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DEMYSTIFYING PROXY ADVISORY FIRMS IN INDIA- Amitabh Abhijit & Adarsh Kashyap¹**Abstract**

Proxy Advisory Firms ("PAFs") are, essentially, third-party entities hired by investors and shareholders to provide them with recommendations based on a detailed research and analysis so as to make their role more active within a company. The PAF regime in India is fairly new, when compared to global counterparts such as the USA where the industry took off in early 1980s itself.

In terms of the service that PAFs provide, they are an instrumental tool for improved shareholder activism and corporate governance, thereby contributing to the prevention of corporate frauds and scandals on a larger scale. Even though the pace of PAFs in India has been slow, the wheels are starting to turn in their favour as the recognition and regulation by SEBI of these entities has become more prominent in recent years.

The objective of the co-authors to this research paper is to present a simplified view on the concept of Proxy Advisory Firms in India, and add to the existing literature on their utility as near-ideal services for bettering the standards of corporate governance in the nation.

Introduction

Proxy Advisory Firms or "PAFs" are entities that conduct detailed research in a concerned corporate body and use this research to recommend investors and shareholders make educated decisions about corporate issues requiring their approval. SEBI (Research Analysts) Regulations, 2014² ("SEBI Regulations"), defines the term 'Proxy Advisors' as "any person who provides advice, through any means, to institutional investors or shareholders of a company, about the exercise of their rights in the company including recommendations on

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²Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Published in The Gazette of India, Extraordinary, Part III-Section4, September 2014.

public offer or voting recommendation on agenda items."³ In other words, they are a third party that a shareholder may employ to help them prepare for their duties as an investor in a company. Since they only provide suggestions based on the information they collect, they only hold a persuasive power over the shareholder backed by their data; the shareholder is not bound by their recommendations.

It is quite obvious that matters mandated under the Companies Act, 2013 to move forward only after shareholder approval are extremely crucial and require extensive knowledge regarding the matter to be approved itself. Such issues usually include the appointment of directors, alteration of the Memorandum of Association, or the Articles of Association. However, the horizons extend far beyond these instances in the context of Corporate Governance and Hostile Takeovers. Since a PAF's clientele consists of investors who remain largely unaware of the affairs of a company, these institutions are instrumental in providing them with the necessary resources to carry out their duties.⁴

In this view, it is interesting to note that despite India's liberalization in the 1990s, PAFs have only taken off, as a concept, in the last ten years. Since the introduction of PAFs in India in 2010, investors and shareholders have gradually embraced the idea of employing a third party to help them make decisions based on a statistical analysis of data regarding a company they have a stake in. PAFs offer consultancy on corporate governance and provide voting recommendations to shareholders' voting items of listed companies.

However, a coin has two sides, and so is the case with PAFs, Various caveats need to be considered before jumping the gun with these institutions, given that they influence corporate decisions of a very high magnitude. Predicaments such as conflict of interest and even tampering with the data may cause companies and body corporates to crumble, and investors may lose their fortunes. Handling a task involving information gathering and then recommending investors based on that information must be done as holistically as possible. Still, often this may not be the case.

Facing this issue, with the rise of PAFs, the Securities and Exchange Board of India ("SEBI") stepped and took the initiative to regulate the operations of such institutions to ensure

³ Section 2 (p), Securities and Exchange Board of India (Research Analysts) Regulations 2014.

⁴Debyanka Naskar, Regulating Proxy Advisory Firms in India, Vol.4 No.1, Journal on Governance, National Law University Jodhpur, 2021.

accountability on the advisor's part. On January 1st, 2021, SEBI's circulars on "Procedural Guidance for Proxy Advisors⁵ and Grievance Resolution"⁶ became effective after being amended on December 31st, 2020⁷, thereby causing a paradigm shift in India's Proxy Advisory Industry that is yet to mature. These regulations will certainly have an impact on the up-and-coming PAFs in India as well as shareholders who make use of these services.

Differentiating between PAFs and Investment Advisors

With the introduction of PAFs in India, it was pertinent to differentiate them from Investment Advisors. The latter has existed longer and is regulated by SEBI's separate set of guidelines.

