

Investors and Proxy Firms are Changing the Indian Corporate Governance Landscape

Stewardship refers to investors' engagement with investee companies on corporate governance and ESG issues that encourage long-term value creation for shareholders. This can take the form of voting on shareholder resolutions and / or direct communication with investee companies.



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INTRODUCTION

The UK Stewardship Code was the first after the global financial crisis. Over the years, several western markets adopted the concept before it spread to Asia. There are two ways in which stewardship codes are adopted – in some markets there is voluntary adoption by a set of asset management firms; in others, it is mandated through regulation. India has taken the regulatory route.

STEWARDSHIP IN INDIA OVER THE YEARS

In India, the first sign of stewardship was in 2010, when SEBI asked mutual funds to publish their voting policies. This was at a time when voting participation was abysmally low and was by show of hands. Because voting was by show of hands, the votes were weighed by the number of shareholders that attended a general meeting, rather than the size of the shareholding behind the votes. The 2010 SEBI regulations had negligible impact given the environment at that time. In a further push, in 2012, SEBI asked mutual funds to publish their votes on shareholder resolutions. But given that the outcome continued to be by show of hands, and that the market was still at the early stages of understanding its stewardship responsibilities, the second set of regulations too had marginal impact.

However, things changed in 2014. SEBI brought in e-voting, which ensured that the outcome of shareholder resolutions was weighed by the number of shares held, and it allowed greater participation since physical presence at the general meeting was no longer required. SEBI asked mutual funds to

disclose not only their votes on shareholder resolutions, but also the rationale for their voting – which meant that even an abstention needed to be explained. Given these contours, mutual funds began to vote on shareholder resolutions and effective participation began increasing.

In 2016, PFRDA compelled pension funds to vote on shareholder resolutions. But PFRDA was different from SEBI – it recommended that all pension funds vote in consonance. For this, pension funds had to operate like bank consortiums, and coordinate how they were going to vote on shareholder resolutions. This was not SEBI's mandate – SEBI did not require mutual funds to coordinate their voting.

In 2017, IRDA took a step ahead of both SEBI and PFRDA – it recommended that insurers draft stewardship codes. Up until then, stewardship was exercised in the form of voting on shareholder resolutions. With the requirement of a stewardship code, insurers were required not only to vote on shareholder resolutions, but also engage with investee companies. For the insurance sector, this was a radical change.

What is a stewardship code?

The purpose of mandating a stewardship code is to publicly describe the approach taken by institutional investors in their decision making to enhance corporate governance practices in their investee companies and provide better returns to the ultimate beneficial owners. A typical code would include managing conflicts of interest, devising internal policies and processes to apply the code, utilizing third-party professionals, monitoring investee companies, escalation procedures, engagement strategies, collaboration with other institutional investors, identifying areas where specific monitoring is needed, proxy advisor oversight, reporting and disclosing voting policies, and periodic review of policies. These help to raise awareness among both internal and external stakeholders of an institutional investor, including the investee companies.

In 2018, PFRDA too asked pension funds to adopt a stewardship code. In 2019, SEBI as the dominant securities market regulator, asked mutual funds and AIFs to adopt a stewardship code as well. In 2022, SEBI insisted that mutual funds were required to vote on all resolutions – which made abstaining from resolutions difficult.

Exhibit 1: Stewardship Principles of IRDAI, PFRDA and SEBI

IRDA	PFRDA, SEBI	Principle
1	1	Formulate a policy on the discharge of stewardship responsibilities and publicly disclose it
2	2	Have a policy on managing conflicts of interest in relation to stewardship and disclose it publicly
3	3	Monitor their investee companies
4	4=	Establish clear guidelines on when and how they will escalate their stewardship activities
5	4=	Be willing to act collectively or collaborate with other investors where appropriate
6	5	Have a clear policy on voting and disclosure of voting activity
7	6	Report periodically on their stewardship and voting activities

Source: IRDA, PFRDA, SEBI websites

Want to become a stewardship professional?

