Role of Institutional Investors in Ensuring Better Corporate Governance

Towards Improved Corporate Governance in India

Role of Institutional Investors

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In political democracy, it is often said that people get the government they deserve. It is equally true that shareholders in corporations get the kind of governance they are willing to put up with. Institutional investors, by virtue of their expertise, and holding-size-and-capacity, are best positioned to proactively shape good governance practices in their investee companies and reactively protest and reject corporate decisions perceived to be inimical to the interest of absentee shareholders.[1] In this paper, given the extent of institutional shareholdings in top Indian companies, we examine the potential influence institutional investors could exert on improving governance practices in their investee companies; we also briefly consider how such institutional investors could enhance their own credibility and transparency in exercising their voting rights so as to protect and promote the interests of their own shareholders and other key stakeholders.

The Potent Principals

The corporate format of business, involving as it does innumerable shareholders, necessarily involves a transfer or delegation of the managerial aspects of business to a group of active sponsors (promoters) or to hired professional experts, in either case supervised and controlled by a board of elected directors. For all practical purposes, this structure translates in to a virtual sidelining of the absentee shareholders (principals) with little say in how their companies are run. Of course, they still have the right to change the board of directors but this right is largely theoretical since the controlling owners, by themselves or in concert with some other block holders, may have a higher voting clout to nullify any revolt by the other shareholders; in any case, given the geographical spread of shareholders it is not easy for all of them to attend members' meetings in person or even by proxy since most of them with small holdings may not find it worth their while to incur the costs of such participation. The only exceptions are of course institutional shareholders who by virtue of their larger holdings and also their own expertise can evaluate and decide to support or reject specific management policies and practices.

There have been some lively debates in the US context among legal luminaries on shareholder primacy versus board primacy.[2] Shareholders in India have several statutorily reserved rights to approve or reject resolutions at members' meetings and in this sense one could argue Indian corporate governance mandates are ahead of countries like the US where many such initiatives are now being considered or gradually implemented.[3] The reasons why such salutary provisions not being effectively exploited to prevent any abuse are threefold: first, shareholder meetings are poorly attended; second, those personally interested in resolutions are not restrained from voting for themselves; and third, institutional shareholders with sizeable block holdings tend to adopt an ambivalent approach that is generally supportive of incumbent management. All these three issues will need addressing if general standards of corporate governance in the country are to improve for the better. The contribution that institutional investors could make towards this objective is indeed immense, as we shall presently see.

Consider the shareholdings of institutional investors in major Indian corporations as reflected in NSE's *Nifty* index as of 31 December 2011. Foreign Institutional Investors held a median of 17.18% with a maximum of 59.01%, Financial Institutions and Banks held a median of 0.25 but a maximum of 18.91%, Insurance Companies held a median of 6.17 but a maximum of 24.03%, and Mutual Funds including Unit Trust of India held a median of 2.97% and a maximum of 14.20%. Substantial shareholdings by any standards and thus potentially a significant voting strength if they are to be exercised as they ought to be in the best interests of their own shareholders and stakeholders. Two recent examples of exercise of such latent power could be recalled with advantage:

- In December 2008, Satyam Computer Services, the Hyderabad-India based, country's fourth largest IT services company announced the proposed acquisition of 100% and 51% respectively of two promoter-sponsored entities in the infrastructure and realty space, projected as a risk diversification initiative to cope with perceived escalation of riskiness of the IT services business. Within hours of the announcement, violent reaction of institutional

investors first in the UK and then in the US against the proposal which obviously smacked of blatant tunneling by the promoters led to the withdrawal of the scheme. This was followed in a few weeks thereafter by the confession of the until-then well respected promoter, B Ramalinga Raju of a massive fraud planned and perpetrated over several years leading to the company being eventually acquired some months later.[4]

- In 2012, Coal India, a listed state owned enterprise, was obliged to follow a government directive on assuring its principal customers, power producing units in the public and private sectors, supply of coal at pre-determined prices irrespective of the cost incurred by the company. This would have seriously undermined the future profitability of the company and certainly was not in the best interest of its minority shareholders even though the government for public policy reasons was prepared to accept its share of any losses. A UK based institutional investor (The Children's Investment Management Fund with about 1.01% equity holding at the relevant time) strongly objected to this imposition on the company that it felt seriously impaired its own expected returns. Even though the company signed the relevant agreement under directions from the government, the company's independent directors, in a rare instance of dissent from government directions, refused to support the proposal as they saw it prejudicial to the interests of the minority. The matter is under litigation.

