PROXY ADVISORY FIRMS – ADVICE AS A VICELIKE GRIP?
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MUMBAI

SUMMARY OF DISCUSSIONS

CONTEXT SETTING

With institutional investors increasingly voting according to the recommendations of proxy advisory firms, the question arises whether thinking on resolutions has been outsourced. Should advice be treated as an input in the decision–making process or should it be unthinkingly endorsed when it comes to voting on resolutions? Does disproportionate power reside in proxy advisory firms? Is there accountability in the advisory process?

DISCUSSIONS

- Proxy advisory firms collect facts and put out recommendations. The recommendations are not binding, but most institutional investors vote according to the recommendation since the investor has to record the reasons for voting against the recommendation, and most investors do not want to do so.
- In the US, herd mentality in voting is observed much more than in India, where institutional investors sometimes disregard the recommendation. The perceived problem is with the investors, and not the advisory firms, which are only carrying out their business.
- A number of companies feel that the firms' recommendations are mechanical. However, their guidelines for voting mention that for a number of parameters, their recommendation would be decided on a case-to-case basis.
- These firms influence investors only for voting, and so do not have a disproportionate influence, as is felt by some companies.
- It is believed that over time, these firms have the potential of becoming very powerful if they have not already become so.

SECOND GUESSING REGULATOR

- In India, law and regulations stipulate criteria for various Corporate Governance related parameters, such as, maximum number of Boards for a Director, Related Party Transactions (RPTs) etc.
- It is seen that the firms have made stricter stipulations which is not appreciated by a number of companies.

FIRMS AND INSTITUTIONAL INVESTORS (especially Mutual Funds)

- While mutual funds (MFs) factor in the recommendations of the firms, they also have an internal view. Their final decision is based on a combination of both these.
- This also becomes important if different proxy advisory firms have different recommendations.
- In most MFs, the fund manager engages with the company, but the compliance officer is the person who communicates the decision to the custodian. There is a possibility that with the compliance officer deciding, the decision is mechanical. The final decision is said to emerge from discussions among a few persons within the organisation.
    - Since SEBI has to be given a report on the voting pattern, and since this is the compliance officer's work, voting too falls in her domain.
    - For a fund manager, whose primary job is to decide on buying/ selling/ holding, it is rarely possible to keep track of all the resolutions that come up in all the companies in which she has invested, and take a decision on the voting, especially since most Annual General Meetings are bunched in two months time period in India. As a result, this work is assigned to the compliance officer.

- However, the inputs of the fund manager are factored in, and if her voting stand on similar issues changes over time, it is the duty of the compliance officer to flag this internally. But in doing so factors such as wrong past decisions, changes in ground realities etc., could be given short shrift.
- Annually, MFs have to disclose their voting to SEBI, and the same is available on the website of Association of Mutual Funds of India (AMFI). In case there has been an unexplained movement in price of some shares, SEBI can question the fund. However, even though the insurance sector in India is sizeable, and invests large sums in the market, it has no similar regulations. In the US, there are no similar disclosures required.

FIRMS AND COMPANIES (for which they are recommending)

- Listed companies should behave maturely when it comes to the recommendations of these firms.
- Some companies have a mindset issue. They often incorrectly believe that a young analyst from these firms should not have an opinion on the resolutions, especially those pertaining to Directors, given their seniority. These companies lose sight of the fact that the analyst basis her opinion on facts, and not on personal biases, if any.
- Some companies also believe that the recommendations of the firms should not be "for" or "against" alone. They should divide their recommendations into compliance and their recommendation, so that investors can differentiate between compliance and good practice. However, this could result in ambiguity with the firms not giving any clear recommendation.
- The US firms, and to a limited extent the Indian firms, do not engage adequately with the companies. But regulating these firms would not help solve this problem.
- While the Indian firms do send their reports in advance to companies to check for facts and have a limited discussion, the US firms do not follow this practice.

