

The proxy adviser regime in India: ingraining principles of natural justice in corporate governance

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Sharad Abhyankar

Khaitan & Co, Mumbai

sharad.abhyankar@khaitanco.com

Rabindra Jhunjhunwala

Khaitan & Co, Mumbai

rabindra.jhunjhunwala@khaitanco.com

Saranya Mishra

Khaitan & Co, Mumbai

Saranya.mishra@khaitanco.com

A 'proxy adviser' is any person who provides advice, through any means, to institutional investors or shareholders of a company, in relation to the exercise of their rights in the company, including recommendations on public offerings or voting recommendations on agenda items. Since the implementation of the Companies Act 2013 (the 'Act') and enhanced corporate governance standards under Securities and Exchange Board of India (SEBI)(Listing Obligations and Disclosure Requirements) Regulations 2015, the role of proxy advisers has become more prominent. Over the last few years, proxy advisers have been at the forefront of advocating compliance with stringent corporate governance norms. Their recommendations have been responsible for shaping increased disclosures, transparency and compliance with the best corporate governance practices by many listed companies in India.

Proxy advisory firms have proved to be influencers of a sizeable proportion of voting power among institutional and large retail investors in India. Having attained this major role in the securities market, proxy advisory firms are also required to demonstrate their functioning as a fiduciary market participant rather than a mere investment adviser. The fiduciary role is far more complex than many other securities market intermediaries.

At the outset, the work undertaken by proxy advisers is rather benevolent as it caters to the shareholders' value and enables them to exercise the supposedly supreme right of voting. However, there is an inherent deficiency in the working model of proxy advisers due to limited interaction with the company and the limitation on information that has to be sourced from the public domain. It is possible that the information available in the public domain may not be complete or accurate, or may even lack context. This can lead to misleading conclusions and errors of judgement in making voting recommendations. A vote cast by an investor by adhering to such recommendations is bound to have ramifications on the company's corporate governance in the first blush. It may also have a ripple effect on its decision-making, similarly placed companies, and the sentiments and perceptions of the securities market. While such recommendations may be made in good faith without knowledge of information being blemished, human factors such as bias or conflict of interest cannot be entirely eliminated. This gives rise to the fear of proxy advisers being dubbed as market influencers in a negative sense. It therefore becomes necessary and crucial for there to be certain supervision exercised over proxy advisers by the market regulator. Very few jurisdictions have tightened regulatory oversight over proxy advisers and set standards for other jurisdictions to emulate. The United States and India have arguably been at the forefront of regulating the mischief that can be caused by proxy advisers by attempting to regulate them.

Glimpses of the Indian regulatory regime

SEBI, as the market regulator, has exercised its power and jurisdiction to set up a framework for proxy advisers in India. The timeline for the evolution of laws regulating proxy advisers in India is as follows:

September 2014

SEBI (Research Analysts) Regulations 2014[1] (the 'RA Regulations') were the first laws that explicitly brought proxy advisers under the legal radar. Although the regulations were elementary, they mandated:

registration with SEBI to undertake the proxy advisory business in India;

disclosures in the recommendations made by proxy advisers;

formation of internal policies and procedures for functioning; and

maintenance of records of the recommendations made.

The RA Regulations also set out the basic framework for a disciplinary code of conduct, which consisted of eight principles: obliging 'honesty and good faith'; 'diligence'; 'confidentiality'; 'professional standard' and 'compliance' of all regulatory requirements; addressing 'conflict of interest'; prohibiting 'insider trading or front running'; and fixing primary 'responsibility' on senior management.

November 2018

SEBI formed a working group to provide inputs and insights into the 'issues related to proxy advisers'. The working group was required to review the provisions of the RA Regulations and functional areas of proxy advisers, including rights and obligations. The working group was also expected to reflect on other matters pertaining to proxy advisers.

May 2019

The working group issued its 39 page report[2], addressing various aspects of proxy advisory firms, which were categorised in buckets of: 'conflict of interest, governance and disclosures'; 'infrastructure and skills requirement'; 'voting, fiduciary duty and information sharing'; 'interaction with corporates'; 'setting basic industry standards'; 'cost and competition'; and 'additional points'.

The suggestions of the working group were grounded in increasing disclosure requirements, the formulation of an elaborate practice-based code of conduct and certain amendments in the law, inter alia, to provide for a dispute resolution mechanism between the company and proxy adviser, revamping certification norms, mandating continuing education, the formulation of a voting/stewardship code for multiple institutional investors and internal working policies, such as voting guidelines being made public. The working group even suggested the proxy advisory service being extended to retail investors, and the recommendations being made available through stock exchange websites for the benefit of the masses. The working group suggested regulatory development on a 'comply or explain' basis, with a pilot run through the introduction of a set of best practices and adoption of an industry-wide stewardship code.

The report was released for public comments in July 2019.

August 2020

SEBI, by way of Procedural Guidelines for Proxy Advisors[3] issued on 3 August 2020 (the 'Procedural Guidelines') and the Grievance Resolution between listed entities and proxy advisors[4], issued on 4 August 2020 (the 'Grievance Resolution Circular') (collectively, the 'SEBI Circulars'), which introduced a new regime for proxy advisers in India.

The SEBI Circulars have increased disclosure requirements for proxy advisers and mandated certain compliances from a good housekeeping perspective, such as policies for voting recommendation, conflict sharing, communication and sharing of recommendation policies. This goes a long way towards streamlining the working of proxy advisers, and prompts them to be more transparent. The SEBI Circulars are expected to have wide implications on the market as a whole as the disclosure requirements add to the responsibilities (including fiduciary duty) of proxy advisers, especially because proxy advisers can be pulled up for non-compliance thereof.

