24 May 2024

Ms. Madhabi Puri Buch
Chairperson
Securities and Exchange Board of India

Subject: Investor feedback on current market practices

Dear Ms. Buch,

We are writing on behalf of the India Working Group (IWG) that APG chairs as well as the undersigned members of the Asian Corporate Governance Association (ACGA). As longstanding capital market investors, we firmly believe that robust regulations set the baseline for good corporate conduct, which in turn helps foster investor confidence and generate long-term economic value; these are points you also raised in your remarks at the ACGA Annual Conference in Mumbai last November. In that context, we wish to share our views on several governance-related regulations and offer some practical suggestions for your consideration.

As a group we are deeply appreciative of SEBI's willingness to listen to the concerns of stakeholders and take appropriate action. We are cognizant of the steps taken by SEBI, particularly over the last few years, to bolster India's capital markets and the overall governance/sustainability framework. The emphasis on transparency around material events, the enhanced sustainability reporting requirements, the clampdown on special shareholder rights and board tenure, as well as the tighter approval criteria for asset sales are all noted among positive measures which will go a long way to empower shareholders and strengthen India's market democracy.

Building on this momentum, we would like to bring to your attention some trends and practices that we find to be of concern as they deviate from institutional investor expectations.

1. **Executive remuneration**
   This is an area that is attracting a lot of scrutiny in recent years. While current regulations provide several checks and balances to monitor pay levels, we believe the framework exposes certain gaps that need to be closed.

   a. **Ambiguous documentation –** Proposals for executive compensation presented to shareholders are often open-ended and lack important details around potential quantum, structure, performance metrics and targets. These resolutions are drafted to provide as much flexibility as possible and consequently end up granting extensive discretionary powers to the board. The opacity creates an information wedge between insiders and outsiders, with the latter (minority shareholders) getting very little clarity on future pay outs and the approach, rigour, and mechanics behind the board's pay-setting processes. At best, the disclosures mention a few generic metrics (for instance revenue growth, EBITDA), but avoid crystalizing these as hard numbers or targets.

b. **Weak oversight –** The lack of transparency has a compounded effect on a second, and more critical, issue: directors are permitted to use their shareholding to vote on their own remuneration proposals. In closely held companies, where directors own a dominant stake, this is the archetypal conflict of interest. Individuals will generally seek to maximize their own pay levels, which may potentially conflict with them acting as responsible fiduciaries for all relevant stakeholders. Investors are increasingly expressing dissent if they are not satisfied with the level of 'interest-alignment'. As per a study conducted by Institutional Investor Advisory Services[1], there were 68 such remuneration proposals in 2022 that would not have mustered the required majority without the controlling shareholder/family backing.

c. **Remuneration Committee composition** – Ideally, pay decisions should be taken by a remuneration committee which, in most markets, is a non-conflicted subset of the board that can exercise impartial direction in formulating remuneration contracts. In our experience, this is not always true in India. Many remuneration committees include family members of executives and directors who have pecuniary relationships with the company. In some cases, the conflicted directors are themselves part of the remuneration committee.

Given the systemic nature of these issues, we believe SEBI could step in to provide guidance and direction. Investors have five key asks:

- **Key performance indicators (KPIs) and target setting.** Remuneration committees should be mandated to articulate pay proposals which have sufficient granularity around KPIs and targets. Creating tangible and measurable contours of compensation, rather than merely stating an upper range of up to 5% of profits, will drive executive accountability and curb excessive level of board discretion.

- **Approval frequency.** Remuneration terms should be put to a vote on an annual basis rather than allow some companies to seek shareholder consent only once every five years. This will give public shareholders greater visibility on incentive pay outs and their linkage with company performance. If there is significant dissent, it should be recorded, reported and explained (refer point 5b below).

- **Enhanced rigour in the compensation setting process.** When growth in pay is not aligned with revenues/profits or growth in median pay of employees, there should be a detailed articulation of the board's thinking behind the pay decisions. If executive pay to median employee pay crosses specified thresholds relevant to the sector, there should be additional commentary around the fairness of the pay levels. Relevant snippets of the peer benchmarking exercise should be shared in such situations.

[1] https://www.iiasadvisory.com/institutional-eye/promoters-vote-in-their-own-salaries-despite-poor-investor-support

- **Voting power of conflicted directors should be curtailed.** While increased transparency would be a welcome start, it does not solve the agency problem. For that, remuneration in controlled companies should be recognized as a self-dealing contract and thus subject to provisions similar to those that govern related party transactions. In particular, the voting power of interested directors should be restricted and these resolutions should pass the test of majority-of-minority approval. In addition, the remuneration committee composition should avoid obvious conflicts of interest.

- **Unbundling of pay and executive appointment resolutions.** In India, pay proposals are often clubbed with resolutions for the (re)appointment of executives. Given that the views on these items could be different – an investor might want to vote for the (re)appointment but not for the pay structure – these resolutions should be unbundled and put forward as separate voting items.

2. **Board-stakeholder engagement.** In a significant majority of companies, there is no independent director engagement with investors and other external stakeholders. Anecdotally, we find that companies are wary of making independent directors accessible as they fear such dialogue may breach SEBI's insider trading regulations. This is unfortunate as even members of the Stakeholders Relationship Committee, whose role includes "Resolving the grievances of the security holders of the listed entity", rarely if ever speak to their important constituencies.

