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Corporate Governance issues in Compensation Arrangements: Analysis of SEBI's Consultative Paper

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Background

Last year, the Securities and Exchange Board of India ("SEBI") introduced the Listing Obligations and Disclosure Requirements Regulations, 2015 ("Regulations"). These Regulations were brought in to provide for a consolidated flow of disclosures and listing obligations for all kinds of securities in tandem with the provisions of the Companies Act, 2013 to ensure shareholder protection and information flow to the stakeholders in the form of mandatory disclosures and approvals.

SEBI periodically proposes changes to various regulations affecting listed securities in order to regulate what are typically called 'market practices' which could potentially lead to non-compliance with law. Some instances where SEBI has regulated market practices can be seen in its prohibition of grant of share based employee benefits to promoters / persons belonging to the promoter group. It also regulated payment of non-compete fee to promoters under the Takeover Regulations.

SEBI recently took cognizance of instances where promoters, directors and key managerial personnel (Senior Management) of certain listed entities received rewards from private equity investors by way of sharing of profits upon the company achieving certain financial targets or when there was an increase in the stock price of the company. The understandings regarding such benefits to senior management are generally recorded under private agreements between the private equity investor and the senior management commonly known as compensation agreements. In its Board Meeting held on 23 September 2016, SEBI highlighted the corporate governance issues that emerged from such arrangements and observed that such compensation agreements executed without the prior approval of shareholders could potentially lead to unfair practices thus prompting SEBI to propose an amendment to the Regulations.

Consultative Paper

On 4 October, 2016, SEBI has issued a Consultative Paper on "Corporate Governance Issues in Compensation Agreements" for public comments. SEBI, under the Consultative Paper has, *inter alia* proposed that the management of a listed company shall not enter into any such compensation arrangements without the prior approval of the board of directors of the listed company as well as its shareholders (by way of an ordinary resolution). SEBI has proposed that Regulation 26 (which governs the obligations of directors and senior management of listed companies) of the Regulations be amended to insert a new sub-regulation (6) as follows:

"...No employee, including key managerial personnel, director or promoter of a listed entity shall enter into any agreement with any individual shareholder(s) or any other third party with regard to compensation or profit sharing unless prior approval has been obtained from the Board as well as shareholders by way of an ordinary resolution".

"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 shareholders by way of an ordinary resolution in the forthcoming general meeting.

Provided further that in case approval from shareholders is not received, all such agreements shall be discontinued.." (Proposed Amendment).

The proviso to the proposed sub-regulation (6) of Regulation 26 (stated above) provides for continuation of any existing compensation agreements, subject to the conditions that the stock exchange be informed and shareholder approval, by way of an ordinary resolution is procured, for such an agreement at the following annual general meeting. The agreement would, however, discontinue if such shareholder approval is not obtained.

Analysis and Conclusion

Commonly referred to as the promoter upside agreements, in these compensation agreements, the private equity investor agrees to share a part of its gains with the senior management subject to certain conditions. These conditions could include the company achieving certain performance targets and the concerned employee continuing to be employed with the company for an agreed period. The Proposed Amendment permits these compensation agreements subject to approvals and proper disclosures. Clearly SEBI has tried to balance commercial interests with regulatory compliance, thereby ensuring shareholder protection.

The concerns raised by SEBI are grounded on legal principles of equity and fair play and directed towards better corporate governance and investor protection. Such agreements could incentivize the management to take decisions which perhaps would otherwise not have been taken per best practices. Illustratively, a director may give short term capital gains precedence over long-term wholesome growth of the company by taking high-risk decisions before the private equity investor exits to secure the benefits under the compensation arrangement leading to possible conflict of interest scenarios. SEBI has proposed an all-inclusive list of persons covered under the definition of the term "Employee" to ensure compliance with the Regulations and the Proposed Amendment at all levels within the company.