In terms of legal definition, the term 'Investment Advisors' is defined under Regulation 2 (1) (m) of the SEBI (Investment Advisors) Regulations, 2013, wherein it is said to mean a person who is involved in the business activity of providing advice regarding investment in exchange for a consideration. On the other hand, as mentioned before, the SEBI Regulations on PAFs insinuate that proxy advisors are into the business of providing recommendations to a shareholder or an investor concerning crucial tasks they must carry out such as voting decisions on a crucial corporate matter or any matter that may require their approval by law.

Conceptually speaking, the difference between these two entities is based on the fact that investment advisors provide advice that is primarily financial and does not concern themselves with the corporate affairs of a company in any capacity. In contrast, PAFs conduct statistical analysis of a company to suggest the concerned shareholder's voting decisions that can influence the very structure of a company. ⁸An investment advisor would never provide recommendations related to the appointment of a company's director. Similarly, PAFs would never engage themselves in advisory services that pertain to an investor's financial condition and whether or not they should keep/dispose of an investment.

⁵Procedural Guidelines for Proxy Advisors, Circular No. SEBI/HO/IMD/DF1/CIR/P/2020/147.

⁶Grievance Resolution between listed entities and proxy advisers, Circular No. SEBI/HO/CFD/CMD1/CIR/P/2020/159.

⁷Procedural Guidelines for Proxy Advisors, Circular No. SEBI/HO/IMD/DF1/CIR/P/2020/256.

⁸Sharon Pinto, Proxy Advisors and their Role in Corporate Decision Making on questions of law, Taxmann, July 2021.

Even though both PAFs and Investment Advisors are research-based entities, their roles are completely different and can even be employed by an investor simultaneously. With the help of investment advisors, an investor may decide where they should invest their money as they will be recommended the same based on information gathered by the firm or the person. At the same time, the investor will be able to make an educated decision on the alteration of the Articles of Association of a company that would change the internal matters of the same, with the services of a PAF.

The Increasing Relevance of PAFs in India

In India, PAFs primarily gained relevance with their viable role in bettering the standard of corporate governance within companies by keeping shareholders updated on a company's affairs, thereby enabling them in making conscious decisions about governance issues in a company such as matters that are subjected to affirmative voting rights of a shareholder.

The development of Corporate Governance in India occurred with a slow pace. In 2000, nearly a decade after the nation's liberalization, the financial market regulator, SEBI, introduced a structure to corporate governance norms through Clause 49 of the Listing Agreement. However, a majority of the businesses and the shareholders thereof remained passive as there was little to no shareholder activism, especially in the case of governance. Thus, the need for PAFs was not felt.

In 2009, the importance of shareholder activism and corporate governance became increasingly apparent after the infamous 'Satyam Scam' wherein the company Satyam Computer Services Ltd. It could mislead the shareholders and artificially inflate its financial status, thereby committing fraud. In this view, while SEBI did take initiatives to ensure a better standard of governance that could prevent such mishaps in the future, shareholders themselves were becoming aware of how important it is for them to have a detailed knowledge of the companies they have invested in.⁹

⁹Subramanian, S., Proxy advisory industry in India [Conference issue]. *Corporate Ownership & Control*, 13(2), 371-378, 2016.

In this view, Mr. Shriram Submanian, an ex-Infosys Consulting employee, took inspiration from U.S.A. and U.K. markets and founded India's very first Proxy Advisory Firm called "InGovern Research Services" ("InGovern") in February 2010.¹⁰ Shortly afterward, in 2011, India's second PAF was promoted with the name "Institutional Investor Advisory Services India Ltd" ("IiAS") by Mr. Amit Singhvi, who was previously the C.E.O. of Gujarat Ambuja Cements Limited.¹¹

These firms and their founders realized transparency was a two-way street in companies and body corporates. Investors who may be extremely affluent could not always devote their attention to a single company and its affairs. This situation was even more applicable to institutional investors whose interests were vested with an extremely diversified portfolio. Thus, they could not afford to prepare detailed research on all of them. Consequently, these firms took it upon themselves to do the necessary research for shareholders in exchange for a fee and then provide the updated data that would facilitate their decisions on a corporate matter. For instance, InGovern launched a service called 'Governance Radar.'¹² That would analyze a company's governance structure and come up with an online platform specifically for corporate governance. Similarly, IiAs offered various services such as 'Vote Recommendations' and 'C.G. Consulting and Education Service.'

