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## NAVIGATING CORPORATE INFLUENCE: OUTSOURCING SHAREHOLDER VOTING TO PAF

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“The quality of the company’s board has now become an important evaluation factor for institutional investors.”

- *Russel Reynolds Association*

### ABSTRACT

In the evolving landscape of Corporate Governance in India, the phenomenon of shareholder activism – in which an interested subset of a corporation’s shareholders seeks to influence a company’s operations or direction – has been steadily increasing. This research paper aims to explore the dynamics of shareholder activism within the realm of Indian Corporate Law, focusing on its impact, effectiveness, and the legal framework governing such activities.

Specifically, the study seeks to address the impact caused by Proxy Advisory Firms (PAF) on the voting pattern of shareholders, how it impacts the long-term performance of the firms. To investigate this, the research examines case study of various shareholder activism in the contemporary times and also analyses the factors relied upon by the Proxy Advisory Firms to and due to that how activist shareholders are being viewed in such firms.

The findings of this study are expected to provide a comprehensive understanding of the role of shareholder activism in shaping corporate governance in India. It also aims to contribute to a deeper understanding of the benefits and challenges of the shareholder activism, offering insights for policy makers, corporate leaders and institutional investors in navigating the increasing influential aspect of proxy firms on shareholders.

**Keywords:** Shareholder Activism, Corporate Governance, Proxy Advisory Firms, Indian Corporate Law, long-term performance.

## INTRODUCTION

For past 30 years, Tamal Kumar Mazumdar, a shareholder, has been travelling from his hometown Kolkata to Mumbai and Delhi to attend the annual general meetings (AGMs) and to be in the shareholders meet of some of the 120 – odd listed companies in which he holds shares. This phenomenon of ‘Shareholder Activism’ has gained a prevalence in the Indian Corporate Affairs. It refers a concept where the shareholders of a company start taking an active part in the affairs of the company that they have made investment in. While shareholders are usually regarded as the passive owners of company, shareholder activism comes into picture when such passive players decide to bring about a change in the governance of the company. The power of shareholder activism is used when shareholders feel that the company is being run in a manner which will inevitably cause their investment to fail and would cause them to incur losses.

Shareholder activism has been gaining popularity in India due to multiple reasons. Some of the most notable reasons are that the shareholders are now more informed about their rights, higher number of institutional investors and most importantly the rise of “Proxy Advisory Firms” in the nation.

In the beginning, with few listed companies and little impact from retail investors, the Indian equity market was underdeveloped. But the recent developments have sparked control transactions and an increase in shareholder agitation, which also includes the significant stakes held by institutional and private equity funds. This activism ranges from dialogue with the management to proxy battles, publicity campaigns, shareholder resolutions, litigation and negotiations with the management.

In *Tata Sons v. Cyrus Mistry*<sup>1</sup>, court struggle ensued after Cyrus was dismissed from his position as Chairman of Tata Sons in 2016. This litigation, which accused the Tata Group of managerial irregularities in the corporation, was among the well-known examples of Shareholder activism in India. Retail investors possess the discretion to abstain from voting; however, institutional investors have a fiduciary obligation to cast votes on virtually all

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<sup>1</sup> *Tata Consultancy Servs. Ltd. v. Cyrus Invs. Pvt. Ltd.*, (2021) 440–441 SCC (India) (Mar. 26), available at [https://main.sci.gov.in/supremecourt/2020/212/212\\_2020\\_31\\_1503\\_27229\\_Judgement\\_26-Mar-2021.pdf](https://main.sci.gov.in/supremecourt/2020/212/212_2020_31_1503_27229_Judgement_26-Mar-2021.pdf) (last accessed Dec. 30, 2024).

shareholder ballots. Consequently, they account for the majority of the votes cast.<sup>2</sup>

## EMERGENCE OF PROXY ADVISORY INDUSTRY IN INDIA

The corporate governance scenario in India is different from that of USA market. Earlier in India, the shareholding pattern was not widespread and listed companies were largely controlled by ‘Promoters.’<sup>3</sup> The emergence of Proxy Firms primarily occurred due to a growing focus on corporate governance practices. Till late eighties almost all institutional investors in India were owned by Government of India. The arrival of foreign investors in the Indian Stock Market in mid and late nineties change the environment due to their active participation in governance issues. As a first step, in December 2005, the Securities and Exchange Board of India (hereinafter; SEBI), introduced structured corporate governance guidelines for listed companies through clause 49 of the listing agreement. Notably, it leads emphasis on the transparency and oversight of related party transactions (RPTs), thereby strengthening corporate governance practices.<sup>4</sup>

