Institutional Investors and Corporate Governance: Some Thoughts on India

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Rebooting Financial Regulation: Ways and Means

Conference organized by the National Institute of Securities Markets (NISM) of India and the Systemic Risk Centre (SRC) at the London School of Economics and Political Science (LSE)

January 20-21, 2022

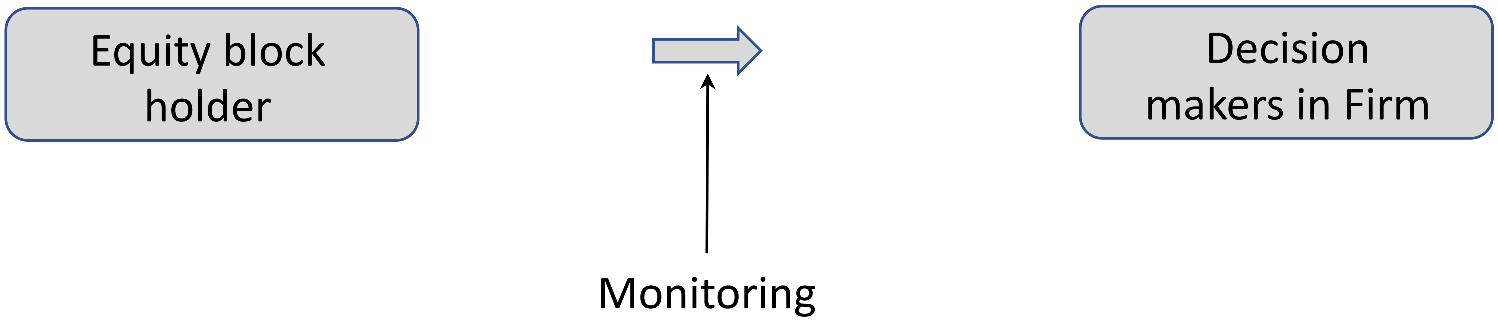
THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

The role of shareholders in corporate governance: The classical view

- To take actions to ensure that decision-makers in firms (typically managers in US/UK but also “promoters” i.e., controlling shareholders in other jurisdictions) act in the best interest of firms’ full set of shareholders/stakeholders.

- Methods available to shareholders:
  - The use of shareholder voice (behind the scenes discussions, shareholder proposals, proxy fights)
  - The threat of blockholder exit (sale lowers price, bad for managers/promoters)

- Classical view of the role of shareholders in corporate governance



Evolution of share ownership in the US

Dasgupta, Fos, and Sautner 2021, "Institutional Investors and Corporate Governance" *Foundations & Trends in Finance*

