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Role Played by Mutual Funds as an Institutional player in Corporate Governance of Listed Companies in India

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Abstract*: With the quantum of ownership by Indian Mutual Funds as an institutional investors in equity shares of listed companies, the manner in which they cast votes, and the extent to which the vote cast is aligned with interest of investors, becomes an important aspect towards improving corporate governance practices adopted by corporates in India and thus development of securities market as a whole. The papers aims to examine the role played by Indian Mutual Funds in improving corporate governance in India, by determining whether Mutual Funds play a role of a active shareholder in India who acts against company's management when decisions made by latter are not in interest of investors; or they simply play a safe role of passive investors who would sell stake in companies that are not observed to be acting in interest of investors. The paper also aims to examine the impact of regulatory mandate in March 2014 towards enhanced disclosure, on the role played by Indian Mutual Funds in improving corporate governance practices.*

I. Introduction

In a 'Company' form of business organization, where the ownership of the organization is separated from its management, the manner in which management performs its role and way in which business decisions are executed towards the larger objective of sustainable growth of the company and thereby value of the investor's funds, is vital. However, due to inheriting conflict of interest, poor governance practices are often adopted by management of companies putting their interest before the interest of the organization and that of its shareholders.Institutional investors (such as banks, mutual funds, insurance companies, investment advisors), that invests pooled assets from large number of investors in equity shares of listed company, can play an influential role in improving corporate governance adopted by management of a company. With their level of holdings in equity shares of listed corporate entities, 'Voting rights' can prove to be a vital and effective tool in hands of institutions to ensure that the decisions taken by the management are in the interest of the investors. As such, the effectiveness and credibility of the entire corporate governance system and company oversight to a large extent depends on institutional investors who can make informed use of their shareholder rights and effectively exercise their ownership rights in companies in which they invest.

Ideally, Institutional investors are expected to act as watch dogs to ensure that the decision made by managements are in interest of investors. IOSCO report captioned "Collective Investment Schemes (CIS) as Shareholders: Responsibilities and Disclosure" (September 2003) states that shareholder rights attaching to CIS portfolio securities should be exercised by CIS operators in the best interests of its investors. Also, the Updated G20/OECD Principles of Corporate Governance, launched in September 2015, have also laid stress upon the rising dominance of the institutional investors; by *inter alia* providing that Institutional investors acting in a fiduciary capacity should disclose their corporate governance & voting policies with respect to their investments and Votes should be cast by such institutions in line with the interest of its beneficial owners. However, of great importance, the question is the level of engagement by institutions in the corporate governance of the listed companies, in practice. Of course, the institutional investors acting in a fiduciary capacity of its clients, have the responsibility to execute their role in favor of their investors, not just by way of making better investment decision and higher returns in short-term, but upon being a co-owner in the investee company, ensuring that its management adopts good governs practices towards long-term growth of investee company that enhances shareholders value. However, not all institutional investors are the same, they may differ in their size, objectives, client profile and prospects which directly or indirectly influence their involvement in corporate governance of investee company.

