Why shareholders need to be good stewards

Our regulatory regime is based on a relatively modest degree of delegation to boards. This implies that shareholders collectively drive business, a consequence of this being that they must learn to be good stewards. They must be more demanding of information from companies, more questioning about the processes and governance structures that companies have in place and more clear-headed regarding how they vote. The buck stops with them.

Speaking at an NSE event a few years ago, Marco Brecht, Professor of Finance, *Université libre de Bruxelles*, highlighted that regulatory attitudes towards obtaining the right balance between managerial discretion and shareholder interests vary across countries. This is despite having broadly similar governance frameworks.

At its core of this balancing act is the age-old principal-agent problem. It arises since there often is a conflict in priorities between the owner of an asset (shareholder) and the person to whom control of the asset (management) has been delegated. Prof Becht went on to illustrate how different jurisdictions approach this, by contrasting the degree of delegation of decisions to boards. There is, in other words, no consensus on what shareholders should vote on and what they delegate.

In the United States, the shareholders delegate most powers to the board, which take all decisions. For example, the remuneration of the executive board is determined by the directors and not by shareholders. There have been attempts to give this right to shareholders, but progress has faltered - the consensus view being that executive compensation is far too complex to be left to shareholders! This has given way to 'say on pay (SOP).' SOP serves as a soft signal, allowing institutional shareholders to react to compensation structures and thereby sway the board's perspective. Another instance regarding the primacy of the board is the recent director re-appointment vote in Twitter Inc.. Egon Durban, failed to secure a majority of the votes cast, but the board did not accept his resignation, asking him to continue. This American approach helps explain the focus on board composition and independent directors not just in governance literature, but in practice.

In Germany, shareholders appoint a supervisory board, that appoints the management, that then takes most decisions, with the consent of the supervisory board. The degree of delegation in the UK is more moderate because shareholders in the UK retain quite a lot of decisions for which they cast direct votes.

In India this degree of delegation is relatively modest. Shareholders retain most of the decision-making power with themselves, even as there is a strong case for a high level of delegation to the board. The argument in support being that as family's own a large piece of the pie, and typically also manage the business, what is good for them as the largest shareholder should be good for all other shareholders. Conversely, the argument for limited delegation is that business families use their dominant shareholding to push through resolutions that benefit them at the expense of the remaining shareholders. So, having shareholders as the final arbiters on most decisions is desirable. Our regulators fall in this second camp, and most decisions are pushed to shareholders.

Our voting guidelines lists 28 items needing shareholders' approval before managements can act. Some are understandable like permission to raise more equity (- dilutes existing shareholders), approve borrowing limits (contain risk), approve appointing and compensating the promoters' kith and kin (how many family members are needed to change a bulb?). Others less so. These will include approving hiring and paying branch auditors, signing off on the fees paid to cost auditors, approve a company charging a fee to deliver some documents to a shareholder, or approving the extent of borrowings via non-convertible debentures, even when it is within the borrowing limits approved. It is not clear

why all these need shareholder approvals; some of these can safely be delegated to boards.

Deciding whether to vote for or against is never easy with many rules and regulations adding to the complexity. Some approvals need >50% shareholders (simple majority) to support, some >75% (special majority) and still others by a majority of minority, before managements can act. These need a revisit. For example, '*promoters*' get to vote on their own salaries. Given that family shareholding is on average at 55%, these resolutions mostly carry. Such resolutions need to be moved to majority of minority.

Second are the byzantine set of regulations that sit alongside. An example being one-third of the non-independent directors needing to retire each year. This results in some directors retiring every alternate year and in the extreme, every year. This could not have been the intent. Many like these need to be reviewed.

There are then the additional checks that are stipulated. For example, a board committee reviews and approves related party transactions before placing them to shareholders. Or the process that is expected to be followed for appointing an independent director. Based on resolutions placed, it appears that in many companies – not all, pay mere lip service as definitions get stretched by the auditors and lawyers. Clear, unambiguous guidance may be needed.