Pre-publication version available free at https://ssrn.com/abstract=3682800

Table 1: Ownership Shares of the US Stock Market in Percent

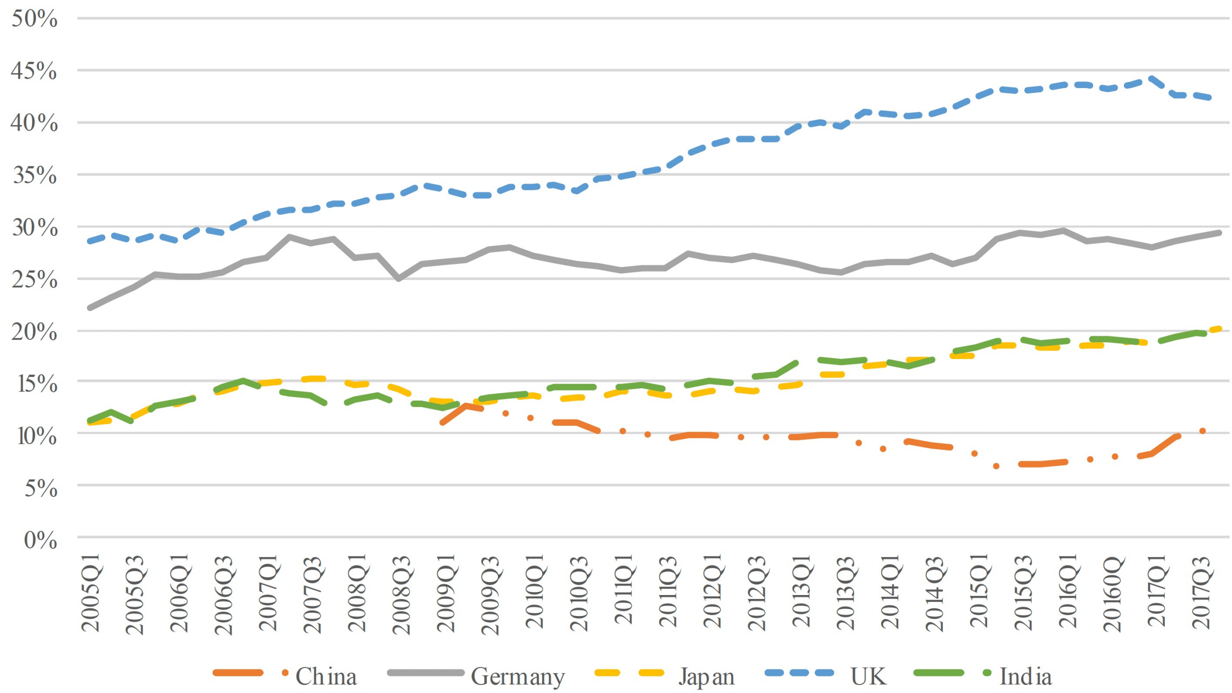
Sector	1950	1970	1990	2000	2010	2020
Private Pension Funds	0.0	8.1	16.2	11.2	7.8	5.4
Federal, State and Government Pension Funds	0.0	1.2	8.1	7.7	8.5	5.3
Insurance Companies	2.6	3.3	4.1	6.2	6.7	1.9
Mutual Funds	1.6	4.8	7.1	18.3	20.2	20.8
Closed-End Funds	0.9	0.5	0.5	0.2	0.4	0.2
Exchange-Traded Funds	0.0	0.0	0.0	0.4	3.6	6.6
Foreign Sector	1.6	3.3	6.9	9.3	13.7	16.4
Household Sector	92.8	78.2	56.5	45.6	37.2	38.3
Other	0.4	0.6	0.7	1.1	1.8	5.1

Source: Federal Reserve Statistical Release Data: Flow of Funds Data United States. Exchange-Traded Funds are first listed in December 7, 2001. The Household Sector includes Bank Personal Trusts.

Evolution of share ownership in 5 next-largest economies

From Dasgupta, Fos, and Sautner 2021

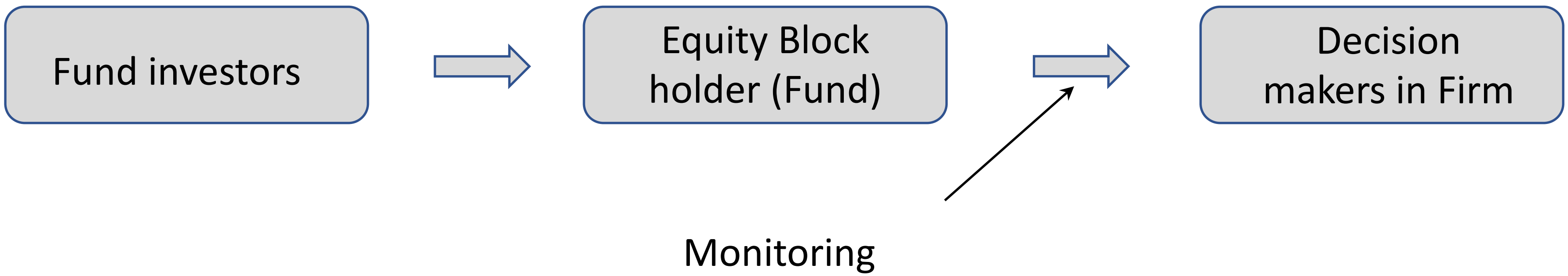
Figure 6: Time-series Evolution of Institutional Ownership around the World