II. Literate Review

In this connection, based on the previous studies on the role of institutional investors in the corporate governance of a company, two competing views have be witnessed: Active Investors: Advocators of this view i.e. active institutional monitoring believe that institutional investors can influence the decision making process of the management because of significant voting power which they possess when they are the owners of large stake in the investing company (Berle and Means, 1932; Jensen and Meckling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1986). Investors with large funds invested in companies try to have long term relations with the company and are more committed to it as compared to small investors (Black, 1998; Blair, 1995) impacting the shareholder value positively. Individual investors with small amount of funds to invest do not have enough incentives to gather knowledge and information about the company in order to monitor and control its functioning (Stiglitz, 1985). On the other hand, institutional investors have the resources and financial holdings to hire internal and external financial analysts so as to collect information and make better decisions based on them.(Easterbrook and Fischel, 1983).The working group on corporate governance of Harvard Business Review in its July-August 1991 publication concluded that institutional investors of public companies should see themselves not only as investors but as owners. They should act responsibly not for themselves and their clients but also for the other small investors and use their power of voting so as to bind the company to take decisions that are not only in the favor of the company and themselves but also for the other small investors. Passive Investors: On the other hand, few research indicate that institutional investors may tend to behave as passive investors and do not take the interest in the corporate governance and decision making of the company. Institutional investors may act passive by holding in poorly performing companies and not acting in the interest of investors because of certain factors like, conflict of interest, myopic goals. David and Kochhar (1996) believe that institutional investors, in order to maintain their good relations with the firms, they may restrict themselves to go against the decisions of the management. One of the other reasons can be the fact that corporate usually park their idle money in money market mutual funds schemes and acting against these corporate means losing their business, cost and benefit analysis may motivate institutions to behave like passive and transient investors disinterested in overseeing management. Pozen (1994) argues that financial institutions generally act passively and change to become active only when their expected benefits exceed the cost incurred. Taylor (1990) and Wohlstetter (1993) claim that financial institutions cannot improve on managers' decisions because of lack of technical expertise and proficiency. Also, Admati (1994) recognize that free-riding among several institutional owners may also deter the capacity for collective action against managers. Thus, some aspects and factors may influence the institutional investors to be passive and do not take involve and engage themselves in the decision making process of the management.Indian Context: Studies by Khanna and Palepu (1999) and Verma (1997) suggest Institutional investors in India play a passive role in the corporate governance system of Indian companies. Sarkar and Sarkar (2000) have similarly observed that the development financial institutions play a passive role in the corporate governance system of the companies. However Sarkar and Sarkar have found that when the debt holdings of the DFIs are high, they play an active role in monitoring the performance of the companies.

III. Current Indian Scenario

In the Indian context, the economy has witnessed a dramatic increase in the institutional activity especially in the foreign institutional investment. FIIs net investments stood at Rs 18,106 crore (US$ 2.65 billion) in March 2016, out of which Rs 16,731 crore (US$ 2.45 billion) was invested in equities. While Mutual Funds, in India, as institutional investors, manage assets worth INR.14.21 lakh crore as on April 30, 2016, of which nearly INR. 3.99 lakh crore (viz. 28.07% of its total assets) is deployed in equity market, which accounts to nearly 3.8 % of market capitalization. The huge volume of Mutual Funds and other institutional investors in the Indian capital market make them an important sect of the economy. With the quantum of ownership by institutional investors such as Mutual Funds in equity shares of listed companies, the manner in which they cast votes, and the extent to which the vote cast is aligned with interest of investors, becomes important for improving corporate governance practices of investee companies and thus development of securities market. They can drive the investee companies to enhance their corporate governance practices leading to better transparency of operations which can contribute to the overall improvement of securities market.To ensure that Mutual Funds in India play an active role towards better corporate governance of listed companies, in March 2010, SEBI came out with list of practices mandating Mutual Funds to publically disclose their voting policy as well as details of actual vote cast by MFs on an annual basis. Subsequently, in March 2014, to encourage MFs to diligently excerise their voting rights in the best interest of investors, SEBI further manadated quarterly disclosure of actual vote cast in important resolutions of investee company, along-with rationale supporting their voting decision (for, against or abstain) on each vote proposal. However, a recent study on role played by Mutual Funds, as an institutional investors, in improving corporate goverence of listed indian companies, is yet to be researched specially pursuant to the recent regulatory effort made towards ensuring that MFs play a active role towards enhancing corporate governance of listed companies.

