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"WITH GREAT POWER, COMES GREAT RESPONSIBILITY": DECODING SEBI'S STEWARDSHIP CODE FOR INSTITUTIONAL INVESTORS

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ABSTRACT

Stewardship code is a tool for enhancing investor participation and transparency, concentrating on how investors discharge their ownership and governance obligations in relation to the investee companies. These codes improve the efficiency of investor-company relationships and contribute to the continuing success of companies while also protecting individual investors. Generally, these codes apply to institutional investors (asset owners and asset managers of equity holdings in listed companies) such as banks, insurance companies, mutual funds, etc. On December 24, 2019, The Securities and Exchange Board of India (SEBI) implemented a mandatory 'Stewardship Code' for Mutual Funds and all Alternative Investment Funds pertaining to their investment in listed equities. The Code consists of six principles and corresponding guidance on how institutional investors must follow these principles. It acknowledges the institutional investors' role in fostering market integrity and corporate transparency. The paper aims to study SEBI's Stewardship Code in detail and analyse its role in shaping future corporate behaviour in India. Further, the impact of the Code on various stakeholders (including companies, individual investors, and institutional investors) is evaluated. In conclusion, a case is made for a uniform stewardship code for the Indian market.

Keywords: **Stewardship Code India, Corporate Governance, Institutional Investors, Alternative Investment Funds, SEBI**

1. INTRODUCTION

An institutional investor is an organisation that invests money in companies on behalf of its beneficiaries, for instance, Alternative Investment Funds (AIFs), Mutual Funds (MFs), pension funds, insurance companies, etc. It deals in securities on behalf of its clients, customers, members, or shareholders. The involvement of institutional investors in corporate decision-making is crucial, as they own larger shares in companies than individual retail investors. As institutional investors perform a vital role in protecting their differentiated investors' interests, they play the role of 'stewards' for their clients **[1]**. The Financial Reporting Council, United Kingdom defines 'Stewardship' as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society"**[2]**. One may also refer to it as one of the revamped models of shareholder activism.

Stewardship codes are often termed as counterparts to the corporate governance regime of any country. Where the corporate governance legislation seeks to minimise conflicts between "agents (boards and managers) and principals (shareholders) of companies, the Stewardship Codes strive for the reduction of conflicts between agents (institutional investors) and principals (ultimate beneficiaries including retail investors)"**[3]**.

In 2010, the United Kingdom became the first nation to implement the Stewardship Code as an aftermath of the 2008 financial crisis, which had highlighted the inadequacy and weaknesses of the corporate governance standards existing at that time in the UK banks and financial institutions. Subsequently, many countries like the United States, Malaysia, Brazil, Japan followed the footsteps of the UK and established their own stewardship frameworks.

In recent times, the Indian government has brought about measures to enable institutional investors to participate actively in company affairs. The journey began in March 2010, when the Securities and Exchange Board of India (SEBI) compelled mutual funds to have a voting policy and to play a more active role while voting for company matters.

While instances of shareholder activism are pretty rare in India, by enacting the Companies Act, 2013, many new measures have been adopted by the country's lawmakers to improve shareholder participation in corporate decision making. The advent of e-voting, an increase in the institutional investment in Indian companies over the years, the proliferation of proxy advisory firms, and the regulatory stimulus to devise a code like the Stewardship Code enable investors to engage more closely with listed companies' boards.

The approach of the Indian regulators has been fragmented, as different regulators have issued separate stewardship codes for different investors. E.g., the Insurance Regulatory and Development Authority of India (IRDAI) issued a code for insurance companies in 2017, the Pension Fund Regulatory and Development Authority (PFRDA) issued a code for pension funds in 2018, and recently the SEBI introduced a code for MFs and AIFs in 2019 **[4]**.

All three Stewardship Codes have many similar principles. They all require institutional investors to track their investments and liaise with the investee companies on corporate governance-related issues. If the institutional investors have any conflicts of interest, they must recognize and tackle them. While casting votes on corporate matters, the codes expect the institutional investors to exercise independent judgment and clearly disclose the voting policies adopted by them along with the voting trends. Institutional investors are also required to regularly report their stewardship activities **[5]**.