While global asset managers have been signatories of stewardship codes for a long time, in India this is a relatively new function. As a result, these skills are not readily available in India. Professionals in this role – both on the asset management side and the investee company side – are learning the ropes as they go along. Experiences and failures tend to be the learning drivers. While the role is at a nascent stage (and is yet to develop into a formal function), its need is undisputed. Professionals that enter this space early are likely to have a stronger growth path and the opportunity to make an impact.

Several global courses (and a handful of domestic ones) focus on ESG but the stewardship function extends beyond ESG. A recently formed global initiative – the StePs programme, (disclosure: I sit on the board of the foundation) for instance is aimed at certifying professionals in the stewardship function. The programme has its proprietary courses and gives credits for other courses already taken by candidates. Professionals interested in pursuing the stewardship function can find more information on <https://stewardship-professionals.com/>.

THE ADVENT OF PROXY ADVISORS IN INDIA

Institutional Investor Advisory Services India Limited (IiAS) was the first proxy advisor to register itself in June 2011 and that became the start of the proxy advisory industry. This was at a time when voting on shareholder resolutions was by show of hands. However, over time, as voting on shareholder resolutions entered the consciousness of domestic asset managers and e-voting empowered them, the role of proxy advisors came to the forefront.



Proxy advisors have been instrumental in bringing the corporate governance debate to the forefront. Their main service is providing recommendations on how institutional investors must vote on shareholder resolutions. Their largest customer base is the asset management industry – including (but not limited to) mutual funds, pension funds, insurance companies. Proxy advisory firms are required by the regulations to publish their voting guidelines – these are frameworks that provide clarity on how proxy advisors reach a decision to recommend voting FOR or AGAINST a particular shareholder resolution. Proxy advisors have different voting guidelines and therefore their recommendations need not be aligned across the same resolution.

With significant advocacy work, proxy advisors have been able to effect regulatory change. IiAS' annual reports on cash hoarding by companies led to SEBI mandating the top 1000 companies to publish a dividend distribution policy. IiAS' annual publication on royalty payments by MNCs led to SEBI mandating that royalty payments in excess of 5% of revenues required a separate shareholder approval under the umbrella of related party transactions (through the Kotak Committee recommendations).

Proxy advisors have also been instrumental in calling out companies and their promoters for transactions and practices that are prejudicial to the interest of minority shareholders. This advocacy has been ably supported by the Indian media that provides another set of push back in such instances.

The Indian proxy advisors operate differently from the global ones. Globally, proxy advisory firms hold investors' proxies and therefore will vote the shares based on their recommendations. However, this is not allowed under Indian regulations. Proxy advisors in India do not hold investor proxies – they provide advice and recommendations, but it is up to the investors to cast their votes accordingly.

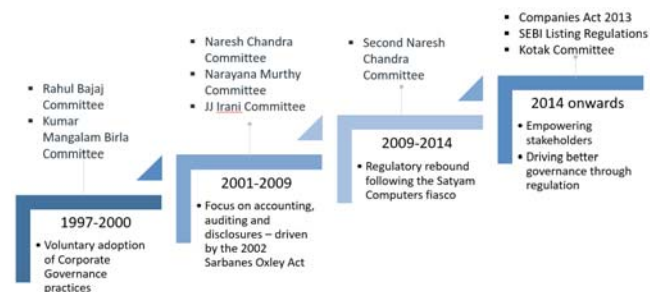
Given the growing influence of proxy advisors, SEBI decided to regulate them under the SEBI (Research Analysts) Regulations, 2014. Today, there are three domestic firms (of which IiAS is one) and one global firm that are registered with SEBI as proxy advisors. Subsequent to this regulation, SEBI has published procedural guidelines for proxy advisors in August 2020.

THE CHANGING CORPORATE GOVERNANCE LANDSCAPE IN INDIA

The corporate governance landscape has changed dramatically since the advent of proxy advisors. While proxy advisors have made a significant impact, the other key stakeholders that have been instrumental in influencing these changes are Regulators, investors and the media.

