

## **Corporate Governance Issues in Compensation Agreements**

### **1. Objective**

1.1. This memorandum seeks the approval to amend the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) to provide for shareholder approval in respect of certain individual compensation agreements between Directors or Key Managerial Personnel or promoters with shareholders or any third parties.

### **2. Need for Review**

2.1. Certain Private Equity (PE) firms entered into reward agreements with the managing director (MD) of a listed entity. The PE firms who were allotted shares on preferential basis entered into an agreement with MD of the company to share a certain portion of the gains above a certain threshold limit made by them at the time of selling the shares and also subject to the conditions that the company achieves certain performance criteria and the MD continues with the company for a certain period.

2.2. It is not unusual for private equity funds to incentivize promoters/ MDs/ CEOs of investee companies, based on performance of such companies. However, when such reward agreements are executed between the private equity investor and the Promoter/ MD of the listed entity without any prior approval of the board and shareholders, it does give rise to concerns. It could potentially lead to unfair practices to achieve the pre-agreed numerical targets.

2.3. Upon examination, it is felt that such agreements are not desirable. It is therefore necessary to regulate such practices. The focus may be on the principle of disclosure and transparency in governance of listed entities. Therefore, before an employee including key managerial personnel, directors and promoters of listed entities enter into such reward

agreements, it would be mandated that such agreements undergo thorough scrutiny of the boards and shareholders who may vote on the resolution approving such agreements.

- 2.4. Vide Board Memorandum no. 66/2016, the Board approved the initiation of public consultation process on the aforesaid proposal to amend the Listing Regulations. Accordingly, the consultation paper was issued on October 04, 2016 inviting public comments.
- 2.5. Subsequently, comments/ suggestions have been received from 12 entities which include 9 advocates / law firms, 1 company secretary, 1 listed entity and 1 individual entity. Upon analysis, it has been seen that 7 entities have agreed to our proposals and suggested some modifications and 5 have expressed reservations. Some of the entities favouring the proposal have suggested that approval of board of directors and/ or disclosures would alone be sufficient for such agreements. There has also been a suggestion that voting on resolution be made a special resolution instead of ordinary resolution for transactions beyond a certain prescribed threshold. On the other hand, some of the commentators have also stated that such compensation agreements incentivize employees/ directors to enhance shareholder value and that it is common practice in various jurisdictions. It has also been suggested that the listed entity is not a party to such reward agreements and have argued against requiring listed entities to obtain shareholder approval or from disclosing it to exchanges.
- 2.6. Based on the comments, in view of the larger interest of shareholders, it is felt that there is a need to have safeguards such as shareholder approval in respect of such compensation agreements. As regards a comment suggesting stringent shareholder approval through special resolution, we may provide for approval of public shareholders.

### 3. Proposal

3.1. In view of the foregoing, the Listing Regulations may be amended to enforce disclosures and shareholder approval for such agreements including existing agreements that extend beyond the date of the amendment. A new sub-regulation (6) may be added to Regulation 26 (Obligations with respect to directors and senior management) to provide on the following lines:

"No employee including key managerial personnel, director or promoter of a listed entity shall enter into any agreement for himself or on behalf of any other person, with any shareholder or any other third party with regard to compensation or profit sharing unless prior approval has been obtained from the Board as well as public shareholders.

**Provided** that all such existing agreements entered into prior to the date of notification and which may continue beyond such date shall be informed to the stock exchanges for public dissemination and approval obtained from public shareholders by way of an ordinary resolution in the forthcoming general meeting..

Provided further that for the purpose of this sub-regulation interested persons involved in the transactions shall abstain from voting.

**Explanation:** The term public shareholders shall carry the same meaning as defined under Rule 2 of Securities Contracts (Regulation) Rules, 1957.

3.2. The Board is requested to consider the suggestions at Paragraph 3.1 above and approve the proposal for effecting amendments to the Listing Regulations.