Part II of the paper introduces the various principles enshrined in the SEBI's Stewardship Code, 2019, along with the corresponding guidance. Part III focuses on the effect of the Code on parties such as companies, individual investors, and institutional investors by pointing out its advantages and disadvantages. Part IV concludes the paper with suggestions and recommendations to bring about the desired effect of the stewardship codes introduced in India by the various regulators.

2. SEBI'S STEWARDSHIP CODE 2019

Increased participation of the institutional investors has been seen as a significant move towards strengthening corporate governance in the investee companies in order to enhance the protection extended to investors' rights in these businesses. On December 24, 2019, SEBI implemented a mandatory Stewardship Code for MFs and AIFs concerning their investment in listed equities. The enforcement of the Code was deferred from April 1, 2020, to July 1, 2020, in light of the COVID-19 pandemic.

Under SEBI's Stewardship code, six principles have been identified, followed by detailed guidance elaborating the ways in which these principles have to be followed by investors.

A. Principle 1 – Formulation of a comprehensive policy and public disclosure

This principle describes ‘stewardship responsibilities’ to include observing and productive collaboration with investee companies on a variety of issues. The issues may comprise performance (operational, financial, etc.), business strategy, corporate governance (including board composition, executive remuneration, etc.), material environmental, social, and governance (ESG) benefits and threats, capital structure, etc.

‘Engagement’ as envisaged by this principle could be through extensive consultations with executives, communication with investee company boards, participating in board or shareholder meetings, etc.

Institutional investors must develop and publicly disclose a comprehensive policy outlining how they plan to fulfil their stewardship obligations. Further, this policy must be reviewed and updated on a regular basis.

B. Principle 2 – Conflict management

Institutional investors must have a clear policy in place for dealing with conflicts of interest in order to satisfy their stewardship obligations, and that policy must be publicly disclosed.

The policy, as mentioned above, should incorporate a systematic approach to identifying and handling conflicts of interest. The interest of the client or the beneficiary takes precedence over the entity’s interests. The policy should also focus on the ways in which corporate matters would be handled in case the interests of clients or beneficiaries do not align.

While formulating the strategy, the institutional investor would have to recognise any possible circumstances where a potential conflict of interest may occur and report the protocols put in place by the entity in the event of a possible situation of conflict of interest.

C. Principle 3 – Monitoring of Investee Companies

Institutional investors should supervise the businesses in which they have a stake. As part of a comprehensive approach, institutional investors ought to introduce a policy of constant inspection of their investee companies in the areas they deem relevant, e.g., corporate performance, corporate governance, and so on.

Investors should define the levels and areas of oversight of investee companies, taking into account the insider trading regulations.

D. Principle 4 – Intervention and Collaboration with other Institutional Investors

Institutional investors must implement a consistent strategy on intervening with the firms in which they invest. They should also execute a transparent policy of liaising with their fellow institutional investors wherever practicable to defend the interests of the ultimate investors. The policy is also required to be published appropriately.

They should identify the circumstances warranting the need for involvement in the investee companies and the approach of such intercession, e.g., the inadequate financial performance of the business, policies, and practices relating to corporate governance, etc.

E. Principle 5 – Voting and Disclosure of Voting activities

Institutional Investors must implement a transparent plan regarding voting strategy and should disclose their voting activities periodically.

In order to preserve and enhance the earnings of the clients and beneficiaries, institutional investors need to make their own voting decisions after careful consideration instead of acknowledging the management decisions. It is imperative to create a robust voting strategy that includes, *interalia*, the procedures to be used for voting, internal mechanisms for voting, proper reporting of balloting, and proxy voting or other voting advisory services, if any.

F. Principle 6 – Periodic reporting of stewardship activities

The institutional investors shall regularly communicate to their clients/ beneficiaries in a readable, straight forward format detailing how their stewardship responsibilities have been accomplished.

The principle lists the various ways in which this reporting could take place. A report may be uploaded on the entity’s website, and the same may be communicated as a part of an annual intimation to institutional investors’ clients and beneficiaries.

3. IMPACT OF THE CODE ON CORPORATE PLAYERS

In India, stewardship obligations of institutional investors are gaining significance owing to multiple factors, including –(a) increased institutional investor ownership of a vast number of corporations; and (b)a large number of institutional investors representing public funds. As a result of having embraced stewardship, the institutional investors move from a tick the box approach to a more holistic understanding of the governance structure of the businesses in which they participate.

