

# Article



## Dance of Corporate Democracy: The rise of proxy advisors

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An investor may influence the operations of a company primarily by his shareholding and, in turn, may affect the shareholder value and the quality of corporate governance. This is more so if the investor is an institutional investor. Institutional investors usually hold large chunk of a company's shares collectively. Institutional investors have become dominant players in corporate democracy and vote with millions of shares at general meetings or on items to be passed by ballots, e-voting, etc. However, institutional investors' primary strength lies in making investments; they may not have adequate expertise or infrastructure to ensure proper corporate governance of their portfolio investees, so as to exercise their voting powers in the best interest of their investee companies and other stakeholders therein. It is for this reason that they depend on the support of *proxy advisors*.

The concept of proxy advisors is an age-old concept in lots of countries, though it may still be a relatively new phenomenon in India. However, with the rise of concern for corporate governance, the advent of the Companies Act, 2013 alongwith various other regulatory changes focusing on corporate governance and keeping in mind the consequences of non-approval of certain proposals such as related party transactions, appointment/re-appointment and remuneration of directors, appointment/re-appointment of auditor's, restructuring schemes, etc., the role of proxy advisors seems to have become critical and has brought a significant change in the scenario of corporate governance. In this article, we have discussed the role of the proxy advisors in Indian and global context, and the regulatory framework related thereto.

### **What is proxy advisor?**

As discussed above, institutional investors may depend on the research and analysis of third parties, i.e. the proxy advisors, for their voting recommendations on the company's agenda at general meetings. The institutional investors invest in various companies across the globe which are regulated by different legal systems and have accordingly different legal complexities and requirements. The role of proxy advisors, thus, is to help such investors by providing valuable research related to corporate governance of that country for taking informed decisions. Their research and ultimate recommendation to the investors may have significant impact on the outcome of the company's voting results. For instance, in the US, Exxon Mobil Corporation recently stated that "*proxy advisors hold a position of unparalleled influence,*" and estimated that between 20-25% of the votes cast at Exxon Mobil's most recent annual meeting were voted automatically in accordance with proxy advisor recommendations.<sup>1</sup> The main role of these proxy advisors or proxy advisors firms is to recommend institutional investors about the rationale for a proposed resolution to be passed by the company and, accordingly, facilitate them to vote "for" or "against" the motion. Accordingly, the proxy advisory firms exert huge influence by potentially swinging the voting at shareholder meetings.

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<sup>1</sup>Comment on Concept Release on the U.S. Proxy System, Exxon Mobil Corporation, August 21, 2012. It is available for download at <http://www.sec.gov/comments/s7-14-10/s71410-313.pdf>.



## **Reasons for engaging proxy advisors**

### ***Role of the institutional investors- whether passive or active?***

The OECD Principles of Corporate Governance (Principles) rely on the assumption that a shareholder can look best after his interest given the sufficient information and voting rights. When a shareholder belongs to a professional body or has sufficient skills and knowledge, more so he can make an informed decision, such as institutional investors. The prospects in relation to voting by such shareholders have been highlighted in Principles II.F and II.G, added in 2004<sup>2</sup> to cover disclosure of voting policies, managing conflicts of interest and co-operation between investors. Institutional investors were expected to be one of the important contributors to corporate governance inasmuch as they were expected to behave in accordance with their skills and knowledge, but seemingly, the behavior was not as expected. This led to formulation of several new principles being agreed by consensus, especially Principles II.F and II.G covering disclosure of voting policies, managing conflicts of interest and co-operation between investors. The annotations to the Principles specified under II.F.1 to the following effect- *“the effectiveness and credibility of the entire corporate governance system and company oversight will... to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest.”*

OECD in its paper on the role of institutional investors in promoting good corporate governance<sup>3</sup> (OECD Paper) has dealt with their behavior and contribution to the corporate governance in few countries. It has been summarized that *“In practical terms, the restriction of the Principles to institutions acting in a “fiduciary capacity” needs to be interpreted broadly since formal fiduciary duties are not specified in many jurisdictions that often prefer the weaker obligation of loyalty.”*

The OECD Paper has dealt with various roles and behavior of the institutional investors and their ultimate contribution to corporate governance.

