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**COMPENSATION AGREEMENTS
UNDER SEBI'S SCANNER**

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COMPENSATION AGREEMENTS UNDER SEBI SCANNER

1. SEBI's view on Compensation Agreements.

- 1.1 Earlier in its meeting of September 23, 2016, the Securities and Exchange Board of India ("**SEBI**"), had expressed its concerns regarding instances of private equity ("**PE**") funds entering into compensation agreements with promoters, directors and key managerial personnel of listed investee companies, based on performance of such companies, without approval of the shareholders. It, thereafter, issued a consultation paper on October 4, 2016 on the corporate governance issues in such compensation agreements in case of listed companies, for public comments ("**Consultative Paper**").
- 1.2 The Consultative Paper highlighted that these compensation agreements envisages the PE funds sharing a certain portion of the gains above a certain threshold limit made by them at the time of divestment of their shares of the listed company, subject to the company achieving certain performance targets and continued employment of such personnel with the company for a certain period. As such arrangements were typically executed without prior approval of the shareholders, SEBI was of the view that there is a need to regulate such arrangements, as it may lead to potential unfair practices.
- 1.3 Based on the Consultative Paper and the comments received thereon, SEBI, in line with its intent to promote and raise the standard of corporate governance, vide its meeting held on November 23, 2016, approved certain amendments to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**Listing Regulations**") to bring compensation agreements under its purview.

An overview of this proposed amendments and its implications is dealt with in the following section.

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2. Amendment to the Listing Regulations.

2.1. To address the corporate governance issues, highlighted by SEBI, as being inherent in such compensation/profit sharing arrangements, SEBI has approved the following amendments to Regulation 26 of Listing Regulations (dealing with the obligations of directors and senior management):

- i) "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."

Ordinarily, parties would enter into compensation agreements without seeking approval of the shareholders. However, by way of this amendment, execution of agreements pertaining to any kind of compensation/profit sharing between the employee of a listed company (including key managerial personnel/director/promoter), with any shareholder/third party (with may include a potential investor or a PE fund) shall require prior approval of not just the shareholders of the company but also SEBI. The scope of this amendment is also wide enough to cover compensation/profit sharing arrangements of all employees (and not just key employees) with any shareholder or third party (and not just the potential investor/PE fund).

- ii) "All such agreements entered during the past three years from the date of notification shall be informed to the stock exchanges for public dissemination including those which may not be currently valid."

This amendment requires disclosure of all compensation agreements/profit sharing arrangements entered in the past 3 years, whether or not they are valid to the stock exchanges for public dissemination. It is obvious that SEBI intends to impose the transparency obligation from retrospective effect even though approval from SEBI is not required for such past arrangements.

- iii) "Existing agreements entered into prior to the date of notification and which may continue to be valid beyond such date shall be informed to the stock exchanges and approval shall be obtained from public shareholders by way of an ordinary resolution in the forthcoming general meeting. The term 'public' shall carry the same meaning as defined under Rule 2 of Securities Contracts (Regulation) Rules, 1957."

Appropriate disclosures are to be made and approval of the public shareholders is to be obtained for the existing compensation agreements, which may have been entered into the past but continue to be valid after the date of notification. While SEBI, in its November meeting hasn't clarified what happens if such shareholders' approval does not come through, based on the language of the proposed

amendment in Consultative Paper, it is likely that the agreements, for which the shareholders' approval is not obtained, would be required to be discontinued or would become enforceable.

iv) "Interested persons involved in the transactions shall abstain from voting on the said resolution."

Every person who is interested in the transaction (such as the shareholders/directors who are party to these arrangements) are barred from voting on the aforesaid resolution.

It is also interesting to note that SEBI on November 22, 2016 (i.e. only one day prior to its meeting of November 23, 2016 where it approved the aforesaid amendments), issued a show cause notice to PVR Limited in relation to the alleged violations committed by Mr. Ajay Bijli, Chairman and Managing Director of the company, of the erstwhile listing agreement and the Listing Regulations *vis-à-vis* an incentive fee arrangement entered between him and the PE investors.

3. Implications.

- 3.1. The compensation agreements typically incentivize the promoters/key employees/directors of the company, to achieve certain performance targets and milestones *vis-à-vis* the company, in exchange for a share in the gains made by the investors at the time of their exit. These arrangements are widely used by investors to not only incentivize the promoters/key employees/directors but to accelerate the growth of the company and its consequent valuation to benefit the investors and other shareholders at large.
- 3.2. But, from SEBI's view point, these arrangements are a breeding ground for corporate governance issues and unfair trade practices. For instance, these agreements may result in promoters/key management undertaking inappropriate/prejudicial practices to enhance company's performance and valuation to satisfy the agreed performance criteria at the cost of long term sustainability and growth of the company. SEBI believes that regulation of such transactions is important to bring in more transparency and accountability.
- 3.3. That said, the devil is in the details, and although SEBI has approved the general scope and extent of these amendments in its board meeting, certain issues still remain unsettled. For instance, it is unclear as to the criteria on the basis of which SEBI would approve/reject such compensation agreements, and whether such approvals, even if forthcoming, would be conditional in nature or not. In absence of such clarity, the requirement of obtaining SEBI's prior approval in a private party transaction seems particularly onerous. If the objective is to bring in transparency and accountability in such arrangements, then the requirement of due disclosures to the stock exchange and obtaining prior approval of shareholders (whose value in the company is likely to be impacted consequent to such arrangements) should have been sufficient.

3.4. As these amendments go beyond disclosures, and require approvals being obtained from shareholders as well as SEBI, the practical difficulties faced while executing these compensation agreements in future may very well act as a dampener to these transactions.

Feedback

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