

SEBI prescribes stricter regime for Proxy advisors; Issues procedural guidelines to be followed in addition to Code of Conduct

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Who are Proxy Advisors ['PAs']

Proxy advisors provide advice to institutional investors /shareholders of a listed entity, in relation to exercise of their rights in the company including voting recommendation on agenda items whether to vote in favour or against a particular company's resolutions by gathering all the data. The investors (whether institutional or individual) become reliant on the advice of the proxy advisors as they guide in making an informed decision. SEBI regulates the activities of proxy advisors in India under SEBI (Research Analyst) Regulations, 2014¹.

Background

Nearly a year after the report of the working group on issues concerning PAs, SEBI has vide circular dated 03rd August, 2020², issued Procedural Guidelines for Proxy Advisors laying down additional guidelines to be adhered to by PAs & Grievance Resolution between listed entities and proxy advisers dated August 04, 2020³.

The provision of these guidelines shall be applicable **w.e.f September 01, 2020**.

In India, PAs are governed by the SEBI (Research Analyst) Regulations, 2014 [**'Research Analyst Regulations' or 'RA Regulations'**]. India is one of the few countries that provide a regulatory framework for proxy advisors. In other countries, proxy advisors are not regulated.

A Working Group on Proxy Advisors [**'Working Group'**] was set up in November, 2018 to review the existing regulatory framework for proxy advisors. The Working Group submitted its report⁴ on 24th May, 2019 which was published for public comments on 29th July, 2019. The working group had made several recommendations to further regulate proxy advisors including added transparency in their functioning and adequate disclosures to clients.

The procedural guidelines & grievance resolution introduced by SEBI has been introduced after taking into consideration few recommendations of the Working Group. These guidelines would come into force on 01st September, 2020.

¹ SEBI (Research Analysts) Regulations, 2014-
<https://www.sebi.gov.in/legal/regulations/sep-2014/securities-and-exchange-board-of-india-research-analysts-regulations-2014-last-amended-on-april-17-2020-34615.html>

² Procedural Guidelines for Proxy Advisors-
https://www.sebi.gov.in/legal/circulars/aug-2020/procedural-guidelines-for-proxy-advisors_47250.html

³ Grievance Resolution between listed entities and proxy advisers-
https://www.sebi.gov.in/legal/circulars/aug-2020/grievance-resolution-between-listed-entities-and-proxy-advisors_47252.html

⁴ Report of the Working Group on Proxy Advisors-
https://www.sebi.gov.in/reports/reports/jul-2019/report-of-working-group-on-issues-concerning-proxy-advisors-seeking-public-comments_43710.html

Role of Proxy Advisors

Proxy advisors, over the past few years, have played a key role in enabling shareholders to effectively participate in corporate governance decisions.

As per a discussion paper⁵ of the European Securities Market Authority ['ESMA'] on Proxy Advisors, *"Proxy advisors can offer a variety of services. The first type of services consists of analysing the proposals for general meetings and providing voting recommendations, either based on the proxy advisor's own voting policy or on the investor's customised voting policy. The second type of activity consists of offering services with regard to the whole voting logistic and transmitting the voting instructions to the issuer, e.g. through a voting execution platform."*

PAs benefit institutional or foreign investors as well as small investors. In case of institutional investors such as Mutual Funds, it becomes imperative to ensure that the voting is done in the best interest of the beneficiaries of such funds and thus, proxy advisors play a crucial role in making recommendations on the same.

Further, foreign investors would not have a complete understanding of the local market practices/ laws. A PA would prepare detailed research reports explaining the rationale behind their recommendation, giving a clear picture to global investors.

Small investors would not normally have the necessary resources required to take an informed decision and thus, proxy advisors assist effectively in providing relevant data which form a basis for their recommendations.

Procedural guidelines for Proxy Advisors

The circular issued by SEBI on August 03, 2020 & August 04, 2020, which comes into effect on 01st September, 2020 brings in stricter norms for compliance on part of Proxy Advisors basis on certain recommendations made by Working Group, apart from the Code of Conduct under the Research Analyst Regulations already being followed by PAs.

Broadly the guidelines mandate PAs to formulate voting recommendations policies, disclose methodologies and processes followed by PAs to clients, promptly disclose any factual errors to their clients, have a stated process for communication, disclose conflicts of interest, etc.

A comparison of the guidelines along with the recommendations of the Working Group and our analysis on the same is given as **Annexure-1**.