   Institutional shareholders place a premium on the quality of independent directors and their depth of involvement in board matters. This is why the norm, as reflected in governance codes and in practice, in many markets is for companies to offer calls or meetings with the independent board chair and/or committee chairs on a periodic basis. In our view, the arguments mentioned around insider trading regulations do not hold much ground: discussions with independent directors will largely be governance-focused (e. board culture, effectiveness and oversight, nomination and succession planning, remuneration), thus are unlikely to constitute price-sensitive information. The reason to seek engagements with independent directors is to understand the workings of the board, not for information on operations that might be price-sensitive. Directors should all have had training around insider trading laws and be cognizant of information that they are not at liberty to share.

   Some independent directors have candidly admitted that they often operate in a vacuum and primarily function based on information and views provided by management, or what they hear informally from their personal network. Therefore, SEBI could consider developing guidelines for an engagement framework between independent directors and shareholders. This will achieve four main objectives:

   i. Help avoid the risk of insular boards and provide a valuable investor perspective to the board;
   ii. Increase the level of accountability, the need to familiarize the director with relevant company matters, and to be actively engaged in board decisions;

iii. Enable investors to gain a more complete understanding of an incumbent board's skillsets, vision, and approach, thereby supporting improved mitigation of business risks and identification of opportunities; and
iv. Over time, create an inclusive environment which will lead to improved decision-making by the board.

3. **Board Leadership**
We are aware that SEBI had earlier mandated splitting the roles of the CEO and Board Chair. This would have aligned with accepted best practice of a split in these roles so as to introduce appropriate checks and balances around board leadership and management oversight. While we recognize that there was some corporate pushback in implementing the mandate, it disappointed many to see this reclassified as a voluntary requirement.

We believe, however, there is still some ground that can be made on this issue. If boards wish to confer individuals with the dual role, the boards could be directed to explain their rationale and/or be recommended to appoint a lead independent director, a role which can support companies in ensuring a high degree of independent thought on the board. A detailed narrative in the annual report will help stakeholders understand the board's approach and why the directors believe a combined role is in the best interests of the company and its shareholders.

4. **Shareholder rights and escalation mechanisms.** India does not have a robust escalation mechanism for minority shareholders when dialogue and engagements do not lead to a mutually acceptable outcome. Shareholders are unable to raise the matter to the board (point 2 above) and class action suits are challenging for various reasons, including the lack of litigation funding. In addition, unlike other markets, filing shareholder proposals is not a viable option.

   a. **Shareholder Proposals –** The 10% shareholding required to put up agenda items at shareholder meetings in India is too high. Given dominant family and promoter holdings, institutional and retail ownership may only be about half of the issued shares, thus the 10% shareholding requirement could translate to significantly higher as a ratio of public ownership. In large companies, it becomes very difficult for individual shareholders, either on their own or even collectively with other shareholders, to accumulate a 10% stake. As a result, the current threshold effectively blocks any real chance of minority shareholders being able to put their proposals across to other public shareholders.

   In many other jurisdictions, the shareholding requirements for calling special meetings and filing agenda items are significantly lower. Reasonable safeguards are embedded to prevent misuse - for example, regulations in the United States allow only long-term investors who have held the stock for a specific period of time (one to three years) to file resolutions[2]. Even with these guardrails, the design still offers more flexibility for shareholders to exercise their fiduciary responsibility.

[2] https://www.sec.gov/divisions/corpfin/rule-14a-8.pdf

In India, we understand that the 10% limit has been articulated under Companies Act, 2013 and therefore mandating a change is not directly under SEBI's remit. However, we urge SEBI to initiate a consultation process with the relevant stakeholders and work towards lowering the threshold over time. Tangible progress on this front will go a long way to foster greater trust in the Indian corporate ecosystem.

b. **Shareholder dissent.** We find resolutions proposed by management at shareholder meetings often sail through even when significant dissent is registered from minority shareholders. This is not surprising, given the high equity ownership of controlling shareholders/promoters.

In some markets, the board needs to take an extra step to assuage such investor concerns. For example, the UK Corporate Governance Code states: "*When 20 per cent or more of votes have been cast against the board recommendation for a resolution, the company should explain, when announcing voting results, what actions it intends to take to consult shareholders in order to understand the reasons behind the result. An update on the views received from shareholders and actions taken should be published no later than six months after the shareholder meeting. The board should then provide a final summary in the annual report and, if applicable, in the explanatory notes to resolutions at the next shareholder meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.*"

We believe provisions like these could be an effective means to ensure boards acknowledge and address investor feedback, even when the final outcome might ultimately still go in favour of management.

SEBI could encourage boards to adopt a similar practice and push them to articulate how shareholder dissent feeds into boardroom discussions. This will ensure companies are not able to sidestep external views and remain unresponsive to the concerns of their investors.

We appreciate having the opportunity to express our views and would welcome a follow-up meeting or call with the India Working Group to discuss these, and other related proposals, further.

Yours truly,

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