

Institutional investor activism in India: A comparative analysis of the stewardship code in UK and India

Ekjot Kaur Dang

Jindal Global Law School, Sonapat, Haryana, India

Abstract

Since it is a well-known fact that the majority of companies in India are in the form of family companies wherein close family members establish and company and manage and control its affairs on a day to day basis. This calls for active corporate governance measures to be used to monitor such companies. Institutional investors' activism is one of the tools for exercising such corporate governance measures. Shareholder activism was almost a non-existent concept in India until the past few years. As a consequence of the global economic crisis, there was a need to adopt pro-active corporate governance strategies, and shareholder activism is one of them.

This paper will be divided into three parts. The first part will give a general introduction to understand who are institutional investors and what are the roles played by them to promote corporate governance. The second part will give an insight into the existing regulations which impose stewardship responsibilities on various types of institutional investors and compare its origin to the UK Stewardship Code. The third part will discuss whether the adoption of the UK based Stewardship regime in India is an effective corporate governance measure?.

Keywords: institutional investors, stewardship code, corporate governance, shareholder activism

Introduction

Institutional Investors are organized legal entities and can be synonymous with the term “intermediary investors” as they manage and invest other people’s money^[1]. “The exact legal form, however, varies widely among institutional investors and covers everything from straightforward profit maximizing joint stock companies (for example, closed-end investment companies) to limited liability partnerships (like private equity firms) and incorporation by special statute (for example, in the case of some sovereign wealth funds). Institutional investors may act independently or be part of a larger company group or conglomerate. This is, for example, the case for mutual funds who are often subsidiaries of banks and insurance companies.”^[2] One of the most ignored characteristics of institutional investors is that they are answerable to their clients as are companies to their shareholders^[3]. They aim at investing these sums in high performing companies with good corporate governance background^[4]. This paper aims at explaining the role played by institutional investors in the framework of corporate governance vis-a-vis the concerned investee companies and whether it is being complied with by institutional investors in India?

Predominantly, there are four categories of institutional

investors in India^[5]. Under the first category comes all developmental financial institutions such as State Finance CORPORATIONS and Institutions like ICICI, IDBI, etc^[6]. “The financial institutions extend both debt and equity financing to the companies. The debt covenants sometimes enable the financial institutions to have their nominee directors in the companies.”^[7] The next category consists of insurance companies such as Life Insurance Corporation. The next two categories include banks and mutual funds^[8]. “The mutual funds collect funds from both individuals and corporate to invest in the financial assets of other companies. In India, the mutual funds participate largely in the equity capital of the companies.”^[9]

The history of institutional investors can be traced back to the pre-economic reforms era of 1991 where only a few institutions were present and most of them were government operated^[10]. The scenario completely changed after the LPG reforms. Liberalization made the Foreign Institutional Investors interested in the Indian capital market and since then the Indian capital market has been a sanguine stock market^[11]. Securities and Exchange Board of India

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ Sahu, A., 2020. Institutional Investments in India: A Review of Literature. *Research Gate*. Available at file:///C:/Users/User/Downloads/Institutionalinvestment_literaturereview_IJCG_April2014.pdf

¹¹ Perumal, R., 2020. Liberalisation of the Law relating to Foreign Institutional Investment and its Impact on Economic Development. [Blog] *Legalserviceindia.com*. Available at: <http://www.legalservicesindia.com/article/689/Liberalisation-of-the-Law-relating-to-Foreign-Institutional-Investment-and-its-Impact-on-Economic-Development.html>

¹ Celik, S. and Isaksson, M., 2014. Institutional investors and ownership engagement. *OECD Journal: Financial Market Trends*. Available at <https://www.oecd.org/finance/Institutional-investors-ownership-engagement.pdf>

² *Id.*

³ Mohanty, Pitabas, Institutional Investors and Corporate Governance in India. National Stock Exchange of India Research Initiative Paper No. 15. Available at SSRN: <https://ssrn.com/abstract=353820> or <http://dx.doi.org/10.2139/ssrn.353820>

⁴ *Id.*

(hereinafter referred to as SEBI) defines Foreign Institutional Investors as:

“Foreign Institutional Investor means an institution established or incorporated outside India which proposes to make investment in India in securities;”^[12]