IV. Objective of Study

The objective of this paper is to examine the role that Mutual Funds, as an institutional player in India, play in the corporate governance of listed companies:

a. Whether they act as passive investors with aim to gain maximum returns and have investment flexibility by selling the shares of companies that are observed to be not acting in interest of investors; or
b. They actually play a role of a active shareholder who monitors activities of investee company's management and cast vote against the company's management on important decisions that are not in interest of investors; as such driving the listed companies to enhance their corporate governance practices.
c. Whether the role played by Mutual Funds in corporate governance of listed companies, has significantly changes pursuant to recent regulatory effort made by SEBI in March 2014 to encourage MFs to diligently excerise their voting rights in the best interest of investors.

V. Research Hypotheses

Pursuant to the recent regulatory effort made by SEBI in March 2014 to encourage MFs to diligently excerise their voting rights in the best interest of investors,

H0: Mutual Funds, as an institutional player in India, still play a role of passive investors, who shall not exercise its voting rights of Investee Company.

H1: Mutual Funds, as an institutional player in India, play a role of active shareholder who participates towards improving corporate goverance practices by active cast of vote on matters that impact investors interest.

Scope

Studying the role played by Indian Mutual Funds in Corporate governance of listed Indian companies and the manner in which they cast vote during the FY 2012-13 and FY 2015-16.

Implications

If the recent regulatory effort mandating MFs to disclose details of actual vote case along-with rationale, is successful the same could be replicated for other institutional players in India, helping to improve governance among listed companies in India, which is ranked 94th out of 144 countries for the efficacy of its corporate boards by the World Economic Forum.

VI. Research Methodology

This paper explores the role of Indian Mutual Funds in corporate governance of listed companies by studying the trend of vote cast during the FY 2012-13 and FY 2015-16, on the matters that affect the interest of shareholders. The information on Mutual Funds' voting policy and the actual trend of vote cast by Mutual Funds, along-with rationale supporting the vote decisions, is being examined from the website of individual Mutual Fund houses.

VII. Data Analysis & Inference

In order to evaluate the degree of compliance to the SEBI Guidelines on the Disclosure of voting results by Mutual Fund Companies, a database has been prepared and certain trends have been identified.

Overall Analysis – Trend of Vote Cast

While analyzing the trend of votes casted viz. "For", "Against" and "Abstain" over a period of time, it can be observed that:

Table A: *Overall Voting Results of all Mutual Funds*

FINANCIAL YEAR	VOTED			ABSTAINED FROM VOTING
	For	Against	Total	
FY 2012-13	47%	1.5%	48.5%	51.5%
FY 2014-15 (till Dec. 2014)	76.5%	6.6%	83.1%	16.9%
FY 2015-16	87.3%	4.4%	91.7%	8.2%

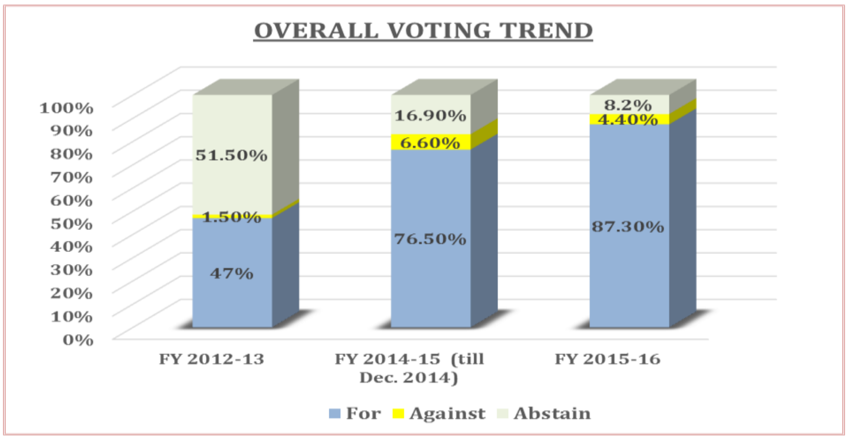

Fig 1: *Votes Trend Analysis of all Mutual Funds*

Observations

a. From the above table and the graph depicting the Votes Casting Trend, it is evident that the from the FY 2012-13 to FY 2015-16, the percentage of votes abstained has reduced drastically; from 51.5% in FY 12-13 to 16.9% in FY14-15 (till Dec. 2014) to 8.2% in FY 15-16. This shall be considered as a good sign towards enhancing corporate governance in India.

