

REGULATING PROXY ADVISORY FIRMS IN INDIA

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Abstract: *Proxy Advisory Firms are a new breed of financial intermediaries that have already made their mark in the developed capital markets. Now, with them finding their feet in the Indian capital markets, there is a case for enhancing the regulating framework to cover them. This paper identifies several other financial intermediaries and how the regulatory coverage on the PAFs needs to mature and catch up to truly protect the interests of the shareholders. The paper also explores the existing regulation in India and outlines some of the regulatory principles followed in developed jurisdictions for comparison.*

Keywords

Proxy Advisory firms. SEBI (LODR, 2015), Corporate Governance Practices, Institutional Investors.

Introduction

PAFs are self-sustaining research firms. They provide recommendations on the implementation of corporate governance guidelines of the companies listed on the stock exchanges. They advise on those matters which require the approval of investors. They guide the investors-institutional or retail of a company with respect to their rights in the company. The concerns on which guidance may be provided include IPO/FPO, voting recommendation, governance issues, appointment or reappointing of board of directors, nomination and remuneration of the directors. These are a few of the matters which are brought to light for approval of the investors at the shareholder meetings. These consulting businesses assist the investors to understand the concern entirely and then make decisions and exert their right to vote. Institutional Investors and Asset Managers are powerful exponents in corporate voting since their retail investors leave the voting up to them. These institutional investors, who are generally unaware of the affairs of the company, are among the most common clients of proxy advisory companies. The suggestions made by the PAF may have a significant influence on the investor's decision-making process. This in turn may have an impact on the firm's operations as in the case of some corporations, these investors may have large shareholding and so a higher number of votes. In line with the principle of Cost-Benefit, the PAFs allow for centralizing the work of information gathering for making key corporate decisions. Had it not been for these advisory businesses, every investor would have to do

their own research and take an independent call. In line with this principle, the PAFs are similar to financial advisors, audit firms, and credit rating agencies. This research paper examines the effect of proxy advisers, the concerns related to their operations, the enforcement of the advice, and the status of existing legislation in India and in other countries across the globe.

Rationale of the study

The primary purpose of the research paper is to examine the role and concerns related to proxy advisory firms. Given that PAFs are a new and upcoming type of financial intermediaries with growing influence and few regulations in place as compared to other financial intermediaries, it is an important area of discussion.

In this paper, we focus on outlining the niche role that PAFs seem to be settling into and how they are different from other financial intermediaries like Financial Advisors, Auditors, and Credit Rating Agencies. The paper covers how their role and influence are growing in importance. Subsequently, it explores the existing regulations with respect to PAFs in India and offers some insight into PAF-related regulations in some of the developed markets.

The paper concludes with making a case for increased external regulation and self-regulation through a code of conduct and making PAFs truly effective in the increasing role they seek to play in the Indian Capital Markets.

Research Methodology

This study is primarily exploratory in nature. Secondary sources of information have been used for accumulating relevant data.

Review of literature

Alexander, Chen, Seppi and Spatt (2009) examined the functioning of the institutional shareholder service suggestions in contestation made by the proxy advisor. This study suggested that the PAFs put across facts and figures to the users. Resultantly there were substantial stock returns around the period of the declaration of public opinion. It was observed that these movements in the stock prices were dependent on the suggestions given by the proxy consulting businesses.

Cotter, Palmiter and Thomas (2010) examined the information pertaining to mutual funds with respect to the voting aspect for the duration of 2003-2008. Through this, they tried to gauge the extent to which the MFs voted following the advice given by the Institutional Shareholder Service. Later it was concluded that MFs voted themselves. They did not

follow the suggestions of either the management or the ISS. The outcomes of the study were contrasted with other types of investors with respect to voting on some definite subjects. It was concluded that mutual funds adhered more to the advice given by the Institutional Shareholder Service.

Ertimur, Ferri and Oesch (2013) explored the impact of PAFs in financial aspects. This was undertaken in connection with the issue of “say on pay”. This research paper emphasises on the procedure adhered to for giving a recommendation by Institutional Shareholder Service and Glass Lewis on the subject under consideration. Both the advisory businesses perform detailed research. The emphasis is on considerations which are specific to the firm. They do not believe in adopting a universal approach. These firms give an unfavourable recommendation to the corporates which do not perform well but give high compensation packages to their executives. There are situations where the firms have different opinions. The influence of their opinions on the voting issue was found to be important.

Overall, the researchers agree that the voting advice given by the proxy advisors impact significantly on the pattern of voting on the resolutions passed at the annual general meetings(AGM). (*Ex. Cotter, Palmiter and Thomas, 2010; Choi, Fisch and Kahan, 2009*).