National Stock Exchange of India Limited, in its quarterly briefing in April, 2013<sup>4</sup> quoted that *“historically, outside (non-promoter) shareholders, whether retail or institutional, have been passive in India. They rarely participated in shareholders’ meetings. In any case, the retail shareholders’ miniscule shareholding made their participation less effective. Notably, however, even the institutional shareholders, both domestic and foreign, who could have made a difference, either did not participate in the meetings or, if they did, it was almost always to vote in support of management and the promoters”*

The World Bank in its report on *“Role of Institutional Investors in the Corporate Governance of their Portfolio Companies”*<sup>5</sup>- with respect to India has also recognized

<sup>2</sup><http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf>

<sup>3</sup><http://www.oecd.org/daf/ca/49081553.pdf>

<sup>4</sup>[http://www.nseindia.com/research/content/res\\_QB1.pdf](http://www.nseindia.com/research/content/res_QB1.pdf)

<sup>5</sup>[http://www.nfcgindia.org/final\\_india-june29.pdf](http://www.nfcgindia.org/final_india-june29.pdf)



that the institutional investors have a very passive role against being active, given their roles and skills. The review report deals with how the institutional investors, acting in fiduciary capacity, should be mandated to disclose their corporate governance policies to the market in considerable details. This was also the concern addressed in the OECD Paper. Accordingly, it was also identified that such problems could in principle be solved by making use of proxy advisors

### ***Proxy advisors and their roles***

Accordingly, keeping in mind that the institutional investors are expected to be key drivers of corporate governance, the need for proxy advisors was felt. Discussed briefly hereunder are the reasons why institutional investors engage proxy advisors<sup>6</sup>:

- a. Proxy advisors generally offer variety of services consisting of both, analyzing the proposals at general meetings and recommending voting decisions.
- b. The recommendations of proxy advisors help the investors to obtain a more considered understanding of different agenda items and to arrive at an informed voting decision, allowing them to optimise their own limited resources and cast their votes in a timely and informed manner.
- c. Considering that institutional investors invest in multiple companies in different industry range and across the globe, it may not be feasible for those investors to have informed knowledge of the corporate governance specifications of that country and hence there may be an inability to understand the need and impact of a particular agenda item. Proxy advisors help to combat this issue as well through their informed consultancy. Due to cross border voting investors may face issues in terms of language of a country. The proxy advisors can assist in mitigating the language issues as well. Further, they may also enable the investors to have a voting platform in cases where electronic voting is a pre-requisite at general meetings.
- d. Apart from the above, general meetings across the globe may be concentrated during a certain period of the year and therefore the investors may not be in a position to gather information and knowledge about all the companies and hence, may not be in a position to take informed decision while voting.

OECD Paper discusses the role in brief where it summarizes that, “*Verdam (2006) points out that most investors tend to follow their advice, first of all, because it is easier from an administrative perspective “for 15 to 20% of ISS’ clients the votes are cast automatically – so without any further action being required– in conformity with ISS’ recommendations” (page 4). In addition, it would require the investor conducting its own research to conclude differently, and would have to “justify and render account both to themselves and to their beneficiaries why they are going against the advice of the expert called in by them” (page 5). Verdam cites research that has shown that 40% of the votes*

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<sup>6</sup> Source: <http://www.esma.europa.eu/system/files/2012-212.pdf>



*cast by institutional shareholders for shares in US-listed companies are in conformity with ISS' recommendations."*

### **Conflict of interest-** *an inherent threat in business models*

The concept of proxy advisors exists for a reason aiming towards better shareholder's participation, however, there are times when there may be a potential conflict of interest in their roles acting as proxy advisors. This conflict has developed over time and is an inherent threat in the way they function.