## THE ECONOMICS OF SELLING INFORMATION TO VOTERS

A Proxy Advisory Firm (PAF) functions as an independent research entity that scrutinizes corporate governance issues and offers a voting guidance regarding shareholders proposals at company assemblies. Being a conduit between shareholders and corporate boards, PAF furnishes insights on significant issues such as executive remuneration, mergers, and other pivotal decisions, allowing investors to make well informed voting decisions relying on firm’s research and evaluations. They digest and evaluate lengthy company filings and gather information which later influences the voting pattern of shareholders. Some of the prominent firms include Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (GL). However, the precise nature of the proxy advisors remains unclear.<sup>5</sup>

For diversified institutional investors, the cost of independent research on each proposal in each of their portfolio companies are substantial, which leads the institutions to get the information

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<sup>2</sup> David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173 (2015).

<sup>3</sup> Subramanian S, *Proxy Advisory Industry in India*, 13(2) Corp. Ownership & Control 371 (2106).

<sup>4</sup> K.S. Khurana, *Proxy Power Play: Comparing the Rise of Proxy Advisory Firms in India and the United States*, 2 HPNLU J.L., BUS. & ECON. 1 (2024), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4837221](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4837221).

<sup>5</sup> *Supra note 2*

from proxy advisory firms instead in exchange of fees.<sup>6</sup> A large number of studies stipulates that proxy advisories have significant impact on shareholder's say-on-pay votes.<sup>7</sup> In India, currently there is no significant caselaw related proxy advisory but there have been many instances where such situation has created havoc. Rather "Procedural Guidelines for Proxy Advisors," which outlines the required standard for conduct and disclosures for these firms have been set up by the SEBI, the primary governing body for proxy advisors.

On the brighter side while offering independent analysis and recommendations, proxy firms help companies to adopt better governance policies to align with the standards, leading a more transparent and accountable management. The cost can also be incurred with the recommendations of proxy firms, but can be offset by long term benefit of better governance and investor confidence. This will in turn lead to market efficiency with the rise of informed voting decision and effective oversight of corporate management along with better alignment of interests between shareholders and management.<sup>8</sup> As the Companies Act grants power to the Shareholders to appoint proxies, Proxy Advisory Firms play a crucial role in this process by acting as proxies for their client, enabling them to cast their votes effectively during these meetings.<sup>9</sup>

## CHALLENGES FACED BY PROXY ADVISORY FIRMS

Most advisory firms have adopted the western standard of governance and therefore are more suitable to cater the requirement of the companies in West.<sup>10</sup> To that of their international counterparts, proxy advisors in India face various challenges and critiques that have precipitated debates about their role, efficacy, and impact on corporate governance. The landscape of PAFs is fraught with challenges shaping the contours of their role in corporate governance. Chief among them is the spectre of conflicts of interest and power dynamics looming over these entities. It is often argued that PAFs may favor specific investor interest or

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<sup>6</sup> Andrey Malenko & Nadya Malenko, *Proxy Advisory Firms: The Economics of Selling Information to Voters*, 74 J. FIN. 2441 (2019).

<sup>7</sup> Jing Zhao, *Proxy Advisors: A Double-Edged Sword for Institutional Investors*, ICHESS (2023).

<sup>8</sup> Pallavi Aggarwal, *What Are Proxy Advisory Firms and Their Role in Indian Corporate Governance*, iPleaders (Oct. 22, 2022), <https://blog.ipleaders.in/what-are-proxy-advisory-firms-and-their-role-in-indian-corporate-governance/?form=MG0AV3> (last accessed Dec. 31, 2024).

<sup>9</sup> R. Mittal & N. Sharma, *Proxy Advisory Framework and the Role of Company Secretaries* (2024) (unpublished manuscript).