Institutional investors have since played an important role in the market but one of the most vital responsibilities assumed by them is ensuring good corporate governance through various tools. Renowned scholars in this field have often shown a conflict of opinion about the role played by institutional investors in corporate governance. Wharton, Lorsch, and Hanson (1991) are of the opinion that institutional investors owe primary and fiduciary responsibility to their own investors and should not actively take part in corporate governance of the company as this can lead to a conflict of interest by them acting as owners^[13]. On the other hand Schliefer and Vishny (1986) are of the belief that institutions investors have greater incentives in supervising corporate governance because of their large shareholdings^[14]. The Cadbury Committee (1992) chaired by Mr. Adrian Cadbury made some observations about the same:

“Institutional investors should encourage regular, systematic contact at senior executive’s level to exchange views and information on strategy, performance, board membership and quality of management.

Institutional investors should make positive use of their voting rights, unless they have good reason for doing otherwise. They should register their votes wherever possible on a regular basis.

Institutional investors should take a positive interest in the composition of boards of directors, with particular reference to concentrations of decision making power not formally constrained by appropriate checks and balances, and to the appointment of a core of non-executive directors of the necessary caliber, experience and independence.”^[15]

The Kumar Manglam Birla Committee Report (1999) chaired by Mr. Kumar also gave suggestions with respect to role of institutional investors in regulating corporate governance in the Indian framework. Some of the suggestions given were:

“Take active interest in the composition of the Board of Directors

- *Be vigilant*
- *Maintain regular and systematic contact at senior level for exchange of views on management, strategy, performance and the quality of management.*
- *Ensure that voting intentions are translated into practice*
- *Evaluate the corporate governance performance of the company”^[16].*

¹² Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995. S.2 (F).

¹³ Advice and Dissent: Rating the Corporate Governance Compact Harvard Business Review. (1991). *Advice and Dissent: Rating the Corporate Governance Compact*. [online] Available at: <https://hbr.org/1991/11/advice-and-dissent-rating-the-corporate-governance-compact>

¹⁴ Shleifer, Andrei, and Robert W Vishny. 1986. “Large Shareholders and Corporate Control.” *Journal of Political Economy* 94 (3): 461-488.

¹⁵ 1992 The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd.

¹⁶ Birla, K., 1999. Report of The Kumar Mangalam Birla Committee On Corporate Governance. SEBI.

Overtime the dominant position has affirmed the importance of role played by institutional investors in monitoring the corporate governance in the investee companies and the biggest reason contributing to this is the high percentage of voting powers that lie with such investors. These investors can further act as a guiding factor to ordinary retail investors who usually don’t possess the expertise to analyze the market situation in a correct manner.

Part-II

There have been multiple instances where the institutional investors have actually used their position in the interest of the company. In the case of Apollo Tyres, minority shareholders (including local and foreign institutional investors) rejected the re-appointment of Neeraj Kanwar as the managing director because of the issue of high compensation as there was a hike of 43% in his annual compensation^[17]. Another example is concerned with The Housing Development Finance Corporation (HDFC), where the issue was with regards to re-appointment of Mr. Deepak Parekh as a non-executive director. This resolution was opposed by almost a quarter of shareholders based on the advice of two US proxy advisories Glass, Lewis & Co. and ISS. “Glass, Lewis & Co felt that the HDFC board was not “sufficiently independent” while ISS pointed out that Parekh was on the board of more than six public companies.”^[18] Institutional Investors have also rejected the pay resolutions in Tata Motors. The resolution was supported by the promoters but almost 65% of the institutional investors and 41% of the retail investors have voted against all three of such resolutions. As a result of such initiative taken by the investors, the special resolution didn’t get approved by a lack of 5% in votes. The institutional investors were of the view that the “variable pay elements (incentive, benefits, perquisites) were not capped, making it difficult to determine minimum remuneration, so they voted against the resolutions.”^[19] Further, in 2014 Suzuki Motor Corporation announced that it would be in a \$488 million project to build a plant in Gujarat^[20]. This resolution was however opposed by the institutional investors who had almost 7% shareholding in the company. The institutional investors further asked SEBI’s intervention into the matter in order to get the rights of minority shareholders protected. Similarly, there have been more instances, where the institutional

¹⁷ Gaur, V.Gaur, V. (2018). *Shareholders reject re-appointment of Apollo Tyres MD*. [Online] The Economic Times. Available at: <https://economictimes.indiatimes.com/markets/stocks/news/shareholders-reject-re-appointment-of-apollo-tyres-md/articleshow/65988382.cms>

