

# An Indian Stewardship Code: Imperatives and Challenges

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## Executive Summary

- A ‘stewardship code’ is a principles-based framework that assists institutional investors in fulfilling their responsibilities to protect and enhance the value of their clients and beneficiaries; adherence to the Code by institutional investors also enhances the corporate governance of the investee companies.
- In March 2017, the Insurance Regulatory & Development Authority (IRDA) pioneered in India a ‘stewardship code’ applicable for insurers comprising seven principles modelled on the UK Stewardship Code; but there is no ‘common stewardship code’ yet in India, which is applicable to all institutional investors.
- Recommendations for a ‘common’ code are reportedly pending official approval by Financial Stability and Development Council (FSDC); meanwhile, the Kotak Committee has suggested that the Code should be based on global best practices.
- While the UK Stewardship Code may provide a useful starting point for the design of the Indian Code, the latter must take into account some special features of Indian capital markets such as significant roles of promoters in many Indian companies.
- Finally, it would be useful to learn from some of the mistakes made in implementing the UK Stewardship Code.

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## I. Introduction

Given their rising importance in capital markets across the world, institutional investors are expected to carry greater ‘stewardship responsibilities’ (that is, responsibilities towards their clients and beneficiaries) “by enhancing their monitoring of and engagement with their investee companies”.<sup>3</sup> By so doing, they are also expected to improve the corporate governance of their investee companies. Not surprisingly, investor stewardship is being increasingly recognized as an integral part of effective corporate governance. Also, over the years, ‘stewardship code’ has received wide acceptance as the appropriate instrument for designing and enforcing the ‘stewardship responsibilities’ of institutional investors in a number of jurisdictions.

What is a ‘stewardship code’? A ‘stewardship code’ is typically a principles-based framework which is designed to assist institutional investors and their stewardship service providers (including proxy advisors) in fulfilling their responsibilities to their clients to protect and enhance the value that accrues to them, and account for how they have done so. The principles enshrined in the Code, which are intended to allow flexibility in their application, are supported by best practice guidance (See Box 1). The Code is typically enforced through a ‘comply or explain’ approach, which implies that the (institutional) investors, at whom this Code is directed, either comply with the Code, or if they do not comply, explain publicly why they do not.

### Box 1: An Illustrative Example of a ‘Principle’ and its ‘Guidance’ from IRDA’s Stewardship Code

**Principle:** Should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.

**Guidance:** Insurers should put in place, maintain and publicly disclose a policy for identifying and managing conflicts of interest with the aim of taking all reasonable steps to put the interests of their client or beneficiary first. The policy should identify scenarios of likely conflict of interest as envisaged by the Board and should also address how matters are handled when the interests of clients or beneficiaries diverge from each other.

**Source:** Guidelines on Stewardship Code for Insurers in India, March 2017, Insurance Regulatory & Development Authority.

In India, although considerable progress has been made in improving Indian corporate governance in recent years, the progress towards the creation of ‘stewardship code’ has been limited. It was the Insurance Regulatory and Development Authority (IRDA) that took a lead in March 2017 and launched guidelines for a ‘stewardship code’ for Indian insurers,<sup>4</sup> who are important investors in India’s capital markets, building on Securities and Exchange Board in India’s (SEBI) issuance of voting disclosure guidelines to mutual funds in 2010.<sup>5</sup> There is however no ‘common stewardship code’ yet that is applicable to all institutional investors, regardless of who they are regulated by (SEBI or IRDA or pension fund regulator, PFRDA). The SEBI Chairman was swift to recognise the absence of such a common code in India while addressing the state of Indian corporate governance and investor stewardship following his appointment in March 2017 and is reported to have considered it as “worrying”.<sup>6</sup>

<sup>3</sup> Report of the Committee on Corporate Governance, 5 October, 2017, SEBI, [http://www.sebi.gov.in/sebi\\_data/attachdocs/oct-2017/1507200012576.pdf](http://www.sebi.gov.in/sebi_data/attachdocs/oct-2017/1507200012576.pdf)

<sup>4</sup> [https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines\\_List.aspx?mid=3.2.2](https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines_List.aspx?mid=3.2.2)

<sup>5</sup> SEBI had prescribed detailed requirements for disclosures with respect to voting policies and actual voting on different resolutions of investee companies by mutual funds in India.