PUSHING FOR HIGHER STANDARDS OF CORPORATE GOVERNANCE

- Overtime, these firms, especially the US firms, have been raising a number of issues in governance, such as Director re-appointment, Director time commitment (including on advisory boards), CEO compensation, employee stock option plans (ESOPs), RPTs etc., which would otherwise not be discussed by investors.
- This has resulted in increased constructive discussion and debate on corporate governance.
- Since this is a new phenomenon, companies may feel that these firms are extreme in their views. Earlier, a number of companies had a similar negative reaction to adverse research reports. However, companies have "grown up" and got used to these views.

REGULATING PROXY ADVISORY FIRMS

- Even though it is very difficult to regulate these firms, the three Indian firms are regulated by SEBI under the regulations for analysts. In addition to inspections, they are checked for conflict of interest (loosely defined), insider trading and front running. However, each of these aspects have their own regulations, under which the firms will be logically covered.
    - Conflict of interest could arise from ownership of these firms (to check for bias in recommendations) or consultancy assignments.
- A demand has been raised by some to also regulate the two US firms since they have presence in India.
- In the US, the two US firms are not regulated because freedom of speech is a sacred right. Further, the advice of these firms is only in the form of guidelines, and is legally permitted. In the absence of adequate disclaimers, these firms can face a class action suit. Therefore, the threat of legal action rather than regulation is the reason for good conduct.
- A number of companies feel that this is especially important so that the firms are held accountable for incorrect information and the nature of views expressed.
- However, these firms have a legal right to operate as long as they do not violate any law.

- Since these firms deal with a large number of resolutions, a case for regulation cannot be made on account of a few genuine mistakes by these firms. However, in the event of a conflict of interest or proven malafide interest, there could be a case for some regulation.
- A limited regulation for Indian firms is counterproductive since in addition to it not extending to the US firms, it would be impossible to discontinue the regulations at a later stage when these firms mature.
- All this makes it practically impossible to regulate these firms. The view of regulating only the Indian firms is also wrong since the US firms too have their offices in India.

POSSIBLE WAY AHEAD FOR COMPANIES

- Companies should understand that there is a role for these firms and should proactively reach out to them for a constructive engagement. The engagement should not be restricted to only the secretarial department.
- In case companies are unable to engage with these firms, they can directly engage with their investors to explain certain resolutions to help them arrive at a decision. The objective should be to improve the quality of decision making.
- Quality of explanation with each resolution should be improved, and where possible, should state the case of the company, so that investors can take an informed decision. The website of the company can be used for active engagement, and the explanation can move beyond the standard restrictive information that is given at present.
- Including a clause in the contract with these firms to the effect that they will engage with the management of the company would not help since it is possible that the engagement is superficial (from either side). If the investor really wants to know, they can check with the firm if they engaged with the company, and based on the response, take an internal call on the voting.
- These firms can be viewed as catalysts for improving the capital market, and improving the quality of debate on corporate governance.
- While companies and individuals may not agree with their recommendations, they should take advantage of these firms' raising the right issues.

EXCELLENCE ENABLERS PRIVATE LIMITED

Excellence Enablers Private Limited (EEPL) is an initiative that focuses on implementation of better corporate governance practices, improvement of Board performance, including audit and evaluation, training of directors and engagement with stakeholders of governance. It is founded on the firm belief that the gap between performance and potential can, and must, be bridged. Consistent with that belief, all our offerings are tailor-made to the specific needs of the organisation or the individuals concerned.

Given that our founder, Mr. M. Damodaran, introduced Clause 49 of the Listing Agreement, dealing with corporate governance in India, and has been a part of both public sector and private sector Boards, as well as performing and underperforming Boards, we offer experience based consultancy and courses on the journey from compliance through governance to performance. Further, given his success in turning around organisations that had been written off, we are uniquely positioned to offer courses on leadership, organisational transformation, and building winning teams.

EEPL has a number of highly experienced and renowned consultants and faculty members who have helped, and continue to help, us deliver programmes that have been well received.