ROLE OF INSTITUTIONAL INVESTORS IN CORPORATE GOVERNANCE

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INTRODUCTION

Institutional investors form the major contributors in the companies in our country. The current plans and policies have resulted to a rise in the rate of flow of FDI and FII in the country. Institutional investors are turning into significant factors of companies. Even though the institutional investor policy is not that dominant in India, yet it is gaining significance. They play an active role when it comes to the corporate governance in US and UK.

They supervise the decisions taken by the Board and also facilitate in exercise of efficient corporate governance in the firm. Big institutional investors can communicate private data that they receive from the administration to other shareholders.

Institutional investors are basically shareholders with major shareholding and thus have the ability to get associated with good behaviours in corporate governance.[1] They are guardians of public money, and act in fiduciary relationship. They are obliged to make decisions that best fulfil the purpose and interests of the companies and guide it to perform keeping in mind the ethics and morals.

This chapter further will give a brief introduction to the historical background and also discuss the issues faced in the role of an institutional investor.

[1] Manya Srivardhan, *Role of Institutional Investors in Corporate Governance,* SSRN, published on April 19, 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1391803&download=yes.

HISTORICAL BACKGROUND

Majorly, the Institutional investors that render external credits to Indian Companies which are listed can generally be assorted as either investment institutions or lending institutions. FIIs and Mutual Funds forms part of the former class while Banks and Financial Institutions forms part of the latter class. UTI which is a mutual fund owned by the Government of India also had the features of a lending institution before it in the recent past made "term loans" to organizations along with putting investments in them by means of the equity market. However, banks can have lending as well as investment relation.

Till 1991, the major institutional investors consisted of DFI, IFCI, ICICI, IDBI, UTI, LIC, GIC and "the Public Sector Banks". All of the above mentioned institutions were owned by the Government. After the economy was liberalized and competition came into picture in the financial sector, mutual funds associated with private sector and FIIs moved into the market and changed the scenario of the institutional investor.

Presently, three different classes of institutional investors are there in India viz. the old ones mentioned above i.e., DFIs, GIC, LIC, UTI, the new ones i.e., mutual funds associated with private sector/insurance companies and lastly the FIIs.[2]

In India, there has been an increase in the sum of money invested in organizations by the institutional investors. The plans that have been followed by the Government have made easier the rise in the rate of flow of FII as well as the FDI in the country. Resultantly there has been an increase in the count of institutional investors also.[3]

ISSUES IN THE ROLE OF INSTITUTIONAL INVESTOR

This part of the chapter deals with the issues relating to the role of institutional investors. Insider trading is one of the major issues. Whenever any institutional investor comes across some poor governance exercise in the organization then in that case, it has two options. It can either intervene in the concerned issue and allow the administration to carry out certain action to change the state of affairs; or sell off the shares in the securities market which is popularly

[2] *India: Role of Institutional Investors in the Corporate Governance of their Portfolio Companies,* The World Bank, June 2005, available at http://www.nfcgindia.org/final_india-june29.pdf (last visited October 12, 2016).
[3] Manya Srivardhan, *Supra* note 1.

known as "voting with the feet". In case when no one in the market is aware of the governance issue then in that case the institutional investor in reality confronts the possibility of being incriminated for insider trading. The exclusive way by which the institutional investor can prevent insider trading problem is to consider the dumb decision of primarily making it open to the people which will lead to a downfall in the price of the shares and thereafter selling them at decreased price.[4]

Another issue which is debatable is that of agency problem. The institutional investors govern big blocks of shares; resultantly there is disparity between the ownership and the control on the other hand. The benefits however preponderates the disadvantages as focused ownership block imposes more beneficial supervising of companies which successively facilitates to come across the agency problem.

Accountability is an additional issue which is often encountered. It is interesting to note that UK has brought a new code named The Stewardship Code for increasing transparency; however this code was not sufficient to defend the fact that the institutional investors are likely to do their task in the right manner. [5]

Further, their stress on short-termism also acts as a critic. Institutional investors become even more short sighted as compared to the individual stakeholders. This is because of the contest of accounts and also their status based on their functioning.

Institutional investors as we see are at present an international institution therefore there ought to be an external body to govern their functioning and interfere when necessary.[6]

CURRENT FRAMEWORK GOVERNING INSTITUTIONAL INVESTORS

[4] Pitabas Mohanty, *Institutional Investors and Corporate Governance in India,* NSE India, available at https://nseindia.com/content/research/Paper42.pdf (last visited on October 12, 2016)

[5] Setu Niket, *India: Does The Involvement Of Institutional Investors Lead To Higher Financial Performance?,* mondaq, last updated on October 26, 2015, available at http://www.mondaq.com/india/x/437478/Fund+Management+REITs/Does+The+Involvement+Of+Institutional+Investors+Lead+To+Higher+Financial+Performance.

