FENCE-SITTERS TO FORCED ARBITERS

Corporates on notice as mutual funds find their voting voice

Since April 2021, Sebi has made mutual funds compulsorily vote on most corporate resolutions. Thanks partly to this, contentious proposals by Eicher Motors and Zee were rejected or withdrawn. But conflicts of interest still stand in the way of truly independent voting by mutual funds

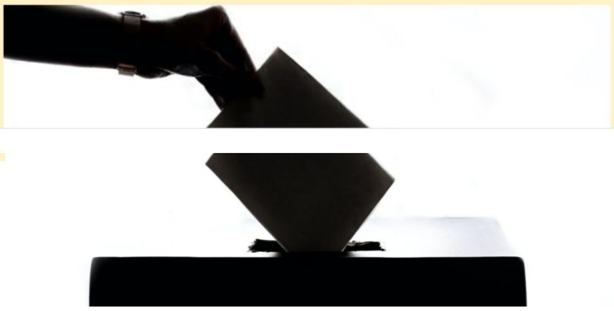
Seetharaman G, 12 Jan 2022

Thanks to the Sebi mandate, abstentions fell to 2% of mutual funds' votes between April-September 2021, compared to 12% in the same period of 2020

And there were eight resolutions in 2021 in which at least 90% of investor votes were not in favour, compared to none in 2020, indicating greater consensus

Besides Eicher Motors, finance company IDFC and fast-food chain Burger King India had their resolutions rejected

But mutual funds are still grappling with conflicts of interest, including having to vote on resolutions of companies who may be investors in their schemes



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HIDE SUMMARY

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But in the second half of 2021, that's exactly what happened with three companies.

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A fund manager with a large mutual fund partly chalks up the increased investor activism, which has traditionally been in short supply in India, to a diktat from the capital markets regulator. In March 2021, the Securities and Exchange Board of India (Sebi) mutual funds to compulsorily vote on most key corporate resolutions—remuneration, director appointments, and , among others—from April. (The mandate extends to all resolutions from April 2022.)

Mutual funds could no longer sit on the sidelines of contentious resolutions. As a result, only 2% of the votes cast by mutual funds in April-September 2021 were abstentions, compared to 12% in the same period in 2020, according to information sourced by *The Ken* from Prime Database, a capital markets data provider. And 5% of those votes were against resolutions, the highest in seven years.

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"Sebi has done a brilliant job by forcing us to vote," says the fund manager quoted earlier. They and several others quoted in the story requested anonymity since they did not want to be seen publicly talking about what is still a very touchy subject.

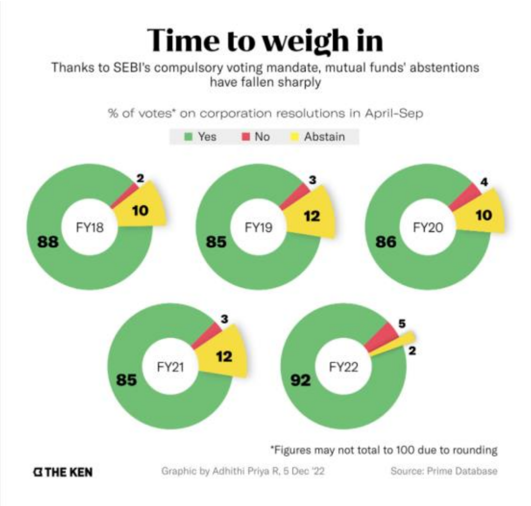
Mutual funds are vital stakeholders in India's equity markets. For instance, they own anywhere between 3-27% of India's top 10 companies by market capitalisation. And retail investor participation in mutual funds has been on the rise—they accounted for a quarter of mutual funds' total assets under management (AUM) as of September 2021, up from a fifth half a decade earlier.

"The moment retail investors park their money with mutual funds, there is a fiduciary responsibility they are entrusting to the funds, and the funds have to exercise it," says Shriram Subramanian. He is founder and MD of the proxy advisory firm InGovern Research Services, which advises investors on how to vote on resolutions.

There are a range of resolutions that can be detrimental to a stock. For instance, allowing independent directors to continue on a company's board when they have turned a blind eye to the company's questionable corporate governance practices. Or approving transactions with group entities that are beneficial to the promoters but not to the company or minority shareholders.

Hence, how fund houses vote on corporate proposals has an indirect bearing on India's 18.5 million mutual fund investors, besides keeping companies in check.

But even with the Sebi mandate, mutual funds are not free of conflicts of interest while assessing resolutions. For one, the very company whose resolution a fund house is voting on might be a large investor in some of its funds. Or the company might have a longstanding relationship with a bank or investment bank that is an affiliate of the fund house. "Mutual funds don't want to be seen as voting aggressively," says Subramanian. "Even if there is no relationship currently, they might worry about a potential future relationship."



