

# PROXY ADVISORY INDUSTRY IN INDIA

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## Abstract

Proxy advisory firms play a significant role in shareholder voting and in the formulation of corporate governance policy. This paper analyses the status of budding proxy advisory industry in India using a case study method. The paper first traces the history of the global proxy advisory industry and also reviews the literature. Then we study the Indian Proxy Advisory Industry, which was born when the market regulator SEBI came out with a regulation in 2010 on "mutual funds" shareholding resolution voting policy. Quickly, three proxy advisory firms came to the market with differing ownership structure. Indian financial market offered great potential for investment through institutional investors. However the institutional investors in India are traditionally restrained them from taking activist role by voting on the shareholder meeting proposals. This poses a challenge to Indian proxy advisory firms along with other challenges typical of an emerging industry. The proxy advisory firms need to overcome the challenges to ensure their success. This pioneering work on Indian proxy advisory industry would open up new research ideas.

**Keywords:** Proxy Advisory, India, Shareholders

## 1. INTRODUCTION

Proxy advisory firms are independent consulting firms that provide research on corporate governance practices of the firms and voting recommendations on governance issues brought before investors at the shareholder meetings (Larcker McCall and Tayan (2013). They also vote on behalf of the institutional investors, based on their recommendations through proxies. The term 'proxy advisory' is derived based on the concept of 'proxy votes', where a shareholder authorizes another person (read proxy advisory firm) to vote on his behalf on the resolutions brought by the management. These issues include the election of the board of directors, approval of equity-based compensation programs, advisory approval of management compensation, and other management- and shareholder-sponsored initiatives regarding board structure, compensation design, and other governance policies and procedures (Larcker et al 2013).

Hence it can be easily observed that proxy advisory firms play a vital role in the corporate governance system by providing the voting recommendations to the outside shareholders, particularly the institutional investors. But the research done in this field is limited to the context of the USA. It is because the proxy advisory industry was dominated by one US firm i.e. Institutional Shareholder Services (ISS) and hence a near monopoly industry. However, the scenario is changing slowly as other countries also getting their own proxy advisory industry. India, one of the fastest emerging economies, has witnessed the birth of its own proxy advisory industry few years back. Given the absence of any research work in the field emerging markets context, our paper attempts to

understand the birth and growth Indian Proxy advisory firms and the challenges facing them through a 'Case study approach'. We adopt a case study approach as the industry is in infancy stages and qualitative research would bring in the better perspective.

The paper starts with analyzing the history of the proxy advisory industry at the global level. Then it studies the Indian Proxy Advisory Industry. We explore the opportunities and challenges facing Indian proxy advisory firms. Finally we also propose the potential future research in the area in India context.

## 2. GLOBAL PROXY ADVISORY INDUSTRY

Typically in listed companies, the managers run the firm which is (also) owned by shareholders. The managers could be professional managers or controlling/promoter shareholders. The outside shareholders have little control over the operational issues of the company, but are affected by decisions taken by the controlling shareholders/managers. Such arrangement might result in conflict situations where the managers take decisions which are not in the interests of the outside shareholders, which is known as Agency Problem (Jensen and Meckling, 1976). There exist a contract between managers and shareholders about how the former should manage the company. However, it is not a complete contract covering every aspect of business decisions because of significant uncertainty, information asymmetries and contracting costs (Hart 1995). In such an environment, some mechanisms are needed to control these conflicts. The precise manner in which these mechanisms are set up and fulfill their role in a particular firm defines the nature and

characteristics of that firm's corporate governance system. The board of directors is the most important internal corporate governance mechanism, in which the board members, elected by shareholders, monitor the functioning of top management. Though they are outside shareholders, institutional investors, due to their significant holding, are one of the most important external corporate governance mechanisms.

Institutional investors became increasingly important shareholders in the US financial markets since the eighties. In the USA, equity ownership by investment advisors, investment companies, mutual funds, insurance companies and pension funds increased dramatically from 24% in 1980 to 50% in 1994. As institutional ownership had increased, their role as shareholders also evolved. Earlier these funds remained as passive shareholders and would simply sell their holdings in underperforming companies. But as their shareholdings increased, often the holdings became so large that the shares couldn't be sold without driving the price down and suffering further losses. Hence they began to abandon their traditional passive shareholder role and became more active participants in the governance of their corporate holdings (Gillan and Starks (2000)). This phenomenon of active monitoring of the governance of the investee firms is known as shareholder activism. Researchers had observed that institutional investors by virtue of their large stockholdings would have greater incentives to monitor corporate performance since they have greater benefits of monitoring (Shleifer and Vishny (1997)). One of the areas where institutional investors could show their activism was in voting on resolutions put forth by management in shareholder meetings. Further, Institutional investors are generally considered fiduciaries for the ultimate economic owners of the assets they are investing, which obligates them to a duty of care and loyalty that includes exercising the voting rights on shares in their portfolios (Larcker, McCall, and Ormazabal (2014)).