[6] Mohammed Akbar Ali Khan, *Corporate Governance and the Role of Institutional Investors in India,* Taylor & Francis Online, published on October 17, 2008, available at http://www.tandfonline.com/doi/pdf/10.1300/J098v07n02_04?needAccess=true.

BANKS, DFIS AND INSURANCE COMPANIES

Banks as well as DFIs come under the supervision of the RBI, together with an unquestioning regulative role undertaken by the Finance Ministry. The chief legislation regulating banks as well as DFIs is the RBI Act of 1934 and the "Banking Regulation Act of 1949". The legislations regulating the IDBI and the UTI were rescinded in 2004 and in the year 2004 in order to make easy the transformation of "IDBI into a banking entity and into market-linked mutual fund" respectively.

Talking about the insurance sector, LIC and GIC are the two biggest "government-owned insurance companies" which are incorporated under the law passed by the Parliament. Both of them are under the oversight of both Ministry of Finance as well as the insurance regulator i.e. IRDA. Other private as well as public sector insurers come down under the ambit of Insurance Act and other ordinances brought forth by IRDA in the year 1999.[7]

MUTUAL FUNDS & FIIS

SEBI issued framework for both mutual fund and FII i.e. FII Regulation 1994 and mutual fund Regulations 1992. In 1997 AMFI was formed. It is a self-regulatory organization and it works toward educating investor and building awareness.

In 2001 the government of India removed ceiling from FIIs. Now different sectoral are subject to shareholder resolution. Also approval for FII vests in hand of SEBI alone.

PENSION FUNDS INDUSTRY

This is newly inserted and would be applied to the Government employees enrolled after January 2004. This system of pension would be governed by the PFRDA proclaimed by legislation in December 2004. The role of this authority is to permit and oversee pension fund managers and their capital requirements, to establish guidelines on market participants. It is also required to circulate FDI caps for this sector.

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[7] Sarita Meena, *Corporate Governance and The Role Institutional Investors,* Academia, available at https://www.academia.edu/6780789/Corporate_Governance_and_The_Role_Institutional_Investors_Legal_Aspects_of_Business_Assignment_Contents (last visited October 14, 2016).

Even the employees employed before January 2004 can join this scheme for obtaining additional benefit. This new scheme is more or less similar to the mutual funds and the people who subscribe will have an option of placing their savings majorly in equity or both equity and debt or completely in debt.

BOARD REPRESENTATION

The Committee recommendation by Kumara Mangalam Birla Committee (2003) on institutional investors were that they shall appoint nominees for board member of companies, only where such appointment is necessary to protect interest of institution.

Further Narayan Murthy committee raised issue that participation of investment institutions can raise conflict of interest. It also suggested that the nominee director should act independent of its institutions interest and shall have same responsibilities as other directors in the company.

INSTITUTIONAL INVESTOR ACTIVISM

RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND INSTITUTIONAL INVESTORS

Problems like high risk in financial sector is consider as sign of bad corporate governance.[8] This can be dealt by shareholders alone but institutional investor holds a great power in their hands when it comes to checking and balancing financial risk. This was given significant attention in Cadbury Report. It was suggested that institutions commitment to their beneficiaries, whose money have been invested in the company will ensure progressive changes in governance of that company.[9]

Institutional investors have gained prominent status everywhere. There is increase in their equity shares ownership. Therefore, their impact on company and its corporate governance is high. So in case where board is not effectively managing its fund then this can be checked by institutional investors. They can influence and also force managers to monitor their fund properly. Corporate governance can't be achieved by company and its mangers or directors

[8] Lumpkin, S.A., *Institutional investors and corporate governance,* [online] OECD Room document No. 18, session 5, 2003, available at http://www.oecd.org/dataoecd/2/3/15813490.pdf.
[9] 2nd ed., Soloman J. *Corporate Governance and Accountability*, Chicester: John Wiley and Sons, ltd, p.50, 2004.

alone. As they end up taking care of their personal interest, therefore institutional investors act as a reminder and keep an eye on company's ultimate performance.[10]

Indian Scenario

In India as well there has been increase in percentage of investment done by institutional investors. Change in FDI and FII policies has also led to increase in number of institutional investors. But in India institutional investors do not exercise any voting rights. There is hardly any significant monitoring role on part of institutional investors.[11] This becomes even lesser significant in case of small companies.

Corporate governance in India govern by OECD principles and Clause 49 of Listing Agreement issued by the Ministry of Company Affairs and SEBI. Wherein case of OECD government has choice in making company follow particular principle. One of such mandatory principle is regarding right of shareholders. It states that right of shareholders must be protected. Regardless of this principles and various other provision issued by SEBI and other regulations under companies act, various complaint have been filed by investors in this regard. Shareholders do not exercise voting rights and do not participate in meetings of company. Hence it can be said investor activism is moderately low in India.

Clause 49 in the listing agreement have introduced new provision wherein institutional investors are independent. Therefore they could exercise their voting right independently. This could improve condition of corporate governance of company. The scam Satyam fiasco are example of absence of good corporate governance norms. The above provision and OECD principle of equitable treatment of shareholders can change the condition of Indian companies. As the principle provides for equal treatment between different classes of shareholders. Therefore they would have a proactive participation from investors. They will play important role in appointment of directors.