From the perspective of a private equity investor, the proposal puts considerable regulatory burden to work out incentivisation of top level employees in listed companies. A workable yet fair solution could be proposed which has been adopted in the past by SEBI where it has mandated board approval with interested parties being disallowed from attending and voting along with disclosures to the stock exchange on the key terms of arrangements without requiring a shareholders' approval, which in most circumstances could be difficult to procure and would increase management burden and costs. Evidently the proposed amendment would create difficulties for the senior management who have already entered into such arrangements with private equity investors and have achieved the agreed milestones under the compensation agreements but fail to procure shareholder approvals. It may be perhaps possible for SEBI to find a solution to this issue worked into the proposed amendments whilst still ensuring the protection of shareholders from the unfair practices by prescribing maximum disclosures.

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Notifications & Circulars

Foreign Direct Investment (FDI) in Non-banking Finance Companies: The Reserve Bank of India by its Notification dated September 9, 2016, amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000. The said amendment substituted the existing caps under paragraph F.8 to annexure B under Schedule 1 of the Regulations, thereby revising the foreign investment caps and entry route in the non-banking financial services sector.

Following this, parallel amendments have now been recently effected in the Consolidated Foreign Direct Investment Policy, 2016 ('FDI Policy'), vide Press Note. No.6 dated October 25, 2016. Prior to these amendments, foreign direct investment in non-banking finance companies ('NBFCs') under the automatic route was permitted only in NBFCs that were involved in any of the 18 specific activities mentioned in the Regulations.

With the rapid growth of innovative non-banking financial services including financial technology services in India, these amendments now facilitate the inflow of FDI beyond the limited ambit of the 18 activities prescribed under the earlier FDI Policy. Therefore, post the amendment, 100% foreign direct investment is now allowed under the automatic route in any non-banking financial services which are governed by financial sector regulators, viz., Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Pension Fund Regulatory and Development Authority, National Housing Bank or any other regulator as may be notified by the government.

In relation to non-banking financial activities which are not yet regulated by any financial sector regulatory body in India or where there is a doubt regarding regulatory oversight, FDI up to 100% will be allowed with prior Government approval, subject to such conditions including minimum capitalization requirements, as may be prescribed by the Government.

Previously, investments in NBFCs under the FDI regime were subject to minimum capitalization norms and other conditions prescribed under the Consolidated FDI Policy. To give a glimpse, for foreign capital upto 51%, $ 0.5 million was required to be brought upfront. For foreign capital more than 51% and up to 75%, $ 5 million was required to be brought upfront. For foreign capital exceeding 75%, the minimum capitalization was $50 million out of which $ 7.5 million was required to be brought upfront and the balance within 24 months.

Given that such entities are already required to comply with minimum capitalization norms prescribed by financial regulators, the removal of minimum capitalization norms under the FDI Policy will now ease FDI in non-banking financial services.

Equity shares to non-resident entity against pre-incorporation expenses: The Reserve Bank of India ('RBI') by its Notification dated October 24, 2016, has amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ('Regulations'). Now, a wholly owned subsidiary set up in India by a non-resident entity and operating in a sector where 100% foreign investment is allowed under the automatic route and where there are no FDI-linked conditions, may issue equity shares, preference shares, convertible debentures or warrants to the non-resident entity against pre-incorporation/preoperative expenses incurred by such non-resident entity, subject to a limit of 5% of its capital or USD 500,000, whichever is less.

This Notification also clarifies that amounts remitted to the investee company's account, investor's account in India or to any consultant, attorney or any material/service provider for expenses relating to incorporation or necessary for commencement of operations of the Indian entity, will qualify as 'pre-incorporation/pre-operative expenses'.

With respect to reporting compliances, the Indian company is required to report such transaction to RBI within thirty days from the issue of equity shares/preference shares/convertible debentures/warrants but not later than one year from the date of its incorporation or such time as RBI or Government of India permits. Additionally, the Indian company is also required to submit a certificate from its statutory auditor to RBI, declaring that the pre-incorporation/preoperative expenses have been utilized for the purpose for which it was received.

