

# **SEBI's Stewardship Code for Institutional Investors**

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## **Background**

While the Bombay High Court initially held that the role of LIC is unconstitutional and malafide, however, the Supreme Court allowed the appeal of LIC and specifically stated that allegation of mala fides against the LIC was baseless.

The very first time when the activism of institutional investors was felt was in the matter of *Life Insurance Corporation v. Escorts Ltd.*,<sup>1</sup> 1986 AIR 1370.

The Supreme Court stated that being a shareholder LIC can exercise all shareholder rights including the requisition of an Extra-Ordinary General Meeting and it is not wrong in its part to deny the issuance of equity linked debentures which can dilute its shareholding.

Institutional investors include entities like Alternate Investment Funds ('AIFs'), Mutual Funds ('MFs'), pension funds, government treasury, insurance companies, to name a few. They invest large amount of funds in companies and their investment is mostly strategic in nature. While their individual investment is huge, the funds that they invest belong to a large pool of diversified investors with small, medium and large contributions. Since the institutional investors play an important role in protecting the interest of diversified investors, they act as stewards for their clients.

Globally also, looking at the sense of responsibility, institutional investors are required, to follow the stewardship code. Countries like United Kingdom<sup>2</sup>, Japan<sup>3</sup>, Australia<sup>4</sup> and United States<sup>5</sup> to name a few have laid down the principles under their respective codes which is similar in nature and intent.

In India also, the Stewardship Code<sup>6</sup> for insurance companies ('IRDAI Code') issued by IRDAI is already in place since 2017. On the very similar lines as that of the global practices and IRDAI, SEBI has pursuant to the approval of the sub-committee of the Financial Stability and Development Council (FSDC-SC), brought the circular detailing the 'Stewardship Code' ('Code') to be adopted by MFs and all categories of AIFs from the financial year starting from April 01, 2020. The only line of distinction between the global practice and that of Indian legislation with respect to this code is that in other countries as mentioned above, the same is applied on the COREX (comply or explain) principle whereas both IRDAI and SEBI has made it mandatory to implement the code.

This write-up provides an overview of the Code to be framed and adopted by the institutional investors. Further, beside the other aforesaid reasons, the idea behind bringing up the Code for institutional investors may also have been guided by the growing equity share of the institutional investors in Indian capital markets. The data w.r.t. to the increasing market share by mutual funds in Indian capital markets is also included.

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<sup>1</sup> <https://indiankanoon.org/doc/730804/>

<sup>2</sup> [UK Stewardship Code](#)

<sup>3</sup> [Japan Stewardship Code](#)

<sup>4</sup> [Australia Stewardship Code](#)

<sup>5</sup> [US Stewardship Code](#)

<sup>6</sup> Click [here](#) to view the IRDAI Code

# Role of Institutional Investors in the corporate governance of companies

Institutional investors play a significant role in holding high standards of corporate governance. Further, the OECD Principles of Corporate Governance<sup>7</sup> contain explicit provisions on the significant role of institutional investors with respect to good corporate governance. It states the following:

*“Institutional investors differ widely, including with respect to their ability and interest to engage in corporate governance. For some institutions, **engagement in corporate governance is a natural part of their business model**, while others may offer their clients a business model and investment strategy that does not include or motivate spending resources on active ownership engagement. Others may engage on a more selective basis, depending on the issue at stake (Isaksson and Çelik, 2013a). The Principles annotations note that if shareholder engagement is not part of the institutional investor's business model and investment strategy, that mandatory requirements to engage, for example, through voting, may be ineffective and lead to a box-ticking approach.”*

Further, as per various research and law papers and legal articles, including but not limited to SSRN Paper<sup>8</sup>, Report on the Role of Institutional Investors in Promoting Good Corporate Governance and various other sources, it is abundantly clear that institutional investors acting in fiduciary capacity are expected to disclose various things. Some of which include policy on managing conflict of interest, voting policies, etc.

Institutional investors view corporate governance differently than individual investors, since they have larger blocks than individual investors and hence, they play a more active role. Institutional investors would generally take up the approach of dwelling into matters, the cost of inclusion to which is less than the benefit that will accrue by engaging itself into it.

## Principles under the Code

### Principle 1 – Formulate policy to discharge its stewardship responsibilities

Formulation of comprehensive policy on discharge of stewardship responsibilities and at the same time disclose it on its website. Such policy shall contain a framework for monitoring and engaging with the investee company on matters like performance, strategy, risk structure, governance and capital structure, etc. A training policy for personnel involved on implementation of the principles is crucial and may form a part of the policy. Further, the policy is also required to be reviewed periodically and in case any activity is outsourced, the policy should provide the mechanism to ensure compliance with stewardship responsibilities.