Kumara Mangalam Birla Committee report in corporate governance in order to facilitate awareness among institutional investors. Though committee recommendation were against investors acting as members of board. This recommendation was further supported by

[10] Setu Niket, *Supra* note at 5.
[11] Vedant Shukla, *Corporate Governance at Crossroads*, (2007) PL Sept. 7

Narayanamurthy Committee report. World banks draft paper suggested that investors should not only focus on interest of CEOs and Asset Managers but also should adhere interest of beneficiaries.

Scenario in USA

In USA institutional investor plays a crucial role in decision making mechanism of the company. Also it helps company in adopting best practices. Yet when it comes to amalgamation or merger or privatization between companies registered in US and another companies registered outside US. So where institutional investor US plays an active role, they might not get involved in corporate governance practices.

In such case investor activism would depend upon the available information about the company outside US before investors exercise their right to vote. In some cases cost of procuring such information is comparatively high.[12]

US model for corporate governance barely have any influence on corporate governance followed in other countries, because the kind activism which is prevailing in US is not followed as such in other countries. Therefore, institutional investors seeking active participation in corporate governance submits a shareholder proposals in order to participate in decision making process of company.[13]

Even after such active role of shareholder activism US has also faced various instances of mismanagements such as Enron Scandal. Since then there were various campaigns to change condition. Campaign such as no vote campaign were launched to express shareholders dissatisfaction toward board. For now even mutual funds are introducing voting proxies and shareholder proposals.[14]

Scenario in UK

[12] James A. Fanto, *The Transformation of French Corporate Governance and United States Institutional Investor*, 21 Brook. J. Int'l L. 1, 1995

[13] Robert G.Vanecko, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance*, 87 Nw. U. L. Rev. 376, 1992

[14] Brent, A., *Some Funds try Shareholder Activism*, Mutual Fund Market News, 2002

In UK institutional investor did not have any direct influence on working of company as institutional investor used to have just short term holding in company. This has changed as now there are long term holding by institutional investors. Now under Combined Code Section 2 which talks about institutional shareholder, states that "institutional shareholder should be ready, where practicable, to enter into a dialogue with companies based on the mutual understanding of objectives."

Therefore there has been significant increase in participation of institutional investor in UK. But while deciding matter they barely go against decision of board. This problem need to be address, institutional investor should be encouraged to raise their opinion so that they can work towards ensuring better corporate governance practices.

SUGGESTIONS AND CONCLUSION

Institutional investors should not be blamed for corporate mal-governance. However, as they are having dominance, they are supposed to carry out the tasks of an active supervisor in the company matters.[15] Keeping this in mind, there are certain suggestions to increase their roles:

1. They should have a clear policy on voting and its disclosure. They should be subject to compulsory voting and the same should be subject to public disclosure.
2. They should form a strong policy for handling conflicting interests.
3. They should supervise the investee companies in order to identify that their Board Structures are efficient and the independent directors render sufficient supervision. They should also participate in the General Meeting as they hold majority of shares in the company.
4. They should reveal their interest to act together with another investors when the need arise and they should also review their policies in light of insider information and conflict of interests.
5. They should lay down clear-cut detailed plan as to when and by what means they will intensify their behaviour for securing and raising shareholder value.

[15] Pitabas Mohanty, *supra* note at 4.

6. They should report at regular intervals about their duties, obligations and voting actions.[16]

In nutshell it can be concluded that there is no easy way of answering whether participation of institutional investors will enhance financial performance. Therefore, this project has analysed the institutional investors and has laid down certain suggestions to enhance their efficient functioning. There are greater possibilities of achieving higher touchstones of corporate governance in organizations due to institutional investor activism as discussed in previous chapter. There are however certain restrictions which prevent institutional investor in doing their tasks effectively. Institutional investors have a greater role to play in increasing the governance rate in companies. This will generate wealth in the long term for the people investing by raising the company's financial performance.[17]

LIST OF ABBREVIATIONS

AMFI	Association of Mutual Funds
CEO	Chief Executive Officer
DFI	Development Financial Institutions
FDI	Foreign Direct Investment
FII	Foreign Institutional Investors
GIC	General Insurance Corporation
ICICI	Industrial Credit and Investment Corporation of India
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India

[16] *Increasing the Role of Institutional Investors in CG,* ingovern, available at http://www.ingovern.com/2013/01/increasing-the-role-of-institutional-investors-in-promoting-corporate-governance/ (last visited on October 13, 2016)
[17] Setu Niket, *supra* note at 5.

IRDA	Insurance Regulatory and Development Authority
LIC	Life Insurance Corporation
OECD	Organisation for Economic Co-operation and Development
PFRDA	Pension Fund Regulatory and Development Authority
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India
UTI	Unit Trust of India

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