With the fear of being scammed and the introduction of proxy advisory services, a new era of shareholder activism has emerged, gradually increasing the popularity of PAFs in India. The industry for PAFs was conceived a decade ago. It shows tremendous potential for growth, especially when private companies are more motivated than ever to become public companies and get listed on stock exchanges.

Furthermore, the Companies Act, 2013¹³ Also provides a lot of emphasis on corporate governance practices compared to its predecessor in 1956. With the law on their side, PAFs has become increasingly relevant for the Indian market. As a result, shareholder activism has increased, leading to a much better standard of corporate governance in India wherein important events such as a merger or an acquisition are handled well, and the possibility of hostile

¹⁰*Id.*

¹¹*supra* 7.

¹²Role of Proxy Advisory Firms in India, Q&A with Shriram Subramanian, B.S.E. Brokers Forum Magazine, April 2013.

¹³Companies Act, 2013, Act No.18 of 2013.

takeovers is reduced. It is an amazing feat for the PAFs in their first decade. Now that SEBI has been recognized and regulated, the services will only become safer and beneficial for the investors and shareholders.

The Instrumentality of PAFs in M&A Transactions

Proxy Advisory Firms (PAFs) is important corporate governance intermediaries that advise institutional investors on voting, particularly on merger and acquisition (M&A) bids, by researching such proposals and giving recommendations to these investors.¹⁴ These suggestions, which are made public, are also used by individual investors.

With an international reach, PAFs has emerged as a force to be reckoned with, particularly in more developed markets such as the United States.¹⁵ When it comes to M&A transactions, however, having a relatively new effect in the Indian market is advantageous.¹⁶ With SEBI imposing certain corporate governance norms via Clause 49 of the Listing Agreement, 2000, PAFs has become an essential mediator in maintaining corporate governance strategy transactions. PAFs lower investors' costs are conducting monetary operations while increasing value to M&A deals.

A famous example of a PAFs role is the Akzo-Nobel merger case, in which prominent PAFs advice against the merging of three overvalued companies affected institutional investors' vote.¹⁷ Similarly, in the case of the merger of Vedanta Aluminium Limited (VAL) with Sesa Goa and Sterlite India, the proxy companies highlighted concerns about human rights issues and a leveraged financial sheet.

Other agreements, such as the sale of Siemens AG's wholly-owned company and related split transactions between United Spirits and Diageo PLC, were rejected by shareholders based on PAFs recommendations. Furthermore, PAFs in India have effectively handled royalty payments to Holcim by Gujarat Ambuja and ACC, Pantaloon's demerger owing to par prices of DVR shares with equity shares and opposition to Escorts restructuring.

Recently, two PAFs in India, IiAS and SES, who advise Infosys shareholders on informed voting decisions, advised shareholders not to vote for Prof Jeffery S. Lehman as the company's

¹⁴ Paul Rose, On the Role and Regulation of Proxy Advisors, 109 MICH. L. REV. FIRST IMPRESSIONS 62 2010.

¹⁵ James R. Copland, Yevgeniy Feynman & Margaret O'Keefe, Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism 22 2012.

