1 June 2021
Market Conduct Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: MCDproxyadvice@treasury.gov.au

WaveStone Capital is an active Australian equities investment manager based in Sydney, Australia with over $5B funds under management. WaveStone was founded in 2006 and is majority owned by its principals; with an investment team that comprises two portfolio managers, four analysts and a dealer. WaveStone aims to provide capital growth over the long term and tax-effective income for its investors by investing in quality Australian listed companies with a sustainable competitive advantage (SCA). Our clients include retail investors as well as institutional investors (corporate and industry super funds).

A key tenet of WaveStone's investment philosophy is to invest in companies where the Board and management have demonstrated a track record of effective capital allocation. It is our view that companies that are respectful of their shareholders' capital and allocate it effectively outperform the market over the long term.

Shareholder involvement in company affairs increased significantly post the passing of the 'two strikes law' that came into effect on 1 July 2011. It required Boards to have a dialogue with shareholders at least once ahead of AGMS – a key development that aligned the interest of shareholders and management. We would strongly argue that this has resulted in better governance of companies and arguably, more Australian companies have succeeded in the global stage. We reference an article we published on this subject in 2018 -https://www.wavestonecapital.com.au/esg-investing-becomes-mainstream/ and attached with this submission.

We feel strongly that the proposed reforms are a step in the wrong direction and hence this submission. The existing system has certainly served the needs of greater transparency and engagement that is required of a listed company in a developed market.

It is worthwhile to outline the actual process of proxy voting that we follow for our investee companies to reason why we think that the changes proposed are unnecessary.

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The Voting Process

We have a range of superannuation funds as our clients. For a majority of our institutional clients and all of our retail clients, we vote on their behalf. A few institutional clients have a super vote option where the client can choose to vote differently.

1. Investee company files the AGM resolutions.
2. WaveStone engages with company on specific resolutions (this is an iterative process).
3. Proxy firm sends us their views.
4. WaveStone engages with proxy firms to clarify and understand differences including any specific issues that have not been taken into account.
5. WaveStone files proxies (we vote on every resolution) and communicate to the investee company in case we have taken a different view to the Board recommendation.

We have a few key concerns related to the changes proposed:

The proxy adviser to us is a service provider whose core competence is to analyse the key issues related to a shareholder resolution. They are able to draw upon their specialist expertise especially in complex areas like remuneration – not just in the case of Australian companies but what they are seeing in other markets. For small businesses such as ours, this is particularly relevant as we do not have access to that database.

We are active managers that own 35-40 companies. Given the importance we place on track record of Board and management, the input from the proxy advisers on the experience and prior track record of existing and new board members dramatically improves our team productivity.

A key part of our due diligence with companies is to engage with the Board on the long term threats and opportunities facing the company, management remuneration and succession plan for the leadership. Apart from the proposed changes becoming logistically impossible given the calendar, we have a strong view that if corporates choose to only interact with the proxy advisers, they will interact less with smaller shareholders like ourselves. This will in our view benefit the managers that choose size (large funds under management) over performance (better outcomes for end investors) – a premise that goes directly against the superannuation reforms proposed by the government (Your Future, Your Super). And ultimately, mediocre performance by Australian companies which will have ramifications for the well being of the country.

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In addition to a report from the proxy adviser, we also get independent research advice on contentious AGM issues from the sell side (broker research analysts) and the reforms being suggested will be in direct conflict with ASIC regulation RG-79 (see figure 1 below). Therefore, the proposed reforms will be a significant step backwards for the industry.

In conclusion, we are making this submission because we strongly believe that the changes will result in sub-optimal outcomes for our clients. There is a small minority of corporates and non-executive directors who feel the pressure from having to front up to their shareholders. To succumb to their narrow interests (often to the detriment of minority shareholders) will significantly lessen the level of governance for a developed market and is not in the best interest of the country.

1. 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.

We make independent decisions related to voting, based on our engagement with the corporate. We disclose our voting record on our website.

Recommendation: *In light of the fact that we exercise our rights on behalf of our clients independently, we do not see any need to change the existing structure. The current system is working well for us.*

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 use ISS as a proxy adviser. ISS was chosen following a competitive tender and we continually assess their performance, including evaluating rival product offerings.

We make voting decisions independently. Often, we vote differently from their recommendation based on our assessment of the issues involved and dialogue with

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the investee company. This is no different to how we make investment decisions related to our ownership of companies.