¹⁸ US proxy advisors behind vote against Deepak Parekh - Financial Chronicle | DailyHunt

Dailyhunt. (2020). US proxy advisors behind vote against Deepak Parekh - Financial Chronicle | DailyHunt. [Online] Available at: <https://m.dailyhunt.in/news/india/english/financial+chronicle-epaper-finance/us+proxy+advisors+behind+vote+against+deepak+parekh-newsid-93605980>

¹⁹ Padma Venkat, C. (2014). *Institutional Investors Reject Tata Motors Pay Resolutions: Is Tide Changing in India?*. [Online] CFA Institute Market Integrity Insights. Available at: <https://blogs.cfainstitute.org/marketintegrity/2014/07/23/institutional-investors-reject-tata-motors-pay-resolutions-is-tide-changing-in-india/>

²⁰ C.H. Unnikrishnan, V. (2014). *Sun Pharma not to allow Ranbaxy minority investors a merger veto*. [Online] Livemint. Available at: <https://www.livemint.com/Companies/R1ZL8jjuip9cTQTSGBOWZM/Sun-Pharma-not-to-allow-Ranbaxy-minority-investors-a-merger.html>

investors have actually actively participated in the decision making process to safeguard the interests of minority shareholders including themselves, such as Sun Pharma's resolutions being opposed in 2014 with regards to a merger with Ranbaxy Laboratories Limited. The investors filed a suit against the concerned companies in the Andhra Pradesh High Court alleging insider trading^[21].

At present, there are three Stewardship Codes for various categories of institutional investors in India. The first code was formulated in 2017 by The Insurance Regulatory and Development Authority of India (IRDAI) for insurance companies. The next Stewardship Code is specifically designed for Pension Funds in India by the Pension Fund Regulatory and Development Authority (PFRDA) in 2018. The most recent development in this regard has been the Stewardship Code, notified by The Securities and Exchange Board of India (SEBI), for all mutual funds and all categories of Alternative Investment Funds. In 2016, a paper published by the India-UK Financial Partnership, recommended that India should adopt its own 'Indian Stewardship Code'^[22]. The purpose behind this is that, *"the Code will build upon the significant progress in corporate governance and trends in increased investor voting in India to migrate towards a "voting plus" and "comply or explain" framework which is the next step in responsible shareholder engagement. It is believed that this will encourage a constructive and mutually beneficial two-way dialogue between shareholders and the boards of listed Indian companies."*^[23] The paper did not elucidate on the contents of such a code but the resemblance of the structure and the rationale behind such code is similar to the UK Stewardship Code.

The IRDAI Stewardship Code works on a 'comply and explain' basis whereas the other two codes are mandatory in nature^[24]. There is a significant amount of similarities amongst all three codes. Some of the principles commonly discussed in these codes are as follows:

- The concerned institutional investors shall formulate a policy in order to discharge their stewardship responsibilities and such policies should be disclosed publically^[25].
- There should be a clear policy on management of conflict of interest in fulfillment of the stewardship duties and its public disclosure^[26].
- Institutional investors should regularly monitor the investee company^[27].
- A policy should be developed to explicitly state the intervention mechanism in any investee company^[28].
- Institutional investors shall also have a policy relating to collaboration with other institutional investors in case there is a need to preserve the ultimate Investors interest^[29].

²¹ *Id.*

²² India-UK Financial Partnership, Responsible Shareholder Engagement An Indian Stewardship Code (2016) <https://www.thecityuk.com/assets/2016/Reports-PDF/ffe02d39f/IUKFP-Responsible-Shareholder-2016.pdf>

²³ *Id.*

²⁴ IRDAI, Guidelines on Stewardship Code for Insurers in India; PFRDA, Common Stewardship Code; SEBI, Stewardship Code for all Mutual Funds and all categories of AIFs, in relation to their investment in listed equities.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

- There should be a comprehensive policy with respect to the voting and there should be a disclosure of all the voting activity done by the institutional investor^[30].