¹⁶ Naren Karunakaran, Proxy firms wade through proposed resolutions, THE ECONOMIC TIMES, Nov. 29, 2011

¹⁷ Role of Proxy Advisory Firms in India, INGOVERN India, at <https://www.ingovern.com/2015/02/shareholder-activism-in-india>

independent director. The lengthy affiliation of Prof Jeffery S/ Lehman with the corporation is the foundation for opposing the appointment. The consulting company assisted per the Companies Act of 2013. "SES does not consider directors linked with the firm for more than ten years to be independent," they stated. This demonstrates that the recommendations of these consulting companies aid in the maintenance of good governance standards in the organization. Even so, the operation of PAFs does raise several concerns, including the independence and impartiality of recommendations, profit-making through advice from firms, the formation of a possible or actual conflict of interest, and measurement inaccuracies. SEBI has already sought to address such concerns with two recent circulars issued by SEBI that are discussed later in this paper. These laws are included to ensure commitment and reduce conflicts of interest if such PAFs represent both shareholders and management and increase the efficiency of business transactions like M&As. Thus, PAFs may significantly assist in the efficiency of M&A transactions while supporting good governance practices within a particular legal framework.

Understanding the SEBI Regulations on PAFs

The SEBI Regulations came way back in 2014, merely four years after the introduction of InGovern, India's first PAF. These regulations were called the SEBI (Research Analysts) Regulations, 2014 for the simple reason that these firms were considered to be research-based entities and nothing more. However, the regulations are rather progressive because they govern vital issues that were bound to come up with the rise of PAFs and their activity in India. The Stakeholder Empowerment Services ("SES") became the first PAF to register under these regulations. These issues were primarily of three kinds:

1. **Conflict of interest-** Considering that PAFs is a third-party service that isn't exclusive to a particular industry, it was understood that an investor of any company could approach them. Subsequently, with their consultancy services catered to the companies themselves, it became important to separate their operations to prevent any harmful effect on shareholder interests. In this context, Chapter VIII of the SEBI Regulations deals with the management of conflict of interest and disclosure requirements that shall apply to PAFs.¹⁸

¹⁸Chapter III, Procedural Guidelines for Proxy Advisors, Circular No. SEBI/HO/IMD/DF1/CIR/P/2020/256.

By Regulation 15 (1) of the same, the research-based entities have to maintain a set of internal policies that govern operations of any research analyst for addressing and acknowledging any actual or even potential conflict of interest that may arise from their work. Moreover, Regulation 17 also provides conditions about the compensation of a research analyst that must be reviewed by the Board of the concerned entity and shall be independent of any other services division. It is important to note that this issue was reiterated in the Procedural Guidelines issued by SEBI in August 2020, which was later amended on December 31st, 2020.¹⁹

- 2. Material misstatements and factual errors:** Since proxy advisors deal with a form of due diligence prepared especially for the shareholders, their research may not always be accurate. It may even get to a point wherein a slight miscalculation could lead to unpredictable consequences. Thus, these research-based entities have been mandated to disclose their reports the extent of research involved in a particular recommendation made to the shareholder under the ambit of Regulation 23 of the SEBI Regulations.

Subsequently, Regulation 20 also prescribes that the research entity shall take adequate steps to ensure that the reports they provide to their clients are based on reliable information collected, with the definition of all consistently used terms being provided within the same.²⁰If such an entity employs a rating system for their recommendations, they shall define the benchmarks about such a system within their reports.²¹.

- 3. Difference of opinion with Companies:** Lastly, provided that PAFs are in a rather sensitive spot due to the very nature of their work, they tend to set out policies and benchmarks that may even supersede statutory requirements. In some cases, these standards may be too extreme for the companies to agree with the PAFs. In this view, it has been discussed in a committee report provided by SEBI that in case of a difference of opinion between the research entity and the company, the parties must exhaust all options before approaching SEBI to intervene in the matter or going for litigation of the dispute.

¹⁹*supra* 6.

²⁰Regulation 20 (a), Procedural Guidelines for Proxy Advisors, Circular No. SEBI/HO/IMD/DF1/CIR/P/2020/256.

²¹Regulation 20 (b), Procedural Guidelines for Proxy Advisors, Circular No. SEBI/HO/IMD/DF1/CIR/P/2020/256

However, there must be a certain standard of the differences as well. For instance, differences based on the opinion backed by factual data and research cannot form the basis of litigation. Essentially, there should not be any trivial issues between the parties based on an unfavourable opinion without any real substance.