But there was a problem in showing activism in voting on resolutions. Most of these institutional investors hold a large number of securities, making the cost of engaging in research necessary to determine the correct vote on every proxy item very high. Determining how to vote on complex issues of corporate governance typically involves evaluating a wide range of idiosyncratic firm issues, such as each director's experience and their cumulative skills, appropriateness of firm oversight and strategy, firm compensation relative to firm strategy, personal characteristics of executives, practices of other industry and labor market competitors, and many others features of the economic setting. This type of research was not the primary business of most institutional investors. Also there would be lot of duplication of research as companies would have many institutional investors invested in them. Hence institutional investors started to outsource the corporate governance and voting recommendation research to third parties. This resulted in the birth of proxy advisory firms.

The proxy advisory industry emerged in mid 1980s in the USA, with establishment of a firm called 'Proxy Monitor' in 1984 followed by 'Institutional Shareholder Services Inc. (ISS)' in 1985.

A major breakthrough came in 1988, when the U.S. Department of Labor took the position that the voting of proxies of shares of stock owned by a pension plan was part of the plan's fiduciary duty to manage employee benefit plan assets. This development prompted managers of employee retirement plan assets to seek help from the proxy advisory industry to satisfy their fiduciary responsibilities to vote proxies in the best interests of their clients.

ISS started growing fast after this regulation as it was the only proxy advisor at the time that covered a broad range of companies, while the other proxy advisory firms like Proxy Monitor and Marco Consulting Group (MCG) had covered only limited number of firms. In the 1990s and early 2000s, ISS' reputation and dominance in the proxy advisory industry continued to increase due to a rise in shareholder activism by institutional investors. ISS grew further through mergers and acquisitions, for example it acquired Proxy Monitor in 2001. In the wake of the corporate scandals and collapse of companies like Enron and Worldcom, institutional investors became more active and turned to the proxy advisory industry for assistance in assessing the corporate governance practices of operating companies and in performing proxy voting functions.

In 2003, the US financial market regulator Securities Exchange Commission (SEC) came out with a rule which required the mutual funds to disclose their complete voting records annually to shareholders. It also required the mutual funds to adopt policies and procedures reasonably designed to ensure that proxies would be voted in the best interests of their clients. The logic behind the rule was that 'requiring greater transparency of proxy voting by funds would encourage funds to become more engaged in corporate governance of issuers held in their portfolios, which in turn would benefit all investors and not just fund shareholders. At the same time, an interpretative letter from the SEC provided that the use of proxy voting policies and recommendations developed by an independent third party such as proxy advisors would be deemed free of a conflict of interest and would meet mutual fund proxy voting obligations. This helped the proxy advisory industry to grow further.

At the end of 2013, ISS was the dominant proxy advisory firm in the USA and also at the international level. ISS had more than 1,700 clients for its corporate governance research services - well ahead of competitors such as Glass Lewis and Egan Jones. It covered around 39,000 companies worldwide for their corporate governance practices. Since its formation in 1985, ISS ownership underwent many changes. In April 2014, Vestar Capital Partners, a private equity firm, acquired ISS from its former parent, MSCI Inc. ISS controlled the bulk of the proxy advisory industry with over 61% market share in 2009 based on client assets. It started declining afterwards as Glass Lewis, the second largest player in the market gained market share.

The research in the field of proxy advisory industry is divided in two streams. First is the stream of research which focused on the impact of proxy advisory firms' voting recommendations. All of them were done in US context and most of them

focused on ISS' recommendations alone. Bethel and Gillan (2002) analyzed the institutional and regulatory environmental features that affect the co-location of share' voting and cash-flow rights in 1998 proxy season. Their study indicated that the negative recommendations from proxy advisory service firms were associated with fewer votes cast favorable to management.

Alexander, Chen, Seppi and Spatt (2009) analyzed the role of ISS recommendations in proxy contests. Their study found that the proxy advisor brings new information to the market as there were significant excess stock returns around public recommendation dates and these price movements depended on the direction of the voting advice. Their study also indicated a robust relationship between recommendations and contest outcomes after controlling for factors such as contest characteristics, voting rules, and ownership levels of dissidents and incumbents. The general implication of these findings is that proxy advice plays a dual role, serving both to certify the quality of rival teams and to help investors predict contest outcomes.

Cai, Garner, and Walking (2009) examined the factors that determine the percentage of "for" votes cast in uncontested director elections using a large sample of director elections from 2003 to 2005. After controlling for several other factors, their study indicated that a negative ISS recommendation reduces the vote in favor of directors by 19%.