On a simple reading of all the three codes, it can be found that there is a substantial resemblance between the all Indian Stewardship Codes and the UK Stewardship Code of 2012. It is such that the Indian regulatory authorities have replicated the broad principles from the UK based code without making much changes keeping in mind the Indian corporate scenario. In the next section, I will discuss whether a replica of the UK Stewardship Code will fit in the Indian scenario of corporate governance.

Part-III

We shall now assess whether the stewardship approach adopted in India from the UK is an effective mechanism for the Indian corporate governance regime. It is noted that the UK has used a 'soft law' approach in various areas concerning the governance of companies, the position is usually to the contrary in the Indian scenario. The UK Stewardship Code uses a 'comply or explain' mechanism as has been adopted by the IRDAI in India^[31]. The adoption of such an approach in the Indian scenario makes it truly difficult for the regulators for a robust enforcement of the stewardship responsibilities. The UK Stewardship Code was amended in 2020 where it was decided that the 'comply or explain' approach has to be replaced with an 'apply and explain' approach, which implies that not only the institutional investors will have to comply with the UK Stewardship Code but they will also need to explain the way in which the Code is applied^[32]. In this context, the Indian regulatory authorities have taken a laid back approach and not put a thought in the efficaciousness of the stewardship regime in India. Even though the SEBI and the PFRDA Codes ask for mandatory compliance with the code, they do not mention anything about the consequences of non-compliance with the code.

One of the biggest problems in adopting the UK model as a replica in India is the very nature of corporations and shareholding in the two jurisdictions. The UK Stewardship Code is a regulation to minimize the agency problem between managers and shareholders^[33]. This Code is meant to regulate a dispersed shareholding pattern. In this context, there is a need to boost the engagement of institutional investors with the management of the investee company. The driving force behind the UK model is that of dominance by the institutional investors^[34]. On the contrary, the shareholding pattern in India is more concentrated in nature. The prevalence of family companies in India tells us the high concentration of shareholding with such shareholders who have a direct and immediate interest in the company. In such a scenario the primary stewards of a company are such family members themselves^[35]. Therefore, the agency problem in the Indian scenario is of majority and minority shareholders. In such a scenario, expecting a policy based

³⁰ *Id.*

³¹ The UK Stewardship Code, 2012

³² The UK Stewardship Code, 2020

³³ Brian R. Cheffins, 'The Stewardship Code's Achilles' Heel', (2010) 73 *Modern Law Review*

³⁴ *Id.*

³⁵ Ronald C Anderson & David M Reeb, 'Founding-Family Ownership and Firm Performance: Evidence from the S&P 500', (2003) 58 *The Journal of Finance*

on a different agency problem cannot be applied to India. At the very core of it, the objectives of the Indian stewardship models should tackle the agency problem within the Indian companies rather than duplicating a model which has a separate set of objectives to achieve.

The last concern regarding the adoption of a UK based corporate governance stewardship model in India is with regards to the shareholder v/s stakeholder approach taken upon by the two jurisdictions. According to Section 172 of the Companies Act, 2006 (UK's Companies Act) UK follows the Enlightened Shareholder Value Model (ESV Model). This can be determined from the drafting in its legislation, which states:

“A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole...”^[36]

One of the supporting pillars of the UK Stewardship Code is the shareholder approach taken under which promotes the welfare of the members of the company solely. Opposing this, one of the basic principles of the Indian corporate law has been the stakeholder approach. This was recently codified in the Companies Act, 2013 which states that *“A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.”*^[37] Apart from this, the Indian legislators have also made the corporate social responsibility a statutory provision in the Companies Act, 2013^[38]. This shows the completely opposing views of the two jurisdictions with respect to the basic underpinnings of their corporate laws. If a stewardship code is drafted keeping in mind the basic principles of corporate law in India, then a UK based approach would never be adopted in its entirety.

India needs a stewardship model that takes into its ambit all the institutional investors rather than regulating only some parts of them and this needs to be done under one regulatory authority to ensure its robust enforcement. Apart from this, a mandatory compliance approach is more suitable for India because such an approach works well within the Indian context where enforcement can be lagging at times. A stewardship code which tackles the right agency problems in the Indian scenario will help to make the corporate governance regime stronger and ensure institutional investor participation in the decision-making process of the board. At the same time, it is pertinent to keep in mind that a stakeholder-based approach is the very backbone of the corporate law regime in India, and therefore, the stewardship code should be able to enforce such principles in its essence.