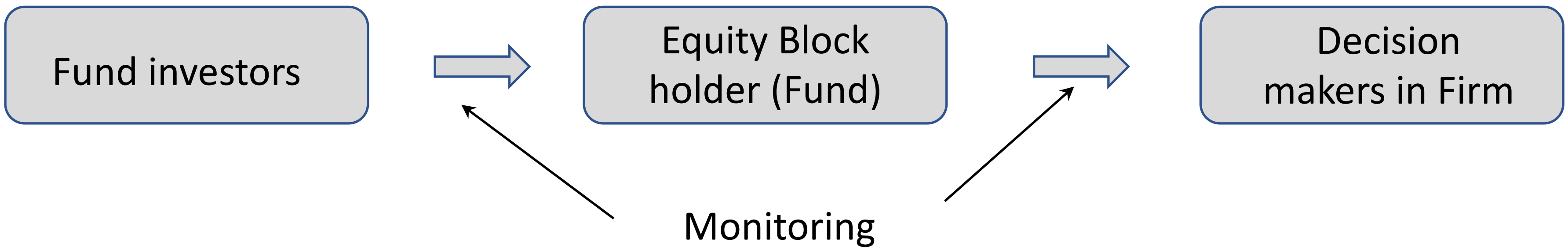
Source: FactSet Ownership. The blue line represents institutional ownership in UK firms, the grey line represents institutional ownership in German firms, the green line represents institutional ownership in Indian firms, the yellow line represents institutional ownership in Japanese firms, and the orange line represents institutional ownership in Chinese firms.

Using different data, IiAS reports than institutional investors owned over 1/3rd of equity in India in March 2019. (Source: IiAS, Corporate Governance Landscape in India, August 2019.)

Defining characteristic: Use “other people’s money” to own blocks



Defining characteristic: Use “other people’s money” to own blocks



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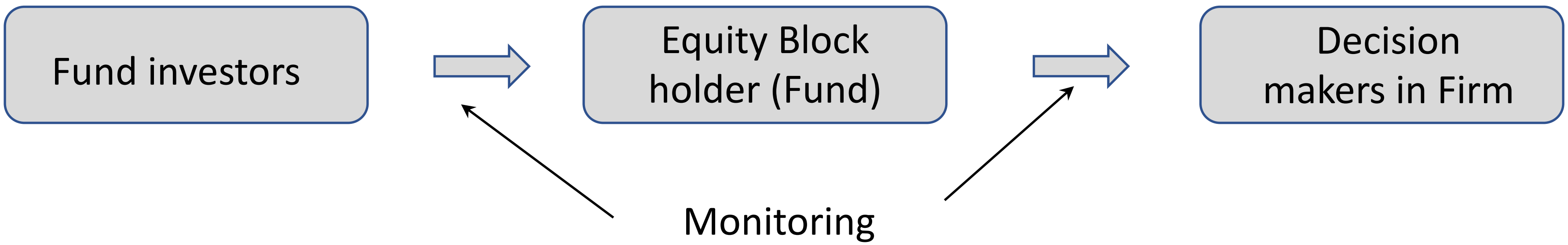

- Multi-layered monitoring central to the role of institutional investors in corporate governance with (at least) two key implications:

1. Institutional investors must choose all actions (including stewardship) with an eye to keeping their clients happy… you can’t be a money manager unless you have money to manage!
    - In finance jargon: Institutional investors “***compete for flow***”
2. Institutional investors can be *regulated* and potentially have ***positive*** obligations placed on them (e.g., obligation to vote, to report voting policies, to engage/monitor, etc.).

- Putting these together: Understanding institutional incentives to compete for flow valuable for designing good regulation.

Corporate Governance in India: Challenges

- Concerns are sometimes expressed about institutional investor engagement in India due to:

1. Multiple codes: 2017 IRDAI code for insurance companies, 2018 PFRDA code for pension funds, 2019 SEBI code for mutual funds and alternative investment funds;

2. Broader legal remit for companies including CSR (embodied in Companies Act of India, 2013);

3. Dominant role of controlling shareholders (“sponsors”).

Corporate Governance in India: Challenges; Thoughts

- Some express concerns about institutional investor engagement in India due to:
- I'm more optimistic!