Decoding the SEBI Guidelines for PAFs in India

After the SEBI Regulations were set in the industry and taught into the practices of PAFs, SEBI produced three circulars within which it had laid out certain procedural guidelines for proxy advisors and grievance redressal mechanism resolution of disputes between listed entities and PAFs. These circulars were provided on August 3rd, 2020, and August 4th, 2020, after which an amendment was issued on December 31st, 2020. It is to be noted that these guidelines were the first of their kind as they had stipulated categories for disclosure requirements for PAFs.

These circulars showcase some of the key recommendations made by a SEBI Working Group in its "Report on Issues Concerning Proxy Advisors."²² Such as providing more emphasis on conflict of interest, voting recommendations, a grievance redressal system, and the fiduciary duty that PAFs have concerning the shareholders.

The circular about grievance redressal, in particular, suggests a remedial model by which the concerned listed companies may be able to approach SEBI if they find a PAF violating the procedural guidelines set forth by SEBI on August 3rd, 2020.

In essence, the guidelines²³ mandate the following steps for all PAFs in India, effective from January 1st, 2021:-

- The PAFs must formulate and adopt a voting recommendation policy that defines the exceptional cases when such recommendations shall be exempted. This policy must be disclosed to a PAF's clients and reviewed on an annual basis.
- A structured process must outline the interaction between the clients and the company. Additionally, a timeline must be stated to receive any comments from the company concerned.

²²Report of Working Group on Issues Concerning Proxy Advisors, Securities, and Exchange Board of India, July 2019.

²³*supra* 6.

- There must also be a policy governing sharing information collected by the PAF with the clients and the company simultaneously. This policy must also be available online on the PAF's website to freely access the clients and the company.
- The PAF must also disclose its research methodology employed to collect data on the concerned company for its clients to ensure transparency in its process.
- The proxy advisors shall ensure the accuracy of the information in their report by clarifying any contentious issues with the company through any comments made by them. In this context, a supplement shall be provided in their report highlighting the same, and their recommendations must be revised by the same.
- Any factual errors or miscalculations in their research should also be disclosed within 24 hours of receiving the rectified information. Consequently, their reports shall reflect the corrected version of the data presented for a recommendation.
- Furthermore, the PAFs must also disclose the legal requirements they teach in their working agreement and are obligated to specify any higher standards of governance they may be employing.
- Lastly, the circular emphasizes a strong conflict of interest policy which shall contain the procedure to disclose any potential conflict of interest discovered by the PAF and mitigate the same.

Suffice it to say, these procedural guidelines are viable when put in the context of a PAF's usual practice of gathering information and providing voting recommendations to their client shareholders. In this view, it can be reasonably assumed that these guidelines will significantly impact not only the existing PAFs in India but also any PAFs that are instituted in the future, thereby making the standard of governance within these firms more stringent than they have ever been in India.

Comparative Analysis with the USA's Proxy Advisory Industry

While the Proxy Advisory Industry in India is yet to mature, other jurisdictions such as the USA have a developed market for the same. In contrast, the USA's PAF industry emerged in the mid-1980s itself through the establishment of the 'Proxy Monitor' in 1984 followed by the 'Institutional Shareholder Service Inc.' ("ISS") in 1985. This seemed to be more than an

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expected outcome given the capitalist nature of the USA's economy and the subsequent evolution of a securities market.

The position of PAFs in the country was legitimized when the U.S. Department of labour emphasized that the voting of proxies of shares owned by a pension plan was a part of its fiduciary duty to manage assets that were included in employee benefit plans. This development led to an immediate demand for PAFs as the management responsible for such plans sought help from experienced research analysts to satisfy their fiduciary obligations to vote proxies in the best interest of their clients.

By the 1990s several other institutions such as Marco Consulting Group ("MCG") came up as well and the industry saw a rise in PAFs. However, ISS still dominated the industry as it had a 'first to the market' advantage given that it dealt specifically with institutional shareholders. With the increase in 'Mergers and Acquisitions' transactions in 2001, the ISS's popularity grew in a steadfast manner so much so that it acquired its competitor, Proxy Monitor in 2001. As of 2014, Vestar Capital Partners acquired the ISS from its former parent company, MSCI Inc. as Glass Lewis started gaining market share in the PAF industry of the USA and became the second most prominent firm.