These examples are indicative of the power that institutional shareholders (despite a relatively small shareholding by Indian standards) could exert on the companies' boards and promoters even when they happen to be the State with an imposing majority holding. Contrasting this are the following two (among many other) instances where institutional shareholders stood by when absentee shareholders' interests could have been bettered:

- The two main partners of TVS Suzuki, a listed joint venture between the highly respected southern Indian TVS Group and Suzuki Motor Corporation of Japan, after some fifteen years of working together, decided to call off the venture in 2001. TVS bought over the entire Suzuki holdings in the JV at Rs 15 per share when the market price at the time was Rs 87 per share. Not only this, but after this buyout the TVS Group enhanced its holding in the company to some 56% from the previous 28%, thus gaining majority control. At the relevant time, institutional shareholders and banks held a little over 20% of the equity of the JV. Couldn't they have done something to gain for themselves and other absentee shareholders a proportionate share of the windfall profits that the Suzuki exit entailed rather than standing by to see the controlling promoters sequestering the entire gains for themselves? (Balasubramanian 2011, pp.7.1 – 7.20)

- A decade later, history repeated itself, this time when another leading two-wheeler company, Hero Honda went through the same motions. Munjal family, the domestic promoters, acquired the roughly 26% holdings of Honda Motors, again at a steep discount over market prices at the relevant time. This also took the promoters' holding in the company to a little over 43% from the earlier 17.33%, giving them a near-majority control over the company. Even more disconcerting, there were indications that the royalties payable to Honda would be higher than was the case when they were a JV partner. Institutional shareholders, insurance companies and banks at the relevant time held approximately 37% of the JV's equity, again not an inconsiderable proportion by any standards. Shouldn't they have done something to share in the gains of Honda exit especially since they were also being asked to bear the impact of the higher royalties?

In both the TVS and Hero cases, the legality of the transactions was not in question. In fact the defective policies of the governments of the day were as much to blame as indeed were the lackadaisical responses of institutional shareholders and independent directors to material issues impacting the interests of minority / absentee shareholders. Of course, one could argue that in both cases (TVS and Hero), the transactions were between two shareholders that would usually be outside the ambit of concern either of the board or of other shareholders; and further, that shareholders as such do not owe any fiduciary obligations to other shareholders and were perfectly entitled to act in their respective best self-interest. While this is true enough in transactions between ordinary shareholders, in case of shareholders who were also directors of the company, arguably their fiduciary responsibility to the company and all its shareholders should take precedence over their rights as individual shareholders.[5] Especially so if there were significant profits arising or potential losses accruing (as in these two cases) that co-partners in the firm may well have a right to participate in the former and preempt the latter. It is also more about the standards of good governance that leadership companies should follow to set examples for other to emulate.

What should Institutional Investors do?

Principally, institutional investors have two key responsibilities: one to their constituents and stakeholders to whom they owe a fiduciary responsibility to create wealth on a sustained basis and to protect their assets from impairment; and two, to monitor and engage with the companies they have invested in for the benefit of their own selves and their co-shareholders not in operational control.[6] Where institutional investors have representation on the boards of their investee companies,

it is such nominee directors' primary duty to look after the interests of the company and all (and especially absentee) shareholders including all institutional investors. While it would be the directors' judgement call to decide on board issues, institutional investors could certainly brief all the directors on their views to help an informed decision.