b. Out of the total votes casted, it is noted that -

a. Percentage of "For" votes has increased from 47% in FY 12-13 to 76.5% in FY14-15 (till Dec. 2014) to 87.3% in FY 15-16.

c. Against percentage of votes has increased from 1.5% in FY 12-13 to 6.60% in FY14-15 (till Dec. 2014), and subsequently decreased to 4.4% in FY 15-16 which can be the consequence of various other factors.

d. Thus, it can be said that institutional investors are becoming the part of the decision making process of the management by using their votes and not abstaining them. This shall be considered as a good trend reversal sign pursuant to SEBI enchaned disclosure mandate.

Sector Wise Analysis

Taking the analysis further and dividing the Mutual Fund Companies into Public, Private and Foreign Sector, the disclosure of voting rights shows the following trend of voting for the FY 2015-16:

Table B: *Sector Wise Voting Results*

SECTOR	NUMBER OF VOTES				PERCENTAGE OF VOTES			
	For	Against	Abstain	Total	For	Against	Abstain	Total
Public	6359	236	1076	7663	82.9%	3.1%	14.0%	100%
Private	25961	827	3061	29849	86.9%	2.7%	10.25%	100%
Foreign	14378	274	231	15961	90.0%	7.9%	1.4%	100%
Total votes	46698	2337	4368	53403	87.3%	4.4%	8.2%	100%

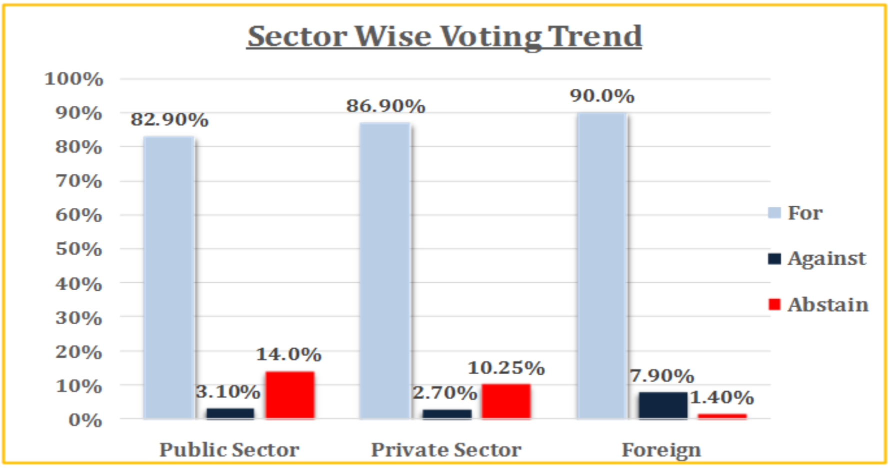

Fig 2: *Sector Wise Voting Trend Analysis*

Observations

As per the data above,

a. With the total abstained percentage of 8.2% across Mutual Funds in FY15-16, Foreign Mutual Funds are observed to be abstaining their votes less (1.40% of their total resolution), while the public sector Mutual Funds are abstaining their votes the most (14% of their total resolution). Hence, the public sector may be motivated to cast vote on shares held in investee companies in order to tackle their high percentage of abstaining votes.

b. Further, while Foreign MFs cast 90% of votes in favor of management, the private sector has the second highest percentage of 86.9% and public sector Mutual Funds with 82.9% of "For" votes.

c. With respect to voting "Against", Foreign Mutual Funds are observed to vote against in 7.9% of their total votes. However, this is comparatively low for Private Mutual Funds (2.7 %) followed by public (3.1%). One of the reasons for such figures could be that the Foreign Mutual Funds have less conflict and better understanding of their voting rights. Nevertheless, Mutual Funds are required to be persuaded towards voting diligently in interest of all the investors and managing conflicts otherwise faced.

