Will institutional investors stand up?

They have clout. They are responsible to their investors. They should do more to keep companies in line

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While the debate on independent directors rages on, little has been said about the role of institutional investors in corporate governance. With more retail investors committing more of their savings to these intermediaries -- mutual funds alone manage about Rs 200,000 crore, about half of which is retail money -- their role becomes critical.

The universe of institutional investors can be, broadly speaking, divided into two. One, institutions that have a clear public good dimension, as they represent the common person's money. These include mutual funds, domestic financial institutions, provident funds, insurance companies and banks. Two, there are FIIs (foreign institutional investors) and venture capitalists, who represent both public and private investors.

Policing others…

As recently as a decade ago, most shareholders were individuals, who could engage with their companies only at AGMs (annual general meetings). Today, the individual stands marginalised. Institutional investors now hold more than half the floating stock of actively traded listed companies. Given that fiduciary responsibility, they have an active role to play, more so since other flanks of corporate governance are weak.

Retail shareholders' activism is yet to take off in India; there are not even 10 investor associations, of which, only two or three are doing any serious work. Independent directors, being 'insiders', will deliver only limited value. The experience of several developed countries shows that institutions are better placed than other kinds of investors to play a leading role in monitoring companies. The failure to do so may result in a loss for their investors.

A recent corporate governance survey conducted by the World Bank in India throws disturbing findings. It shows that most domestic mutual funds play a passive role in the corporate governance of their portfolio companies. They seldom, if ever, review the agenda of shareholder meetings, leave alone attend it, or convene informal meetings with the management. Insurance companies and banks are relatively more active, FIIs a shade better. Significantly, all of them support the incumbent management.

Most institutions are myopic investors, uninvolved in corporate governance. They prefer that contentious matters are resolved behind the scenes, rather than put to vote to shareholders. Even the best chief executive of an institution is not willing to be an activist or be perceived as one. It's no surprise then that not once have we seen a mutual fund vote against a resolution, or be critical of a company's actions in the press, or take it to court.

Increasingly, institutional investors can't just be passive equity managers. They should participate objectively in board resolutions. They should monitor corporate governance practices of companies and interact with other institutions on such matters. They should intervene to shake up boards of under-performing companies and promote best practices in board composition, executive remuneration and other matters. Participation by shareholders adds value. For example, venture capitalists willing to invest both money and ideas tend to do better than the market.

In the past few years, considerable amount of work has been done, through legal and regulatory measures, to improve corporate governance. However, enforcement is still lacking. Government regulations, while necessary, are inherently inefficient. Regulators, who are monopolist by nature but subject to political and public scrutiny, often seek comfort in rules and process. For instance, in issue prospectuses, the overriding objective is to minimise the risk of litigation. Helping investors make an informed decision is a secondary goal. The small investor is swamped with information, but starved of knowledge. Large investors are better placed, which is why, in a free market, the informed and active among them are the best regulators. Investor meetings and lunches have to give way to conference calls, group emails and videoconferences.

…and themselves

There is also an urgent need to focus on the corporate governance of institutions themselves. Institutions have to become more transparent, more accountable. They should disclose their corporate governance practices, voting policies and voting records. They should also disclose material conflicts of interest. In the US, proxy votes made by mutual funds have to be publicly disclosed. Regulators also mandate disclosures of 'who owns what' on a single website and, also put out this disclosure inversely -- 'what is owned by whom'.

Corporate governance should be about performance, not about conformance. It is a means to an end, not an end in itself. It is up to institutional investors to lift their performance. For the time is not far when we will have the 'lead plaintiff' provision of the US, under which large shareowners can be named controlling parties in class-action shareholder suits.