Interestingly, the SEBI Circulars were issued shortly after a similar move[5] by the Securities Exchange Commission in the US, and there are certain similarities.[6]

Two-way communication

Agnostic of the proxy adviser business model, the Procedural Guidelines have set up a channel of two-way communication between the listed company and the proxy adviser. Accordingly, the interaction between the company and the proxy adviser has undergone a paradigm shift.

Prior to the SEBI Circulars, there was discretionary, limited or no interaction between the duo (see Figure 1). More often than not, the company would not be approached by the proxy adviser for preliminary data gathering, or even subsequent data verification.

With the mandatory requirement of interaction between the company and proxy adviser, the engagement between the duo has increased manifold (see Figure 2).

Under the Procedural Guidelines, the proxy adviser is now required to share recommendations with the company at the same time as sharing them with the investor. The company has the right to respond with its comments and clarifications, or explain the

rationale or context of a proposal in a time-bound manner. Duty is cast on the proxy adviser to relay these comments and clarifications to the investor through an addendum, with revisions, if any, to the recommendations.

This two-way channel of communication bolsters a company's right to be heard and comment. This gives an opportunity to the company to defend its actions in the instance that the proxy adviser is operating at a higher threshold than applicable law to make an adverse recommendation. The right, however, is available to the company only in respect of voting recommendations and not in respect of addendums or other consultation by the proxy adviser to the investor.

From a company's point of view, this right plugs the information gap and the mischief that may be caused by such a gap, and consequently saves the day for the company, as misinformation is avoided.

While the SEBI Circulars offer the right for the company to interact with the proxy adviser, the scope of such communication is limited and must be handled with utmost caution. The Act mandates that the company has to set out all material facts in the explanatory statement annexed to the notice calling a general meeting or seeking a postal ballot. The exchange of communications between the proxy adviser and the company may not be available in the public domain, and this itself may create information asymmetry between shareholders seeking voting recommendations, and others. If the company's response to a voting recommendation includes information, a rationale or justification that cannot be sourced in the explanatory statement itself, the validity of the notice (and consequently the general meeting) may be questioned.

Time shall be the true test of which point of view gains acceptance once the SEBI Circulars become operative.

Grievance redressal mechanism

Through the Grievance Resolution Circular, SEBI has placed itself as an arbiter between the company and the proxy adviser should there be an instance of non-compliance of the guidelines by the proxy adviser. In the case of non-compliance, the company may approach SEBI, which shall further examine the matter.

The grievance redressal mechanism, although primarily meant to resolve disputes between the company and the proxy adviser, is also a means for the company to enforce its right of being heard and, to that effect, is a prescribed remedy for the said right. Accordingly, the SEBI Circulars read conjointly ascribe legal rights that are with recourse or remedy and align with the principles of natural justice and equity.

Conclusion

Notably, India is one of the very few jurisdictions that has attempted to regulate proxy advisers, and has thus placed itself in the unique position of setting a precedent for other countries to take inspiration from. Suffice to say that SEBI has not only been a proactive regulator, but also exhibited traits of a good policy-maker by way of inculcating jurisprudential principles in corporate practice. Although more regulatory developments are expected to implement the suggestions of the working group, it would be interesting to see whether the new regime will have a meaningful impact on the functioning of proxy advisers or become a normative coefficient in the regulatory space. Depending on how India Inc reacts to this, it would also determine whether proxy advisers are sleuths for investors or a consigliere instead.

Another aspect that would require deeper scrutiny is how the grievance redressal mechanism unfolds in action. Most voting recommendations are expressions of opinion based on judgement, principles and standards of corporate governance adopted and adhered to by a proxy adviser. It is more than obvious that opinions differ. It would be worth researching how SEBI interprets the meaning of disputes or conflicts when they arise out of differences of opinion and judgement as regards advising shareholders to vote against a resolution. At this stage, it is not clear what remedy would be offered by SEBI at the end of such a grievance redressal process.

The SEBI Circulars were initially due for implementation effective 1 September 2020, however, SEBI has extended the implementation timeline of both Procedural Guidelines[7] as well as the Grievance Resolution Circular[8] to 1 January 2021, considering the representations by proxy advisers, and the business and market conditions on account of the Covid-19 pandemic.

Notes

[1]See www.sebi.gov.in/sebi_data/commondocs/RESEARCHANALYSTS-regulations_p.pdf accessed 11 November 2020.

[2]See www.sebi.gov.in/reports/reports/jul-2019/report-of-working-group-on-issues-concerning-proxy-advisors-seeking-public-comments_43710.html accessed 11 November 2020.

[3]See www.sebi.gov.in/legal/circulars/aug-2020/procedural-guidelines-for-proxy-advisors_47250.html accessed 11 November 2020.

[4]See www.sebi.gov.in/legal/circulars/aug-2020/grievance-resolution-between-listed-entities-and-proxy-advisors_47252.html accessed 11 November 2020.

[5]See www.sec.gov/news/press-release/2020-161 accessed 11 November 2020.

[6]See www.khaitanco.com/thought-leaderships/Tightening-the-noose-on-proxy-advisors-influencers-of-India-Inc accessed 11 November 2020.

[7]See www.sebi.gov.in/legal/circulars/aug-2020/procedural-guidelines-for-proxy-advisors-extension-of-implementation-timeline_47412.html accessed 11 November 2020.

[8]See www.sebi.gov.in/legal/circulars/aug-2020/-grievance-resolution-between-listed-entities-and-proxy-advisors-extension-of-timeline-for-implementation_47424.html accessed 11 November 2020.