One needs to ponder over possible conflict of interest in case of recommendations by the proxy advisors? The proxy advisors simply recommend their voting decisions to the investors, who in turn exercise the same as per the advice of the proxy advisors. However, the rationale and the contents of their research are usually unavailable to the company to ascertain the reason for voting, especially when it may be against a motion. In India, the institutional investors hold around 10%-20% of the paid up share capital of a company, therefore, are able to influence the decisions of the company to extent of their shareholding. Since, the rationale of decision by the proxy advisors is unknown to the company, it is oblivious of the reason for its defeat of the resolution or comparatively lower voting in favour of a motion. Proxy advisors are supposed to be unbiased and give their independent decisions to the investors so as to play a constructive role in facilitating greater shareholder involvement. However, at times such firms may also be consultants to the investees as well as advisor to the investor; it is in these cases that there are chances of conflict of interest. It is a major concern as conflict of interest coupled with biased recommendations translates into actual votes, thereby adversely affecting shareholders' value.

To combat these issues SEBI vide its notification dated 1<sup>st</sup> September, 2014 introduced SEBI (Research Analysts) Regulations, 2014 ("Regulations"). According to the Regulations, the proxy advisors are required to maintain a minimum capital, disclose the extent of research behind their recommendations and frame policies on interacting with and getting responses from the companies on which they are issuing reports. Provisions of the Regulations are dealt with in the latter part of the article.

### **Conflict of interest: International discussions**

*A 2007 US Government Accountability Office Report (GAO, 2007)<sup>7</sup> concluded that the main source of potential conflict of interest for proxy advisors was the simultaneous provision of services to institutional investors and corporate clients.*

The OECD Paper also summarized that *"There is the view that the proxy voting industry is already too influential leading to voting and voting recommendations that are "tick the box" in nature and not sufficiently differentiated by country and by company. There is also the question of conflicts of interest prevalent in the industry."*

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<sup>7</sup> Source: OECD Paper



The most common concern being conflict of interest, which is seemingly inherited in their business models, has been discussed in the Discussion paper by European Securities and Market Authorities (ESMA)<sup>8</sup>. The various possible ways in conflict of interest may arise, have been discussed. Some of the conflicts are as mentioned hereunder:

- a. ***Dual service***: A clear conflict exists when proxy advisors provide dual service, both as consultancy services to issuers and proxy research and advice to investors, to institutional clients with respect of those issuers. The risk is that proxy advisors could provide inappropriate proxy advice to investors, as they are effectively advising investors on how to read statements by issuers which they themselves may have influenced through their advice to those issuers.
- b. ***Relationship of proxy advisor with issuer***: The advice by the proxy advisor given to the investor may be influenced due to its relations with the issuer e.g., the proxy advisor may have some other commercial or personal relationships with the issuer or the issuer's major shareholders, which in turn may result in rendering biased advice to the investor.
- c. ***Potential interest of proxy advisor in issuer***: potential conflicts are likely to arise when owners, directors or officers of proxy advisory firms serve on public company's boards and that have proposals on which the proxy advisors are making voting recommendations.
- d. ***Relative influence of proxy advisor client***: Influence by one investor client on the advice of the proxy advisory firm given to another investor clients, in order to maintain its business relations with the investor might influence its advice, even if it is not necessarily the best course of action for the proxy advisor for providing objective and independent advice.

In order to mitigate the risk involved in their services ESMA have come up with the EU code of conduct.

### **Recommendation by ESMA on identification of code for Proxy Advisors**

ESMA had released a Discussion Paper on proxy advisors industry on 22<sup>nd</sup> March, 2012 and received response to the same. Based on the feedback on consultation ESMA have drafted its final report on "*The Proxy Advisor Industry*"<sup>9</sup>. In its report ESMA advises on developing an EU Code of Conduct (Code) that focuses on:

1. ***Identifying, disclosing and managing conflicts of interest***: Proxy advisors should seek to avoid conflicts of interest with their clients. Where a conflict effectively or potentially arises the proxy advisor should adequately disclose this

<sup>8</sup><http://www.esma.europa.eu/system/files/2012-212.pdf>

<sup>9</sup><http://www.esma.europa.eu/system/files/2013-240.pdf>



*conflict and the steps which it has taken to mitigate the conflict, in order that the client can make a properly informed assessment of the proxy advisor's advice.*

2. ***Fostering transparency to ensure the accuracy and reliability of the advice:*** *Proxy advisors should provide investors with information on the process they have used in making their general and specific recommendations and any limitations or conditions to be taken into account on the advice provided so that investors can make appropriate use of the proxy advice.*

This will include:

- a. Disclosing general voting policies and methodologies
- b. Considering local market conditions
- c. Providing information on engagement with issuers

### **Guidelines by SEC (Securities and Exchange Commission)-United States**

The guidance proposed in Europe by ESMA was followed by issuance of guidance note by SEC. On June 30, 2014, the SEC issued long-awaited guidance regarding proxy advisory firms, in the form of a Staff Legal Bulletin<sup>10</sup>.