In the past, the disclosures required from the institutional investors were focused on voting; there have been enough instances of involvement that have mostly gone undisclosed. We can expect more pressure on institutional investors to spur corporate behaviour **[6]**. As the Code enables the institutional investors to obtain the companies' relevant information, it would allow them to make informed decisions **[7]**. Further, it could discourage companies from proposing a range of resolutions expecting push back and ensuring greater accountability from companies' management. There is a likelihood that the institutional investors would steer the companies to become more responsible businesses with a profound stakeholder-focused approach.

While there are numerous advantages of the Stewardship Code, the successful implementation of it will need to overcome several challenges. As is anticipated, the Code will increase the compliance burden of Mutual and Alternative Investment Funds. The limited number of people employed by AIFs would be unable to monitor the companies the way SEBI wants them. Additionally, as AIFs invest in thousands of firms every year, it would be an arduous task to monitor each of them effectively as prescribed by the SEBI circular.

Another challenge in the way of institutional investors would be the inaccessibility to unpublished price-sensitive information from an insider trading perspective, which is likely to hinder the ability of organisations to monitor their investee firms adequately.

By introducing the Stewardship Code, the regulator's main objective is to compel the institutional investors to carry out a crucial role in the corporate governance of corporations they invest their money in. However, one main issue that remains in India is that concentrated shareholding remains an essential feature of the corporate setup in India. Promoters/ promoter groups stay in the majority, whereas, in comparison, the institutional investors remain in the minority. While the shareholding of institutional investors is on the rise, it is still a long shot for the regulator to anticipate significant improvements in the way companies are governed by introducing the new Code. This problem is exacerbated by the passiveness of institutional investors in India with regards to company affairs, and the instances of conflicts between the promoters of the company and institutional investors have been instead a rare phenomenon. Asset managers and retail managers may also develop differences of opinion.

Although the Code is a good step towards improving the overall corporate governance regime in India, however, it must be backed up by robust regulatory supervision. Without proper vigilance, such regulations can theoretically result in a box-checking approach by investors or nominal obedience to principles with minimal tangible results directly attributable to efforts towards good stewardship or furthering the interests of their clients.

Most of the jurisdictions across the world have a standard stewardship code that extends to all kinds of investors; however, India has adopted a segregated approach whereby three different codes are catering to different types of business entities. The three regulators, namely SEBI, IRDA, and PFRDA, have each endorsed their own stewardship code that their regulated entities need to adhere to. This is different from how stewardship was initially supposed to be introduced.

We have also observed signs of regulatory divergence. One example of this is the recent circular rolled out by IRDA, which compelled the insurance companies to review and update their policies and undertake active intervention in companies with poor financial performance, engagement on remuneration, and possible lawsuits. By having multiple stewardship codes, we are only inviting confusion and diverging regulatory compliances by various institutional investors whose role vis-à-vis the governance of companies is more or less similar in nature.

One code will allow us to create a more systematic approach towards stewardship and will bring the governance mechanisms in tandem with our current market structure. This is the exact approach followed by the EU countries by adopting the Shareholders Rights Directive, which has proved to be by and large successful. In the past few years, because of a steady influx of foreign investment in India and the level of sophistication achieved in the corporate sector, our institutional investors are now in a stronger place to monitor the corporate activities of their investee companies. Investors are expected to engage with their investee companies collectively, and that is why it is imperative to have similar expectations regarding their collective intervention. Therefore, regulators need to join their hands and work together on a common stewardship code for the Indian market. They need to encompass the various principles enshrined in their respective codes and develop one comprehensive code applied uniformly across sectors.

4. CONCLUSION

The efforts of the Indian lawmakers so far are commendable in nature; however, there is a lot of scope for improvement. While it may be too early to determine the overall impact of the Code on the investment environment in the country, the need of the hour is a centralised legislative system for stewardship, representing a range of categories of investors, which also concurrently recognises the stakeholder interests. The incremental growth of a conscientious institutional investor is to be encouraged as it ushers the Indian companies into the ESG-focused governance agenda and stakeholderism.

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