<sup>10</sup> Bharat Reddy & Ananya Jain, *Impact of Proxy Advisory Firms: Turning Tides and Failing Resolutions*, India Corp. L. (Oct. 23, 2023), <https://corporate.cyrilamarchandblogs.com/2023/10/impact-of-proxy-advisory-firms-turning-tides-and-failing-resolutions/>.

may adopt ‘one size fits all’ approach, without considering the company-specific contexts. This will lead to the increase of risk that the recommendations would be such that are not in the best interests of all the shareholders or for the long-term benefit of the company.<sup>11</sup>

As per Chairman Rep. Scott Garrett of Capital Markets and Government Sponsored Enterprises Subcommittee, *“Proxy advisory firms have increasingly teamed up with unions and others to push proposals that are generally immaterial to investors and often reduce shareholder value.”* He also added that *“proxy advisory firms have increased the costs of doing business for many public companies and disincentivized private companies from going public, all without a corresponding benefit to investor returns.”*<sup>12</sup>

The role of PAFs is often characterized by a complex duality, where they function as both advisors to investors and consultants to companies on which investors rely for guidance. In response to these concerns, regulatory framework such as that of Regulation 23 of SEBI has been established, which mandates the disclosure of conflict of interest and require the formulation of internal policies designed to manage and mitigate such conflicts.

Additionally, the proxy advisory firms are not held to a fiduciary standard, which requires them to demonstrate recommendations in the best interest of shareholder. It is also a question of concern that whether paid clients are given special access to information or might have insufficient staff to accurately examine the full scale of proxy items on which they provide recommendations.<sup>13</sup> Their reliance on publicly available data, might cause unsuccessful capturing of the full picture of company’s situation, generalist expertise across various sector which undermines the industry-specific complexities while evaluation, providing selective information and the absence of clear guidelines are among the various other issues possessed by Proxy Advisors.

Although proxy advisors are integral to the corporate governance in India, they are akin to various challenges and criticisms that underscore the need for an unbiased and balanced

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<sup>11</sup> S. Shekhar & N. Ojha, *Proxy Advisory Firms: Shaping Corporate Governance Practices in India*, Indian Rev. Corp. & Com. L. (Jan. 12, 2024), <https://www.irccl.in/post/proxy-advisory-firms-shaping-corporate-governance-practices-in-india>.

<sup>12</sup> Hearing Examines Role of Proxy Advisory Firms, Press Release, Fin. Servs. Comm. (June 5, 2013), <https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=336808>.

<sup>13</sup> David F. Larcker, Brian Tayan & James R. Copland, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, Harv. L. Sch. F. Corp. Governance (June 14, 2018), <https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/>.

approach. In order to effectively get away with these concerns, continuous dialogue among regulators, proxy advisors, companies, and investors is essential to ensure that the contributions to corporate governance by proxy advisory remains sustainable and beneficial.

The major problem in Indian Corporate Governance System is the lack of awareness among the investors about the seriousness of corporate governance problem in the investee firm. The deficiency in awareness led to a considerable apathy towards corporate governance practices among domestic financial institutions. In order to investigate, one could empirically analyze stock price reactions when proxy advisory firm recommends voting against management's resolutions during shareholder meetings.

## **PROXY INDUSTRY IN THE INDIAN MARKET**

The lack of competition within the proxy advising industry, which, driven by the economies of scale, aligns more closely with the characteristics of a natural monopoly and reflects an oligopolistic market structure. This Observation strikes contrast with that of the higher levels of competition found in the other industries, which underscores the potential failure for market structure. Interestingly, there is absence of any significant criticism about the price charged for the services of proxy advisories.<sup>14</sup> Insights from the SEC's November 2018 Roundtable on the proxy advisory indicates the fear that the regulation of the industry could lead to higher, rather than lower, costs due to an augmented regulatory burden.

The proxy sector exhibits a higher degree of concentration and lacks adequate regulatory oversight, potentially resulting in market inefficiencies. The substantial influence of proxy advisory firm's recommendation on corporate governance underscores the need for stringent regulation, akin to that governing other investment advisors. PAF's recommendation might not always align with the interest of the shareholders. For example, ISS's recommendation that HP's shareholders should support a merger that would decrease the value of HP. Additionally, they make it difficult for public companies and asset managers to challenge their advice.

