27th May 2021

Market Conduct Division
The Treasury
Langton Crescent
Parkes ACT 2600
Email: mcdproxyadvice@treasury.gov.au

Dear Market Conduct Division

Re: Response to Proxy Advisors – Consultation Paper from Department of Treasury

I welcome the opportunity to respond to the Department of the treasury consultation paper on transparency of Proxy Advice. Intervention by policy makers is urgently required.

As the founder of TechnologyOne, one of the early software start-ups in Australia 34 years ago, and one of the first software companies to list on the ASX in 1999 before the dotcom boom, I have witnessed first-hand the significant benefits of being a public company. In recent times I have also become concerned about the rise of proxy advisors and their significant influence on public companies.

We are at the start of a new industrial revolution driven by AI, SaaS, blockchain, robotics, 3D printing and quantum mechanics. As a significant investor in start-up's - both in Australia and overseas - it is clear that public companies are not keeping pace with the private markets in this time of accelerating change.

Public companies today are being forced to adopt a highly restrictive governance model based on a "one size fits all" approach, imposed on all public companies with no consideration to their individual unique circumstances. This restrictive approach is bureaucratic, inefficient and importantly- stifles innovation, which is critical for the 21st Century.

Private markets have no such impediments, and as a result, significant capital is moving from public into private markets and companies are staying private for much longer. A recent example is Canva's valuation of $20b, raising $92m, all the while remaining in the private markets, something that would have been unheard in the past.

Having received a first strike at our recent AGM, I have witnessed 'firsthand' the potentially negative effects of dealing with proxy advisors, and the impact that this has on Institutional Investors and external consultants.

It is well documented that proxy advisors have a "one size fits all checklist" approach to governance which is applied to each company leading to negative voting recommendations for non-conformance. Scant consideration is given to the unique circumstances of each company.

As the ACCF (American Council for Capital Formation) has published *"Academics have written that there is no empirical evidence that proxy advisors' benchmark governance policies promote shareholder value, effective governance or any meaningful advancement of the advisors' championed social causes. Indeed, a 2009 study by three Stanford economists concluded that, when boards altered course to implement the compensation policies preferred by proxy advisors, shareholder value was measurably damaged".* [1.]

An example of proxy advisor benchmark policy is the requirement for a majority of independent directors to the detriment of executive directors who bring substantial knowledge, or major shareholder directors who have "substantial skin in the game". Research undertaken by Professor

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Peter Swann at UNSW Australian School of Business, has shown this approach has engendered direct shareholder losses of AU$50 billion.[2]

Proxy advisors have enormous influence over public companies, though they deny this. A recent example of their substantial influence is proxy advisor ASCI recent public threat to ASX directors on climate change, to recommend a vote against their re-election. This is a disturbing trend with proxy advisors promoting “governance correctness”, a corporate version of political correctness.

Recently proxy advisors have promoted the fact that only a small percentage of resolutions fail to pass at the Annual General Meeting, so this shows their influence is not significant. The fact the number is small bears no relationship to the influence they exert. For example, only a very small percentage of people get speeding fines in a year, yet the influence it has on drivers’ behaviour is significant.

The significant influence of proxy advisors arises because institutional investors rely heavily on them to simplify the task of reviewing hundreds of public company’s remuneration (rem) and governance, and they rarely vote against the proxy advisor’s recommendations, to avoid criticism and to avoid having to justify why they voted against their recommendation. This phenomenon is called Robo-Voting and is well documented and researched in the USA.

Robo-Voting is problematic, as it is reliant on proxy advisor recommendations being correct. Harvard Law School research has shown many institutional investors are indeed automatically voting in-line with the recommendations and policies of the proxy advisor. This leads to poor outcomes. Research published in Journal of Law and Economics concluded *“...outsourcing voting to proxy advisory firms appears to have the unintended economic consequence that boards of directors are induced to make choices that decrease shareholder value”.*[3]

It is important to remember proxy advisors aren’t the actual fiduciary and therefore have no legal obligation to act in the best interest of shareholders. It is no wonder institutional investors deny they robo-vote, as to admit to this, opens them up to significant criticism.