We are currently in the fourth generation of governance reforms. Regulatory reforms have changed from initially being voluntary adoption of codes, to mandatory requirements – enforced through Clause 49 of the Listing Agreement and Companies Act (1956 and 2013). The new reforms are focussed on empowering investors. While the Companies Act 2013 has brought in provisions relating to class action suits, SEBI has tightened the governance expectations through SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. The regulations on related party transactions Through the majority of minority vote have not only curtailed financial leakages, but also brought to light the number of business adjacencies being held in promoter-controlled companies. SEBI has also used disclosure as an effective form of enforcement.

Exhibit 2: The fourth generation of governance reforms



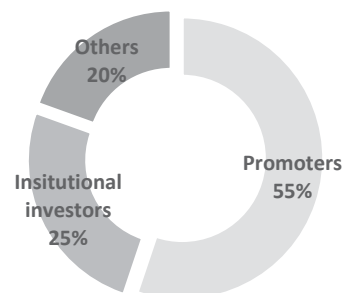
Source: IiAS research

Investors have played a critical role in establishing governance structures along with proxy advisors. Asset managers, from choosing to abstain more often than not in the early years, are now becoming increasingly vocal. As compared to before, more than 75% of the capital is being voted upon.

Asset managers also recognize that voting on shareholder resolutions is not sufficient to influence change – and they are increasingly using engagement as a method to effect better corporate behaviour. As a result, one company that announced a royalty payment to its parent company for the use of the brand had to withdraw this decision within 24 hours after significant investors push – which was also demonstrated in an immediate decline in the stock price. There are three directors that resigned on the morning of the AGM in which they were being reappointed – following the push back from proxy advisors and investors to their directorships.

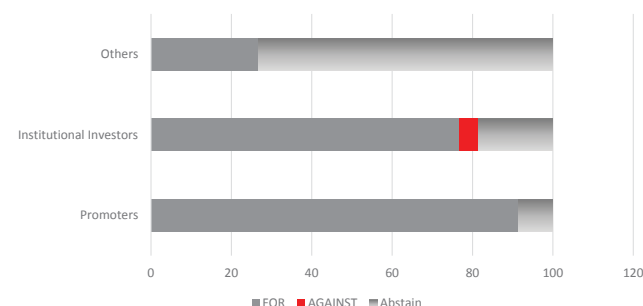
Effecting changes in corporate behaviour is difficult in the Indian context because of the nature of the shareholding. About 55% of the shares are held by promoters, about 25% by investors and the rest by retail and other body corporates. As a result, ordinary resolutions tend to pass easily. Even so, by and large, companies are getting more sensitive to the reaction of both, proxy advisors and investors.

Exhibit 3: Ownership structure of Indian listed companies (FY22)



Source: IiAS research

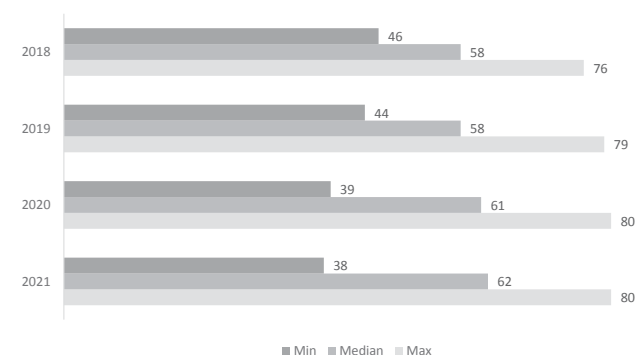
Exhibit 4: Voting patterns of the shareholder groups in FY22



Source: IiAS research, www.iiasadrian.com

Corporate Governance standards in India are improving. For the past six years, IiAS has been evaluating the S&P BSE 100 index constituents on the IFC-BSE-IiAS Indian Corporate Governance Scorecard. Over the four years between 2018 and 2021¹, scores of S&P BSE 100 companies have improved as has the overall distribution of the scores. Given that the S&P BSE 100 index constituents account for over 70% of total market capitalization, it is a reasonable representation of the overall market performance.