A. Proxy Advisory Firms - a new type of Capital Markets Intermediary

The PAFs perform the function of creating awareness among the existing shareholders. They educate the investors about the corporate governance guidelines given by SEBI (LODR) Regulations, 2015, that have to be adhered to by all the listed companies. As a result, the proxy advisory firms could serve as catalysts in the implementation of corporate governance guidelines.

However, it is important to understand the difference between Proxy Advisors and some of the other important intermediaries in the capital markets.

I. Proxy Advisors versus Investment Advisors

The term "financial advisor" which was introduced in the year 2013 has been defined under Section 2(1)(m) of the SEBI (Investment Advisor) Regulations. According to the regulations a ‘financial advisor’ is an individual who works in the industry of giving advice to the investors in exchange for payment. However, a proxy adviser only advises shareholders on how to vote; they do not offer advice on whether an existing investor or future investor should make or retain a particular investment. Organizations that offer financial assistance especially include investment advisors.

In contrast to proxy advisers, investment advisers suggest on how to vote on agendas, like the adoption of a public offer by shareholders. They conduct research in order to give guidance regarding investment decisions made by their customers. However, giving financial advice is not a part of the function of proxy advisers.

II. Proxy Advisors versus Auditing Firms

Like an auditing firm, proxy advisory firms can be involved in multiple relationships with their clients. This is expected to create a conflict of interest due to the need for preserving the ongoing relationships and the need to provide fair advice in their role as Proxy Advisor. Therefore, to maintain objectivity, the auditors are restricted in the types of services that they can offer to their clients.

Furthermore, the auditors should generally periodically turn over as required in several jurisdictions. However, there are no such limitations on PAFs.

The rules regarding the financial statements that auditors certify are very transparent, thorough, and standardized but PAFs have no such standards. Also, the audit work is subject to scrutiny by regulators whereas there is no such requirement on PAFs.

III. PAFs versus Credit Rating Agencies

Credit Rating Agencies are hired by the company itself. Therefore is a possibility for disruption of interest. Proxy advisers are hired by institutional shareholders and asset managers.

Credit rating agencies gather facts for asset managers that are used for making investments. The rating agency analyses the credibility of a firm. (for investment into its credit instruments like bonds, Corporate Paper, etc), The PAFs focus on the voting recommendations for investors.

Both PAFs and credit rating agencies serve to cut down the overlap in the efforts by various individual investors.

B. The impact of PAFs on Corporate Decisions

The indirect power exerted by the PAFs can be seen from the research conducted by N. Malenko and Y. Shen. They researched one of the largest PAF in the USA called Institutional Shareholder Services Inc. (ISS) and its influence on voting outcomes in the USA. In their research published in 2016, Malenko and Shen showed a strong statistical correlation between a negative view by the ISS and a fall in support. The reduction in support for the

voting agenda was a significant twenty-five percentage points.

The PAFs perform the function of creating awareness among the existing shareholders. They educate the investors about the corporate governance guidelines given by SEBI (LODR) Regulations, 2015, that have to be adhered to by all the listed companies. Resultantly, the proxy advisory firms could serve as catalysts in the implementation of corporate governance guidelines.

The inherent downside of this, is the existence of strong potential for power concentration with proxy advisors. The other flip side is the absence of regulations over or precautions with regard to their opinions are the procedural drawbacks. The rules might surpass the boundaries of the law because they are centered on optimal governance mechanisms.

The recommendations issued are not subject to approval of any regulatory body. They are primarily opinions of the consulting firms. These may thus may be interpreted differently leading to different conclusions. Thus, the given opinions must be used by the shareholder for reference to formulate his independent decisions.

The impact of PAFs on Corporate voting

The figure below outlines the negative PFA vote on voting on corporate decisions. It states various resolutions that were rejected in Annual General Meetings. The rejections were based on negative recommendations given by the PAFs.

Name of the Company	Year	Agenda	Vote against
Mangalore Chem	2016	RPT	>99%
Kolte Patil Dev	2017	RPT	>98%
Raymond	2017	RPT	>97%
J&K Bank	2018	Appointment of NED	87%
Hinduja Global	2017	Employee Stock Options	85%
Finolex Cables	2017	Office of profit	78%
Gammon India	2018	Waiver of excess remuneration	75%
DB Realty	2017	Related Party Transactions	52%
Suzlon Energy	2018	Issue of securities	42%
KPIT Tech	2017	Appointment of R.A. Mashelkar as Independent Director	35%
Sintex industries.	2017	Appointment of Indira J Parikh as Independent Director	25%
Finolex Cables	2017	Appointment of Indira J Parikh as	63%

		Independent Director	
PC India	2017	Appointment of Non-Executive Director	71%

Source: SES Advisory

According to the existing regulations relevant to PAFs in the country prior interaction amongst the voting consulting firm and the subject company is not permissible. This restriction might be favourable for the independence of proxy advisory firms to express their thoughts.