### Principle 2- Have a clear and detailed policy to manage 'Conflict of Interest

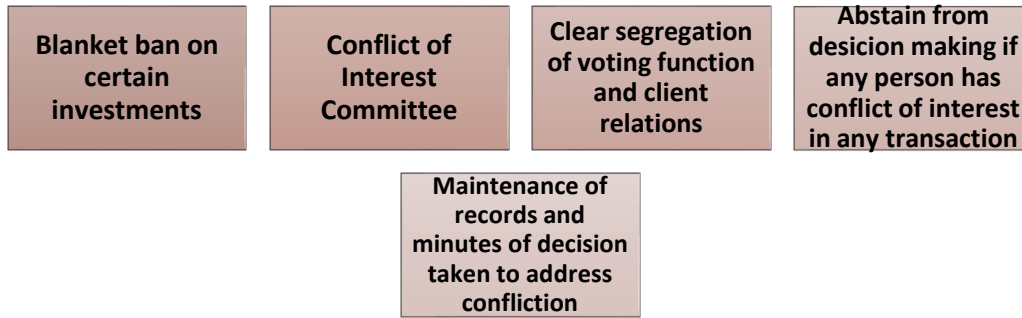
The institutional investors should identify the areas where conflict of interest may arise should lay down clear cut policy to identify and manage such conflict. Institutional investors should always give preference to the interest of its client/investors before the interest of investee company. Also provide periodic update of the same publicly.

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<sup>7</sup> <https://www.oecd.org/corporate/Corporate-Governance-Factbook.pdf>

<sup>8</sup> To view the SSRN Paper on Role of Institutional Investors in Corporate Governance, click [here](#)

### Action for mitigating conflict of interest:



### Principle 3 – Monitor the business of Investee Company

Institutional Investor should monitor the investee companies as per their size i.e. different level of monitoring for the different investee company and it should also keep in mind the regulation related to Insider Trading while asking for the information from investee company. Areas which may be monitored are as follows:



### Principle 4 – Have a clear policy on identifying intervention in the Investee Company as well as collaborate with other Institutional investors for interest of its investors

Frame a clear policy on identifying intervention areas in the investee company. Intervention may include poor financial performance of the company, corporate governance related practices, remuneration strategy, ESG risks, leadership issues, litigation. Hence, institutional investor must have clear policy to identify such intervention and meeting or discussion with the board should be done to solve such intervention. Further, the policy should also contain the provision for collaboration with other institutional investors for meeting or fulfilling the interest of ultimate investors.

### Principle 5 – Clear policy on voting right and disclosure of same

Clear policy on voting right and disclosure of same. Instead of blind faith on Investee Company's management, institutional investors should exercise its voting right after in depth analysis. All the voting policies should be publicly disclosed.

