

Shareholder Activism: Role of Proxy Voting Policy and Advisory Services

A perceptible degree of improvement can be observed in corporate governance practices in almost all countries in the world. The improvement is due largely to statutory regulations. If further improvement is to take place voluntarily among businesses, their shareholders will have to become active and act as responsible owners. This does not happen because shareholders belong to different categories such as punters, proprietors, minority holders, block holders, etc. Capital market provides shareholders with an exit route and, so, they remain passive. Only institutional investors-cum-shareholders can possibly improve corporate governance practices. Two recent developments—rise of proxy advisory firms (institutional investors can access logical recommendations on voting in annual/extraordinary general meetings) and SEBI directive in March 2010 (mutual funds to formulate proxy voting policy and place that in public domain)—are likely to improve these practices in India. This article examines issues involved in shareholder activism and its developments in India in our times. Read on...



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Introduction

Corporate governance (CG) issues were relegated to the background by the financial crisis of 2008, though to some extent, they also had contributed to the crisis. Governance mechanism of many large financial institutions was found inadequate. There was no market discipline in these bodies, nor did their share prices reflect their watered-down value and inefficiencies. Their top executives drew excessive salaries, while shareholders lost their wealth. Despite all that, these institutions were too big to fail; and government bailout became the last resort.

Otherwise, CG practices are improving in all countries in a slow and certain manner due to statutory changes; besides, shareholder activism could be another factor. If the ultimate aim of CG movement is to make companies adopt the best CG practices voluntarily, shareholder activism is the most important remedy.

Shareholder Activism

If shareholders discard their apathy and behave like responsible owners, they can keep managers, i.e. their agents who enjoy plenty of autonomy and may work against shareholder interest, in check. There are many reasons why this does not happen always, since not all

equity shareholders are alike, as their aspirations and approaches differ. Therefore, there is no united front.

Let us look at major types of shareholders.

The Economist having a penchant for colourful terms, suggests that shareholders should be classified as *punters* and *proprietors*. *Punters* are gamblers or speculators, who have nothing to do with CG; they want to maximise returns in the short-run and their aspirations are taken care of by stock markets. They constantly watch fluctuations in share prices and make appropriate moves to make money from them. Stock market acts as an exit route for them. When we say activism, we advocate 'voice' over 'exit'.¹ When capital market functions efficiently, all investors have an incentive to give preference to exit rather than voice option. *Proprietors* are long-term investors who may act as engaged owners, i.e. taking sufficient interest in the affairs of their companies and provide wise overviews. They may voice their concern and take steps to bring about necessary corrective actions. They are not swayed by short-term fluctuations of stock markets, while willing to give time to the management for taking risk and implementing its ideas. Of course, all long-term owners or proprietors are not engaged owners. Ignorance, apathy and blind trust in the management are found in many of them, since they happily abdicate the responsibility of ownership.

The second classification distinguishes between *minority shareholders* and *block holders*. The former get short shrift in CG being at the receiving end, and they lack information and voting power to ensure that their opinions are translated in policy resolutions. They also do not have adequate representation on the Board of Directors. In contrast, *block holders* having the power to vote appoint directors to carry out the desirable changes. Institutional investors (IIs) have become an important entity among *block holders* comprising mutual funds, investment banks, pension funds, financial institutions, trusts and endowments.

When we say shareholder activism, IIs are the principal category of shareholders that matters. Having financial muscles and an understanding in market developments, they employ trained research analysts to make informed investment decisions. They can, therefore, grapple with CG issues and make meaningful interventions in contrast to individual shareholders, which looks like a too-good-to-be-true scenario, since,

except for a few, IIs have mostly shied away from activism. They have their own set of problems and most of them are plainly not interested in CG matters.

Problems with II Activism

1. *Differentiation among IIs*: Among IIs, mutual funds have a different way of working as compared to others. For their open-ended schemes, mutual funds receive and pay out funds on a daily basis and so they find it convenient to invest funds by using stock market price index. Even for their close-ended schemes, mutual funds decide to buy/sell stock on the basis of fluctuations in the stock market index. They have no incentive to look beyond share prices and deal with correcting fundamentals. For diversifying risk, a fund goes for a varied portfolio and avoids holding many shares in one company. Other IIs, particularly life insurance companies and pension funds, have a set, fairly certain payout and so they can commit their funds for a long time in a particular avenue. Trusts and endowments do not have a certain payout. These IIs can therefore take active interest in the governance of investee companies. Shareholder activism thus devolves to these IIs.