<sup>6</sup> <http://economictimes.indiatimes.com/markets/stocks/policy/independent-directors-not-independent-says-sebi-chief-ajay-tyagi/articleshow/58421640.cms>

## II. Increasing Popularity of ‘Stewardship Code’

The first ‘stewardship code’ was published by the UK’s Financial Reporting Council (FRC) in 2010, in response to lessons learned from the financial crisis. It has been reviewed every two years and now has approximately 300 signatories including many leading institutional investors such as Aberdeen Asset Management, BlackRock and Capital International.<sup>7</sup> The signatories are committed to adopting and upholding the Code’s principles, which relate to:

- publicly disclosing their policy on how they will discharge their stewardship responsibilities;
- having a robust policy on managing conflicts of interest, which should be publicly disclosed;
- monitoring their investee companies, which is regarded by the FRC as an ‘essential component of stewardship’;
- establishing clear guidelines on when and how they will escalate their stewardship activities by, for example, attending and speaking at Annual General Meetings (AGM);
- their willingness to act collectively with other investors;
- having a clear policy on voting and disclosure of voting activity; and
- reporting periodically on their stewardship and voting activities.

There are now at least 10 ‘stewardship codes’ globally which are mainly modelled on the UK approach. In addition, a number of large and influential investors in US markets launched the Investor Stewardship Group in January 2017.<sup>8</sup> It published a Stewardship Framework, which has rapidly gained momentum and traction among other major US investors and will be effective from 1 January 2018.

## III. Making of an Indian Stewardship Code: Essential Ingredients

In its meeting held in April, 2016, the Financial Stability and Development Council (FSDC) felt the need for a ‘stewardship code’ in India.<sup>9</sup> Subsequently, a committee set up by the FSDC under the chairmanship of SEBI with representatives of IRDA and PFRDA is reported to have considered various aspects of introduction of a ‘stewardship code’ in India and submitted its recommendations, which are pending FSDC’s approval.<sup>10</sup> Meanwhile, the SEBI appointed ‘Committee of Corporate Governance’ under the chairmanship of Uday Kotak, has among other things, recommended a ‘common stewardship code’ for the entire financial sector on the lines of global best practices. Coincidentally, last year, the India-UK Financial Partnership (IUKFP), of which Uday Kotak was Co-Chair, recommended that steps be taken to develop a voluntary, principles-based Indian Stewardship Code based on a ‘comply or explain’ and a ‘voting plus’ framework.<sup>11</sup> But, what would be the essential ingredients of an Indian Stewardship Code?

To engage in stewardship with the requisite authority, the asset managers must demonstrate that they live up to the standards they expect of their investee companies. The framers of the Code in any jurisdiction have to be mindful of this as well as the fact that every jurisdiction has some special features. For designing a ‘stewardship code’ for India, although the UK Stewardship Code might be a useful starting point, it would be wrong to transplant the UK Code’s principles and supporting guidance without adapting them to the special features of the Indian capital market. These special features include the significant role of promoters in many Indian companies, as well as the conflicts of interest, particularly in respect of (a) asset managers who are part of conglomerates with multiple and diverse businesses, many of which are listed, and (b) many asset managers which are State owned and controlled.

<sup>7</sup> <https://www.frc.org.uk/news/november-2016/tiering-of-signatories-to-the-stewardship-code>

<sup>8</sup> Investor Stewardship Group - <https://www.isgframework.org>

<sup>9</sup> Chaired by the Governor, Reserve Bank of India (RBI) and attended by Dr. Arvind Subramanian, Chief Economic Adviser, Ministry of Finance; Shri U. K. Sinha, Chairman, SEBI; Shri T. S. Vijayan, Chairman, IRDAI; Shri Hemant G. Contractor, Chairman, PFRDA; Deputy Governors of the RBI, Dr. Urjit R. Patel, Shri R. Gandhi and Shri S. S. Mundra; Shri Deepak Mohanty, Member Secretary of the Sub-Committee, Executive Director of the Reserve Bank and others.