Companies come in all ‘shapes and sizes”. An example is AfterPay (founder driven, revolutionary) versus Westpac (established, monolithic). It makes no sense to enforce exactly the same model on these two very different companies. It is therefore no surprise that enforcing a “one size fits all model” with no consideration for specific constraints and opportunities faced by a company, does not promote shareholder value creation. Diversity in approach is crucial and is the underlying principal of both evolution and innovation.

Interestingly, the ASX does not enforce a “one size fits all” approach to governance, but an “if not, why not” approach. The ASX has published guidelines and asks public companies to report against these guidelines, and if they are different, to explain why. This approach is a much more sensible approach.

What the ASX approach demonstrates is transparency and disclosure are the key, so investors can make informed decisions on what they are investing in, rather than pushing all public companies to look and operate the same.

The two-strike rule has also played an important role impacting public companies. Under the two-strikes rule, when more than 25 per cent of shareholders vote down two annual remuneration reports in a row, it triggers a vote on a board spill that could result in the company's entire board of directors facing re-election.

Proxy advisors plus robo-voting by institutional investors, when coupled with the two-strike rule is placing enormous pressure on boards to conform to a dubious “one size fits all” approach. Furthermore, a significant amount of time, effort and intellectual bandwidth that should be directed by public boards to growing their business, is being directed to deal with this situation.

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Unfortunately, rather than debate the issues, I have seen personal attacks, to undermine the credibility of those prepared to speak up. This has made public company directors reluctant to speak publicly about the matter. The 'cancel culture' has entered this debate.

But change is at hand. The changes proposed by the Treasurer, Josh Frydenberg, would mean proxy advisors would have to give public companies their research and advice at least five days before they give it to their clients and provide the company a right to respond. This is only sensible as it will allow errors to be identified and further information provided to clarify controversial matters. It makes no sense for votes to be cast based on inaccurate information.

The practice of robo-voting also needs to be addressed. Institutional investors should demonstrate they have not simply relied on proxy advisor reports to fulfill their fiduciary duties to their members, but that they have considered all the facts and are indeed voting in the best interest of the members. The cost associated in doing this would be minimal when compared with the significant funds under management, but irrespective, cost is never an argument for not fulfilling one's fiduciary duty.

There is no doubt shareholders should be able to agitate against Board decisions, push for change, and use their votes to telegraph their displeasure and to vote directors out when they come up for re-election. These powers already existed before the two-strike rule was implemented.

What the two-strike rule did was bring a focus on rem and provided shareholders a "say on pay'. The two-strike rule has unfortunately gone too far and is being used as the ultimate weapon, to try and force all sort of questionable changes onto public companies, when it is not truly representative of shareholders wishes.

The two-strike rules needs to change to make the rem resolution voting more representative of the wishes of the majority of shareholders. Like any other AGM resolution the threshold for a strike should be 50%, not 25%; and again like any other AGM resolution, major shareholders on the board should be allowed to vote on the rem resolution, if there is no conflict of interest. This could be achieved by putting the director's fee's into separate resolution.

Public markets do offer significant benefits, but unless public markets evolve from their current state, they will not be competitive in the 21st Century, an era driven by entrepreneurs, innovation, and technology.

Yours sincerely

Adrian DiMarco
Founder / Executive Chairman

Reference Materials:

[1] https://corpgov.law.harvard.edu/2018/11/07/are-proxy-advisors-really-a-problem/
[2] https://www.afr.com/companies/independent-directors-cost-shareholders-50b-20140730-jeimd
[3] https://corpgov.law.harvard.edu/2019/11/25/robovoting-and-proxy-vote-disclosure/

Enquiries:

Darren Needham-Walker
Group Director – Marketing
P: +61 7 3167 7235
M: +61 456 772 881
E: **Darren_Needhamwalker@technologyonecorp.com**

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