Cotter, Palmiter and Thomas (2010) analyzed mutual fund voting data for the period 2003-2008 and attempted to identify the extent to which mutual funds voted in line with the voting recommendations of ISS. It was found that mutual funds' voting on their own, following neither the recommendations of management nor the ISS, the frequency was compared with other shareholders. In looking at voting on particular proposal types, such as the proposals to declassify the board, to submit rights plans to shareholder vote, and to require majority voting of directors, mutual funds voted in line with ISS recommendations much more frequently than with contrary management recommendations, baring few exceptions like the proposal to separate the chair and CEO positions, where mutual funds favored the management generally. The study also provided some explanations for the behavior of mutual funds in voting. One theory was that mutual funds believe that ISS would be able to identify value-producing voting choices in better manner as an expert. Another potential explanation is that ISS methodology for making recommendations tends to anticipate the voting predilections of institutional clients, including mutual funds; ISS recommendations simply reflect what mutual funds are already thinking and planning to do. In addition, mutual funds knowing they must disclose their actual votes may tend to herd, on the theory that only voting outliers can be subject to criticism. I.e. ISS serves to organize "proper" voting by mutual funds, whether or not it is value-enhancing or reflects how mutual funds would have voted on their own.

Choi, Fisch and Kahan (2009) analyzed the significance of voting recommendations by four proxy advisory firms -ISS, Glass Lewis, Egan Jones,

and Proxy Governance in connection with uncontested director elections. The Study indicated that most U.S. companies have shifted in recent years from plurality to majority voting and as a consequence, the importance of shareholder voting in uncontested elections increased a lot. Further the authors conducted a detailed analysis where they distinguished correlation from causality by examining both the recommendation itself and the underlying factors that may influence a shareholder's vote. Finally they conclude that popular accounts substantially overstate the influence of ISS. Their results indicate that the impact of an ISS recommendation is reduced greatly once company- and firm-specific factors important to investors are taken into consideration.

Ertimur, Ferri and Oesch (2013) investigated the economic role of proxy advisory firms in the context of mandatory "say on pay" votes. The paper focused on the process of analysis followed by the two most influential proxy advisory firms, ISS and Glass Lewis to make a voting recommendation on "say on pay". It was found that both firms perform a detailed analysis, emphasizing firm-specific considerations rather than resorting to one-size-fits-all approaches, and are more likely to issue an Against recommendation at firms with poor performance and higher levels of CEO pay. While there are occasions where both firms disagree in their recommendations, the influence of their recommendations on the voting outcome was found to be significant. But the sensitivity of shareholder votes to these recommendations varies with the institutional ownership structure, the rationale behind the recommendation and certain firm characteristics, indicating that at least some shareholders ignore these recommendations. The study also highlighted that half of the firms respond to the adverse shareholder vote triggered by a negative recommendation by engaging with investors and making changes to their compensation plan. However, the study did not find any evidence for significant market reaction to the announcement of such changes, even when material enough to result in a favorable recommendation and vote the following year. The study concluded that, rather than identifying and promoting superior compensation practices, proxy advisory firms' key economic role was processing a substantial amount of executive pay information on behalf of institutional investors, hence reducing their cost of making informed voting decisions.

Larcker Mcall and Ormazabal (2012) examined changes in executive compensation programs made by firms in response to proxy advisory firm say-on-pay voting policies. The study found three important results by analyzing a large sample of firms from the Russell 3000 that are subject to the initial say-on-pay vote mandated by the Dodd-Frank Act. First, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes. Second, a significant number of firms change their compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms apparently in an effort to avoid a negative recommendation. Third, the stock market reaction to these compensation program changes is statistically negative. This according to the authors,

indicate that the proprietary models used by proxy advisory firms for say-on-pay recommendations appear to induce boards of directors to make choices that decrease shareholder value.

Larcker Mcall and Ormazabal (2013) studied the economic consequences associated with the board of director's choice of whether to adhere to proxy advisory firm policies in the design of stock option repricing programs. Using a comprehensive sample of stock option repricings announced between 2004 and 2009, the analysis indicated that repricing firms following the restrictive policies of proxy advisors exhibit statistically lower market reactions to the repricing, lower operating performance, and higher employee turnover. Across all firms that decided to pursue a repricing program, the study indicate that the value of the program to shareholders was a decreasing function of whether the program complied with the restrictive policies used by ISS and GlassLewis for determining their voting recommendations to institutional investors. These results are consistent with the conclusion that proxy advisory firm recommendations regarding stock option repricing's are not value increasing for shareholders.

Broadly, there is a consensus among the researchers that the voting recommendations by proxy advisory firms have lot of influence in the actual voting pattern of the resolutions in the shareholder meetings. (Ex. Cotter, Palmiter and Thomas, 2010; Choi, Fisch and Kahan, 2009).