Size Wise Analysis

In this section, all the Mutual Funds are divided in three categories; High, Mid and Low; according to their AAUM. Top ten Mutual Funds in terms of highest AUM as on April, 2016 are classified in Category 1: High then the next fifteen Mutual Funds in terms of AUM are grouped in Category 2: Mid and the rest Mutual Funds with lowest AUM are categorized in Category 3: Low.

Table C: Size Wise Voting Results

CATEGORY	NUMBER OF VOTES				PERCENTAGE OF VOTES			
	For	**Against**	**Abstain**	**Total**	**For**	**Against**	**Abstain**	**Total**
Category 1 HIGH (Top 10 MFs by AUM)	22656	1356	2150	26240	86.34%	5.17%	8.19%	100%
Category 2 MID (Next 15 MFs)	15089	550	1002	16642	90.67%	3.30%	6.02%	100%
Category 3 LOW (Remaining MFs)	8953	431	1207	10591	84.53%	4.07%	11.40%	100%

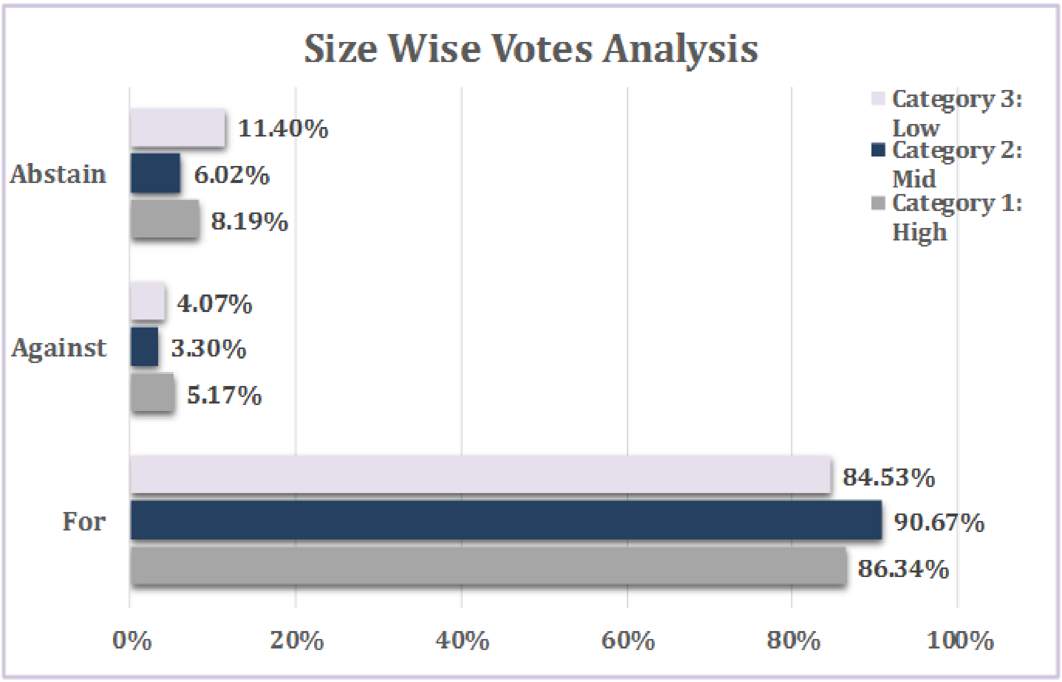

Fig 3: *Size Wise Voting Trend Analysis*

Observations

a. As per the data above,The top- level Mutual Funds are showing a decent picture as compared to other levels; with highest votes cast against management's decision (5.17%) and a modest percentage of vote cast "For" management's decision (i.e., 86.34%). But the abstain votes (i.e. 8.19%) is a matter of concern and needs to be improved by them given that their AUM in the industry amounts to 80.44% of total.

