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SEBI'S STEWARDSHIP CODE FOR MUTUAL FUNDS & ALTERNATIVE INVESTMENT FUNDS

- AN ANALYSIS

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1. When mutual funds and alternative investment funds invest in listed companies, should they behave like any other shareholder of such listed companies or should they act as stewards of such companies? The Securities and Exchange Board of India (“SEBI”), which regulates India’s securities market as well as mutual funds and alternative investment funds, has issued a stewardship code *vide* its circular no. CIR/CFD/CMD1/168 /2019 dated December 24, 2019 (“**Stewardship Code**”), which imposes a number of obligations on mutual funds and alternative investment funds (hereinafter jointly referred to as “**Institutional Investors**”), in their role as investors in listed Indian companies. The Stewardship Code was meant to come into effect from April 1, 2020. However, vide circular number SEBI/HO/CFD/CMD1/CIR/P/2020/55 dated March 30, 2020, the date of commencement has been postponed to July 1, 2020, on account of the novel coronavirus disease pandemic.
2. The Stewardship Code has six principles (“**Principles**”), each of which comes with some guidance (“**Guidance**”) annexed. The six Principles are as follows:
 - 2.1. **Principle 1: *Institutional Investors should formulate a comprehensive policy on the discharge of their stewardship responsibilities, publicly disclose it, review and update it periodically***
 - 2.1.1. Every Institutional Investor which has invested in a listed company should formulate a comprehensive policy on how the fund intends to fulfil its stewardship responsibilities. The aforementioned policy should be reviewed and updated periodically and the updated policy should be publicly disclosed on the entity’s website.
 - 2.1.2. Institutional Investors are not barred by SEBI from outsourcing their stewardship responsibilities. If outsourced, Institutional Investors should have a mechanism to ensure that stewardship responsibilities are exercised properly and diligently. The stewardship policy should detail the mechanism in order to ensure that the entity to whom stewardship responsibilities have been outsourced, exercises them properly and diligently.
 - 2.1.3. A training policy for personnel involved in the implementation of the Stewardship Code’s Principles is crucial and may form a part of the comprehensive policy.
 - 2.2. **Principle 2: *Institutional Investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.***
 - 2.2.1. The Stewardship Code provides that Institutional Investors should formulate a detailed policy for identifying and managing conflicts of interest arising on account of an Institutional Investor investing in a listed company. The conflict management policy should ensure that the interest of the Institutional Investor’s clients and beneficiaries takes priority over the interest of the Institutional Investor. The conflict management policy should also address how matters are handled when the interests of clients or beneficiaries diverge from each other.
 - 2.2.2. The conflict management policy is required to:
 - a. identify possible situations where conflict of interest may arise, such as where an investee company is an associate of the Institutional Investor; and
 - b. put in place procedures to manage such conflict of interest situations. The procedures may include:

- i. blanket bans on investments in certain cases. The Stewardship Code does not suggest what types of conflicts would justify a blanket ban or even require the conflict management policy to mention the same. It merely requires the conflict management policy to specify if the Institutional Investor might use a blanket ban to manage a conflict of interest;
- ii. having a '*Conflict of Interest*' committee to which such conflicts may be referred to;
- iii. clear segregation within the Institutional Investor's organisation for managing and applying its voting rights and for handling client relations and sales;
- iv. providing for recusal from decision making relating to any transaction by individuals having any actual/ potential conflict of interest in such transaction; and
- v. maintenance of minutes of meetings where decisions were taken to address such conflicts.

