimate beneficiaries. In light of the widely held view that enhanced stewardship and investor engagement benefit companies, their investors, and society as a whole, we respectfully suggest that the Treasury's overriding regulatory objective should be the promotion of long-term, constructive shareholder engagement, rather than the imposition of procedural requirements on proxy votes.

Wholly owned by the international business of Federated Hermes, we put forward a vision for the 2020s⁶ outlining how active stewardship must sit at the heart of investment firms' activity, operations, and purpose. In this journey, we believe⁷ ESG integration is an essential component of investment fiduciary obligation, and this view is increasingly reflected in regulations. Academics are also making the connection between investment outperformance and effective asset stewardship. In fact, the international business of Federated Hermes believes investment is two activities rolled into one, namely: (i) allocating capital and (ii) being a good long-term steward of that capital. Stewardship is the less well-known and understood component of investing, but it should be seen as a key activity for an investment management firm alongside buy, hold and sell decisions. Acting as a responsible steward of capital does not solely involve proxy voting. There is far more to it than that.

We believe that a regulatory approach that recognises more clearly defined engagement responsibilities of institutional investors, such as considering the role of institutional investors in the governance of corporations that goes beyond proxy voting, rather than approaching investor/company interactions exclusively through increased regulation of proxy advisory firms, is more likely to contribute to an effective stewardship ecosystem in Australia, creating value for corporations, investors and beneficiaries.

In our opinion, the Treasury could more effectively promote a culture of stewardship and improve the level of constructive investor engagement with companies by raising the bar for stewardship across the investment industry. Many other markets, such as the European Union, the United Kingdom and Japan successfully utilise such an approach through, for example, stewardship codes, and regulators in these markets underpin these responsibilities with principles-based regulation. We would encourage the development of a demanding stewardship code across the industry with a focus on stewardship activities and their outcomes, not just policy statements. The UK Stewardship Code⁸ constitutes an example of best practice. It now comprises a set of 12 'apply and explain' Principles for asset managers and asset owners, and a separate set of six Principles for service providers. We invite you to review the papers⁹ we have published on that matter.

⁶ <https://www.hermes-investment.com/uki/insight/stewardship/stewardship-the-2020-vision/>

⁷ <https://www.hermes-investment.com/uki/insight/outcomes/no-time-like-now-why-investors-are-moving-on-esg/>

⁸ <https://www.frc.org.uk/investors/uk-stewardship-code>

⁹ <https://www.hermes-investment.com/uki/eos-insight/eos/raising-the-bar-for-stewardship/>

<https://www.hermes-investment.com/uki/wp-content/uploads/2021/03/stewardship-report-2020-eos-at-federated-hermes-1.pdf>

<https://www.hermes-investment.com/uki/insight/stewardship/stewardship-the-2020-vision/>

[_https://www.hermes-investment.com/ukw/wp-content/uploads/2021/03/ifh-corporate-stewardship-report-03-2020.pdf](https://www.hermes-investment.com/ukw/wp-content/uploads/2021/03/ifh-corporate-stewardship-report-03-2020.pdf)

Potential alternative solutions also include enhanced disclosure requirements for shareholder voting research through best practice guidelines. This can be accomplished via industry groups such as the Best Practice Principles Group (BPPG)¹⁰ which developed Best Practice Principles for Shareholder Voting Research, or transparency obligations such as those required under the European Shareholder Rights Directive¹¹ on conduct, conflicts of interest and methodology for proxy advisors. In our view, these solutions more effectively advance the laudable goal of greater transparency about the extent of interaction between proxy advisory firms and companies, as well as about the methodologies employed and information sources used in preparing voting research and recommendations. Both solutions are also respectful of and compatible with the diversity in proxy advisory firms' business models and size, as these firms do not represent a rigid, cumbersome, one-size-fits-all approach to the corporate proxy review process.

These alternative solutions are flexible and market-based, enabling the customers of proxy advisory firms to assess which provider can best meet their needs. They impose requirements for increased disclosure and mitigation of conflicts of interest, without imposing cumbersome and costly procedures that are inconsistent with the business models of all but the largest two proxy advisory firms. We ask the Treasury to consider adopting our alternative solutions in place of the existing proposals.

EOS appreciates the opportunity to provide comments to the Treasury on its proposals. We welcome the opportunity to discuss our views with you in greater detail. If you have any questions or would like additional information regarding this letter, please do not hesitate to contact the undersigned at pauline.lecoursonnois@hermes-investment.com.

Yours faithfully,

Pauline Lecoursonnois
Engagement, EOS at Federated Hermes

¹⁰ <https://bppgrp.info/>

The compliance Statement of EOS at federated Hermes is available here: <https://bppgrp.info/wp-content/uploads/2021/03/eos-corporate-bpp-compliance-statement-12-2020.pdf>

¹¹ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017L0828>