With the growth of proxy advisory industry, came the cry for regulating them. There were allegations that the basis on which the proxy advisory firms make recommendations were not disclosed and they had conflicts of interests in their offerings. For example, ISS had a wholly owned subsidiary called ISS Corporate Services, which provided consultancy services to more than 1100 corporate clients across the world on their corporate governance practices in order to improve shareholder value and reduce risk. This resulted in conflicts of interests as the parent ISS may be making recommendations on the voting for the resolutions brought by the same corporate clients. The second stream of research works on proxy advisory firms focused on conflicts of interests in the operations of proxy advisory firms. Many research works highlighted the need for regulating them. (Belinfanti, 2008; Clark and Van-Buren, 2013). ISS countered this argument stating that it had built process level wall between the two divisions to avoid conflict of interests. The proxy advisory firms argue that the perceived conflict of interest is made out to be big issue due to lobbying by the corporate entities wary of shareholder activism. There was some support for ISS among the researchers also. Dent (2014) indicated that while it is possible that proxy advisory firm might give wrong recommendation, it may not really result in huge losses to the shareholders as in the case auditing failure.

### *Indian Proxy Advisory Industry*

The corporate governance scenario in India was different from that of the USA market. In India, the shareholding pattern is not widespread and the listed companies were largely controlled by

promoters. The promoters could be the private business families or the government or the multinational parents. Even in India institutional investors, like mutual funds, insurance companies and foreign institutional investors, had significant shareholding in listed companies. Till late eighties, many institutional investors in India were owned by the government of India. They traditionally remained passive investors and always supported the promoters on governance issues. The private institutional investors came into the market in a big way in nineties. But they also continued to remain passive. The entry of foreign institutional investors in Indian stock market in the mid and late nineties changed the environment to certain extent as they tend to be more active in governance issues. In the year 2000, the financial market regulator Securities Exchange Board of India (SEBI) had come out with structured corporate governance norms for the listed companies through Clause 49 of listing agreement. Still the domestic institutional investors continued to remain passive and seldom involved in governance issues. Hence the question of voting against management-proposed resolutions in shareholder meetings did not arise at all. So the proxy advisory industry was non-existent in India.

In 2009, Indian financial market was shocked by a huge corporate scandal in one the prominent software services firm 'Satyam Computer Services Ltd'. SEBI took many measures to avoid such scandals again. One such step was to come out with a regulation in February 2010 which demanded more transparency in the voting by Indian mutual funds in the resolutions of shareholders meeting of their investee companies. The regulation required mutual funds to disclose their general policies and procedures to determine the manner in which voting rights could be exercised on the shares held by them. Mutual funds were also required to disclose on their website the manner in which they exercised their votes on resolutions in shareholder meetings.

When SEBI came out with mutual funds voting disclosure requirements regulation in February 2010, some entrepreneurs sensed that this was the moment for proxy advisory industry in India. They were aware that the proxy advisory industry took off in a big way in USA after SEC came out the regulation requiring the mutual funds to disclose their voting records and the same could happen in India.

### *InGovern Research Services*

The first proxy advisory firm to come up in India was 'InGovern Research Services' started by Mr. Shriram Subramanian. He quit his job with Infosys Consulting and started InGovern in June 2010, based in Bangalore, with a sale of office in Mumbai, the financial capital of India. In September 2010, InGovern launched 'Governance Radar' its proprietary framework for analysing corporate governance structure in the listed firms and quickly tied up its first client. In June 2011, InGovern launched its online platform for usage by investors called "InGovern Corporate Governance Platform"<sup>39</sup>. InGovern got the attention of the investors when it

<sup>39</sup><http://www.businesswireindia.com/news/news-details/launch-corporate-governance-platform-institutional-investors/26965>

came out with its first press release in July 2011 on the corporate governance practices of Wipro and IDFC. It recommended the institutional investors to vote against reappointment of the independent directors in the respective boards of both Wipro and IDFC. That press release made companies sit up and take note, as for the first time in the Indian corporate governance scene, someone was making specific recommendations for voting in the AGM resolutions. This also brought InGovern to the attention of 'Broadridge Financial Solutions', a US based servicing company for the financial industry. Broadridge was the leader in securities processing, clearing and investor communication<sup>40</sup> and electronic proxy voting. ProxyEdge was the electronic proxy delivery and voting solution for institutional investors from Broadridge. ProxyEdge served more than 3,500 institutions globally and carried vote recommendations from multiple agencies and also helped to ensure the participation of the largest stockholders of many companies in AGM resolutions. Broadridge approached InGovern to have a business tie-up. In September 2011, both the firms finalized the alliance for the sale and distribution of InGovern's proxy research and vote recommendations for listed Indian companies through Broadridge's ProxyEdge voting platform<sup>41</sup>. The Broadridge tie-up helped InGovern reach foreign institutional investors who were users of the ProxyEdge platform across the world.