### Principle 6 – Periodically report on these Stewardship activities

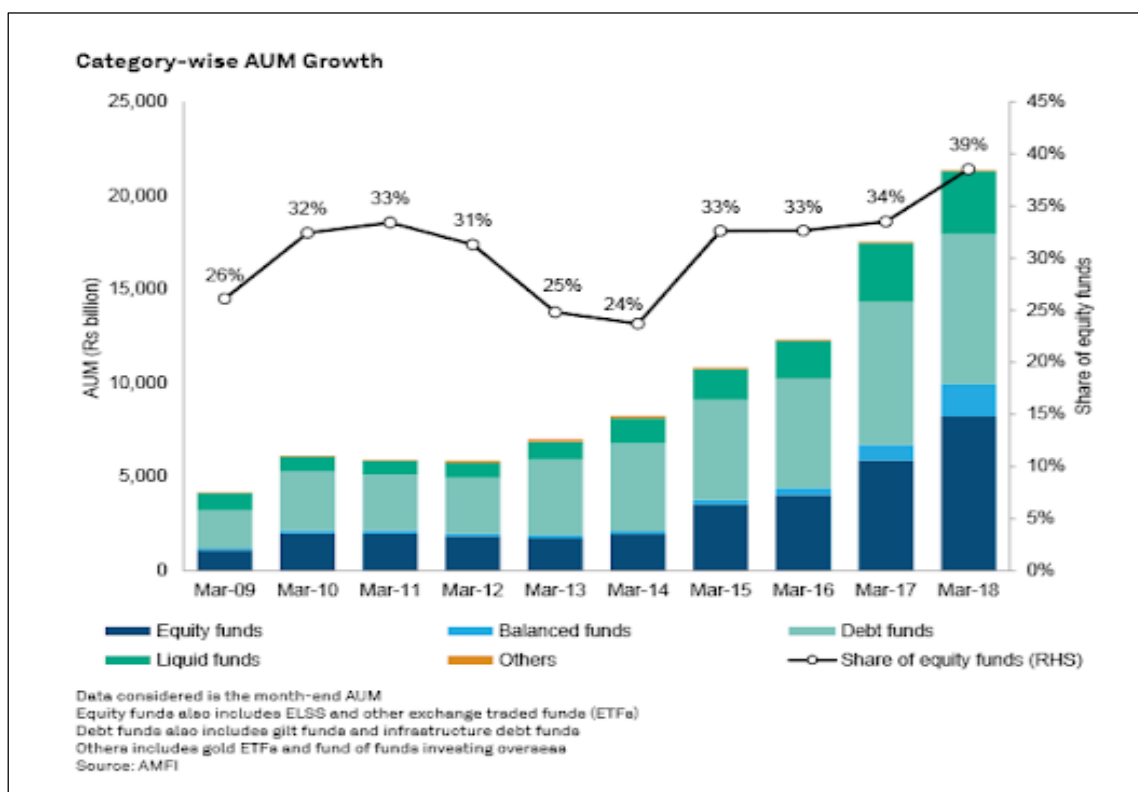
Institutional Investors shall report regarding every principles to its client/investors about its stewardship responsibilities and same shall be placed on the website.

## Introduction of Code guided by growing trend of MFs in Indian Capital Markets

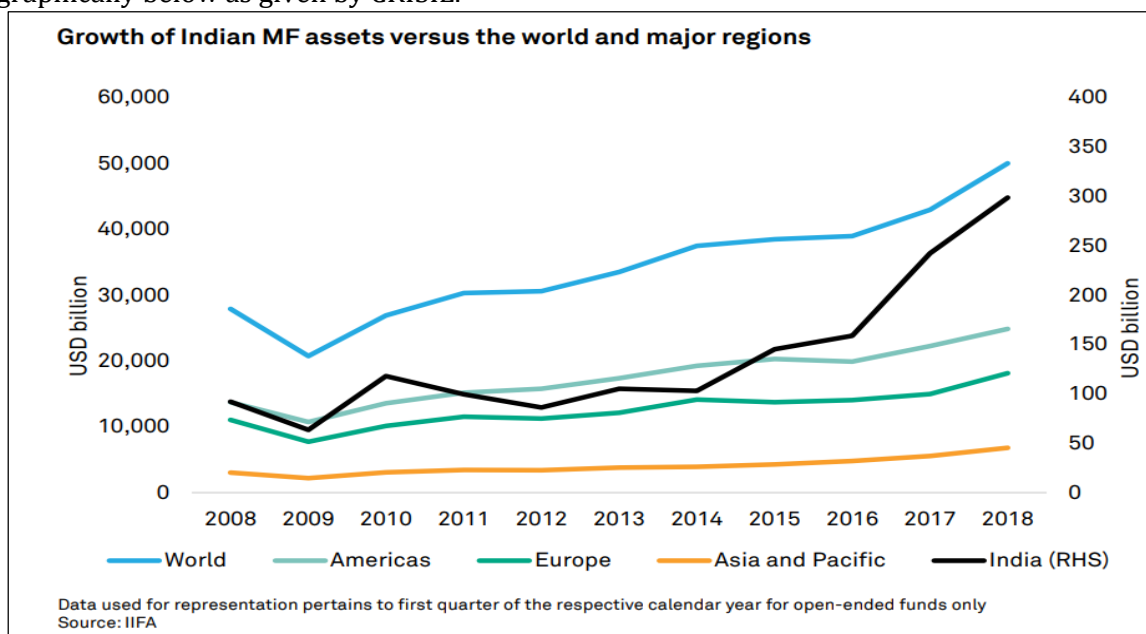
As mentioned earlier, it is also most likely that the growing market share by the institutional investors may have been one of the reasons for introducing as well as mandating the implementation of this Code unlike the other countries where the same is voluntary.

As per the [research paper](#) published by AMFI, the mutual fund industry's stellar growth has come on the back of a surge in equity-oriented funds, which saw their assets under management (AUM) log a whopping 38.6% compound annual growth rate (CAGR) between March 2014 and June 2019.