2. *Way of working*: IIs encounter a paradox known as '*active investing, passive ownership*'. What it means is that, the work of shuffling investment portfolio on the basis of changing stock price index is on-going. It takes up all their time and so, the investor has little time to think about CG. IIs activism demands the reverse i.e. *passive investing and active ownership* which could leave the IIs with a feeling that, they have not made full use of the opportunities in the stock market to maximise return on investment. Many IIs, and not just mutual funds, follow indexation i.e. choosing a particular stock market index and buying all shares included in it. Any change in the index is faithfully replicated so as to obviate the need for making a judgement. Some IIs even outsource the work of choosing investment portfolio to professional managers who charge fat fees. It would be too much to expect these IIs to get down to messy governance issues. Secondly, as mentioned above, IIs follow the practice of spreading themselves thin for containing risk. So, they are not powerful block holders, always. Received wisdom of maintaining distance between industrial and finance capital, curbs on insider trading have resulted in many restrictions on how much IIs can invest in individual companies.

¹ A. O. Hirschman in his *Exit, Voice and Loyalty: Responses to Decline in Firms, Organisations and States* (1970) states that two responses, voice or exit are possible to any unsatisfactory situation in a firm or system.

3. *Free rider problem:* Many IIs exist today. Which one among them will be the first one to become active on CG front? It will have to spend a lot of time and money in regularising wrong matters. It cannot share these costs with other IIs. Any potential benefit of its intervention will, however, be shared by other IIs. So no II has any incentive for seizing the initiative for CG matters.

4. *Conflict of interest:* Many IIs have multiple relations with corporate clients as insurers, investment advisors, portfolio managers, consultants, etc., and their interest as block holders of equity, might be in direct conflict with their interest in the above categories. Hence, many IIs have traditionally kept a low profile as block holders.

5. *No time or interest:* Many IIs are simply not interested in nor have time for stewardship of investee companies. Consolidated shareholding in both UK and USA shows that 30% of outstanding shares are invested as per indexing, 20% as per various computer algorithms in search of value anomalies in different industries and 30% shareholders rely totally on the advice of their stock brokers who earn more, the more they shuffle their clients' portfolios. None of these groups, i.e. 80% of shareholders, have the long-term, informed engagement with their holdings which can make them activist owners.² Bill Gates Foundation and Warren Buffet are not interested in activism. They are satisfied with returns on investment and expect investee company executives to manage professionally. An occasional nudge to top executives is the most they are willing to supply. They do not believe that they will ever take part in managing investee companies.

The above factors also help us understand why nominee directors of public financial institutions in India did not make much headway for four decades - from 1950 to 1990. In spite of government support and backing of sister institutions, they did not intervene in CG of investee companies. There were a few exceptions, e.g. Swaraj Paul's bid on Escorts in early 1980s, where publicity, media scrutiny led to specific government directives to them and they followed these. The number of these cases was so small that for all practical purposes, the considerable might of public financial institutions remained only on paper.

Two Recent Developments

Firstly, proxy voting advisory firms have appeared on the scene in India. They specialise in carrying out CG research and also propose proxy voting solutions

in the form of specific recommendations. They state whether a particular resolution in a shareholder meeting should be voted for or *against* and give reasons for their recommendations. This is based on their continuing work of marshalling and analysing information and drawing conclusions from it. IIs can outsource the job of voting on particular resolutions in AGM/ EGM to them.

Proxy voting advisory services are new in India. However, in UK and USA, they have helped IIs for long. For example, The Pensions and Investment Research Consultants Ltd. (PIRC) was set up in 1986 in UK by a consortium of public pension funds, to give them advice on governance issues concerning investee companies. PIRC has set out a number of principles of CG. It examines whether individual companies comply with them, discusses its observations with their management and then publishes its views about the line of action that shareholders ought to adopt. Most of the managements take its comments very seriously and modify their actions so as to avoid adverse comments.

