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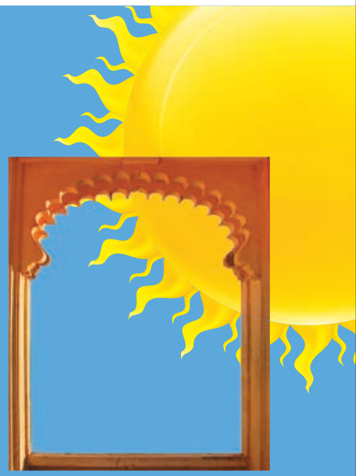

EMERGENCE OF SHAREHOLDER ACTIVISM IN INDIA

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Executive Summary

- The increase in shareholder activism is a new fact of corporate governance in India.
- The key drivers for activism are:
  - regulatory changes facilitating greater shareholder participation; and
  - market forces pushing towards an activist stance among investors.
- These are consistent with international trends.
- While it remains to be seen whether activism will have a significant effect on companies with concentrated ownership, its impact cannot be ignored.
- The benefits of activism can be realized if companies, the investing community, and corporate governance intermediaries such as proxy advisory firms take the appropriate steps.

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Activism in Action: TCI vs. Coal India

It was dubbed as the corporate battle between David and Goliath. Early 2012, The Children's Investment Fund (TCI), a hedge fund based in the UK, began exerting itself as a shareholder of Coal India Limited, a government company. While TCI holds a 1% stake in Coal India, it was up against the Government of India that holds 90% of the company. TCI's grouse was that Coal India was refusing to sell its products at market prices due to heavy government influence, including through directors appointed by the Government. TCI also raised a number of specific issues regarding the management and governance of Coal India as a public listed company. Although the articles of association of Government companies such as Coal India confer a right on the President of India to direct the companies' affairs in public interest, TCI has not been satisfied with the responses it received, and has initiated legal action against Coal India and its directors in a Kolkata court. It has also taken the Government to arbitration under certain bilateral investment treaties that India has entered into.

Around the world, TCI has a remarkably successful track record in forcing managements to change their policies in response to its activist stance. Whether it will enjoy similar success against Coal India or any other company in India remains to be seen.

Shareholder activism, a hitherto non-existent phenomenon in India, has become pervasive in recent years. This development has been aided both by efforts on the part of regulators to encourage shareholder participation in corporate decision-making, and by the growth in the activist stance of institutional investors in the Indian markets. This is part of a growing international trend, particularly in the wake of the global financial crisis. Indian companies cannot afford to ignore this phenomenon, and would be well advised to formulate their strategy on investor engagement as part of their corporate policy.

Regulatory Reforms towards Greater Shareholder Participation

Historically, outside (non-promoter) shareholders, whether retail or institutional, have been passive in India. They rarely participated in shareholders' meetings. In any case, the retail shareholders' miniscule shareholding made their participation less effective. Notably, however, even the institutional shareholders, both domestic and foreign, who could have made a difference, either did not participate in the meetings or, if they did, it was almost always to vote in support of management and the promoters.

Over the last decade, however, regulatory reforms in India have focused on promoting shareholder participation in corporate decision-making. This has been implemented through a step-by-step approach that addresses different facets of shareholder participation (see box below).

Regulatory Reforms: Shareholder Meetings and Voting

2001: Voting by postal ballot introduced for certain types of resolutions

2010: Option to companies to hold shareholders' meetings through video conference and other electronic means

2012: E-voting made mandatory for top 500 companies listed on the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE)

2012: The Companies Bill, 2012 approved by the Lok Sabha contains expanded rights to shareholders, including rights to approve certain related-party transactions

2013: SEBI introduced significant changes to the listing agreement that are aimed at protecting minority shareholder interests in mergers and other forms of corporate restructuring involving listed companies

Although shareholders cannot be compelled to exercise their corporate franchise, these measures are likely to induce retail shareholders to be more participative in shareholder meetings, thereby increasing their ability to affect the outcome on the resolutions proposed at the meetings.

Certain measures have been introduced specifically for the institutional investors. For example, the Securities and Exchange Board of India (SEBI) requires mutual funds to play a more active role in the corporate governance of the companies they have invested in. Asset management companies must now state their policies on voting in portfolio companies and disclose the specific exercise of voting rights on certain matters. This requires mutual funds to take a more considered view of their investments. While SEBI's regulation currently applies only to mutual funds, its broader message could perhaps be adopted by other institutional investors even without a regulatory mandate.