Global regulatory framework governing proxy advisors

United Kingdom ['UK']

The Proxy Advisors (Shareholders' Rights) Regulations 2019⁶, is the regulation governing PAs in the UK, which lays down broadly, what disclosures the PA is required to make to its clients and further, how to tackle conflicts of interest.

Unlike the Indian regulations, where PAs must follow the Code of Conduct laid down by SEBI under the RA Regulations, the UK regulations do not mandate a Code of Conduct to be followed while making recommendations.

Rather, where PAs have their own Code of Conduct that they adhere to, they must make necessary disclosures to the client. Where no Code of Conduct is adopted, they must provide a clear explanation why this is the case.

⁵ ESMA –

<https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-212.pdf>

⁶ For the text of the regulation, visit

<https://www.legislation.gov.uk/ukxi/2019/926/made>

Similar to what is now mandated by the procedural guidelines for PAs in India, the UK law also requires Proxy advisors to put in place procedures to identify any potential conflicts of interest and where the same is identified, it must be disclosed to the clients.

United States of America ['USA']

The Securities Exchange Commission ['SEC'] recently adopted new rule⁷ amendments to provide investors using proxy advice with more transparent, accurate and complete information.

The amendments in the final rule add conditions to the availability of certain existing exemptions from the information and filing requirements of the federal proxy rules that are commonly used by proxy voting advice businesses.

These conditions require compliance with disclosure and procedural requirements, including conflicts of interest disclosures by proxy voting advice businesses and two principles-based requirements.

The Rules prevailing in the US broadly cover similar norms for proxy advisors mainly focusing on disclosure of conflicts of interest among other requirements.

Conclusion

Globally the need for proxy advisors has been recognised and subsequently the issues surrounding them have been addressed by way of rules and regulations. Enhanced transparency and disclosure on part of the PA to the investors is increasingly important to ensure the investors have sufficient information to make informed decisions.

PAs provide substantial value addition to the industry and plays a major role in increasing corporate governance in companies as their recommendations have a major impact on company's workings.

Certainly the added compliance by way of procedural guidelines intend to help PA firms in effectively ensuring their role towards their clients.

Read our previous write up on the subject here -

SEBI revisits the regulatory framework for Proxy Advisors (Dated: August 20, 2019)

<http://vinodkothari.com/2019/08/sebi-revisits-the-regulatory-framework-for-proxy-advisors/>

⁷ SEC Rule -

<https://www.sec.gov/rules/final/2020/34-89372.pdf>

Annexure-1:
Comparison of the guidelines along with the recommendations of the Working Group

Headings	Procedural Guidelines & Grievance Resolution	Recommendations of the Working Group on PAs	Remarks/ Our Analysis
<p>Voting recommendation policy</p>	<p>Para 1(a): Proxy Advisors shall formulate the voting recommendation policies and disclose the updated voting recommendation policies to its clients.</p> <p>Proxy Advisors shall ensure that the policies should be reviewed at least once annually.</p> <p>The voting recommendation policies shall also disclose the circumstances when not to provide a voting recommendation.</p>	<p>Para 12: Ensure that a proxy advisor's voting recommendations and analysis are disinterested, and also carry the appearance of disinterest, proxy advisors should have policies and procedures in place with respect to:</p> <ol style="list-style-type: none"> 1. Managing and disclosing conflicts of interests; 2. Business Model; 3. Separate legal entities/units and Chinese Walls; 4. Just say no; 5. Board Independence; 6. Methodology; 7. Communication. 	<p>The intention is to communicate the voting recommendation policy followed by the PA while making recommendations to its clients.</p> <p>In certain cases, such as potential conflicts of interest, the PA may not provide a voting recommendation. Such cases must also be disclosed in the voting recommendation policy.</p> <p>Also PAs shall ensure that the policies are reviewed atleast once annually.</p>
<p>Research methodologies and process followed</p>	<p>Para 1(b): Proxy Advisors shall disclose the methodologies and processes followed in the development of their research and corresponding recommendations to its clients.</p>	<p>Para 94. h: Disclosing the methodologies and processes they use in the development of their research and recommendations.</p>	<p>The recommendation of the Working Group is adapted and the PAs shall disclose the methodologies and process they use for their research and recommendations.</p>
<p>Disclosure of errors in reporting</p>	<p>Para 1(c): Proxy Advisors shall alert clients, within 24 hours of receipt of information, about any factual errors or material revisions to the report.</p>	<p>No corresponding para. However, the working group mentioned that factual errors were noticed to be very rare.</p>	<p>This would provide for prompt disclosure of any error made in facts or a revision made to any earlier recommendation of the PA. Since any revision or corrections made are time critical for clients, they should be disclosed within 24 hours of receipt of such information.</p>