The real purpose of PAFs was realized in 2001 with the wake of corporate scams such as the fall of Enron Corp. that largely occurred due to Enron's dubious accounting practices, including a technique known as "mark-to-market accounting" that allowed the company to record to unrealized future gains from some trading contracts into current income statements, thus giving the illusion of higher current profits. A number of other tactics were used such as the employment of 'Special Purpose Entities' ("SPE") for its troublesome operations. Much of the blame was attributed to the ignorance of the shareholders as they allowed Enron's executives to mismanage funds coupled with poor corporate governance. In this context, the need for shareholder activism was realized and PAFs like ISS were seen as an instrumental tool to achieve the same.

This seems to be a trend with PAFs in emerging markets as even in the case of India, the market for PAFs was only made possible due to the 'Satyam Computers Scandal' which led to growing shareholder activism in the nation.

The point of distinction between the two market stands to be the fact that the USA has much more sophisticated market for PAFs with various firms with ISS and Glass Lewis being the

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dominant players, the Indian PAF industry really only has three prominent firms, the IiAS, SES and InGovern, . Indeed, the USA's market is, in a way, much more mature given that it has 30 years over the Indian market, yet the growing securities market in India is yet to effect a change to the existing arrangement.

Nevertheless, the recent inclination of the Indian companies towards an Initial Public Offering ("IPO") and the emergence of innovative start-ups with the same goal could trigger the Indian PAF market to mature and even surpass the trajectory of the USA. It may even be possible that only InGovern and IiAS compete with each other for market share by scaling their services across the nation. While it may prima facie seem to be an unlikely scenario, it could very well be the arrangement of the PAF industry in India for a considerable amount of time.

Concluding Analysis

We have gone through a comprehensive take on Proxy Advisory Firms in India throughout this research paper. It is understood that PAFs is a unique idea aimed at making the functions of shareholders more convenient, especially in terms of governance regarding the concerned companies. Much like any industry, as soon as the Proxy Advisory in India took off, the need to regulate their operations became apparent, especially in light of the financial scams such as the 'Satyam Scam' that gave rise to such firms. Additionally, the sensitive nature of their work also made it important to ensure that the risks regarding PAFs were minimized so that shareholder interest was protected.

Therefore, SEBI's regulations and the procedural guidelines that came subsequently were most definitely a necessity and did fare well in regulating the workings of a PAF. However, the regulations are still not as exhaustive as they should have been. Several aspects have been left ambiguous and may cause a problem shortly. These predicaments may arise because SEBI has not clarified the implementation process enough regarding differences of opinion and conflict of interest.

Nevertheless, there are various positive features as well. Introducing a grievance redressal mechanism and the mandate about disclosures are welcomed additions to India's existing legal framework. However, it would still be premature to predict whether introducing these guidelines will cause friction in the industry. Still, it can be reasonably assumed that they should lead to a better corporate governance standard despite its shortcomings.

As of now, PAFs are not as prevalent given that there are only two major firms, InGovern and

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IiAS, that hold most of the market share. Additionally, the abundance of family-owned businesses also makes it difficult for any minority shareholders to question the authority of the promoters who usually own the majority shareholding and thus dominantly run the company.

Yet, what is important to realize is that the Proxy Advisory Industry in India has established its ground by passively increasing shareholder activism within companies and making the management of a company more responsive towards the needs of the shareholders. Now that India has had a surge in the incorporations of 'Start-up' companies that are not family-based business entities, the PAFs can be employed by majority shareholders and provide recommendations that can entirely change the trajectory of a company.

In this view, it can be predicted that this is not the end for regulations on PAFs in India. As new PAFs come up offering various services to both the shareholders and the companies, new regulations will be issued to regulate the same by SEBI. Therefore, even though the legal framework surrounding PAFs in India has been sufficient so far, the introduction of the procedural guidelines by SEBI indicated that with the rise of the industry, the standards for its governance must be increased.

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