In general meetings of members of investee companies, institutional investors should be present and vote on material resolutions on their merits and after due prior internal consideration, transparently disclosed to their own shareholders and stakeholders. Principle 6 of the UK Stewardship Code (FRC 2010, p. 8)lays down, "Institutional investors should have a clear policy on voting and disclosure of voting activity," and proceeds to counsel that they "should not automatically support the board. They are also asked to "disclose publicly voting records and if they do notexplain why."

Similarly, as substantial block owners of equity in investee companies, institutional investors should ensure their valuable votes are cast in favour of resolutions that are beneficial to the interests of the company and all its shareholders. "In most jurisdictions there is no explicit obligation to vote. In some others there is anobligation to vote for some types of resolution. For example, in Israel, a fund manager, [a] pension fund and [an] insurance company must participate and vote if the resolution couldharm unit holders such as through approval of related party transactions and Switzerlandis considering a similar requirement. The latter two institutions must also vote in theelection of external directors" (OECD 2011, p.34). India is no exception and there are no mandatory obligations on shareholder to exercise their votes. While this may be acceptable in case of small retail shareholders, there would appear to be no justification to extend such freedom to institutional and other corporate shareholders who have the wherewithal in terms of resources and expertise. In the absence of any legislation, it may be worthwhile for such entities to voluntarily impose on themselves such an obligation as evidence of their commitment to good governance practices.

This is a salutary requirement that would enforce some discipline in matters of voting on important company resolutions. Formulation of a general policy and sharing it with the concerned stakeholders would help in avoiding to a large extent use of discretionary decisions; especially if the requirement is also to disclose any major deviations from policy in voting specific resolutions at company meetings, it would further strengthen the credibility of the institutional investor entity's own commitment to good in-house governance besides augmenting its right to seek better governance practices in the investee companies. The question of course is whether institutional investor entities are independent enough to embark upon such a mechanism of good governance; in particular, state owned or controlled domestic institutional investors may find it difficult to gain acceptance to such levels of transparency in their voting profiles but a move towards such levels of excellence may well distinguish the leaders from the rest.

Regulatory and Legislative Reforms

While in general it is philosophically sound to argue in support of minimal state or regulatory interventions in the conduct of legitimate business, there are some areas of national interest where mandates (maybe even with a comply or explain option) are imperative. Protecting absentee/minority shareholders' interests in corporations qualifies as one such field if only because it is such a fundamental reputational building block in attracting domestic and international investment. It minimizes governance risks associated with equity investments and hence a key driver to promote such activity. Two themes in this regard are considered here: empowering effective board independence, and empowering effective absentee/minority shareholder participation on key matters affecting their interests.[7]

Empowering Effective Board Independence

Enhancing board independence and effectiveness is by itself unlikely, in all but a few exceptional cases, to be adequate to upgrade governance standards without, concomitantly, also empowering the non-aligned directors' role and positioning. The present legislative and regulatory dispensations in India and indeed in most countries do not adequately provide for such empowerment. Doubtless there are some provisions that partly address this problem.[8] Where board independence is imposed by regulation rather than invited through genuine conviction, as is generally the case in India in a vast majority of companies, it is not unusual to have important matters routed through and approved by boards without many of the independent directors being present and participating.

Two recommendations deserve serious consideration in placing the independent component of the board at the centrestage of board effectiveness:

- The present quorum requirements for board and committee meetings do not mandate the presence of any of the non-aligned directors. Theoretically, it is possible to have a valid board meeting only with executive directors and approve important decisions, notwithstanding the presence of independent directors on the board. For non-aligned directors' surveillance role to be effective, it is important that board meetings necessarily have them or at least a majority of them to be present at the meeting.