Then there are instances where regulators need to ratify a decision or sign-off, for example appointing the CEO of a bank, a stock-exchange, or a media company (- as investors suddenly discovered), or the Comptroller and Auditor General appointing an auditor in a Public Sector Undertaking. The shareholders in these instances have a role, but not the final say.

Even as the broader eco-system works to mend these anomalies, we must recognize that our regulatory regime is based on a relatively modest degree of delegation to boards. Shareholders are collectively responsible for driving business and must learn to be good stewards. They have to be more demanding of information from companies, more questioning about the processes and governance structures a company has in place and more clear-headed regarding how they vote. The buck stops with them.

BS Business Standard

A modified version of this blog appeared in Business Standard on 16 August 2022. The article can be accessed here:
https://www.business-standard.com/article/opinion/why-shareholders-need-to-be-good-stewards-122081501012_1.html

Disclaimer

This document has been prepared by Institutional Investor Advisory Services India Limited (IiAS). The information contained herein is solely derived from publicly available data, but we do not represent that it is accurate or complete and it should not be relied on as such. IiAS shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. This document is provided for assistance only and is not intended to be and must not be taken as the basis for any voting or investment decision and/or construed as legal opinion/advice. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigation as it deems necessary to arrive at an independent evaluation of information referred to in this document (including the merits and risks involved) and exercise due diligence while using this report. The discussions or views expressed may not be suitable for all investors. The information given in this document is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. IiAS reserves the right to make modifications and alterations to this document as may be required from time to time; however, IiAS is under no obligation to update or keep the information current. Nevertheless, IiAS would be happy to provide any information in response to specific queries. No copyright infringement is intended in the preparation of this document. Neither IiAS nor any of its affiliates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of this information. This report may cover listed companies (the 'subject companies'); IiAS may hold a nominal number of shares in some of the subject companies to the extent disclosed on its website and/or these companies might have subscribed to IiAS' services or might be shareholders of IiAS. IiAS and its research analyst(s) do not have any financial interest in any of the subject companies except to the extent disclosed on its website.

Confidentiality

This information is strictly confidential and is being furnished to you solely for your information. This information should not be reproduced or redistributed or passed on directly or indirectly in any form to any other person or published, copied, in whole or in part, for any purpose without the written permission of IiAS. This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject IiAS to any registration or licensing requirements within such jurisdiction. The distribution of this document in certain jurisdictions may be restricted by law, and persons in whose possession this document comes, should inform themselves about and observe, any such restrictions. The information provided in these reports remains, unless otherwise stated, the copyright of IiAS. All layout, design, original artwork, concepts and other Intellectual Properties, remains the property and copyright of IiAS and may not be used in any form or for any purpose whatsoever by any party without the express written permission of the copyright holders.

Other Disclosures

IiAS is a SEBI registered entity (proxy advisor registration number: INH000000024) dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions of about 900 listed Indian companies (https://www.iiasadvisory.com/iias-coverage-list). Our products and services include voting advisory reports, standardized services under the Indian Corporate Governance Scorecard, and databases (www.iiasadrian.com and www.iiascompayre.com). There are no significant or material orders passed against the company by any of the Regulators or Courts/Tribunals.

This article is a commentary on general trends and developments in the securities market.

About IiAS

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for about 900 companies that account for over 95% of market capitalization.

IiAS provides bespoke research, valuation advisory services and assists institutions in their engagement with company managements and their boards.

IiAS has equity participation by Aditya Birla Sunlife AMC Limited, Axis Bank Limited, Fitch Group Inc., HDFC Investments Limited, ICICI Prudential Life Insurance Company Limited, Kotak Mahindra Bank Limited, RBL Bank Limited, Tata Investment Corporation Limited, UTI Asset Management Company Limited and Yes Bank Limited.

IiAS is a SEBI registered entity (proxy advisor registration number: INH000000024).