<sup>10</sup> Report of the Committee on Corporate Governance, 5 October, 2017, SEBI, [http://www.sebi.gov.in/sebi\\_data/attachdocs/oct-2017/1507200012576.pdf](http://www.sebi.gov.in/sebi_data/attachdocs/oct-2017/1507200012576.pdf)

<sup>11</sup> <https://www.thecityuk.com/research/iukfp-responsible-shareholder-engagement-an-indian-stewardship-code/>

Further, it is useful to recognize that there is an increasing interest of foreign investors in Indian capital markets. That said, it must be noted that many foreign investors, whose Indian investments may represent a relatively small proportion of their total assets under management, may regard engagement with Indian companies as disproportionately expensive.

The primary purposes of a principles-based Indian Stewardship Code should be to:

- encourage all institutional investors to vote frequently, transparently and thoughtfully;
- provide a generally accepted framework for responsible shareholder engagement;
- better inform discussions in Indian boardrooms in respect of investor views on relevant issues and improve the accountability of Indian boards to their shareholders;
- improve the quality of investment decisions by investors in Indian companies; and
- strengthen the confidence of Indian retail investors and foreign investors in the integrity of Indian capital markets.

It is particularly important that the Indian Stewardship Code be supported by best practice guidance that will provide practical pointers to help ensure that the Code gets off to a flying start.

The other essential ingredient is that the Code – both the principles and the guidance – enjoys wide support of leading investors and the boards of the companies in which they invest. This will require consultation with the key players in a purposeful yet patient way to ensure that both investors and boards embrace the Indian Stewardship Code enthusiastically from the outset. Also, the views of proxy advisory firms, who are playing an increasingly important and influential role in India, must not be ignored.

It is relevant to bear in mind that more and more institutional investors – particularly the foreign ones – are integrating the analysis of environmental, social and governance (which is often referred to as ESG) into their investment decision making and stock selection processes. The increased transparency afforded by companies about ESG matters provides to investors valuable information for both analysis and engagement.

In the final analysis, an effective Indian Stewardship Code should improve transparency and accountability throughout the stewardship chain to such an extent that it results in enhanced investor returns over the long-term, and lower cost of capital for Indian companies in general and companies with high standards of corporate governance, in particular.

#### **IV. Focus of Engagement between Investors and Investees**

Responsible shareholder engagement should lie at the heart of the Indian Stewardship Code. Such engagement goes beyond voting at general meetings. Investors, indeed, are expected to engage with the company, before or even after the meeting, to provide a clear and concise explanation if they did not support the board's voting recommendation. Further, such engagements must be underpinned by an open and honest dialogue, generally conducted in an environment of confidentiality and trust, to help ensure there is a mutual understanding across a wide range of policy issues including:

- board balance and composition – not least in respect of diversity – and board effectiveness;
- the role of promoters;
- strategy and dividend policy;
- executive remuneration;
- the quality of corporate reporting, audit, risk-- including cyber risk--and control;
- corporate culture and values; and
- environmental and social policies and other aspects of corporate social responsibility.

It is very important that investors respect the authority and responsibilities of the board, and resist any temptation to engage in matters that might be construed as micro-management. Rather, there should be a two-way meaningful communication on the key policies issues that pertain to the company's governance and sustainable success, although the topics discussed would vary from company to company and from investor to investor. As well as investors asking questions, boards and senior management should seize the opportunity to ask questions of their investors to learn, at first hand, the shareholder expectations.

### V. Three Lessons to Learn from the UK Stewardship Code Experience

What are some of the lessons that India can learn from the UK's experience?

First, it would be beneficial to consider embedding stewardship and corporate governance into the mainstream investor relations process of Indian companies to achieve effective dialogue and accountability. In the UK, stewardship relations conducted under the auspices of the UK Stewardship Code, are often channelled through a process parallel to investor relations, involving the chairman's office and the dedicated governance and stewardship teams at the investment houses. As a consequence, the company's senior management and the investors' portfolio managers are frequently side-lined. At a time when ESG issues are increasingly integrated into investment decision-making – a trend which is likely to continue – it would seem sensible to bring ESG and stewardship into the mainstream investor relations process from the outset, to help ensure all the key players, and not just a select few, are joined-up effectively. Toward this end, there is merit in the regulator considering the benefits of incorporating enabling mechanisms in its corporate governance requirements.