Exhibit 5: Scores of S&P BSE 100 index constituents on the Indian Corporate Governance Scorecard



Source: IiAS research; <https://www.iiasadvisory.com/governance-Scorecard>

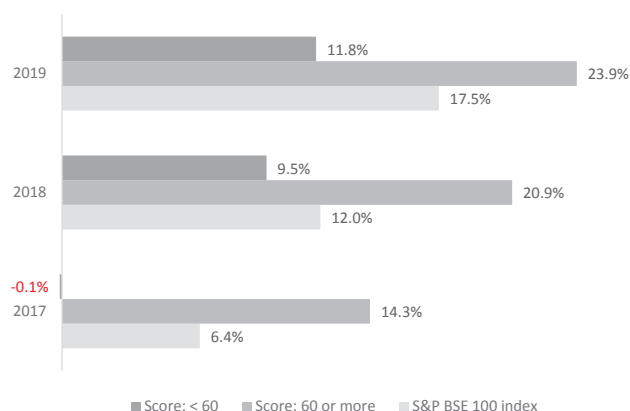
1. 2022 assessments are under way and its results have not yet been published by IiAS



GOVERNANCE MATTERS

IiAS' assessment of companies on the Indian Corporate Governance Scorecard shows that those that scored 60 and above (considered well-governed) had lower stock beta and better price performance than those that scored less than 60 – at a portfolio level. While individual companies may be an exception, by and large our research establishes that markets reward good governance.

Exhibit 6: Price performance of companies evaluated between 2017 and 2019 on the Indian Corporate Governance Scorecard



Source: IiAS research; <https://www.iiasadvisory.com/governance-Scorecard>

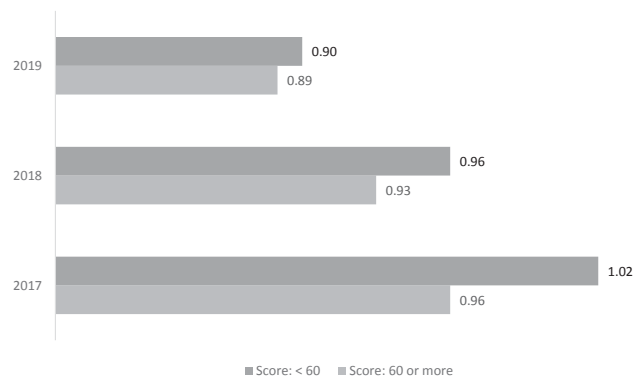
Notes:

- 2017: Stock price performance analyzed from 1 November 2017 to 29 October 2021

Investors are moving beyond discussing governance and are focussed on ESG, with several ESG funds being created. Proxy advisors are working with investors in helping them assess ESG performance of companies and helping them embed ESG metrics into their investment decisions.

- 2018: Stock price performance analyzed from 1 November 2018 to 29 October 2021
- 2019: Stock price performance analyzed from 1 November 2019 to 29 October 2021

Exhibit 7: Stock beta of companies evaluated between 2017 and 2019 on the Indian Corporate Governance Scorecard



Source: IiAS research; <https://www.iiasadvisory.com/governance-Scorecard>

Notes:

- 2017: Stock beta performance analyzed from 1 November 2017 to 29 October 2021
- 2018: Stock beta performance analyzed from 1 November 2018 to 29 October 2021
- 2019: Stock beta performance analyzed from 1 November 2019 to 29 October 2021

CONCLUSION

Investors are moving beyond discussing governance and are focussed on ESG, with several ESG funds being created. Proxy advisors are working with investors in helping them assess ESG performance of companies and helping them embed ESG metrics into their investment decisions. While E and S of the ESG are still not within the regulatory purview of shareholder approval, we expect engagement between asset managers and companies to increase multi-fold with discussions on some of these long-term risks.