Potential for unfair practices

The regulatory mechanism for the proxy advisors is gradually developing.

Issues relevant to the proper functioning of the PAFs, the regulations, and suggestions given by them call for regulatory attention.

In the discussion given below the concerns faced by the PAFs along with the regulatory framework have been listed below. In India, the SEBI Regulations make it compulsory for all PAFs to be licensed to operate. The PAFs are mandatorily required to follow an ethical code of conduct as given by the SEBI Guidelines.

C. Existing Regulation to support the Principles of Transparency

In keeping with the **principles of transparency**, the PAFs are required to ensure that they either do not offer advice in case their position is disputed, or disclose all conflicts along with their advice. Thereafter the shareholders can make up their own minds about following the PAFs advice or not.

I. Avoiding Conflicts of interest

Conflict of interest is a serious matter that calls for due attention in the case of proxy advisory firms. They not only provide services like consulting to the company but also are advisors to its shareholders. This may result in skewed opinions which get mirrored in the suggestions given by the consulting firm. This has a detrimental effect on the interests of the stakeholders. Chapter III of the SEBI Regulations pertains to the resolution of conflicts and transparency guidelines applicable to the proxy advisors.

According to Regulation 15(1) of the Procedural Guidelines for proxy advisors, the firms must have internal policies & mechanisms to address the real time or potential conflicts emanating from buying and selling of securities of the subject company. The aforesaid Regulations further limit the dealings by employees of these consulting firms.

Regulation 17 of the SEBI guidelines provide for the conditions on the remuneration level received by research analysts. The remuneration is fixed by the board of the PAF. It has not to be dependent on the brokerage department. Another restriction in place is on the publication of PAF reports by analysts who have worked at the subject company in managerial positions.

SEBI issued procedural guidelines for PAFs on 3rd August 2020. As per the guidelines, PAFs are required to

1. Declare matters of conflict of interest on every document where they are giving their consultation. These statements must address areas of potential conflict
2. Clear-cut procedures should be in place to communicate and control any probable disruption that may appear from any other organizational activities such as advisory activities to the clients.

II. Avoiding any factual errors and misstatements

As per Regulation 23 of the SEBI Regulations proxy advisors must reveal in their reports the extent of research behind every recommendation. The efficacy of its policies and mechanisms is also to be stated. These policies and procedures have to be revisited at least once a year. They shall also communicate the procedure adopted in carrying out research and the outcomes.

III. Disclosure of interactions with the subject company

Regulation 23 of the SEBI Regulations, stipulates a proxy advisor to

1. Declare the policies and means for communicating with subject companies
2. Disclose to the issuers of opinions of the PAF and review of recommendations.

The above-mentioned SEBI procedural guidelines mention clearly that the PAF shall have well defined channels of communication to keep its clients and the company well informed. The report to their clients and the company shall be shared simultaneously. The said 'sharing policy' has to be available on the website of the advisory firm. For the companies to give comments a defined timeline needs to be given by the consulting firms. If the concerned company differs on the recommendations given then the PAFs can be informed. In such cases the PAFs can revise their recommendation if they find it appropriate to do so.

IV. Disclosure of conflict of opinion to the subject company

The opinions of the said advisors are primarily dependent on their research and analysis. These do not require the consent of any regulatory body. The procedural guidelines instruct the PAFs to disclose the guidelines given by SEBI along with their recommendations.

As per WG Report dated 29th July 2019, on concerns relevant to proxy advisors, SEBI has advised the Proxy advisors to communicate the unaltered reply of the company to all its supporters. In case the company is not convinced with the reply given by the PAF under the SEBI Regulations, it may again approach the proxy advisors. In case the corporate still remains dissatisfied with the reply, they may appeal to SEBI for involvement. Opinions that are supported by reliable public data, cannot be the ground of any complaint or litigation. Litigations on non-substantive grounds should not be initiated by the company. A complaint may be filed by companies in cases of non-adherence of the statutory ethical Code of practice prescribed under SEBI guidelines.

D. Proxy Advisory Firms - as regulated in developed countries

I. Avoiding Conflicts of interest

In the USA, advice given by PAFs is considered solicitation and therefore comes under the ambit of federal laws. Federal laws in the USA (Rule 14a-9 of General Rules and Regulations of SEC) require all conflicts of interest to be disclosed in sufficient detail and call for severe penalties and punishments for failures to comply.