Second, the regulators responsible for the Indian Stewardship Code should take, and be seen to take, an assertive approach to Code compliance from the outset, recognising that the Code signatories will need encouragement and exhortation to embrace the Code's principles fully in the early days. It took the FRC until 2016 - six years after the UK Code was launched – to enforce compliance by naming and shaming those signatories who were failing to provide adequate transparency on Code compliance. The FRC took a further year to effectively remove from the Code's list of signatories those who still did not make the requisite improvements.<sup>12</sup> Far better that the Indian Stewardship Code regulator(s) should make clear their intention to sort the wheat from the chaff after, say, a couple of years of the Code being in place. Such an assertive approach would send a strong message to retail investors as well as institutional investors, about the importance attached to responsible shareholder engagement and sound stewardship by the participants in India's capital markets.

Third, the investment and corporate communities in India should develop best practice 'Indian Stewardship Code Engagement Guidelines' to assist companies and investors alike to implement the Code with confidence and conviction in a way that underpins the prospect of mutually beneficial engagement. In the UK, many investors and companies were uncertain initially, in the absence of generally accepted engagement guidelines, about how to approach the practical aspects of stewardship engagement. Such guidelines, which should be reviewed every couple of years, will serve to help ensure that the Code is a living Code by providing a generally accepted and authoritative template and toolkit to address the 'how to' of responsible shareholder engagement, which can be surprisingly harder to achieve in practice, particularly in the early days, than it sounds in codified theory.

### VI. Some Practical Tips for Boards and Investors

Although the Indian Stewardship Code is yet to be published, the IRDA's 'stewardship code' for insurers, which comprises seven principles modelled on the UK Stewardship Code, is perhaps an indicator of what is yet to come. Investors and companies need to be supportive of responsible shareholder engagement, irrespective of the status of the Code. Box 2 provides just a few pointers for boards of directors and investors as they start to consider how they will fulfil their respective responsibilities.

<sup>12</sup> FRC Press Notice, 3 August 2017 [https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report\\_en.pdf](https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf)

## Box 2: Preparing for the Indian Stewardship Code – Some Practical Best Practice Planning Tips

### For Boards of Directors

- ◆ Have an appropriate process for dealing with engagement requests from shareholders. It should identify which executives should have the responsibility for responding to such requests.
- ◆ Have a proactive shareholder relations programme and not always wait for investors, particularly large investors, to knock on company's door.
- ◆ Disclose about the engagements with investors appropriately in the annual report. Thoughtful consideration should be given to provide a clear and concise summary of such engagement.

### For Institutional Investors

- ◆ All members of the investment team to have a clear-cut framework of principles and guidelines to ensure that they take decisions on a consistent basis over time and across the team.
- ◆ As regards conflicts of interest in voting and engaging, it is never too early to (a) identify such conflicts (which should be recorded in a conflicts register), and (b) to consider how each conflict can be managed in way that does not prejudice the best interests of clients and customers.
- ◆ While accounting to clients, customers and beneficiaries for how they complied with the Indian Stewardship Code, institutional investors need to give consideration to the frequency of reporting, and perhaps adding a new section dedicated to stewardship in the website. They also need to identify the person responsible for

## VII. Conclusion

Effective corporate governance and responsible shareholder engagement under the auspices of an Indian Stewardship Code should further enhance the attractiveness of India's capital markets for domestic and international investors alike.

It seems probable that in the foreseeable future there will be a principles-based comply-or-explain Indian Stewardship Code, which will apply to all regulated institutional investors in India. It must be tailored to take into account the special features of Indian corporate governance including the role of promoters and the incidence and nature of conflicts of interest: otherwise, it will wither on the vine.

The British experience in implementing the UK Code, which has been in existence for over 7 years now, could be valuable for India. It would be useful to learn from the mistakes made by the British in putting their code into practice. Some of the lessons learnt from the British experience have been outlined in the previous section.

In the final analysis, the Indian Stewardship Code should be regarded as a means to an end and not an end in itself. With this in mind, companies and investors should now start giving serious thought to what they need to do to enable and embrace responsible shareholder engagement for the benefit of all concerned.

## References

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