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WE DO NOT HAVE DODD FRANK, BUT SHAREHOLDERS' ACTIVISM IS ON RISE IN INDIA

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Abstract: *Executive compensation issue is one of the areas of concern for shareholders' in India. Apart from high pay inequity in terms of median pay difference between the executives and non-executives; on executive compensation, we have also issue like gender pay gap. Shareholders in India today can exercise their voting power for or against executive compensation, as new Companies Act today require companies to disclose executive compensation details in proxy note. Other than executive compensation issues, also in India, we find shareholders are influencing decisions on diversity in board, issues on re-appointment of directors, terms of stock options, environment issues, etc. All these are happening despite we do not have any Dodd Frank in India. Rising shareholders' activism in India are attributable to regulatory and institutional support, and for proxy advisory firms. Proxy advisory firms' can recommend their paid members (mostly institutional shareholders) to exercise their voting power either for or against the executive compensation, based on their analysis. They even make their basis of analysis transparent, so that shareholders' can make an informed choice. However, recent filing of a defamation suit against a proxy advisory firm in India by century old company is likely to gag the spirit of corporate governance. This paper examines important issues on executive compensation, regulatory and institutional frameworks, and role of proxy advisory firms.*

Key Words: *Say-on-pay, Executive Compensation, Performance-Related-Pay, Proxy Advisory Firms, Stock Options, Key Performance Indicators*

Introduction

Dark side of Indian corporate governance practices since 2007 onwards primarily revolve on rising executive compensation. Unlike in other countries, Indian companies whose shares are publicly traded are mostly closely held. Founder promoters and their families largely held majority stake of companies, which typically indicates concentrated ownerships. Obviously, these promoters and their family members represent in the Board of such companies, and key executive positions are also held by them. Minority shareholders hardly get opportunity to represent in the Board and vent their concerns on executive compensation in the annual general meetings. Moreover, in India we do not have Dodd Frank and consequent institutionalized approach on `say-on-pay' (SOP). In line with the USA and other countries, some proxy advisory firms have been started in India to offer paid services to institutional shareholders on important agenda points of proxy notes, circulated by the companies before their annual general meeting. Recommending institutional shareholders to exercise their options on SOP pertaining to executive compensation has now started getting prominence. Initial response of corporate India on such move was not encouraging. But of-late adverse reporting on corporate governance issues, more particularly on rising executive compensation, are being taken seriously for several ramifications. Proxy advisory firms' critical notes get widely published in social media, and this dampens the spirit of investors with immediate consequence of reduced share prices and falling market capitalization. Worst affected in this process are majority shareholders, i.e., founder promoters and their families.

Typical syndromes of executive compensation trend in India are; delinking of executive compensation from companies' performance, widening gap between executive compensation and other employees, and propensity to pay more to promoter CEOs than non-promoter CEOs. In India, the term compensation and benefits are defined as remuneration as provided in The Companies Act, 2013, and The Income Tax Act, 1961. The Income Tax Act, 1961 is more inclusive, as it considers any perquisites (weather monetary or non-monetary) within the purview of remuneration, or compensation and benefits *per se*.

PWC's proxy season review in the USA indicates growing awareness on corporate governance issues even encompassing environmental, social, climate change, board diversity, etc. In India also we find similar shift for institutional and partly for legal pressures. Companies in India have now started disclosing these aspects in their proxy notes. Again, the report says over all shareholders' support for SOP in the USA is as high as 91% in year 2017, indicating companies growing awareness on rationalization of executive compensation. Another proxy season review of 2017 by Sullivan & Cromwell of the USA also captures shift on corporate governance issues on the above listed areas, rather than SOP alone.

Importance of Executive Compensation in India

Balanced approach to executive compensation helps companies in attracting and retaining top talent and at the same time in protecting their interest, benefiting all the stakeholders. It fosters a win-win situation both in terms of increased value proposition for the executives and for the companies. Satisfied executives can perform better, and thus can help companies to achieve their business goals and strategies. The role of executive compensation is to attract and retain top talent at executive position and incentivize them in the way, so that they work for the benefit of the company, furthering the objectives of the company and increasing the business value. Balanced approach to executive compensation requires decision on balanced compensation-mix, suitably delineating fixed and variable components. Variable components are performance aligned with substantial focus on stock options with multiple riders. Typically, in India fixed component of executive compensation is substantially higher. In some organizations it is even more than fifty percent of total pay. Such culture of high fixed compensation even reflects on choosing the variables, which in most of the cases are used as top-ups. For example, performance-related-pay (PRP) formula is so crafted in India, executives in general get a substantial portion of their total pay as incentives. Culture of putting pay at risk even for executives is yet to get institutionalized. Therefore, issues of executive compensation substantially affect the interests of other stakeholders, more particularly investors, whose dividend payouts decrease with the increase in executive compensation. Theoretically such syndrome signifies high agency cost in India, i.e., high cost of executive compensation.