1. Multiple codes: 2017 IRDAI code for insurance companies, 2018 PFRDA code for pension funds, 2019 SEBI code for mutual funds and alternative investment funds;
   - Unified coding has many benefits, but fragmentation isn't *intrinsically* a problem, as the US framework suggests.
2. Broader legal remit of for companies including CSR (embodied in Companies Act of India, 2013);
   - The stakeholder orientation enshrined in Indian law is progressively less of an issue, given the sharp increase in ESG mandates amongst global institutional investors.
3. Dominant role of controlling shareholders ("sponsors").
   - Key issue, raises arguably one of the most important requirement for institutional engagement in India: ***coordinated engagement***, because a greater weight of institutional investors is required to have an impact in the presence of promoters.
   - SEBI's 2019 code already recognizes coordination as a key goal (Principle 4: "a clear policy for collaboration with other institutional investors where required").
   - Let's think about the need and the means to ***incentivize*** coordinated engagement.

Why must coordinated engagement be incentivized?

- Engagement enhances shareholder value, but it is costly.
- If *others* engage and generate value enhancement, those that do *not* engage still benefits (while avoiding the costs).
- Creates incentives to free-ride on others; in technical terms, engagement is a “public good”– the individual equity blockholder’s incentive to engage is too low relative to its overall benefits (externality).
- Externality implies role for regulation.
- Regulation should go further than just encouraging and/or mandating coordination.
  - The former may be ignored, and the latter is hard to enforce.
- Appreciating institutional incentives to compete for flow may help to design regulations that encourage coordinated engagement.
- In the rest of my talk, I’ll outline two coordination mechanisms that emerge from my own work that may be useful in this regard.

Coordinated Shareholder Voice

Brav, Dasgupta, and Mathews, *Wolf Pack Activism*, forthcoming in *Management Science*

Pre-publication version available free at https://ssrn.com/abstract=2529230

- Theoretical analysis.
- Institutional investors (funds) have different skills in identifying and/or participating in shareholder engagement; but those that are skilled and can (now and in the future) are more desirable for fund investors.
- Shareholder engagement is costly but benefits not just engagers but also non-engagers. (Externality referred to earlier.)
- Incentives to compete for flow helps to reduce the externality:
  - Investor capital flows from (unskilled) non-engagers to (skilled) engagers following successful engagement.
  - Reduces the externality by rewarding those who engage at the expense of those who do not.
- ***Regulatory consideration:*** How to make fund-by-fund information about engagement efforts available in *comparable* form on a regular basis? Ease proxy access?
- This may help incentivize coordinated exercise of shareholder voice.

Coordinated Shareholder Exit

Cvijanovic, Dasgupta, and Zachariadis, *The Wall Street Stampede: Exit as Governance with Interacting Blockholders*, ECGI WP 632/2019. Latest version available free online at https://ssrn.com/abstract=3473877

- Theoretical analysis and supporting empirical evidence.
- Institutional investors who compete for flow do not wish to be left with significant holdings of a company abandoned by an engaged blockholder.
- When engaged blockholders feel bad decisions are being made and sell out, institutional investors who are particularly sensitive to flows (mutual funds) will sell out behind them, increasing price impact.
- Makes the threat of exit of an engaged blockholder more effective.
- Large sample evidence from US activist hedge fund exits (1994-2011): Following exits by activist hedge funds, mutual funds sell out significantly more than other institutional investors.
- ***Regulatory consideration:*** How to provide timely and precise information about the ***trades*** of engage d blockholders to market participants? How to promote effective knowledge of the ***types*** of other blockholders to engaged blockholders?
- This may help incentivize coordinated engagement via correlated exits, specially in firms where mutual funds hold significant numbers of shares.

Conclusion

- The holdings of institutional investors are progressively increasing.
- Enhances the importance of ensuring that they can effectively engage in stewardship activities.
- A key step to rendering institutional investors effective stewards is coordinating their engagement.
- Over and above encouraging coordination (through governance codes), regulations can additionally pivot on the key incentive of institutional investors to attract investor capital.
- There are several ways in which the incentive to compete to capture or retain investor capital can encourage engagement activities.
- I’ve briefly outlined two such ways in this talk. Each has regulatory implications.
- Building effective regulation that pivots on institutional investor incentives represents a promising area on which the academic literature now provides guidance.