Exclusively listed companies ("ELC") of De-recognized/Non-operational/exited Stock Exchanges placed in the Dissemination Board ("DB"): The Securities and Exchange Board of India (SEBI) through its Circular No. SEBI/HO/MRD/DSA/CIR/P/2016/110 dated October 10, 2016 has clarified the process with respect to raising of further capital and exit of ELCs from the DB of nationwide stock exchanges, to protect the interests of investors of such ELCs.

Upon fulfilling the terms of the provisions under the SEBI (Issue of Capital and Disclosure Requirements Regulations), 2009 (ICDR), the ELCs on the DB shall be required to exercise one of two options – to either raise capital for listing on nationwide stock exchanges or to provide an exit mechanism to its investors.

Firstly, such ELCs shall be allowed to raise capital for meeting the listing requirements through preferential allotment route. Respective nationwide stock exchanges hosting the ELC on its DB shall accord in-principle approval and monitor compliance with ICDR. For any allotment made to the promoters / public in excess of the threshold limits (5% or 25% as the case may be) of the SEBI (Substantial Acquisition of Shares and Takeovers Regulations), 2011 (SAST), provisions of SAST shall not be applicable, provided however, that overall holding of the promoter group shall not exceed 75% of the paid up capital of the ELC.

Alternatively, an ELC may provide an exit mechanism to investors, the procedure for which is also provided in this Circular. All ELCs shall be required to ensure compliance with the procedure for exit and the oversight and monitoring of such exit mechanism is to be carried out by the respective nationwide stock exchanges.

ELCs that are yet to exercise either of these options have been mandated to submit their plan of action to the designated stock exchange within three months from the issuance of this Circular. The designated stock exchange will then review the plan of action and ensure its speedy implementation within six months. Failing timely submission of a plan of action by an ELC, the concerned nationwide stock exchange may recommend appropriate penal action against such erring ELC as well as its promoters and directors.

Such penal liabilities may occur in the form of freezing of shares of the promoters/ directors; attachment of bank accounts/ other assets of promoters/ directors of the erring company so as to compensate the investors and/or barring the company, its directors, its promoters and other companies which are promoted by any of them from directly or indirectly associating with the securities market or seeking listing for any equity shares for a period of ten years from the exit from the DB. Further, the list of directors, promoters, etc., of all non-compliant companies shall be disseminated on SEBI website and shared with other respective agencies.

External Commercial Borrowings by Startups: The Reserve Bank of India, by A.P. (DIR Series) Circular No. 13 dated October 27, 2016, has permitted start-up enterprises in India to access loans under the External Commercial Borrowings ('ECB') framework to meet any expenditure in connection with the start-up's business, subject to certain conditions including those described here.

A private limited company/partnership firm/ LLP qualifies as a 'startup' for up to 5 years from the date of its incorporation/registration;

if its turnover for any of the financial years is not more than INR 250 million; and if it is engaged in innovation, development, deployment or commercialization of new products, processes or services.

The amount that may be raised by an Indian startup shall be limited to USD 3 million or equivalent per financial year, and can be denominated either in Indian Rupees ('INR') or any convertible foreign currency or a combination of both. In case the borrowing is in INR, the foreign currency-INR conversion rate will be at the market rate as on the date of agreement.

The borrowing can be in the form of loans or non-convertible, optionally convertible or partially convertible preference shares. Further, the borrowing entity can choose the type of security - whether immovable, intangible assets (including patents, intellectual property rights), financial securities, etc. - which is to be provided to the lender, subject to compliance with foreign direct investment / foreign portfolio investment / or any other norms applicable for foreign lenders / entities holding such securities.

Regarding the eligibility of a lender / investor under this framework, the lender should be a resident of a country who is either a member of Financial Action Task Force (FATF) or a member of a FATF-Style Regional Bodies. However, overseas branches/subsidiaries of Indian banks and overseas wholly owned subsidiary / joint venture of an Indian company will not be considered as recognized lenders.