The guidance imposes some responsibilities on the investor clients who retain the services of proxy advisors. The proxy advisory firms are expected to comply with the guidance. Some of the points of due diligences to be ensured by these proxy firms are:

1. They must have the capacity and competency to adequately analyze proxy issues;
2. They must have robust policies and procedures- to identify and address any conflicts of interest, to provide current and accurate information;
3. They need to disclose to the investor clients to whom voting recommendations are made, if they have any significant relationships or material interest, including conflicts of interest arising from providing consulting services to companies;
4. They need to disclose potential conflicts of interest.

The SEC and ESMA and other capital market regulators worldwide are realizing the importance of the role of the proxy advisors and the impact they have on the corporate governance. Thus, steps are being taken by them on a continuous basis to formulate regulations/guidelines in order to ensure that the decisions of the proxy advisory firms are more transparent, reliable and independent, thereby curbing the threat of conflict of interest.

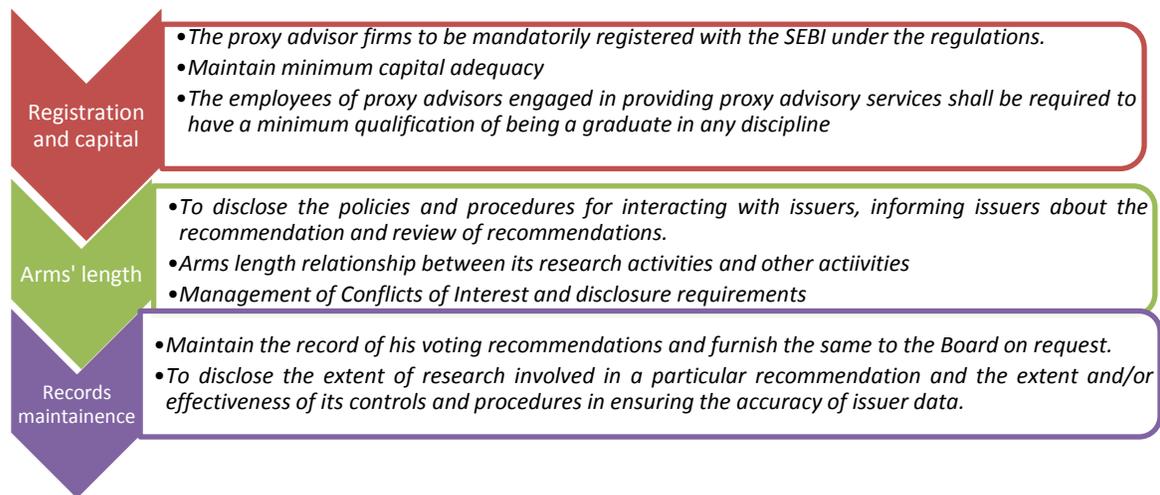
### **SEBI (Research Analysts) Regulations, 2014-India**

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<sup>10</sup><http://www.sec.gov/interps/legal/cfslb20.htm>



The proxy advisors while providing their services to the investor clients are inter-alia required to abide by the Regulations notified recently by the SEBI. These Regulations, in a way, protect investors from any motivated research reports by the advisory firms. Further, utmost care has been taken to avoid conflict of interest by way of the provisions of the Regulations. The proxy advisor, apart from complying with other provisions of the Regulations, also has some additional disclosure responsibilities. Below are some of the requirements of the Regulations:



## Major global proxy advisory firms

The proxy advisory industry is dominated by mainly two USA based advisors having its network worldwide:

- Institutional Shareholder Services Inc. (ISS)*<sup>11</sup> and
- Glass Lewis & Co.*<sup>12</sup>

This duopoly structure has allowed them to have a significant influence on corporate governance policy. They jointly capture a significant portion of market worldwide in terms of rendering of their services.

