excellence enablers CORPORATE GOVERNANCE SPECIALISTS
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Expert Expressions
Corporate Governance Demystified

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They have suddenly surfaced centre-stage, and that too with a bang. In recommending against the reappointment of one of the Icons of India Inc, proxy advisory firms have turned the searchlight on themselves.

Messengers or messiahs? Disproportionate influence of mere advice? Like them or not, you ignore them at your peril.

Editor

SHOOTING THE MESSENGER?

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The trinity of age, attendance and tenure has begun to haunt corporate Boardrooms. Resolutions for reappointment, of Directors, which used to be passed by shareholders without discussion or debate, have become conversation pieces within and outside of Annual General Meetings. The credit, if one might call it that, goes entirely to a relatively latter-day phenomenon in the governance space - Proxy Advisory Firms. While their recommendations cover a whole gamut of issues, the focus herein, courtesy a recent episode, is on the resolutions relating to reappointment.

The role of proxy advisory firms, as also the manner in which they go about their business of making recommendations, has been the subject of considerable debate in the last few weeks. At one end of the spectrum are allegedly detached observers, welcoming shareholder activism, riding on the advice of proxy advisory firms. At the other end are insiders, wondering aloud, whether outsourcing of thinking, and decision making, is healthy for the corporate sector.

The facts first. Foreign institutional investors with investments in corporate entities across several jurisdictions, often find it a challenge to keep abreast of every relevant development in the investee companies. Resultantly, they fall back on the advice given to them by proxy advisory firms in regard to whether they should, or should not, support a resolution being brought by the management to the shareholders for approval. It is no one's case that the recommendation of the proxy advisory firms is not preceded by adequate indepth research. Regrettably, however, recommendations are often the outcome of a mechanical application of predetermined criteria, without taking into account the specifics of the company that has been thoroughly researched.

In the Indian context, decisions on whether or not to support resolutions, are based almost entirely on the recommendations of one or more of the 2 proxy advisory firms in the US, and/or one or more of the 3 proxy advisory firms in India. These firms are, more often than not, the providers of resolution-specific advice to institutional investors from outside of India. The reported disconnect in the manner in which advice is given stems from the fact that whereas fund managers are the persons likely to interact with company managements, the advice of proxy advisory firms is received, and acted on, by compliance officers who instruct custodians to exercise their votes. Since agreeing with the recommendations of the proxy advisory firms is much the easier option, it is fair to presume that application of mind is minimal. This also manifests herd mentality among institutional investors. That a mechanical application of guidelines could be disruptive and could go against the interest of the shareholders, institutional or retail, does not seem to merit adequate attention.

It is time to revisit the trinity. Age is a good starting point. Internal guidelines of some of the proxy advisory firms are to the effect that persons above the age of 70 should be "persuaded" not to remain on Boards. The fact that the Regulator, having applied its mind, has indicated that the election of persons above the age of 75 would need a special resolution does not seem to have persuaded these firms to revise their criteria. There is increasingly a clamour for younger Boards. Considering that the Board of Directors is the seat of wisdom, which among other things is a function of age, it is incomprehensible why the considered decision of the Regulator should be second-guessed by prescribing a lower age limit.

Attendance, or the lack thereof, is the second stick with which to beat a Director coming up for re-election. There too, there is a mechanical approach leading to persons having less than 75% attendance being treated as not serious enough to merit a Board position. The possibility that there could be emergent last minute reasons for a Director to miss out on a Board meeting does not seem to concern the advisors. Further, in some companies, which are in the process of acquisitions or dealing with contentious court matters, there is often the requirement of holding Board meetings with very little notice, making it next to impossible for many Directors to participate, even through video conferencing. With a few such meetings taking place, without the attendance of the entire Board, there could be a situation where an individual Director falls short of the stipulated minimum of attending 75% of the Board meetings. It does not need extraordinary powers to conclude that a Director who missed out on a few meetings convened at very short notice should not be considered as a non-serious Director.

The third element which stands in the way of many Independent Directors continuing as such is tenure. For reasons that one can quarrel with, the lawmakers decided that tenure before the commencement of the Companies Act, 2013, which came into effect in 2014, would not be relevant, and that only tenure post the appointment to the Board in terms of the Companies Act, 2013 would be taken cognisance of. The negative fallout of this prospective application of restriction of tenure meant that many persons who had been on the Board for decades, got a fresh start in 2014. As a result, the term of appointment of an overwhelmingly large number of Directors will come to an end in 2019. Some of these Directors may not seek re-election, for personal reasons, including the fear of increasingly strict penal provisions and the laundry list of liabilities.

Focussing on the attendance details for only the previous year is unlikely to give a clear indication of the time devoted by the Director concerned throughout the term of his/her appointment. It is also imperative for persons acting on such mechanical advice to consider that in some cases, the whole Board will be exiting at the same time. That such an event could be destabilising and disruptive is as plain as daylight.

In their defence, some proxy advisory firms have argued that they attach the highest importance to the contribution made by Directors. It is difficult to comprehend how persons sitting far away from the Boardroom, and without the omniscience of God, Government and Google, are in a position to assess or appreciate the contribution of individual members of the Board, unless they explain contribution only in terms of attendance records. It is useful to remember that in many Boards, there are value-adding serious professionals, who, for good reasons, are unable to attend all meetings. Yet, as insiders know and appreciate, the contribution of such Directors, within and outside Boardrooms, is often critical. A mechanical application of the minimum attendance requirements would remove such value-adding Directors from corporate Boardrooms.
A continuing constructive conversation between the proxy advisory firms and management will help the former understand and contextualise the resolutions that they are required to examine, with a view to formalising their recommendations. The demand that proxy advisory firms, advising on Indian companies, should be regulated in India, is at best a sub-optimal solution. Engaging with the companies is what the situation requires.

There is reasonable evidence to conclude that foreign proxy advisory firms do not factor in Indian realities while making their recommendations. The disconnect perhaps owes itself to a fundamental flaw in the Corporate Governance framework in India, which is that the shareholding pattern, and the existence of promoters, are not in sync with western Corporate Governance models and conclusions based thereon.

Blaming proxy advisory firms for sub-optimal decisions by investors is understandably unfair. Shooting the messenger is an avoidable pastime. However to escape blame, the messengers need to be dispassionate in their recommendations and address any possible conflicts of interests arising from ownership or additional revenue streams. In the ultimate analysis, the recommendations of the proxy advisory firms are meant to result in informed investing. The moot question is when they inform, should investors mechanically conform?

Readerspeak – Referees in the Regulatory Space

"S. Sandilya, Chairman, Eicher Motors"
"I agree with you that the regulatory organisations must be financially self-sufficient and not have any linkage with the powers that be for their day to day operations."

"Sabyasachi Hajara, Former Chairman Shipping Corporation of India"
"Total independence in every sense and full autonomy of the Regulators distinctly improves the level of comfort for the investors."

Do let us know of any specific issues you would like to see addressed in subsequent issues.