The National Association of Pension Funds (NAPF) in UK runs a voting issues service, that provides a report on each forthcoming annual or extraordinary general meeting of companies, proposed resolutions and NAPF's opinion about contentious issues in them. It also gives a checklist showing how far a company met with different best practices of CG. Institutional Investors Advisory Services Ltd. (IIAS) and InGovern Research Services, established in India in 2009, are two proxy voting service firms. InGovern Research Services provides both CG research and proxy voting solutions to its clients. Its research team has developed a Governance Radar with over 400 criteria dealing with major issues such as board of directors and its committees, shareholders rights, disclosure, audit and accounts, operational policies, etc. IIAS had recently targeted some large companies for excessive executive compensation. It criticised a large and well-respected company for not having a succession policy and for taking ad hoc action in this respect. The highlight of the working of both these firms is the specific nature of their comments and recommendations. They are sharp and acute and there already exist instances where the wrong they pointed out was speedily corrected. Thus in their short life span, these advisory firms are already doing fruitful work. Their contribution will be strengthened in future and it will help shareholders, particularly minority shareholders.

² Monks, Robert A.G.: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: The Role of Institutional Shareholders in Corporate Governance and the Global Financial Crisis, International Perspectives, (ed.s) William Sun, Jim Stewart, David Pollard, Cambridge University Press, Cambridge, 2011.

Both the firms have drawn attention of observers of capital market developments. Significant stakes in both were acquired by informed individuals and organisations. These are early days but a distant future possibility is that, they might develop vested interests and then might not remain impartial or wedded to shareholder interest. With growing popularity, more such firms will be established in future and then unhealthy competition might start among them for getting clients. They might well add one more tangle to the issue of conflict of interest.

The *second* development refers to a SEBI circular dated 15th March, 2010, which obligated mutual funds to disclose their proxy voting policies and also the record of actual voting in investee companies in their portfolio. Annual reports of mutual funds for financial year 2010–11 disclose this information.

Voting policies or guidelines for exercising voting rights as revealed by Indian mutual funds, generally relate to the following matters:

- Share option plans including ESOPs
- Executive compensation, Directors' compensation and election, removal
- Shareholder voting rights
- Anti-takeover proposals
- Debt financing and related party transactions
- Issue of equity without pre-emptive rights and increase in authorised capital
- Alterations in Memorandum of Association
- Restructuring proposals

SBI Mutual Fund has accordingly stated that, on routine matters which do not materially affect interest of unit holders, it will abstain from voting. When it believes that it will be in their best interest, it shall vote for or *against* a resolution. On working of boards of directors, it is *against* fixed retirement age for directors and compulsory minimum stock ownership, against the board having the authority to set its own size or having a fixed tenure. On shareholder proposals, it is *against* any restrictions on shareholders' right to call special meetings, right to act by written consent, to remove directors and issue of preferred stock with superior voting rights. Similarly, it is against anti takeover proposals, mergers and restructuring schemes which entrench existing management. As regards executive compensation, it is *against* stock options and stock incentive plans that result in excessive dilution and against excessive golden parachute plans.

UTI MF has stated that it will vote on issues affecting shareholder interest keeping in mind its equity holding in a particular company, adequacy

of information, impact on its investment, conflict of interest and ultimately, shareholder interest. It has stated candidly that, if the impact on shareholders is not significant, it may not even attend meetings. Reading these policy statements makes for fascinating reading. They reveal all the accumulated wisdom on CG in a clear, distilled form. While voting policies of Indian mutual funds are not as yet in the same class of international IIs for their lucidity and directness, they nonetheless represent a good deal of progress.

To justify the above statement, few proxy guidelines from Glass, Lewis & Co. (2011), an international advisory firm, could be quoted:

1. *Directors' appointment*: Vote against a director who has attended less than 75% board/committee meetings in the last year. Vote against him if he is a CEO of a company where financial statements had to be changed after he had certified them.
2. *Slate elections*: This is a practice of the entire board of directors, not individual directors, getting elected afresh. It is a better practice than that of staggered boards, often kept in the interest of continuity. Vote against the entire slate, if significant issues have been raised against even one of its members.
3. *Ratification of auditors*: If audit fees amount to less than one-half of total fees payable by a company to auditors, do not re-elect them.
4. *Executive compensation*: Vote against an executive compensation package if it does not have a service contract, if the service contract provides for notice period of more than one year. Performance based equity compensation plans for senior executives should be encouraged.
5. *Directors' remuneration*: No retirement benefits need be provided to directors.
6. *Exercise of voting rights*: Simple majority voting structure is preferable and supermajority vote requirements work against shareholder interest.

When we come down from lofty principles to the actual record of voting by mutual funds, a sense of déjà vu becomes prominent. In 99% cases, they have voted *for* the resolutions. However, one does get the feeling that the stage is being set for bigger changes, should the need arise.

Conclusion

Both these developments are going to improve CG practices in the country and help minority shareholders. ■