- Equally, it is important to mandate that certain key decisions on specified topics be approved by the board only if a majority of independent directors of the company (not of just those present) affirmatively vote in support. This provision will ensure independent directors' voice is heard and their votes count. (With this provision in place, the Coal India matter would not have passed muster since all the

independent directors on the board had opposed the government intervention on pricing)

Empowering Effective Minority Shareholder Participation

There is a strong case for reining in the rights of shareholders who stand to benefit to the exclusion of other shareholders through certain material proposals brought up for approval at members' meetings. In fact the OECD Principles of Corporate Governance (OECD, 2004) specifically recommend that in such circumstances, the shareholders negatively impacted (namely those who may stand to lose by such approvals) alone should vote on the resolutions. This is a salutary and excellent principle to adopt. The Irani Committee on Corporate Law Reforms (2004, para 35) was more receptive, recognizing it as a good governance practice to be adopted by companies, but stopped short of recommending legislation on the ground that would be difficult to implement. The impact of the provision would be significant since institutional shareholders could evaluate issues prejudicial to minority interests and vote against in the full knowledge their votes would count since interested shareholders (like the government in the Coal India case) will be restrained from voting on such matters involving related party dimensions.

Often, such provisions especially at general meetings of members are opposed on grounds that all shareholders are equal and therefore should not be denied their voting rights. But the fact of the matter is that where some stand to gain at the expense of the others in the same category, equity demands that they be preempted from using their strength against the others. Not unlike the dictum that in a civilized society, one's liberty of action or speech is always circumscribed by their potential encroachment on the liberty of others.

Face with such radical *albeit* rational proposals, it is not unusual to ask how these issues have been dealt with elsewhere in the world. Several countries have legislation or regulation that is similar to this recommendation. Illustratively, in the United Kingdom and Australia, certain share buyback proposals have to be approved by shareholders negatively impacted. In South Africa, the Johannesburg Stock Exchange rules seek to ascertain whether such resolutions have received majority backing not reckoning interested parties' votes. But more importantly, if India is convinced on the fairness of this recommendation in the interests of better corporate governance, should it not go ahead and set an example to the rest of the world rather than always looking to adopt "best practices" only from other countries?

It's good to note that the capital market regulator, SEBI, has referred the proposal concerning interested shareholders to the government for possible incorporation in the Companies Bill pending before the Indian parliament. At this stage one can only speculate on whether, if at all,and in what form this proposal will eventually find its way to the Companies Act. If it does, some ten years after the recommendation was first made in a now-long-forgotten government committee report (DCA 2000), it would be a landmark development the country can well be justly proud of.

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[1] The expression,*Absentee shareholders*, probably better reflects the class of shareholders in a corporation who, unlike promoters and other dominant shareowners, are not in operational control, and to designate them, as is often erroneously done, as *minority* shareholders is inappropriate since quite frequently they represent aggregate holdings in excess of 50%. For example, As of 31 December 2011, among the fifty companies comprising National Stock Exchange's prestigious *Nifty* index, fifteen companies reported "promoter" shareholdings of less than 50% while another five had no promoters at all.

[2] See Bainbridge (2005), Bebchuk (2005, 2006) Strine (2006)

[3] *Say in Pay* initiative in the US, following the global financial meltdown in 2008-09 and the public anger at what were considered unconscionable executive compensation packages even as the respective companies were speeding down towards financial distress and even closure, is one such. Indian legislation for decades had empowered shareholders to approve managerial remuneration and with prescribed ceilings

[4] *All that Glitters … Board Governance and the Sustained Subterfuge at Satyam* in Balasubramanian (2011, pp. 4.1 -4.36)

[5] See for example, *Greene v. Dunhill International Inc.*, 249 A 2d 427 432 (Del.Ch.1968) cite in the *Report of the Standing Committee on Company Law Reforms on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance(2000),* p. 108 (Balasubramanian 2010, p. 306, n 41 p. 657)

[6] This might involve some free rider issues such as their co-shareholders benefitting from their initiatives without bearing any part of the associated costs. Not looking after their own interests just to preempt others freely benefitting may amount to cutting one's own nose to spite the face and hence best avoided

[7] For a detailed discussion on this and the concept of *Interested Shareholders,* see Balasubramanian (2009, pp. 563-574)

[8] For example audit committees in the United States listed companies to comprise of only independent directors; Indian company law mandates audit committee recommendations on all financial and accounting matters to be binding upon the board with a provision that where the board disagrees, it can reject such recommendations with the only requirement that grounds for such actions should be explained; and so on