2.2.3. The policy for management of conflicts has to be publicly disclosed as well as periodically reviewed and updated.

2.3. **Principle 3: *Institutional Investors should monitor their investee companies.***

2.3.1. Institutional Investors need to continuously monitor their investee companies, especially with respect to various matters such as the investee company's operational and financial performance, business strategy, corporate governance, board structure and diversity, remuneration, capital structure, related party transactions, opportunities or risks including environmental social and governance ("**ESG**") risks, shareholder rights and grievances etc. The level and degree of monitoring should vary according to the type of investee company and Institutional Investors should put in place appropriate levels of monitoring for different investee companies. Companies where larger investments are made may call for higher levels of monitoring *vis-à-vis* companies where the amount invested is insignificant from the point of view of the Institutional Investor's assets under management. The Stewardship Code says that investors may also specifically identify situations where they do not wish to be actively involved with the investee companies, for instance, in case of small investments. It has been left to the discretion of the Institutional Investors to decide what constitutes a small investment. Would it be acceptable for Institutional Investors to not monitor investee companies at all, where their investments are below a certain threshold? The Stewardship Code is silent on this point.

2.3.2. Institutional Investors should also bear in mind insider trading regulations while seeking information from the investee companies for the purpose of monitoring.

2.3.3. Institutional Investors need to have a policy for the monitoring of investee companies which specifies the areas to be monitored, mechanism for monitoring etc. The monitoring policy should identify situations which may trigger communication of insider information and the procedures adopted to ensure insider trading regulations are complied with in such cases.

2.4. **Principle 4: *Institutional Investors should have a clear policy on intervention in their investee companies. Institutional Investors should also have a clear policy for collaboration with other Institutional Investors where required, to preserve the interests of the ultimate investors, which should be disclosed.***

- 2.4.1. Institutional Investors should have a clear policy identifying the circumstances for active intervention in the investee companies and the manner of such intervention. The policy should also involve regular assessment of the outcomes of such intervention. Intervention should be considered even when a passive investment policy is followed or if the volume of investment is low, if the circumstances so demand. Circumstances for intervention may, *inter alia*, include poor financial performance of the company, corporate governance related practices, remuneration, strategy, ESG risks, leadership issues, litigation etc.
- 2.4.2. The mechanisms for intervention may include meetings/discussions with the management for constructive resolution of the issue and in case of escalation thereof, meetings with the boards, collaboration with other investors, voting against decisions, etc. Various levels of intervention and circumstances in which escalation is required may be identified and disclosed. This may also include interaction with the companies through institutional investor associations such as the Association of Mutual Funds in India (AMFI). A committee may also be formed to consider which mechanism should be opted, escalation of matters, etc. in specific cases.
- 2.5. **Principle 5: Institutional Investors should have a clear policy on voting and disclosure of voting activity.**
- 2.5.1. Institutional Investors should exercise their voting rights in investee companies on an independent basis, after in-depth analysis. They should not blindly support the management's decisions.
- 2.5.2. Institutional Investors should have a comprehensive voting policy, which should:
- a. state whether voting will be through e-voting, physical attendance, proxy, etc.;
 - b. contain guidelines for assessment of proposals from investee companies for taking decisions in relation to such proposals;
 - c. provide guidelines on how to vote on specific matters/ circumstances, set out a list of such possible matters/ circumstances and the factors to be considered before a decision is taken to vote for/ against/ abstain;
 - d. formulate an oversight committee which will serve as an escalation mechanism in certain cases. It is unclear as to who would be entitled to escalate a decision by an Institutional Investor's management to an escalation committee;
 - e. cover the use of proxy advisors; and
 - f. have a policy for the management of conflict of interest issues which arise in connection with voting.
- 2.5.3. The voting policy, voting decisions (including the rationale for the decision), use of proxy voting/voting advisory services, etc. should be publicly disclosed. The voting policy should state the manner (such as through an annual report to investors or on the Institutional Investor's website) and periodicity (possibly quarterly) of disclosure and provide for the disclosure of whether the Institutional Investor voted for or against or abstained with respect to every proposed resolution as well as the rationale for voting. In the event the voting policy provides for the use of proxy voting or other voting advisory services, the Institutional Investor should disclose the scope of such services, details of service providers and the extent to which the Institutional Investor relies upon or uses the recommendations made by such services.