The Mid-level Mutual Funds are observed casting vote in most of the resolution as the percentage of abstain voting is least i.e., 6.02%, but with the highest "For" voting they are not going against the proposals of the management as the percentage of "Against" voting is just 3.30%.

b. The Low-level Mutual Funds are required to show better results as they are observed not casting votes as they have with high "Abstain" voting percentage of 11.40%, among other categories. However, they are observed to be casting vote better "Against", given that in 4.07% of resolution these categories have casted vote against.

Other observations

a. It has been noticed that the institutional investors are voting in favor of the proposals which are of routine nature or are in normal course of business. Also, the proposals for appointment and reappointment of directors and auditors and declaration of dividends are mostly accepted by the institutional investors. Furthermore, the proposals which are for the good prospects and are in favor of all the shareholders of the Investee Company are voted in favor by the institutional investors.
b. It has been observed that the institutional investors have voted against certain proposals when they do not comply with the statutory requirements or are not in sync with the rules of the company. Also, certain Institutional Investors have voted against the appointment or reappointment of top level management, management remunerations, matters pertaining to merger or company restructuring, that are not in interest of investors. In many such cases, due to vote cast by institutions against the management decision, the resolutions could not be passed and the management had to re-work their plans. This shows the importance of vote cast by institutional investors towards improving goverence practice of Indian corporates.
c. While examining the pattern of voting, it has been witnessed that the Institutional Investors have abstained themselves from voting when they do not receive satisfactory reasons and information regarding the proposal. Thus, they are not voting by blindly trusting the investee companies and are able to contribute on their part.
d. A couple of Mutual Funds abstained themselves from voting because of passive investments. This should not have been the case as voting rights are given to shareholders in equity shares of a company, irrespective whether decision to invest in company was a part of active investment stratergy or a passive one.

VIII. Conclusion

a. The data and the observations above show that subsequent to Mutual Funds mandate to disclose vote reason for each vote cast in March 2014, MFs have been playing an active role in the corporate governance practices in the investee companies by judiciously and effectively using their voting rights.
b. With the increase in trend of vote cast against the management decisions on important matters that are not in favour of investors, wherein in few cases management had to re-work their plans as such resolutions could not be passed, shows the importance of vote cast by institutional investors such Mutual Funds towards improving goverence practice of Indian corporates. The enhanced SEBI disclosure norms are proving to be in greater good, enhancing corporate governance practices in investee companies.
c. However, certain observations are required to be addressed:

- A total of 8.2% of abstained votes and just 4.4% of against votes.
- High percentage of "Abstain" votes by public sector Mutual Funds.
- Not much against votes by Private Sector Mutual Funds.
- Large number of "Abstain" votes for Low and High AUM Mutual Funds.

IX. Recommendations

For Mutual Funds, the guidelines provided by SEBI in March 2014 are proving to be effective to an extent and are helping to achieve the objective they were meant to accomplish. Though some measures can prove to improve the results:

a. Passive Investments by Exchange Traded Funds (ETFs)/ Index funds in investee companies should also be directed to actively cast vote.
b. In order to encourage other institutional investors to play active role in enhancing corporate governance practices in India, it is desirable that similar mandate of disclosing trend of vote cast along-with rationale for each voting decision should also be manadated for other institutional investors (such as Insurance

companies, Banks, Alternative investment Funds). Such uniform disclosure norms shall not just remove the regulatory arbitrage across institutional investors, but shall assist in promoting good governance practices in its true sense in India, thereby improving the rank of India in the efficacy of its corporate boards by the World Economic Forum. With such enhanced governance practice aimed towards long term growth of the corporate entity and its shareholders, the securities market as a whole shall be beneficial.

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