In January 2012, Mohandas Pai, the former Board Member, HR Head and CFO of Infosys Technologies Ltd invested in InGovern as an angel investor. "His (Pai's) expertise, domain knowledge and relationships will help InGovern catalyze better corporate governance in India," remarked Shriram. Mr.Pai said "India needs to create a strong ecosystem for good corporate governance. Treating minority shareholders fairly is a critical step in building a strong equity markets." Mohandas Pai had also become an advisor to InGovern and he was joined by another corporate governance expert, Shankar Jaganathan<sup>42</sup>.

As on August 2015, InGovern offered a bouquet of services 'Vote Recommendations', 'Corporate Governance Score Cards', 'CG Consulting and Education Service', 'Risk Monitoring Service' and. InGovern was planning to expand its service offerings to include 'Proxy Voting Service', Electronic Voting Platform' and 'Securities Class Action Services' in the future. Vote recommendations was the standard product of InGovern offered to all the clients, while others services were typically custom made for clients, based on the InGovern's proprietary CG framework. As of April 2014, InGovern offered voting recommendations for more than 500 listed firms. These 500 companies typically conduct around 650 shareholder meetings in a year.

As indicated earlier, InGovern the pioneer in the Indian proxy advisory industry was founded in 2010. But within a short period of two years, two

more firms arrived in the market. They were 'Institutional Investor Advisory Services India Limited' and 'Stakeholders Empowerment Services'. Further the global market leader ISS also provided vote recommendations on selective Indian companies.

### *Institutional Investor Advisory Services India*

Institutional Investor Advisory Services India Ltd (IiAS) was the second proxy advisory firm to start in India. It was promoted by Anil Singhvi, former Gujarat Ambuja Cements CEO, and Amit Tandon, former managing director of Fitch Ratings. The company started its operations in July 2011 and was managed by Amit Tandon as the managing director. Within few month of its start, IiAS got funding through equity participation by BSE Limited, Axis Bank Ltd, Fitch Group Inc., HDFC Ltd, ICICI Prudential Life Insurance Ltd and Tata Investment Corporation Ltd<sup>43</sup>. Its office was located in PJ Towers that houses Bombay Stock Exchange in down town Mumbai, the hub of Indian financial services Industry. IiAS provided voting recommendations for over 300 companies as on August 2015.

In addition to voting advisory, IiAS also provided assistance to investors with proxy voting & AGM/EGM 'end-of-day' minutes and acts as a record keeping agent by maintaining the history of votes cast in shareholder meetings. The other services by IiAS are listed below

- Valuation advisory services and assisting institutions in their engagement with company managements and their boards, including legal assistance.
- Assistance to investors to aggregate votes by bringing a cross-section of investors with common concerns to engage with company managements.
- Developing governance scorecards<sup>44</sup>.

Tandon was supported by an Executive Director and a Chief Operating Officer at the top level and had team of research analysts as on April 2015. Financially IiAS was relatively better placed than its competitors as it had the support of investors with deep pockets. It is also the largest among the three competitors in terms volume of business.

### *Stakeholders' Empowerment Services*

Stakeholders' Empowerment Services (SES) was founded by Jitendra Nath Gupta (former senior officer with SEBI), his son Arjun Gupta (formerly with Ernst & Young's financial services vertical) and his friend Amarendra Singh (formerly with Deutsche Bank) in mid-2012. It was registered as a non-profit organization and the managing director .J.N.Gupta in an interview, said that it was a conscious decision. He said "...(SES) does not have any kind of association with any listed company and, thereby, avoids scrupulously all potential conflicts of interest and prohibits any kind of return to its

<sup>40</sup> Investor Communication Solutions business involves the processing and distribution of proxy materials to investors in equity securities and mutual funds, as well as the facilitation of related vote processing

<sup>41</sup><http://www.broadridge.com/news-events/press-releases/>

Broadridge-and-InGovern-Announce-Alliance-for-Sales-and-Distribution-of-Proxy-Research-and-Vote-Recommendations-for-Listed-Companies-in-India.html

<sup>42</sup>[http://thefirm.moneycontrol.com/story\\_page.php?autono=746942](http://thefirm.moneycontrol.com/story_page.php?autono=746942)

<sup>43</sup>[http://articles.economicstimes.indiatimes.com/2011-1123/news/30433234\\_1\\_iias-anil-singhvi-lakh-shares](http://articles.economicstimes.indiatimes.com/2011-1123/news/30433234_1_iias-anil-singhvi-lakh-shares)

<sup>44</sup> IiAS website <http://www.iias.in/> accessed on 25.5.2015

shareholders/promoters<sup>45</sup>. A March 2013 article in a business newspaper indicated that SES had six employees and was planning to hire two more<sup>46</sup>. It had its office in a middle-class housing complex of Malad in suburban Mumbai. As on April 2014, it analyzed the corporate governance practices of more than 480 companies and provided voting recommendations. It also provided issue based corporate governance reports on listed companies based on client requirements<sup>47</sup>.