## **REDRESSALS TO THE ISSUES OF PAF**

Despite the hardships caused by PAF the investors tend to use the services provided by these

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<sup>14</sup> Chester S. Spatt, *Proxy Advisory Firms, Governance, Failure, and Regulation*, Harv. L. Sch. F. Corp. Governance (June 25, 2019), <https://corpgov.law.harvard.edu/2019/06/25/proxy-advisory-firms-governance-failure-and-regulation/> (last accessed 2025).

institutions in order to maintain the reduced cost of research in order to vote in the resolution of the companies. In order to achieve more reliability and better support, PAF can be more transparent in their process while grasping the opportunity to rectify their mistakes. Analyzing the challenges with a deeper understanding and avoiding the 'one size fit all' process PAF can easily provide better assistance to the shareholders regarding their situations.<sup>15</sup>

The Procedural guidelines have put in place some guard rails to allow companies to rectify any non-compliances flagged by proxy advisors through a mandatory consultation requirement between the proxy advisors and the company.<sup>16</sup> The best way to showcase that the company works transparently is that the company should always grab the opportunity to address the recommendations of PAF advising a vote 'against' the proposal.

Enhanced collaboration and nurturing better communication with the companies can help PAF gain better insights, improving their quality and relevance of their recommendation.<sup>17</sup> Employing Industry specific experts with PAF to provide nuanced and informed advice to the shareholders. Enhancing of Transparency and building Trust among the investors and the companies, constant engagement with the shareholders can help PAFs to foster in the Indian Market.

One of the most accepted and recommended sources to this system is 'Regulation'.<sup>18</sup> Limiting the proxy voting system and instead using the active analysis at hand would benefit the voting process. Apart from broader reforms, a concrete step to fix the industry would be to modernize the voting requirements to prevent robo-voting. Increased disclosure requirements, formulating an elaborate practice-based code of conduct and amendments to the existing provisions, inter alia, providing for a dispute resolution mechanism between the company and proxy advisors are some other measures to be adopted in order to regulate or enhance the proxy industry in India.

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<sup>15</sup> Chester S. Spatt, *Proxy Advisory Firms, Governance, Market Failure, and Regulation*, in *Financial System of the Future* 1–21 (Fed. Reserve Bank of Atlanta 2019), <https://www.atlantafed.org/-/media/documents/news/conferences/2019/10/31/financial-system-of-the-future/presentations/spatt.pdf>.

<sup>16</sup> *Supra* note 10

<sup>17</sup> *Do Not Fear the Critic: How Proxy Advisors Improve Shareholder Decisions in India*, Vajiram & Ravi (July 4, 2024), <https://vajiramandravi.com/upsc-daily-current-affairs/editorial-analysis/do-not-fear-the-critic-how-proxy-advisors-improve-shareholder-decisions-in-india/>.

<sup>18</sup> J. Glassman & J. Verret, *How to Fix Our Broken Proxy Advisory System*, Mercatus Ctr. (Apr. 16, 2013), <https://www.mercatus.org/research/research-papers/how-fix-our-broken-proxy-advisory-system>.

## CONCLUSION

The landscape of shareholder activism in India, driven by a combination of informed investors, institutional participation, and the emergence of Proxy Advisory Firms, has significantly transformed the country's corporate governance framework. PAF's have emerged as pivotal players, bridging the gap between shareholders and corporate boards by providing critical insights and informed recommendations. This has fostered a culture of transparency and accountability, encouraging companies to align with the best governance practices. However, the proxy advisory industry in India faces notable challenges, including conflicts of interest, inadequate contextual analysis, limited regulatory oversight, and a lack of competition.

PAF can serve as torchbearers of corporate governance and prove a much-needed impetus to stakeholder activism.<sup>19</sup> It is too early to comment on the effectiveness of these proxy firms, as the concept is still developing, and the recommendations put forth have yet to gain significant influence on voting decision. To ensure the sustainability and efficacy of PAFs, a multi-faceted approach involving regulatory framework, enhanced transparency, industry specific expertise, and stronger stakeholder engagement is essential. Further their role can be streamlined through stricter regulations, tailored recommendations, and the modernization of voting processes.

While assessing the overall impact, these identified loopholes need targeted attention. Future reforms should focus on fortifying monitoring mechanism, enriching the precision of guidelines, and instituting standardize criteria for assessing methodologies. Only with the help of such, PFAs can transform into an entity that uniformly fosters good governance within the Indian Corporate sphere.

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<sup>19</sup> *Supra* note 9