We get specialist research on investment ideas from the sell side community – that doesn't mean that we buy and sell shares solely based on that advice. We have an investment team of well credentialled analysts that use our proprietary investment process and philosophy to identify companies we own in our portfolios.

Recommendation: *We believe that this is already the case and do not understand why this is necessary.*

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 view the voting advice we receive from ISS in the same way that we get advice from the sell side research analyst on a particular company. In fact, sell side analysts routinely provide advice on AGM related issues much like proxy advisers and within their research team have specialists who analyse and communicate their views to their clients.

ASIC (RG-79) has clear guidelines on how sell side analysts communicate with the product issuer – it intrigues us as to why the rules should be different for the proxy advisers. And if there are not, the same rules will apply to sell side analysts – which will be a significant step backwards for market integrity.

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Communication

RG 79.140 A communications policy should outline appropriate and inappropriate communications practices within the organisation and with external parties. Particular attention needs to be paid to communications between research staff and other staff of the research report provider, and between research staff and external organisations (particularly product issuers). The communications policy should be made clear to all staff (both research staff and others). This includes, but is not limited to, information barriers: see RG 79.125–RG 79.129.

RG 79.141 Research report providers should ensure that research reports or information about their contents are not communicated outside the research report provider before the report is provided to clients in the normal course of business. This does not mean that a research report provider cannot check the factual accuracy of parts of a research report with a product issuer before it is provided to clients. However, we expect that this checking would be done in a carefully controlled way (e.g. without communicating the recommendations or opinions also contained in the report).

Figure 1: Source: ASIC

Recommendation: *This approach is in direct conflict with RG-79 and we strongly believe this is not in the best interests of corporate governance for listed entities.*

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 make our voting decisions independent of the proxy adviser after engagement with the company. Given our response to Option 3, we do not see Option 4 as required. If the company feels strongly about an issue, the company should respond through an ASX release not dis-similar to how companies respond currently to short reports – especially if there are factual errors.

Recommendation: *In light of our explanation, we see no reason for this to happen. There are already established processes for communication of material information to the market.*

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Requiring suitable licensing for the provision of proxy advice

Option 5: Ensuring advice is underpinned by professional licensing. Under this option proxy advisers would be required to obtain an AFSL for the provision of proxy advice. The purpose of the license would be to ensure that proxy advisers are making assessments on issues that have a material impact on the conduct of business in Australia with appropriate regulatory oversight and the necessary care and skill required.

We agree with this especially if proxy advisers are providing advice to unsophisticated investors.

Recommendation: *We agree with this – we think this is already the case with the existing proxy advisers.*

If you wish to follow up on this submission or have any questions, please contact Raaz Bhuyan, Principal and Policy Manager, WaveStone Capital at raaz.bhuyan@wavestonecapital.com.

Kind regards,

Raaz Bhuyan
Principal and Portfolio Manager
WaveStone Capital

ESG Investing Becomes Mainstream

10 October 2018

The increasing client expectation from investors to not only deliver investment return, but to achieve this by considering Environmental, Social and Governance issues has escalated rapidly over the last 12-18 months. Some in the industry are pushing for this to become a fiduciary duty. For early adopters in the Responsible Investing sector, the evolution to get to this point has taken a long time. What was once a specialised investment thematic (Socially Responsible Investing) begrudgingly tolerated with a large amount of scepticism, is today increasingly becoming mainstream.
The focus on ESG integration into investment processes is having an increasingly positive effect on corporate behaviour. The banning of non-reusable plastic bags by the big supermarkets, capital allocation decisions by energy companies to invest in renewable energy, major banks stopping funding of predatory pay-day lenders and the acknowledgment there is a genuine need for diversity targets in the workforce are all examples of how investors are influencing corporates to be aware of their 'social licence' when it comes to delivering returns to shareholders.

The 'two strikes' law certainly heralded a new era for Governance

The 'two strikes' law (that came into effect on 1 July 2011) designed to hold directors accountable for executive renumeration was the first big step that had a major impact on ESG considerations in investing. This rule was initially met with scepticism from boardrooms across Australia. It required Boards (especially Chairperson and Chairs of the Remuneration Committee) to have a dialogue with shareholders at least once ahead of their AGMs. As time has passed, it has certainly emboldened Boards to have more influence around management renumeration, strategy and appointments – all of which have no doubt led to better investment returns for individual companies and the broader market.