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Stated communication process	Para 1(d): Proxy Advisors shall have a stated process to communicate with its clients and the company.	No corresponding para.	Development of such a stated process is intended to enable smooth and correct flow of information.
Sharing policy	Para 1(e): Proxy Advisors shall share their report with its clients and the company at the same time. This sharing policy should be disclosed by proxy advisors on their website. Timeline to receive comments from company may be defined by proxy advisors and all comments/clarifications received from the company, within timeline, shall be included as an addendum to the report. If the company has a different viewpoint on the recommendations stated in the report of the proxy advisors, then proxy advisors, after taking into account the said viewpoint, may either revise the recommendation in the addendum report or issue an addendum to the report with its remarks, as considered appropriate.	The working group did tackle the question of information sharing with corporates and highlighted that 2 out of 3 PAs share their reports with the corporates while 1 out of 3 does not. Para 61: The Working Group recommends that except for factual errors, proxy advisors should not be mandated to carry views which they don't subscribe to and the company has enough resources to publicise a differing viewpoint.	This essentially provides that PAs must share their reports with the client as well as the company in question at the same time. The report shared with the company must specify a timeline within which comments may be received from the company. After comments are received, the initial recommendations may be revised after consideration by the PA. This is in line with the working group recommendations as the PA is not mandated to carry views that they do not subscribe to, except for factual errors.
Comparison of legal requirement with higher standards	Para 1(f): Proxy Advisors shall clearly disclose in their recommendations the legal requirement vis-a-vis higher standard they are suggesting if any, and the rationale behind the recommendation of higher standards.	Para 72: Proxy Advisory firms must clearly disclose the legal requirement vis-a-vis the aspirational / higher standard they are suggesting. Further, where higher standards are evaluated, the policy behind it should be disclosed.	With the intention to bring out the rationale of the recommendations, a PA is now required to disclose the legal requirements and the higher standard that they suggest (which may arise from globally recognised regulations).
Disclosure of conflict of interest	Para 1(g): Proxy Advisors shall disclose conflict of interest on every specific document where	Para 94 a: Disclosure of conflict of interest and how it is managed. The disclosures should	One of the main areas of concern is potential conflict of interest which is being addressed in this provision

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	they are giving their advice. Further, the disclosures should especially address possible areas of potential conflict and the safeguards that have been put in place to mitigate possible conflicts of interest.	appear on every specific document where they are giving their advice. A generic disclosure/disclaimer on the proxy advisor's website is inadequate and it should be extended to every place, including news quotes where a proxy advisor makes a statement. Disclosures should especially address possible areas of potential conflict and also the safeguards that have been put in place.	introduced by SEBI. The Working Group had also discussed this area at length. Disclosure of conflicts of interest are also prevalent in global laws concerning PAs.
Procedures to manage conflicts of interest	Para 1(h): Proxy Advisors shall establish clear procedures to disclose, manage and/or mitigate any potential conflicts of interest resulting from other business activities including consulting services, if any, undertaken by them and disclose the same to clients.	Para 94 b: The proxy advisor should take appropriate steps to manage, mitigate and/or disclose any potential conflicts of interest resulting from ancillary business activities. Creation of 'Chinese Walls' between proxy firms and their consultancy firms. There should be clear procedures to handle conflicts of interest.	
Grievance Resolution	Para 3 of grievance circular: SEBI will examine the matter for non-compliance by proxy advisors with the provisions of the Code of Conduct under regulation 24(2) read with regulation 23(1) of the SEBI (Research Analyst) Regulations, 2014 and the procedural guidelines for proxy advisors issued vide SEBI circular no. SEBI/HO/IMD/DF1/CIR/P/2020/147 dated August 03, 2020.	Para 94: Listed companies which are aggrieved by a view of a proxy advisor may approach SEBI for redressal of its grievance. It may further provide a mechanism for the same.	SEBI in its guidelines has provided that it shall examine the non-compliance by proxy advisors according to: 1. Regulation 23(1) w.r.t provisions of Chapter II, III, IV, V and VI of SEBI (Research Analysts) Regulations, 2014; 2. Regulation 24(2) w.r.t Code of Conduct as specified in the Third Schedule of SEBI (Research Analysts) Regulations, 2014; and 3. SEBI Circular dated August 03, 2020 w.r.t Procedure Guidelines for Proxy Advisors;