Ratio Decidendi

'Trust Deed' just like 'Will' is not an arbitration agreement

Supreme Court of India has held that 'Trust Deed', which provides for resolving the disputes arising between the beneficiaries of the Trust through arbitration, does not constitutes an 'agreement' much less an "arbitration agreement" within the meaning of Section 2(b) and 2(h) read with Section 7 of the Arbitration and Conciliation Act, 1996. The Apex Court in this regard noted the definitions of 'arbitration agreement' and 'party' as provided in Sections 2(b) and 2(h), and the provisions of the Section 7 listing out requirements for an agreement to constitute a valid and enforceable arbitration agreement.

Relying on decision in the case of *Vijay Kumar Sharma Alias Manju* v. *Raghunandan Sharma Alias Baburam* - 2010 (2) SCC 486, which dealt with the execution of 'Will', the court was of the view that the principles laid down in said case can also be applied in the present case dealing with 'Trust Deed' inasmuch as in both the cases, it is the testator/settlor who signs the document alone.

It was held that since legatee/beneficiaries do not sign the document or are not required to sign such document, they are not regarded as party to such deed despite the trustees accepting the deed, and hence 'Deed' does not partake the nature of an agreement between the parties. The Court in this regard also held that the trustees are only required to carry out the provisions of the Trust Deed and hence there cannot be any agreement *inter se* trustees or beneficiaries to carry out any such activity. Lastly, the Court was of the view that that since adequate remedy is provided under the Trust Act for deciding disputes in relation to Trust Deed, trustees and beneficiaries, remedy provided under the Arbitration Act is barred by implication. [*Vimal Kishor Shah* v. *Jayesh Dinesh Shah* - Civil Appeal No. 8164/2016, decided on 17-8-2016, Supreme Court]

Conversion of shares and increase of authorized share capital, when illegal:

In the present petition before the Supreme Court, the contention of the respondents ("Sanwalka Group") was that the company had come under the control of the appellants ("Gupta Group") by various actions and omissions. For the aforesaid reason, the respondents had filed a petition before the Company Law Board under Sections 397 and 398 of the Companies Act, 1956 ("Act"). The bone of contention was certain shares that were initially held by the appellants and subsequently forfeited. Upon forfeiture, the said shares were issued to the respondents.

According to the respondents, the appellants without notice to the respondents had increased the authorized share capital of the company. Through a board meeting convened on the same day, this decision was ratified and it was decided that the company would allot bonus shares in the ratio of 60:1 i.e. 60 bonus shares for each fully paid up equity and preference share. No bonus shares were issued to the Sanwalka Group. Through a series of further allotment, shares were issued to the Gupta Group. The respondents contended that these actions were being done to reduce the shareholding of the Sanwalka Group, which was in majority, to a negligible minority in the company.

The Supreme Court noted that the Gupta Group was guilty of not having issued a call notice under Section 53 of the Act and held that forfeiture of the shares upon not responding to the call notice was not envisaged under the Articles of the company. The Court further observed that notice of the general meeting in which the authorised share capital of the company had been increased, the issue of bonus shares and conversion of preference shares to equity shares had been discussed, was not given to the Sanwalka Group in contravention with Section 172(2) read with Section 41 of the Act. The Supreme Court also held that the issue of bonus shares out of the revaluation reserves of the company, was *ultra vires* the power of the directors since the Articles did not empower the board to issue such shares. Striking down the share conversion of preference shares into equity shares, the Apex Court held that due to a series of unacceptable actions by Gupta Group, this was a clear case of oppression. [*Tin Plate Dealers Association Pvt. Ltd.* v. *Satish Chandra Sanwalka* - Civil Appeal Nos. 589/2010 and 599/2010, decided on 7-10-2016, Supreme Court]

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