These cover disclosures of

- Any facts related to the agreement, or association of the PAF (or its associates) that is pertinent in evaluating the purpose of the consulting firm; and
- Any plans and mechanisms that can be used to recognize are used to identify any conflict emerging from such circumstances.
- The measures are taken to deal with any such conflicting situations, that emanate from business or connections.

II. Avoiding any factual errors and misstatements

In the case of the UK, the approaches used for enabling these services are:

- Disclosing the pertinent source of the facts used for providing these services.
- Systems that guarantee that the investigation, consulting, and voting suggestions are standardized. They are prepared and put together by individuals who are eligible to make them.

- Accounting of the domestic market, political scenario, regulatory framework, and conditions specific to the organization.
- Involvement with the company under consideration or its shareholders.
- Strategy of the consulting firm related to the avoidance and handling of probable disruption of interest.

III. Disclosure of interactions with the subject company

Under USA jurisdiction, reforms in Rule 14a of the SEC Act, 1934, provide exceptions to the PAFs with regards to the need of filing the proxy rules provided that registrants that are part of proxy voting advice have ensured that this advice has been made available to them at or earlier to the time when such advice is shared with the consulting business's clients. The modification also gives rules for clarifying plans and mechanisms of the PAF These may require the registrants to:

- file their final proxy statement at least forty calendar days before the shareholder meeting
- declare that they will use the proxy advice for the internal requirements only. They will not publish or use the voting advice elsewhere except with the registrant's employees or consultants.

IV. Disclosure of Difference of opinion between shareholders and the subject company

In the United States of America according to the proposed SEC modifications it is a must for consulting businesses to make their proxy voting advice accessible to the companies under consideration at or prior to the time when such advice is shared to the PAFs clients. The same shall give an equitable chance for rendition to the companies under consideration.

In the UK, while the acceptance of the Code of Conduct is not compulsory under the Proxy Advisors (Shareholders' Rights), 2019, provided the proxy advisors provide a concrete reason for not doing so. The provisions suggest that any organization or individual may file an issue to the Financial Conduct Authority (FCA), in case of violation of any provisions. Further, the Code of Conduct needs to be revised within a period of twelve months.

In the case of Australia, Section 912D of the Corporations Act of Australia 2001 states that a licensed financial consultant (covers PAFs) is supposed to file a written report with the ASIC. In case of a violation in the fulfillment of the obligation given under the Act, it should be fulfilled within ten working days after knowing of the contravention. The consulting advisory firms are presently not required to take a license under the Corporations Act, the said provisions are not relevant to them.

ASIC in its review of proxy advisor consulting practices dated June 2018, suggests that if a company under consideration finds a matter that is false or misleading in consulting firm report the company should:

- inform the proxy adviser of the issue immediately and ask for rectification.
- consider whether it would be right to respond to the matter by way of an ASX declaration or use other means of informing the clients.

Conclusion

The discussion in the research paper leads to the conclusion that the regulatory architecture for proxy advisory firms needs to be strengthened.

In comparison to the developed economies, the following areas call for attention :

Disclosures as per Principles of Transparency: PAFs have amassed immense awareness in the recent past. Their impact over institutional investors has gradually enhanced. PAF has the ability to impact the working of the corporations on the grounds of the voting suggestions. Declaration of all relevant facts and figures which have a bearing on the suggestions given by the consulting firm are extremely essential. Disclaimer is given by these advice businesses in their reports. They substantiate that the opinions given by them are solely their own.

Enhanced External (by Regulators) and Internal (vide a Code of Conduct) Oversight: Even though it is compulsory for a proxy advisory firm to have an ethical code of practice under the Regulations given by the Securities Exchange Board of India, still there should be a regulatory body which supervises the implementation of the said Code.

The guidelines and suggestions given by the PAF are available for public use and may influence the conclusions drawn by the stakeholders of the corporation under consideration. Therefore, it is essential that these should be clear, free of biases and complete disclosure of the material facts should be made. It may further be required that, in situations where the consultant is giving recommendations established on his understanding of the prevalent law, the advisor shall specify this to the client.

Adequate and Timely Disclosures to Subject Company: At present, SEBI procedural guidelines make it necessary for consulting firms to communicate the report with their clients and the company under consideration together.

As per the reforms suggested in the United States and the Australian regulatory mechanism, these advisors would be asked to share their report with the corporation under consideration before they issue it to its investors. The same may enable in filling the gap of information if

any.

RAF Client Institutional Investors not completely absolved of responsibility: The institutional shareholders should give due weightage to the opinion of the consulting firm and the corporate under consideration. Finally, form their own decision on the facts and figures available to them and conclude on the matter.

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