### 3. POTENTIAL OF INDIAN PROXY ADVISORY INDUSTRY

The Indian proxy advisory industry showed tremendous potential for growth. In the USA, where the proxy advisory industry was well developed, it was estimated that mutual funds pay around 0.1 per cent of their assets under management (AUM) as fees for such advice. With an estimated AUM of just over Rs 7000 billion in India (for the financial year 2013-14), the growth potential for proxy advisory firms could be enormous, said the experts<sup>48</sup>. The demand for proxy advisory services was expected to grow multifold, given the growth potential of Indian economy.

#### *Potential Growth of India Economy*

The long-term growth potential of Indian economy was projected to be high and according to a Goldman Sachs report in 2007, the average GDP growth rate was expected to be 6.9 till 2050. The growth slowed down due to lack of economic reforms after the 2009 national elections due coalition pressures at the central government. Still GDP growth was always above 4.5% during 2009-14 period also. Further, the long-term growth projections continued hold good even during the slow growth period. It was projected that Indian economy would touch US \$ 4.5 trillion on 2020<sup>49</sup> and US \$ 6.5 trillion<sup>50</sup> in 2025 from US \$ 1.9 trillion in 2012-13. The growth sentiment turned positive after the 2014 national elections that provided for a stable government with decisive mandate. The absolute majority obtained by the new ruling party was expected to facilitate pro market economic reforms. According to Goldman Sachs report published after 2014 election results, India's GDP growth was likely to increase from 4.6 per cent in FY14 to 6.5 per cent in FY16, driven by an

improvement in investment demand and stronger exports<sup>51</sup>. The positive atmosphere reflected in the stock market also. A study by Assocham<sup>52</sup> in May 2014 projected that the FII inflow was expected to touch US \$ 60 billion in the financial year 2014-15 as against the 2013-14 inflow of US \$ 29 billion<sup>53</sup>. This was major positive indicator for proxy advisory firms as the FIIs showed lot of shareholder activism and expected seek voting recommendations.

#### *Entry of Pension Funds in Equity Markets*

Pension fund was another sector which was expected play in big role in Indian stock market. The Government of India set up National Pension System (NPS) in 2004 and its subscription was made mandatory to all government employees. In 2009, NPS was thrown open to all Indian citizens in the 18-60 age groups on a voluntary basis. However, it has failed to take off in the voluntary segment mostly due to legal restrictions and lack of popularity. As on January 2013, the coverage of the existing pension system was about 11% of the organized sector workers and employees. In September 2013, the government passed Pension Fund Regulatory and Development Authority (PFRDA) Bill, which removed most legal problems like lack of statutory status to the Pension fund regulator PFRDA. It also allowed FDI in pension sector up to 26% or such percentage as may be approved for the insurance sector, whichever was higher<sup>54</sup>. Investment corpus in the Indian pension sector was estimated to reach greater than US\$ 1 trillion by 2025 as the sector move forward to realize its full growth potential after the passage of the PFRDA Act 2013, according to a Report on Pensions Business in India, prepared jointly by Ernst & Young and Confederation of Indian Industries, which is one of India's apex business association. A major portion of inflow would come to stock market, which in turn would create more potential for proxy advisory firms.

#### *Improved Corporate Governance Practices and Hostile Takeovers*

Further, the new 'Companies Act 2013' also provided lot of emphasis on corporate governance practices. For example, as per Companies Act 1956, companies were allowed to hold their own shares through a trust, called treasury stocks. These treasury stocks, apart from providing future liquidity, helped promoters to prevent hostile takeovers, as the trust holding the shares will typically comply with the promoters. The new 'Companies Act 2013' abolished this practice and prohibited the companies holding treasury stocks. This in turn would provide more

<sup>45</sup> Subramanian.N.S and Aravind.I, Regulation necessary but not sufficient for corporate governance. J N Gupta, Business Standard December 12, 2012 retrieved from [http://www.business-standard.com/article/markets/regulation-necessary-but-not-sufficient-for-corporate-governance-j-n-gupta-12121700136\\_1.html](http://www.business-standard.com/article/markets/regulation-necessary-but-not-sufficient-for-corporate-governance-j-n-gupta-12121700136_1.html) accessed on 2.5.2014

<sup>46</sup> Subramanian.N.S and Aravind.I, Proxy warriors. Business Standard March 8, 2013 retrieved from [http://www.business-standard.com/article/companies/proxy-warriors-113030800504\\_1.html](http://www.business-standard.com/article/companies/proxy-warriors-113030800504_1.html) accessed on 2.5.2014