A matter of momentum

The vast majority of resolutions put forward by companies are passed as they are considered routine and don't have a material impact on the business.

Less than 1% of roughly 5,750 resolutions between April-September 2021 were rejected, according to an online database run by Institutional Investor Advisory Services (IiAS), a proxy advisory firm. That's similar to the figure in 2020.

But there is a crucial difference. There were 10 resolutions in 2021 in which at least 75% of the votes were against—like the LT Foods resolution—compared to just two in 2020. And there were eight resolutions in 2021 in which at least 90% of the votes were not in favour, compared to none in 2020. So, in essence, the proposals that are defeated are being done so with greater consensus than before.

In fairness, other institutional investors, including foreign institutional investors, pension funds, and insurance companies have had a role to play in this as well. For instance, Reliance Life Insurance Company, Exide Life Insurance Company, and the California Public Employees' Retirement System (CalPERS) were among the investors that voted against the Eicher Motors resolution concerning its MD Siddhartha Lal.

"When you begin voting, you do it as box-ticking," says Amit Tandon, founder and MD of IiAS. "But then you start asking for more information."

Since 2010, mutual funds have had to disclose their voting policy and how they voted on resolutions every quarter. Funds also have to state the rationale behind their decisions.

Before Sebi mandated them to vote, some mutual funds abstained from voting quite frequently. "Sometimes you would get lazy and abstain on routine resolutions," says a senior executive with a mid-sized fund house. They add that a fund would also refrain from voting against a resolution simply because the fund had a large holding in the company, and the resolution being defeated would affect the stock price.

ICICI Prudential Asset Management Company, India's second-largest fund house by AUM, abstained on nearly half the resolutions between April-September 2020. Not surprisingly, they voted on all resolutions in the same period in 2021.

What is odd, though, is that Kotak Mahindra Mutual Fund continued to abstain on a third of the resolutions between April-September 2021—an anomaly among fund houses—despite the Sebi order. Its abstentions were mostly on director appointments and remuneration, including the Eicher Motors resolution, on which its rationale was: "Continuity in the management of company, however cannot opine on individual remuneration."

While Kotak did not respond to *The Ken's* questions, ICICI declined to comment.

It might only be a matter of time before even the likes of Kotak ditch abstentions, given the broader trend. "In our view, there is no leeway to abstain," says the fund manager with a large fund house quoted earlier.

Even with more resolutions being defeated, funds are conscious of not wanting to come across as antagonistic. "We are not activist shareholders," says a senior executive with a top-five fund house. "We are more than happy to work with management on resolutions."

But sometimes, funds don't get to engage with companies before making up their mind.

Clearing the air

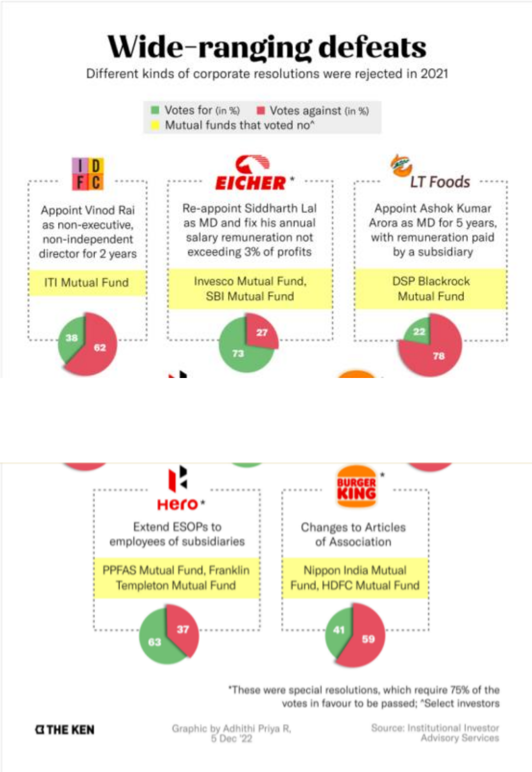
"Eicher reached out to us only on the last day of voting," says the fund manager with a large fund house quoted earlier. "By then, we had already registered our vote." They cite Hero MotoCorp, India's largest two-wheeler manufacturer, as a counterpoint to Eicher.

Even Hero went to its shareholders in August to reappoint Pawan Munjal as chairperson and chief executive for five years. "But they reached out to us a month in advance, right after the AGM notice was out. There was a lot of openness." The resolution was passed, with 93% of the votes in favour.

In October, two months after its resolution was rejected, Eicher modified Lal's remuneration, and sought approval under two resolutions—one to reappoint him as MD for five years and the other to fix his salary. Both were approved with well over 90% of the votes being in favour. Eicher did not respond to *The Ken's* questions.