Market-Driven Activism and Governance Intermediaries

Going beyond merely responding to these regulatory efforts, shareholders themselves have proactively begun to adopt a more activist stance. They have started to engage with management and promoters of companies to pursue corporate policies that may enhance shareholder value. Investors such as private equity funds and venture capital funds, for example, have begun the exercise of 'relationship investing', which involves the establishment of a long-term relationship between the investors and the company. Where mere interaction with management is found to be ineffective, activist investors typically advance to the next stage of voting against the company's resolutions. The ultimate option of confronting management with efforts to displace them has been used elsewhere in the world; but in India such option is quite daunting given that most companies are controlled through a significant stake held by the promoter. On the odd occasion, activist investors have also threatened and initiated legal action against companies, as we have seen in the TCI-Coal India case.

The activist investors are now effectively aided by the emergence of a set of corporate governance intermediaries in the form of proxy advisors. While proxy advisors play a significant role in influencing corporate decision-making internationally, the industry is still nascent in India, having been established only as late as 2010. Proxy advisory firms analyze corporate proposals and make recommendations to their clients, who are primarily institutional investors, on the manner in which they should exercise their votes at shareholders' meetings. The firms also publicly announce their recommendations on specific proposals, which can be utilized by retail shareholders too.

There are three proxy advisory firms established in India so far,[i] and they have already published several recommendations regarding corporate proposals pertaining to various listed companies in India. It is difficult to determine the exact nature and extent of the impact of the proxy advisory industry, given that it is relatively new. There is, however, no doubt that the extensive discussion of their recommendations, particularly in the financial press, provides a greater degree of information to shareholders in deciding whether to approve or reject specific corporate proposals (see box below). This may have the ultimate effect of raising transparency and governance standards in Indian listed companies.

Examples of Greater Shareholder Participation and Activism in 2012-13 [ii]

Company A: In a resolution for increase in royalty to a parent company, over 50% of the non-promoter shareholders participated, out of which nearly 83% voted against the resolution.

Company B: In a resolution for corporate restructuring of a company, where the non-promoter shareholding is 44.9%, nearly half of them voted against the resolution.

Company C: In another case of corporate restructuring, 18.4% shareholders voted against the scheme as against institutional shareholding of 14.8%, which indicates the presence of retail shareholder activism, albeit modest.

Earlier in 2011, managements had to withdraw resolutions in three cases after minority shareholders (not institutional investors) expressed dissent.

International Trends

World-over, shareholder activism has taken on a more vibrant role, particularly after the global financial crisis. While institutional investors have been gradually increasing their engagement with their portfolio companies, the new brand of hedge fund activism has taken corporate boardrooms by storm. Influencing their actions are proxy advisory firms such as ISS and Glass Lewis, which are two predominant firms in the industry. [iii]

The regulatory climate seems to increasingly favour greater retail shareholder participation in critical corporate decisions. For example, the US has introduced "say-on-pay" reforms whereby shareholders would have the right to vote on executive compensation, albeit on a non-binding basis. The UK is proposing to take one step further to migrate its "say-on-pay" requirement from a non-binding vote to a binding one. Not only are the shareholders obtaining substantive powers in decision-making, their access to decision-making is also being made easier. For instance, Turkey is said to be one of the first countries (along with India) to introduce mandatory e-voting in listed companies. [iv]

Similar efforts are being undertaken for the institutional investors as well. The Stewardship Code in the UK is a classic example of regulatory efforts to enhance overall governance standards by seeking greater involvement of institutional investors.

While the influence of proxy advisory firms in the governance of companies cannot be questioned, the policy makers worldwide are increasingly recognizing the possibilities of conflicts of interest that these firms may face and are attempting to ascertain ways of eliminating them. One such conflict of interest, for example, may arise when the proxy advisory firms operate on a for-profit basis and advise both the companies and the investors. In recognition of this, regulators are actively considering proposals for regulating the proxy advisory firms in Europe [v], the United States [vi] and Canada [vii]. Attempts are also being made to define their roles more clearly.

Overall Perspective on Shareholder Activism

Despite the growing popularity of shareholder activism, there has been some skepticism about its efficacy. *First,* there is no overwhelming empirical evidence yet to establish that shareholder activism in fact enhances long-term shareholder value, or that the benefits of activism exceed the costs. *Second,* in engaging with activist shareholders who may have an eye on immediate returns, companies and their managements may be distracted from pursuing their long-term goals. *Third,* activism could potentially be misused by competitors to unfairly target companies. *Finally,* the effect of shareholder activism may be largely muted in the Indian context where most companies have a controlling shareholder. In such companies, it would be difficult to alter the outcomes of shareholders' meetings or to deter the controlling shareholders from pursuing the policies that they believe are appropriate.

