excellence enablers CORPORATE GOVERNANCE SPECIALISTS
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INSTITUTIONAL SHAREHOLDERS – EXPECTATIONS AND REALITY
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SUMMARY OF DISCUSSIONS

Background

In addition to being a significant presence in listed entities, institutional shareholders are the entities that are expected to constructively challenge the Boards and managements to do what is consistent with the interest of stakeholders. The track record in discharging the Stewardship role is somewhat patchy. While institutional shareholders should not remain passive, they should not also move from activism to adventurism.

- *What factors do institutional investors consider when they invest, as well as when they decide to stay invested? Are there any factors that they should consider, but are not doing at present?*
- *Does the investment decision travel beyond mere numbers?*
- *Is ESG considered while deciding on investment? Is the absence of a track record, a deterrent for some companies who wish to invest?*
- *Is the quality of Board, and its Directors, especially Independent Directors, considered to be important while taking the investment decisions?*
- *Do institutional investors vote with their feet if things go wrong or do they stay there and fight the battle?*
- *Are the interactions with management constructive and value-adding?*
- *How is the possibility of asymmetry of information guarded against?*
- *Do institutional investors perform the stewardship role?*
- *How do institutional investors in India fare as compared to their international counterparts in all these aspects?*

DISCUSSIONS

- In the 1960s and 1970s, Peter Drucker wrote about the role that Mutual Funds would play in the future, and said that capital will not be owned only by the capitalists, but by many, and those many will decide how to deploy this capital in the best interest of the investors. In India, this has started only recently, as compared to well capitalised economies. Capitalists still own the capital and its deployment, and Mutual Fund is at the tail-end, in order to make a little money for its investors.
- The role of persons in the Mutual Fund industry is difficult since the motivations are different from what obtains internationally.
- Value creation for shareholders has become very important.
- The market is becoming more sensible, and it reflects on the business environment too.
- Institutional investors are very effective in driving change.

CORPORATE GOVERNANCE STANDARDS IN INDIA

- Since capital is owned mostly by promoters, it is difficult for Mutual Funds to create a proper governance structure in portfolio companies.
- At present, ESG and shareholder activism seem remote.
- Corporate Governance standards, including those laid down by statute as well as the disclosures, when compared to other emerging markets, are good. Control exercised by large investors/ promoters is lesser, and minority shareholders are taken a lot more seriously. As compared to some of the advanced economies such as USA etc also, India fares better. Corporate compliance and adherence has improved drastically.

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- With increased regulations, it is easier for fund managers to oversee the implementation of factors that lead to improved governance. When majority of minority became law, it was easier for institutional investors to vote. Regulation empowers fund managers. Misgovernance cannot be stopped in toto, but can be reduced.
- Persons responsible for Corporate Governance are like goal-keepers. They are judged for the number of goals that they let in, and not for the number that they prevented/ saved.
- Market is a good leveller. There is a premium on the stock of the companies that are considered to be well governed. If one has invested in bad companies, it comes out clearly.
- Investment decisions cannot be taken on the basis of quality of Boards for want of information. What is good is a judgement call. Good CEOs do not necessarily have good boards, and vice versa. There is a distinction between a good CEO and good Board composition.
- As far as Directors' appointment is concerned, it is difficult for a fund manager to decide whether a Director will add value from the point of view of shareholders, or not. Assessing the quality of a Board, from the outside is not easy. There have been situations in the past, when the Board seemed to comprise the right set of Directors, but that did not necessarily add value. As a result, governance standards of the company is the only factor that can be considered. Also, with a cap of 10 Boards for a Board member, it is difficult for a Director to do justice to all the Boards. Further, since minutes of meetings etc are not in public domain, it is not possible to assess the contribution of individual Directors from the outside.
- Also, if the compensation paid to Directors is limited, it is difficult to decide whether Directors would function for the shareholders or for the company. Stock options should not have been discontinued for Independent Directors.
- There are concerns around who influences board decisions, and between Independent Directors and Nominee Directors, who has more voice inside the boardroom.
- If at the time of re-election of Directors, their score card/ report card is made public, it could help in voting.
- Stewardship code has been helpful, especially in situations relating to conflict of interest. There are companies that are encouraging their fund managers to take independent decisions.
- Alignment of interests is important. For Private Equity firms, it is easier to drive governance. This is because they build a company in order to sell it, and buyers are discerning. They will not buy a company if there is no governance. A lot of the practices that they introduce may not be mandated by law, but are good practices.

FUND MANAGERS AND GOVERNANCE

- There are situations where there could be a conflict between the investment side, and the business side. In such cases, even if there are Corporate Governance issues, it is not always easy to flag them since the ecosystem may not support hard stances on governance. This is because Mutual Funds have their own investors and stakeholders, who may have a point of view on some of the portfolio companies. Things are moving in the right direction slowly, but it is not easy.
- Corporate Governance is too serious to be left to fund managers alone. As long as they carry the burden alone, it will be sub-optimal.
- Mutual Fund managers are not incentivised on the basis of governance standards of their portfolio companies, but only on the basis of how well their portfolio companies are performing. However, if they do perceive risks associated with Corporate Governance, they limit their exposure to the company.
- They do not consider whether the companies are doing the right things, in the right manner, and are the right results coming. If these factors are considered, there may not be too many companies to invest in.