When HDFC Life decided to acquire rival Exide Life Insurance for ~Rs 6,700 crore ($900 million) in September, analysts believed the deal was expensive and wouldn't bring a lot of benefits to HDFC. "So, HDFC explained to us why they did what they did," says the senior executive with a mid-sized fund house mentioned above. "Companies like HDFC care a lot about how they are perceived." The HDFC Life resolution was passed unanimously.

Such was the momentum among minority investors in 2021 that some big names bit the dust. Finance company IDFC's attempt to extend the board tenure of Vinod Rai, its non-executive chairman, was defeated in September. (We have written about IDFC shareholders' grouse against the company and its board over delays in unlocking value in its investments.) Rai is a former bureaucrat who served as the Comptroller and Auditor General of India (CAG).



It's not just resolutions that were defeated but also some that were withdrawn signalled which way the winds were blowing.

When Zee Entertainment Enterprises sought to reappoint board members Manish Chokhani and Ashok Kurien, proxy advisors strongly opposed the move. IiAS said they had both been on the audit committee in the year ended March 2020 and were "accountable for the losses on account of related party transactions as well as governance concerns outlined by previous independent directors—which resulted in a significant erosion in shareholder wealth."

At least 14 institutional investors voted against the resolutions, including multiple mutual funds. "You wouldn't think someone like Chokhani would be voted against," says the fund manager with a large fund house quoted earlier. Chokhani is a renowned investment banker who was CEO of Enam Securities and chairman of private equity firm TPG Growth India.

Ostensibly to avoid further embarrassment, Chokhani and Kurien resigned a day before Zee's annual general meeting in September, and the resolutions were withdrawn. US investment firm Invesco, the largest public shareholder in Zee, had also demanded the removal of Chokhani and Kurien, along with Zee MD Punit Goenka. Zee has since merged with Sony Pictures Networks India.

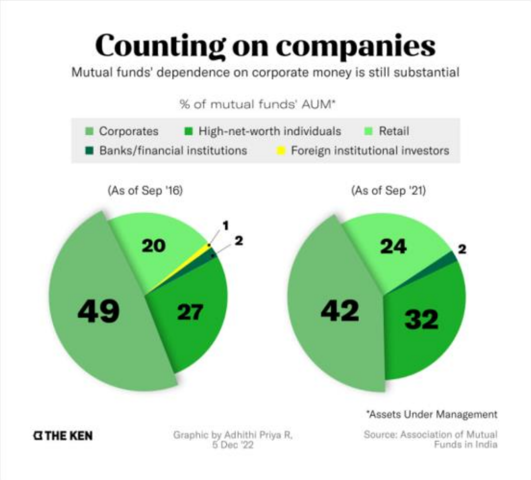
A handful of high-profile victories for corporate governance, however, does not necessarily constitute a movement. Even if Sebi has forced mutual funds to grow a spine, the very nature of their business may prove to be a burden.

Between the hammer and the anvil

Most people might associate mutual funds with investments by the general public. But that's just 24% of mutual funds' AUM, according to the Association of Mutual Funds in India. Funds also turn to a variety of other sources, including banks, foreign institutions, and high-net-worth individuals. But corporates are mutual funds' biggest client base.

Even if corporates' share of mutual funds has declined over the past five years, at 42%, it's still substantial. Mutual funds' reliance on corporates is deepest in short-term debt schemes, with companies accounting for over 80% of AUM in this category.

"Corporate money has always been important for asset managers to be on league tables," says Kaustubh Belapurkar, director of fund research at data provider Morningstar. "It's not necessarily money-making for them, but helps in terms of assets."



So, voting against a key resolution of a company that is also a big client does pose problems for fund managers, according to multiple people *The Ken* spoke with.

On paper, though, mutual funds state that they make decisions in the best interest of their investors. SBI's voting policy claims that where an investee company has "substantial" investments in its schemes, the voting committee will review its resolutions. And that there is a clear distinction between the voting and sales functions, and no sales team will be on the voting committee.

If the decline in corporates' contribution to mutual funds' AUM continues, fund managers will have less to worry about, but they will still not be rid of the problem entirely.

More importantly, mutual funds should start taking a public stance on issues of corporate governance, says Subramanian. A case in point is the rules of the Companies Act, 2013, which allow someone to serve two consecutive terms of five years each as an independent director from 2014, regardless of how many years they had been in that position till then.

A May 2021 study by IiAS found that as of December 2020, 25 companies on the Nifty 500 index had independent directors who had been on the board for at least 30 years, including the drugmaker Pfizer and Bajaj Electricals. A long tenure on the board, critics say, could result in an independent director being too close to the promoters or management and not questioning their decisions.

"Compliance with law is not the spirit of governance," Subramanian adds. With mutual funds now forced to intervene, this could change for the better.

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