Similarly, India has an institutionally backed voting/proxy advisory firms like *Institutional Investor Advisory Services India Limited (IiAS)*, *Stakeholder Empowerment Services (SES)*, *InGovern*.

<sup>11</sup><http://www.issgovernance.com/>

<sup>12</sup><http://www.glasslewis.com/>



## **Practical aspects of research and analysis by the proxy advisors**

Usually, all the companies have a team of investor relations to deal with the queries and concerns of the investors. The main role of this team is, at the time of general meetings to be held by the companies or at the time of events such as postal ballot, to handle the queries by investors in relation to the items of resolution. The proxy advisor, in such cases, makes the call for their clients to enquire from the investor relations department with respect to benefits and advantages to the investors from the proposed resolution. The institutional investors may also want to enquire as to why at all a particular resolution is proposed. Based on the response to their queries from the investor relations department, the proxy advisors reason their decision and accordingly advise their clients. Many a times, due to such decisions of the proxy advisors, the company may get perturbed as it may significantly impact the overall voting pattern of the company or at times may even result in turn down of a resolution.

The proxy advisors, thereafter, upload on their website their reasoning and views for a particular resolution of a particular company. Some of the practical examples where voting affected the decisions of the investors are discussed below.

## **Impact of Proxy advisory firms over the decisions of the Indian Corporate**

The role of the proxy advisory firms seems all the more prominent in the big corporate giants, when the proposed resolutions in the members' meeting do not result in the manner anticipated by the company. In the current year, member meetings of companies like JSW Steel, Alembic Pharmaceuticals, IPCA Laboratories and Lupin concern was shown by the proxy firms on the agenda of remuneration package of promoter chairman of the company<sup>13</sup>. As per the views of SES, one of the proxy firms in India, promoters take home indirect ownership premium over non-family professionals and board members, inspite of having an impartial remuneration committee in these companies. They are of the view that the promoters and executive directors should take equal or lower compensation than the highest paid professional in the company.

Further in 2014, questions were raised on similar issues by the proxy firms for leading business houses and accordingly, recommendations were made by some firms to the investor clients to vote "against" the proposed resolution in the meetings. A resolution by Tata Motors was proposed to pay excess compensation to three executive directors, wherein two of the three Indian proxy advisory firms recommended that shareholders should support the resolution. SES and global proxy firm ISS, on the other hand, advised

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<sup>13</sup>[http://articles.economicstimes.indiatimes.com/2015-07-27/news/64918998\\_1\\_proxy-advisory-firms-promoters-high-salaries](http://articles.economicstimes.indiatimes.com/2015-07-27/news/64918998_1_proxy-advisory-firms-promoters-high-salaries)



shareholders to vote against it<sup>14</sup>. The resolution was turned down sending shock waves across India Inc.

### **Effect on corporate democracy**

With ever growing institutional shareholdings and recent regulatory reforms in order to enhance shareholder participation, proxy advisory firms have had a large influence on shareholder votes. It is thus critical that these independent advisory firms issue unbiased recommendations and be free of potential conflict of interests. Although, increased competition could reduce the magnitude of these conflicts, competition itself may not be enough to completely eliminate them.

Thus, the Regulations may help combating the issues challenging the corporate governance. In a way, it can be perceived that the scenario is changing gradually over a period with the recent Regulations. The recommendations and reports by these proxy advisory firms could be relied upon. On the other hand, where the advisory firm makes genuine and justified recommendations to the investors, the same might not turn out as per the expectations of the promoter of issuer company. Thus, it can be said that corporate can no more predict the votes of this group of shareholders, as they seem to be making an attempt to increase their participation in an informed manner. Indian Inc needs to act rationally while proposing an item of business. General Meetings are no more a one man show; the corporates may also have to dance to the tunes of these proxy advisors, the so called activist investors behind the scene.

Read articles on:

1. Other articles on Companies Act, 2013 at: <http://www.india-financing.com/component/content/article/281.html>

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<sup>14</sup>[http://thefirm.moneycontrol.com/story\\_page.php?autono=1157593](http://thefirm.moneycontrol.com/story_page.php?autono=1157593)