2.5.4. Since March 15, 2010, SEBI has required mutual funds to disclose their voting policies and actual voting on resolutions of investee companies. Initially, as per the SEBI's circular no. SEBI/IMD/CIR No 18 / 198647 /2010 dated March 15, 2010 ("**MF Circular 2010**"), in order to ensure better corporate governance of listed companies, asset management [companies of mutual funds ("**AMCs**")] were *inter alia*, required to disclose the following on their respective websites as well as in the annual report distributed to the unit holders of the AMC from the financial year 2010-11:

- a. the general policies and procedures of the AMC for exercising the voting rights in respect of shares held by the mutual fund;
- b. the actual exercise of proxy votes in annual general meetings/extraordinary general meetings of the investee companies in respect of the following matters:
 - i. corporate governance matters, including changes in the state of incorporation, merger and other corporate restructuring, and anti takeover provisions;
 - ii. changes to capital structure, including increases and decreases of capital and preferred stock issuances;
 - iii. stock option plans and other management compensation issues;
 - iv. social and corporate responsibility issues;
 - v. appointment and removal of directors;
 - vi. any other issue that may affect the interest of the shareholders in general and interest of the unit-holders in particular.

The format for disclosure of voting by mutual funds in general meetings of listed companies was set out in annexure B of the MF Circular 2010.

2.5.5. In partial modification of the MF Circular 2010, in order to improve transparency and encourage mutual funds/AMCs to diligently exercise their voting rights in the best interest of the unit holders, SEBI issued circular no. CIR/IMD/DF/05/2014 dated March 24, 2014 ("**MF Circular 2014**") that, *inter alia*, provides the following:

- a. AMCs are required to record and disclose specific rationale supporting their voting decision (for, against or abstain) with respect to each vote proposal set out in paragraph 2.5.4 (b) above;
- b. AMCs are required to publish a summary of the votes cast across all its investee companies and its break up in terms of total number of votes cast in favour, against or abstained from;
- c. AMCs are required to make a disclosure of votes cast on the website of the respective AMC in a spreadsheet format on a quarterly basis, within 10 (ten) working days from the end of each quarter. Further, AMCs are required to continue to disclose voting details in their annual reports. The revised format for disclosure of votes cast by mutual funds in respect of resolutions passed in general meetings of the investee companies and the format for presenting summary of votes cast by mutual funds is set out in annexure B of the MF Circular 2014;
- d. AMCs are required to obtain auditor's certification on the voting reports being disclosed by the AMCs, on an annual basis. Such auditor's certification are required to be submitted to trustees and also disclosed in the relevant portion of the mutual fund's annual report and website; and
- e. the boards of AMCs and trustees of mutual funds are required to review and ensure that AMCs have voted on important decisions that may affect the interest of investors and the rationale recorded for vote decision is prudent and adequate. The confirmation to the same, along with any adverse comments made by auditors, are required to be reported to SEBI in the half yearly trustee reports.

2.6. **Principle 6: Institutional Investors should report periodically on their stewardship activities.**

2.6.1. Institutional Investors should report periodically on their stewardship activities to their clients/ beneficiaries, in an easy to understand format, on how the Institutional Investors have fulfilled their stewardship responsibilities in accordance with their stewardship policies. For this purpose, the Institutional Investors may:

- a. place on their websites a report on implementation of the Principles; or
- b. send the report to clients/beneficiaries as part of an annual intimation.

2.6.2. Different Principles may also be disclosed with different periodicities. For instance, whilst voting may be disclosed every quarter, implementation of the conflict on interest policy may be disclosed annually. Any updation of a policy should be disclosed as and when done.

3. Non-Obstante

SEBI clarifies through its Guidance annexed to Principle 6 that the Principles do not constitute an invitation to manage the affairs of a company. Neither do they prevent an Institutional Investor from selling a holding when it is in the best interest of the clients or beneficiaries of such Institutional Investor.