Some of the Board scepticism is well founded

One of the key reasons for the scepticism by Boards was the lack of consistency and short termism shown by investors in their approach towards governance issues. By way of example, a very well-regarded Director was Chairman of two ASX 100 companies. The share price of one had done exceedingly well and the other quite poorly over the same 12-month period. An independent survey of investors rated the same person as one of the country's top Chairmen for one company and at the bottom for the second underperforming company. The view among some Boards was that the Remuneration report was being used as a protest vote against poor short-term share price performance rather than any real focus on governance (and ESG issues) that was going to benefit shareholders in the long term.

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The Banking Royal Commission has made the topic of ESG very real

The significant adverse impact on the share prices of banks and wealth managers from the Royal Commission fallout has focused the minds of investors and asset owners on ESG-related issues. The chart below presents the share price performance of CBA and AMP over the last 12 months. Despite both companies posting reasonable earnings, the impact on not focusing on their 'social licence to operate' has resulted in big fines, damage to their brands, increasing capital requirements and earnings headwinds. These consequences are starkly reflected in the material share price underperformance for both these companies.

Source: IRESS

Climate Change is top of mind for domestic insurers and energy intensive companies

The discussion around rising energy prices in Eastern Australia in the last 12 months following the closure of the Hazelwood coal fired power station in Victoria last year has certainly brought the impact of climate change closer to home. The brown outs in South Australia, the shortcomings of the National Electricity Market and constant political and regulatory intervention has made investing in the domestic energy sector almost impossible, with no certainty around longer term returns.

Regulators globally have been focusing on climate change related risks to the finance industry, encouraging greater disclosure. In recent years, Australia has been regularly impacted by natural disasters that have taken a toll on its insurance companies such as Suncorp and IAG. Companies such as Rio Tinto and BHP have been focused on reducing their carbon intensity by largely divesting non-core assets – in the case of Rio Tinto, their sale of Coal & Allied thermal coal assets resulting in a lower carbon footprint. These companies are certainly aware that negative screening on ESG related issues was resulting in a structural increase in their cost of capital.

Reporting and analysis has some way to go

Somewhat ironically, CBA had been named Australia's most sustainable business on the Global 100 Index (100 most sustainable companies globally assessed by Corporate Knights and announced annually at the World Economic Forum) for three consecutive years. It was also ranked first among banks worldwide. Until the AUSTRAC civil proceedings against the company in August, this assessment would have been echoed by most local investors in Australia. The recent APRA report following its prudential inquiry into CBA has delved into issues of its governance and culture that have not previously received adequate attention from investors. Consequently, we expect enhanced disclosure by all corporates around risk and governance and Boards will likely ensure these key values are considered an integral component of executive renumeration going forward.

Investors need to focus on longer term outcomes

Akin to the earlier example of the Director who thought investors were being schizophrenic, we as investors need to take our share of responsibility for not focusing on longer term outcomes. The increasing evidence of using ESG for tactical alpha opportunities will result in these issues getting greater focus –the recent media reporting and Senate inquiry into franchising businesses is an example of that.
We consider that many successful Australian companies within high profile essential and semi-essential industries (e.g. Banks & Utilities) are entering a challenging period of increased scrutiny. Historically most local industry leaders have enjoyed the benefits of good market structures with strong barriers to entry and hence great returns over a prolonged period. Since the GFC, a lack of top line growth has meant sustaining those returns has been more difficult, and recent hopes of synchronised global economic growth as a fillip to revenue has dissipated such that Australian corporates have had to show their dexterity by improving efficiencies and reducing costs to maintain returns.
Against this backdrop of no, or at best low top line revenue growth, community concerns (amplified by the media and politicians) around social and environmental issues, have put the spotlight on bad behaviour and cultural issues – forcing incumbents to simplify their businesses and shed inertia revenues which is significantly impacting returns. A good example of a company that has been in the eye of the storm more recently is Telstra.

Sustainability of returns is the key

At WaveStone, our investment process helps us consider and integrate ESG into our investment decisions. Capital allocation is a key tenet of our investment process, so on the governance front, we are well aware of the benefits of good governance that can result in sustainable returns for our investors. We will certainly be focusing more

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on Environmental and Social factors in future. This will include trying to identify proactively where there are cultural issues in an organisation, questioning management on their approach to risk management, monitoring decision making and how they deal with potential environmental risks that challenge their long-term prospects.

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