While it is necessary to take note of the above concerns, there is no doubt that activist shareholders are increasingly becoming a force to reckon with in India, consistent with developments in other parts of the world. With increasing oversight of portfolio companies and being aided by corporate governance intermediaries (such as proxy advisory firms), activist shareholders are in a better position now to enhance the overall standards of governance in India.

Moving Ahead

In view of the developments and issues relating to shareholder activism in India and abroad, an ideal goal would be to fashion shareholder activism in a manner that achieves positive effects on corporate governance, while minimizing its negative consequences.

This would require efforts on the part of all stakeholders in the corporate governance of listed companies. Corporate governance intermediaries (such as proxy advisory firms), for example, could voluntarily strive to maintain independence and avoid any possible conflicts of interest. Further, the SEBI, as the regulator, may consider the adoption of a code of conduct for institutional investors, for which the Stewardship Code in the UK may be taken as a reference point. Finally and most importantly, efforts are required on the part of the investor community as well as the listed companies and their managements. The following checklist may serve them as a useful guide (see box below).

In short, shareholder activism has become a reality in India. Indeed, there are signals that it would be more widespread in future with growing support from SEBI and proxy advisory firms. Shareholder activism, however, entails both risks and opportunities. To ensure that the opportunities are taken advantage of, while risks are contained, further complementary efforts are necessary by all parties concerned.

A Checklist for Dealing with Activism

For Institutional Investors

- Exercise stewardship and greater oversight by participating in corporate decision-making
- Be more transparent about voting policies generally and the exercise of votes in specific meetings
- Inculcate the practice of attending all general meetings
- File questions, requests for additional information or objections with the companies and insist on response at the meeting
- Positively engage with companies and provide strategic direction to enhance overall shareholder value
- Work with companies to develop a set of "best practices" on corporate governance that they could adopt
- Rely upon proxy advisors and other governance intermediaries, but only after exercising due diligence regarding the absence of any conflict of interest of such intermediaries

For Companies

- Gauge shareholder interest on company strategies and other significant proposals
- Avoid any strategy that takes shareholders for granted
- Increase transparency and share appropriate information with shareholders
- Prepare and implement a robust shareholder relationship policy or approach
- Monitor all proxy advisories regarding the company
- Prepare to deal with activist situation in a consolidated manner after obtaining consensus on the board
- Circulate the board's responses to any proxy advise (that is contrary to management's proposals) in advance to the shareholders and read them out at the general meetings.

Some Resources

Jayati Sarkar & Subrata Sarkar, *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India* (2000), **http://www1.fee.uva.nl/fm/Conference/cifra2000/sarkar.pdf**

Paul Rose, *On the Role and Regulation of Proxy Advisors,* MICHIGAN LAW REVIEW: FIRST IMPRESSIONS, http://www.michiganlawreview.org/articles/on-the-role-and-regulation-of-proxy-advisors.

Stuart Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States* (2007), **http://ssrn.com/abstract=959670**

Umakanth Varottil, *The Advent of Shareholder Activism in India*, **http://ssrn.com/abstract=2165162**

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i. They are (i) InGovern (http://www.ingovern.com/); (ii) Institutional Investor Advisory Services (IIAS) (http://www.iias.in/); and (iii) Stakeholders Empowerment Services (SES) (http://www.sesgovernance.com/).

ii. The data for this sample has been taken from the reports of the meetings filed by the companies with the stock exchanges and also from reports of proxy advisors.

iii. ISS controls about 61% of the industry. James R. Copland, Yevgeniy Feyman & Margaret O'Keefe, *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism 22* (Fall 2012).

iv. Melsa Ararat & Muzaffer Eroglu, *Istanbul Stock Exchange Moves First on Mandatory Electronic Voting,* The Harvard Law School Forum on Corporate Governance and Financial Regulation (Nov. 6, 2012).

v. European Commission, *Green Paper: The EU corporate governance framework* (2011), *available at* http://ec.europa.eu/internal_market/ company/docs/modern/com2011-164_en.pdf; European Securities and Markets Authority, *Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options* 22, ESMA 2012/212 (Mar. 22, 2012).

vi. Mary L. Schapiro, *Remarks to the CorporateCounsel.Net,* "Say-on-Pay Workshop Conference (Nov. 2, 2011), *available at* http://sec.gov/news/speech/2011/spch110211mls.htm; Joseph E. Bachelder III, *Say on Pay: Who is Watching the Watchmen?,* The Harvard Law School Forum on Corporate Governance and Financial Regulation (Apr. 11, 2012).

vii. Canadian Securities Administrators, *Potential Regulation of Proxy Advisory Firms,* Consultation Paper 25-401 (Jun. 21, 2012), *available at* http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120621_25-401_proxy-advisory-firms.htm.

About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavored to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.