- Mutual Fund managers evaluate on a daily basis, how well their portfolio companies are performing. Their average holding is for 2 years, when most other persons have a time horizon of 10 years. This makes it difficult for them to take a long-term view. There is certain degree of churn that happens, and this causes a gap between expectations and reality.
- There are a number of situations that could lead to a conflict of interest. Such as, fund managers could face a situation where they invest against a large corporate, who is an investor in her/his fund. This is questionable, and in such situations, she/he will have to check internally.

INTERACTION WITH PORTFOLIO COMPANIES

- Institutional investors feel that interaction between institutional investors and the company, including PSUs, has increased. A number of companies are conscious of their ratings, such as on ESG parameters, and so are engaging.
- However, this comes with a trade-off, which is that CEOs of portfolio companies rarely meet institutional investors one-on-one, and only interact in analyst calls.
- Getting the contact details of one single point of contact in the portfolio company is not easy for institutional investors. If each Board has a Lead Independent Director, that person can be a single point of contact for such investors, in case they want to discuss any governance related matter.

VOTING

- Investors are careful while voting.
- There are limitations to the activist role that institutional investors can play, and the extent to which they can use voting as a tool to bring about changes to the Corporate Governance standards of a company. This is because not all the resolutions get voted out. But over the years, there has been improvement. Institutional investors are aware about the power of voting as a tool to improve Corporate Governance.
- Decisions on resolutions are coming under greater scrutiny. Since the outcome, as also the recommendations of the proxy firms, have to be disclosed, the accountability of fund managers has increased. They are asking the right questions. This has also resulted in increased informed voting.
- Companies are concerned about reputational risks. They are concerned about institutional investors voting against resolutions since large investors voting against a resolution will come out in the media. This has resulted in an enhanced engagement between the institutional investors and the company.
- The new pension scheme method is important because all investors come together, discuss and vote. It gives a certain degree of anonymity to the fund manager, which helps.
- Institutional investors cannot always play the role of activists. They are not inherently activists. They too prefer a certain degree of anonymity. Despite this, they do show some activism some times.
- Universal funds cannot get into adventurism. There are limited choices because there are institutional relationships that are involved, and those depend on the chieftains and the fund managers.
- Improved quality of disclosures by companies will help improve voting in the long run.

ESG

- ESG is all about responsible investing. Stock markets are becoming smarter, and are driven by international trends such as how to reward companies which are focusing on ESG or how to punish companies which are not focusing on ESG.
- ESG has been adopted by most institutional investors and Private Equity firms, but it is impractical in a lot of spheres, mainly because it is difficult to measure some aspects. The ESG score card is only about matching boxes. Private Equity firms undertake diligence on some aspects of ESG.
- It is not easy to punish companies which are not following ESG norms. However, there is an increased consciousness around ESG.

- Internationally, environment is given priority, followed by social and governance factors. But in India, it usually is the other way round. There is no homogeneity in views, and so it is difficult to have a standard approach to ESG. One of the reasons for this is that the approach depends on the competence to measure each of these factors. In India, the competence to evaluate environment is less, however, internationally, environment affects companies more, and hence they focus on it. There are vested interests.
- Also, social standards used internationally cannot be blindly copied in India. They have to be contextualised. ESG has to have a country-context. Also, what some persons consider to be governance, is not so. The impression internationally is very different from the Indian context.
- There should be rules/standards on ESG, based on which companies should be made to disclose, and then fund managers can look at trends, and implement them in their own portfolio companies. One partner in each Private Equity firm is designated to report that ESG has being considered while taking investment decisions.
- Some companies have started offering ESG ratings, wherein the process followed by them has been contextualised to Indian realities.

DILEMMAS

- In the case of any issue, institutional investors face a dilemma - Whether to walk out or to vote against the resolution. Ideally, investors should disassociate the entity from the promoter, and then take a decision. This does not happen in India. If it did, it could save a number of companies because it would give elbowroom to the investors.
- Under SEBI regulations, interaction with companies will be difficult, because the responsibility of the fund manager would increase if a promoter was to share some information which is a UPSI. Concept of materiality needs to improve.
- Enforcement of existing laws, and demarcation of role and responsibilities of executive and non-executive Directors has to improve substantially, to improve the confidence of institutional investors.
- Surveillance, investigation and enforcement should be fast to prevent errant companies from having their way.
- Code of conduct for fund managers is too stringent, and could cause problems in retaining talent.
- If institutional investors collaborate, and stand united, they can make a bigger and more powerful impact. There have been a number of international instances too where this has happened, such as in the case of Australian pension funds. They have created a body which does background research on governance practices adopted by companies, and access to this information is provided to the members. A platform can be created to share such knowledge.

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CORPORATE GOVERNANCE SPECIALISTS
ADDING VALUE, NOT TICKING BOXES

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EXCELLENCE ENABLERS PRIVATE LIMITED

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

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

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

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