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This article first appeared in the Fortune India February issue under the title ‘Corporate Governance: Investors gather heft’

Institutional Investors: Growing heft

Corporate India is heading towards a future where it will not just be managements and boards, but investors as well who will drive corporate behaviour

The role of institutional investors in Indian corporate governance is evolving. Starting from being providers of capital, their role has extended. Today, as shareholders, they realize that they are more than purveyors of capital and that they, in turn, have a fiduciary responsibility to their investors to engage with their portfolio companies. Taking on this responsibility has helped outside shareholders declare, when needed, their displeasure with promoter control and management-proposed resolutions from which minority investors do not stand to gain. In India, this dynamic must continue to grow and evolve to create an appropriate balance in the corporate governance hierarchy.

In American and British companies, management and ownership generally tends to be separated. As a result, the dialogue between a company’s shareholders and its management is through its board. The board is expected to hire the ‘right’ CEO and senior management, fire the wrong leader, ensure compensation is fair and provide strategic direction to the company.

In contrast in India, this dialogue is expected to take place between two sets of shareholders. Both the promoters and outside stakeholders are owners looking for ways to make their business flourish, but with interests often pulling them in different directions. Most of these conflicts in interests occur during related party transactions – essentially, when the company transacts with the promoter group or companies controlled by the promoters. Historically, this has been a cause of significant investor concern and seemed to be the key route of financial leakage. The other concern is simply differential treatment of one set of shareholders – for example, promoters hold majority equity and vote on their remuneration, which is seldom aligned to company performance. Controlling shareholders would often use their equity to force through certain decisions, sometimes ignoring the minority shareholders’ voice.

Institutional investors, for their part, by abstaining from voting their shares, allowed promoters force their way through. There were several rationalizations for the investor apathy. The promoters are critical to the business and have controlling interest. Further, given the relative shareholding, voting will not make a difference, and antagonizing the promoters is detrimental to the institutional investors' management access. The other was always the quantum argument – if the breaches, or leakages, were not too large, one could turn a blind eye. And, one had to travel to the AGM to vote on shareholder resolutions (till e-voting came in 2014). Investors opted for the Wall Street Walk – simply exit the stock if the company undertook transactions that the investors did not approve of.

But that situation has recently started to change. What accounts for this? One is the change in regulations, that has pushed the governance agenda centre-stage. The second is increased institutional ownership.

Three themes define the current regulations. One is the advent of e-voting, which changed the way voted were counted from the earlier method of show-of-hands. E-voting not only created easy voting access to shareholders, but also allowed the outcome to be weighed by the shareholding. Two, the emphatic use of regulation to enforce governance practices – using a combination of mandatory disclosures, regulatory diktats, and 'comply or explain' provisions and three by empowering different stakeholders to assert their rights.

Increased institutional ownership coincided with the economy opening-up from 1990's. The mutual fund industry took-off, private insurance companies entered the fray, and FII's stated investing, taking institutional holding from low double digits to 24% by 2009. This was also the time when 'promoters' steadily increased their shareholding in companies. Promoter holdings in NSE-listed companies peaked at just over 64% in 2009. Since, then foreign institutional investors have continued to pour money into the market, mutual funds have spread, pension funds are now permitted to invest in equities and there is a small but growing set of AIFs. Institutions now own close to 35% of the market. And *promoter* holding is down to 54%.

This increased ownership itself has some consequences, one of which is that from holding three shares for each one held by institutional investors, the controlling shareholder now own 1.5 shares. The power equation has now altered.

This surge in institutional holding has coincided with one other regulatory development, namely the roll-out of *stewardship* codes by institutional investors. Stewardship is a set of principles or guidelines aimed primarily at institutional investors, who hold shares, and thus, voting rights in companies. Implying that it is part of the fiduciary duty of investors to behave as good owners of companies. Stewardship codes require investors to monitor and, where necessary, engage with companies on material matters, including environmental, social, governance, strategy, performance and risk issues and to vote their shares at company meetings.

Today IRDA, PFRDA, and SEBI have asked insurance companies, pension funds, mutual funds and AIF's to adopt a stewardship code. They expect institutional investors to monitor companies they invest in, engage with them in critical issues, have voting guidelines, vote and disclose their decisions.

Increased institutional ownership also means boards will come under far greater scrutiny, with board members being held accountable not just in cases of board failures but for how they and their companies perform. Investors will soon drive appropriateness of disclosures, how are related party transactions to be treated, aligning CEO salary with performance, how companies should approach ESG, and much more.

All in all, in future expect that it will not just be managements and boards, but management, boards and investors who will drive corporate behaviour.

This article first appeared in Fortune India, February 2020 issue

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The attached article is a commentary explaining general trends in the securities market.

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