<sup>47</sup> SES website <http://www.sesgovernance.com/> accessed on 25.5.2014

<sup>48</sup> Mathews.A.C.The Crusaders, Business Standard, June 6, 2013, retrieved from <http://www.businessworld.in/news/corporate/the-crusaders/911582/page-0.html> accessed on 2.5.2014

<sup>49</sup> GDP to quadruple to \$ 4.5 trillion by 2020. Edelweiss, Indian Express, March 20, 2010, retrieved from <http://archive.indianexpress.com/news/gdp-to-quadruple-to-4.5-trillion-by-2020-edelweiss/593260/> accessed on 2.5.2014

<sup>50</sup> [http://www.hindustantimes.com/Images/Popup/2013/3/10\\_03\\_D\\_graph2.pdf](http://www.hindustantimes.com/Images/Popup/2013/3/10_03_D_graph2.pdf)

<sup>51</sup> BJP's win rekindles hope for reforms, growth. Goldman, Business Today, May 23, 2014 retrieved from <http://businesstoday.intoday.in/story/bjp-win-rekindles-hope-goldman-sachs/1206498.html> accessed on 25.5.2014

<sup>52</sup> One of India's apex trade association, expanded as Associated Chambers of Commerce and Industry of India

<sup>53</sup> Total foreign investment projected to more than double in FY 14 on Modi wave. ASSOCHAM, May 25, 2014, retrieved from <http://www.assochem.org/prels/shownews.php?id=4508y> accessed on 2.5.2014

<sup>54</sup> Pension Bill to attract FDI; better products coming. India Inc, Economic Times, September 6, 2013, retrieved from [http://articles.economicstimes.indiatimes.com/2013-09-06/news/41835257\\_1\\_pension-bill-pension-sector-pension-fund-regulatory](http://articles.economicstimes.indiatimes.com/2013-09-06/news/41835257_1_pension-bill-pension-sector-pension-fund-regulatory) accessed on 2.5.2014

potential for hostile takeovers as the free float shares increases. The role of proxy advisors in such hostile takeovers is very important.

#### 4. CHALLENGES FACING INDIAN PROXY ADVISORY INDUSTRY

Overall, the future potential was high for proxy advisory industry but there are plenty of challenges and hurdles in the short and medium term. The proxy firms needed to figure out ways overcome the challenges, which are explained below.

##### *Indifference towards Corporate Governance Practices*

The major problem facing the Indian proxy advisory industry was the lack awareness among the investors about the seriousness of corporate governance problem in their investee firms, according to the experts. The lack of awareness resulted in lot of indifference towards the corporate governance practices of the firms, particularly among the domestic financial institutions. This was unlike in USA, where, the MFs usually voted according to the recommendations of proxy advisors. Hence the major proxy advisory firms like ISS held considerable sway in corporate decisions, acting as an effective check on self-serving decisions by the management. The reason was the legacy passive investor attitude of domestic institutional investors.

Creating awareness about the need for shareholder activism and educating the institutional shareholders about the importance of proxy advisory firms in ensuring better corporate governance practices is a big challenge. There are efforts from various other stakeholders to create awareness about the shareholder activism and responsible investing. The professional bodies like Institute of Chartered Accountants of India (ICAI - national professional accounting body of India) & Institute of Company Secretaries of India (ICSI - national professional association of company secretaries of India) and educational institutions like the Indian Institutes of Management were conducting conferences and training programs on the issue of shareholder activism. Even the regulator SEBI started involving proxy advisory firms like InGovern while preparing regulations related to shareholder activism.

##### *Resistance from Corporate World & Regulation*

Even though institutional investors were yet to recognize the utility of the service provided by the proxy advisory firms, and derive the complete benefits, the corporate entities had taken note of their presence. They had their own reservations about the proxy advisory firms and accused them of following unilateral style of advocacies. "They don't check with us. You should get back to us before getting anything printed. On occasions, proxy firms take extreme positions. Sometimes these are even incorrect positions. In that case, you are not guiding, but misleading investors," said a senior executive of

one of the companies targeted by the proxy firms<sup>55</sup>. But some experts were of the opinion that regulation at this stage of industry would hamper its growth. In an interview given in late 2012, J.N.Gupta of SES suggested that there was still time before regulations become necessary. He said "We welcome regulation. This gives trust to users. However, it is a chicken and egg issue. What - proxy advisory or its regulation - should come first? What do you regulate if there is no proxy advisory? How does proxy advisory develop if there is no regulation? In fact, regulation and development move hand in hand in a virtuous circle. We should allow proxy advisory to develop to an appreciable extent to absorb regulation"<sup>56</sup>. In mid- 2014, the market regulator has come out regulations for research analysts which also covered the proxy advisory firms. The regulations, which came into effect from December 2014, required the research firms to register with SEBI and also required to employ analysts who have cleared a certification program<sup>57</sup>.