References

- Umakanth Varottil. Emergence of Shareholder Activism in India, NSE, 2013. https://archives.nseindia.com/research/content/res_QB1.pdf
- Çelik S, Isaksson M. Institutional investors and ownership engagement. OECD Journal: Financial Market Trends, 2014. Available at <https://www.oecd.org/finance/Institutional-investors-ownership-engagement.pdf>
- Mohanty Pitabas. Institutional Investors and Corporate Governance in India. National Stock Exchange of India Research Initiative Paper No. 15. Available at SSRN: <https://ssrn.com/abstract=353820> or <http://dx.doi.org/10.2139/ssrn.353820>
- Sahu A. Institutional Investments in India: A Review of Literature. Research Gate, 2020. Available at file:///C:/Users/User/Downloads/Institutionalinvestment_literaturereview_IJCG_April2014.pdf
- Perumal R. Liberalisation of the Law relating to Foreign Institutional Investment and its Impact on Economic Development. [Blog], 2020. Legal service india.com, Available at: <http://www.legal-services-india.com/article/689/Liberalisation-of-the-Law-relating-to-Foreign-Institutional-Investment-and-its-Impact-on-Economic-Development.html>
- Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, (F), 1995, (2).
- Advice and Dissent: Rating the Corporate Governance Compact
- Harvard Business Review. Advice and Dissent: Rating the Corporate Governance Compact, 1991. [online] Available at: <https://hbr.org/1991/11/advice-and-dissent-rating-the-corporate-governance-compact>
- Shleifer Andrei, Robert W Vishny. “Large Shareholders and Corporate Control.” Journal of Political Economy. 1986; 94(3):461-488.
- The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd, 1992.
- Birla K. Report of The Kumar Mangalam Birla Committee On Corporate Governance. SEBI, 1999.
- Gaur V, Gaur V. Shareholders reject re-appointment of Apollo Tyres MD. [online] The Economic Times, 2018. Available at: <https://economictimes.indiatimes.com/markets/stocks/news/shareholders-reject-re-appointment-of-apollo-tyres-md/articleshow/65988382.cms>
- US proxy advisors behind vote against Deepak Parekh - Financial Chronicle | Daily Hunt Daily hunt. US proxy advisors behind vote against Deepak Parekh - Financial Chronicle | Daily Hunt, 2020. [online] Available at: <https://m.dailyhunt.in/news/india/english/financial+chronicle-epaper+finance/us+proxy+advisors+behind+vote+against+deepak+parekh-newsid-93605980>
- Padma Venkat C. Institutional Investors Reject Tata Motors Pay Resolutions: Is Tide Changing in India?. [online] CFA Institute Market Integrity Insights, 2014. Available at: <https://blogs.cfainstitute.org/market-integrity/2014/07/23/institutional-investors-reject-tata-motors-pay-resolutions-is-tide-changing-in-india/>
- CH Unni krishnan V. Sun Pharma not to allow Ranbaxy minority investors a merger veto. [online] Livemint, 2014. Available at: <https://www.livemint.com/Companies/R1ZL8jjuip9cTQTSGBOWZM/Sun-Pharma-not-to-allow-Ranbaxy-minority-investors-a-merger.html>
- India-UK Financial Partnership, Responsible Shareholder Engagement an Indian Stewardship Code, 2016. <https://www.thecityuk.com/assets/2016/Reports-PDF/fff02d39f/TUKFP-Responsible-Shareholder-2016.pdf>
- IRDAI, Guidelines on Stewardship Code for Insurers in India; PFRDA, Common Stewardship Code; SEBI,

³⁶ Section 172 of the Companies Act, 2006

³⁷ Section 166(2) of the Companies Act, 2013

³⁸ Section 135 of the Companies Act, 2013

Stewardship Code for all Mutual Funds and all categories of AIFs, in relation to their investment in listed equities.

18. The UK Stewardship Code, 2012.
19. Brian R. Cheffins, 'The Stewardship Code's Achilles' Heel', *Modern Law Review*, 2010, 73.
20. Ronald C, Anderson, David M Reeb, 'Founding-Family Ownership and Firm Performance: Evidence from the S&P 500'. *The Journal of Finance*, 2003, 58.
21. Section 172 of the Companies Act, 2006.
22. Section 166(2) of the Companies Act, 2013.
23. Section 135 of the Companies Act, 2013.