4. Applicability

SEBI's cover letter to Institutional Investors enclosing the Stewardship Code states (once in the subject line and once in the main body of the letter) that it applies only to listed equities. Therefore, it does not apply to investments by Institutional Investors in listed debt.

5. Many policies or just one policy?

5.1. Principles 1 to 5 refer to various policies. Principle 1 requires Institutional Investors to formulate a comprehensive policy on how they intend to fulfil their stewardship responsibilities. It also requires a training policy for personnel involved in the implementation of the Stewardship Code's Principles. Principle 2 refer to a conflict management policy. Principle 3 requires a policy for the monitoring of investee companies. Principle 4 refers to 2(two) policies, 1 (one) of intervention in investee companies and another for collaboration with other institutional investors where required. Principle 5 refers to a voting policy.

5.2. The Guidance to Principle 1 clarifies that the training policy can be part of the comprehensive stewardship policy. The Guidance to Principles 2 and 3 states that the conflict management policy and the policy for the monitoring of investee companies are to be a part of the comprehensive stewardship policy. Principle 4 does not give any hint whether the policies for intervention and collaboration are to be part of the comprehensive stewardship policy. Principle 5 calls for a comprehensive voting policy.

5.3. On balance, it appears that SEBI's intention is for Institutional Investors to have a single comprehensive stewardship policy which covers policies for:

- a. training the personnel involved in the implementation of the Stewardship Code's Principles;
- b. conflict management;
- c. monitoring of investee companies;
- d. intervention in investee companies;
- e. collaboration with other institutional investors; and

f. voting.

6. Issues for category 2 alternative investment funds

- 6.1. The Guidance to Principle 1 makes it clear that the comprehensive stewardship policy needs to be disclosed on the Institutional Investor's website. The Guidance to Principle 2 states that the policy for management of conflicts has to be publicly disclosed. Principle 5 states that the voting policy, voting decisions (including the rationale for the decision), use of proxy voting/voting advisory services, etc. should be publicly disclosed. However, disclosures under the policy, such as details of the actual voting done, may be disclosed to the clients and beneficiaries of the Institutional Investors either through an annual report to investors or through the Institutional Investor's website. Principle 6 permits disclosure regarding stewardship activities to clients/ beneficiaries through an annual intimation or by placing a report on implementation of the Principles on the Institutional Investor's website.
- 6.2. The Stewardship Code is likely to raise some interesting issues for category 2 alternative investment funds ("**Cat 2 AIFs**") that invest primarily in unlisted securities. The SEBI (Alternative Investment Funds) Regulations, 2012 permits Cat 2 AIFs to invest in listed equities provided they invest primarily in unlisted investee companies or in units of other alternative investment funds. SEBI has clarified¹ that this rule requires the investment portfolio of a Cat 2 AIFs to be more in unlisted securities as against the aggregate of other investments. Therefore, it is possible for a CAT 2 AIF to invest entirely in unlisted securities. Should a Cat 2 AIF issue a Stewardship Policy even though its private placement memorandum ("**PPM**") specifically states that it shall not invest in listed securities? It is also possible that a CAT 2 AIF may end up not investing in any listed equities even though its PPM permits it to invest in listed securities to a certain specified extent, subject to applicable laws. Does the CAT 2 AIF have to publish a Stewardship Policy even before it invests in listed equities? It is hoped that SEBI shall clarify these issues, which are also relevant for category 1 alternative investment funds.
- 6.3. Cat 2 AIFs are used to keeping their activities under a heavy shroud of secrecy. Their PPMs are not publicly available and they are regulated with a light touch. It is quite likely that their investment strategies and voting policies are sector specific, which means that they may have the same policy for all enterprises within a sector, whether they are listed or not. Having to make publicly available a stewardship policy for their investments in listed equities could tantamount to disclosing the Cat 2 AIF's strategy with respect to investments in unlisted companies in the same sector.

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¹ Circular no. CIR/IMD/DF/14/2014 dated June 19, 2014.

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