##### *High Competition*

The other concern among industry experts was the space for three firms in this uncertain environment. Even in USA, throughout the history of proxy advisory industry it was mostly a monopoly or duopoly market for practical purposes. In such an industry, where it was at nascent stage, there might not be enough space for three players commented the industry experts. It makes the competition tighter among the existing players, there by affecting profitability.

##### *Human Resource Requirements*

Corporate governance research is unique in its own way and hence the human resource requirements. As on 2015, the human resource requirements of the industry were low and the firms were managing in their own way. InGovern was hiring fresh graduates and training them. SES was hiring engineers to the work.

When the question was asked on what do engineering and mathematics have to do with corporate governance, J. N. Singh of SES answered "Logical reasoning. You need to connect the dots. The IIT guys are good at it"<sup>58</sup>. According to the experts these practices indicated that the industry was experimenting with new ways to overcome the human resource problems. It would become a major issue once the industry starts growing.

<sup>55</sup> Subramanian.N.S and Aravind.I. Proxy warriors. Business Standard March 8, 2013 retrieved from [http://www.business-standard.com/article/companies/proxy-warriors-113030800504\\_1.html](http://www.business-standard.com/article/companies/proxy-warriors-113030800504_1.html) accessed on 2.5.2014

<sup>56</sup> Subramanian.N.S and Aravind.I. Regulation necessary but not sufficient for corporate governance. J N Gupta, Business Standard December 12, 2012 retrived from [http://www.business-standard.com/article/markets/regulation-necessary-but-not-sufficient-for-corporate-governance-j-n-gupta-112121700136\\_1.html](http://www.business-standard.com/article/markets/regulation-necessary-but-not-sufficient-for-corporate-governance-j-n-gupta-112121700136_1.html) accessed on 2.5.2014

<sup>57</sup> [http://articles.economicstimes.indiatimes.com/2015-05-14/news/62165488\\_1\\_research-analysts-research-entity-investment-advisers](http://articles.economicstimes.indiatimes.com/2015-05-14/news/62165488_1_research-analysts-research-entity-investment-advisers)

<sup>58</sup> Subramanian.N.S and Aravind.I. Proxy warriors. Business Standard March 8, 2013 retrieved from [http://www.business-standard.com/article/companies/proxy-warriors-113030800504\\_1.html](http://www.business-standard.com/article/companies/proxy-warriors-113030800504_1.html) accessed on 2.5.2014

## 5. RESEARCH IN INDIAN PROXY ADVISORY INDUSTRY

Given that proxy advisory industry in India is just five years old, no research work has been published so far. The research scope for Indian proxy advisory industry is different from that of the US market. The conflict of interest situation does not exist, as Indian market is yet to reach stage where companies seek professional advice on corporate governance matters. However, the other major research issue of the influence of proxy advisory firms on voting patterns of institutional investors is valid in Indian context also, though for different reasons. The major problem in Indian corporate governance system is the lack awareness among the investors about the seriousness of corporate governance problem in their investee firms. The lack of awareness resulted in lot of indifference towards the corporate governance practices of the firms, particularly among the domestic financial institutions. However, it would be interesting to test whether the situation has improved or not since 2010. To study this, one can empirically analyze how the stock prices react when a proxy advisory firms advises to vote against the management's resolutions in the shareholder meeting. Event study methodology could be used for this purpose. A strong negative reaction in the share prices on the day of negative recommendation would indicate seriousness of the shareholder on the issue.

Secondly we can also empirically test to what extent the institutional investors adhere to the negative voting recommendations of the proxy advisory firms. The voting recommendations and the actual voting patterns could be obtained from available databases and can be compared.

Thirdly one can survey the level of awareness of about shareholder activism among the institutional investors. There are efforts from various other stakeholders to create awareness about the shareholder activism. However to what extent these efforts are effective need to be tested.

Another potential research topic in this field is in the economic stream. Traditionally the proxy advisory service industry was a monopoly for practical purposes. But in India, already three firms are operating and all of them have different ownership pattern. It provides an excellent platform to conceptually analyze the competition in this industry from economic perspective and study the right ownership structure for the firms in this industry.

## CONCLUSION

The analysis of the history of proxy advisory industry indicated that it owes its growth to the increasing shareholding of institutional investors in US equity market and the regulatory requirements imposed on them. The industry, for practical purposes, was a monopoly till 2005, which is one the reason on why the research works in this field are limited. The pattern of emergence of proxy advisory industry is being repeated in India also with arrival of three proxy advisory firms. However the growth of proxy advisory industry in India may not be

similar to that of USA as ownership pattern of listed corporate entities in India are different from that of USA. It also provides its own unique research questions for the proxy advisory industry in India.

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