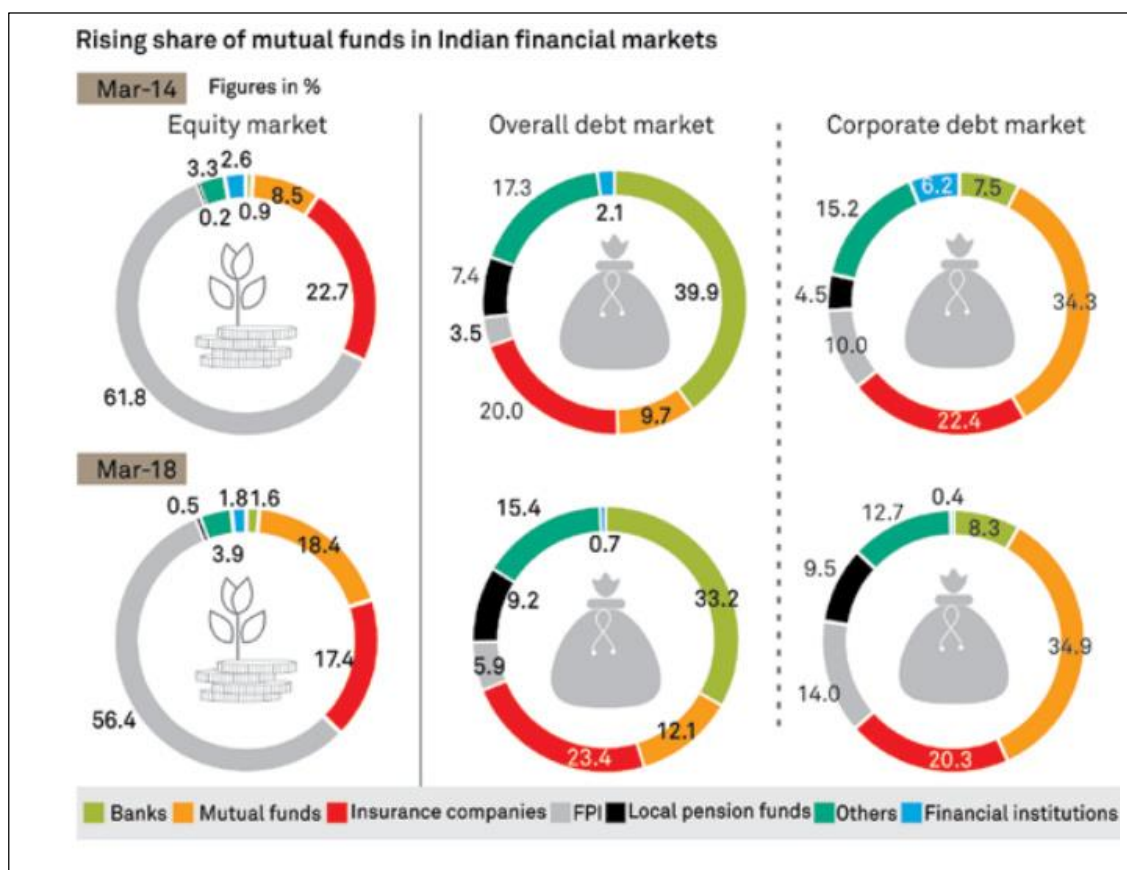
The surge took the equity-oriented mutual funds' share of industry assets to 45% as of June 2019, up sharply from 24% as of March 2014.



Further, the [factbook](#) issued by CRISIL also refers to the figures which makes it evident that the Indian capital markets have seen a huge leap in the share of MFs. The same is represented graphically below as given by CRISIL.



Further, the rising share of MFs in Indian financial markets can also be seen as represented below:



## Conclusion

While the Code has been framed rightly to improve investor protection as well as good corporate governance, the question that remains is the way forward for AIFs and MFs to kick start the implementation of this circular. Considering the applicability is from the financial 2020-2021, there is a lot to do by the AIFs and MFs currently in terms of framing of the policy with a holistic approach of covering all the principles and be ready with the same before 1<sup>st</sup> April, 2020.

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*Institutional investors have great potential to influence and make the investor company set high standards of corporate governance. As far as the cases of Escorts and DCM are concerned, it is quite evident that they have the power of destabilizing the management by exercising their shareholder rights. Further, since they continue to hold the fiduciary obligation towards their investors, documenting and following this Code becomes all the more relevant.*

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