Regulatory and Institutional Pressures

Regulatory and institutional pressures on executive compensation in India are mounting. For example, The Companies Act, 2013 provide for maximum ceiling on executive compensation, restricting it to 11% of the net profit of the company in a year. When executive compensation exceeds prescribed ceiling, it needs shareholders' approval in the general meeting. For compensation and benefits plan of CEOs, often companies go for disproportionately higher compensation. To check such propensity, The Companies Act in India also stipulated no individual compensation in a company can exceed 5% of the net profits. Similar cap on sitting fees of the directors (maximum Rs. 1 lakh per meeting), can also be construed as another important move in regulating executive compensation.

Some of the mandatory disclosures on executive compensation in proxy statement for companies in India are:

- Ratio of executive compensation in comparison with the median compensation of the employees
- Percentage of increase in CEO compensation vis-à-vis Directors
- Percentage increase in compensation of employees
- Percentage increase of company's performance vis-à-vis executive compensation
- Variation in the share price of the company (when the company is listed) or net worth (when the company is not listed)
- Logic behind increase in executive compensation
- List of employees (NEOs, i.e., non-executive officers) whose compensation exceeds Rs. 60 lakhs per year, including specific mention when they are related to any Director or Manager.

Regulatory provisions provided in The Indian Companies Act emphasized on linking executive compensation to performance, stipulating ceiling based of company's net worth. The Act further provides the need for shareholders' approval, when companies decide to pay more, i.e., above the stipulated limit. Central Government approval is also necessary when companies pay more than the stipulated limit even when profits are adequate. But with slackened control, for obvious majority stake of owners' promoters; such provisions are easily flouted. Hence concentrated ownership can be attributed as major reasons for undeterred growth of executive compensation, rising disparities, and affecting the interests of minority stakeholders. Security and Exchange Board of India's (SEBI) analysis indicates even loss-making companies in India raised executive compensation and widened the gap between compensation of top executives and the median compensation of other employees.

Problems of Executive Compensation in India

Unlike other countries, in India, we do not have any strict separation of control and ownership of companies. This is also valid in case of listed companies, which are by nature closely held. This indicates managerial positions, more particularly key managerial positions, are mostly staffed by friends and relatives of the promoters. Rising executive compensation for such category of employees obviously conflicts with other stakeholders' interests. However, such trend is not in the USA and UK for typical distributed ownership of companies, i.e., typical nature of widely held companies. On the one hand agency problem in closely held companies in India does not impair the strategic and business interests, managers and owners being the same; but on the other hand, this affects other stakeholders' interests, particularly minority shareholders. Although minority shareholders' vote on SOP cannot be binding on companies, but their negative voting has far reaching implications. Some of the recent cases in India corroborate this.

Another important aspect in executive compensation is choosing of appropriate yardstick for executive compensation. In true sense pay for performance as a model has been embraced by Indian companies. However, such practices are strictly enforced for executives who are not part of promoters' families. For non-family executives PRP serves as good incentive plan, and this can act as an effective instrument for attracting and retaining talent. From stakeholders' point of view also PRP model does not invite any criticism, as companies can reduce compensation pay-outs for executives when they fail to perform. But real challenge here is appropriate selection of KPIs (key performance indicators). Both internationally and in India, it is observed that to dole out incentives to executives, performance standards are deliberately kept low. This has reduced the sanctity of PRP, and in India particularly it has now become an additional top-up. Good example is public sector enterprises in India. All executives get some PRP amount at the end of the year, more as additional benefits. Although it is also the responsibility of the compensation committee to guard against such malice, for companies in private sector also, both in India and in abroad, performance standards for PRP have often become an issue for discussion in shareholders' meetings. Proxy advisory firms also, in many cases, through their critical analysis and research, recommended for negative voting. Despite this, in many companies' shareholders still nurture their grievances on executive compensation.

Other important aspect of executive compensation in India, and so also in abroad, is the propensity to dole out stock options with minimum riders. In most of the cases, other than the minimum period of vesting; executives can enjoy the benefit of stock options, without even committing them to performance achievement. Some good organizations, however, provide restricted stock units (RSUs) with multiple riders, one of which obviously is performance achievement at pre-determined level. Weather executive compensation plan is win-win or not, depends on multiple factors. However, more important factor is balanced compensation-mix strategies, sustaining maximum stress on variables. While deciding on variables, companies also emphasize on certain other KPIs like; executives' value addition to the company, ethics and diversity inclusivity, commitment to social responsibility, etc.

Institutional and Regulatory Support

To curb such trend, SEBI's consultative paper on Review of Corporate Governance Norms in India suggested mandatory formation of compensation committee and emphasized on the need for enhanced disclosure of compensation policies. However, such disclosure requirements are still considered inadequate, mostly because these are open-ended in respect of valuation of perks and bonus payouts. Institutional Investors Advisory Services (IIAS) in India recommend the need for compulsory shareholders' voting on bonus payouts. Fixed components of executive compensation can however be put to vote right in the beginning. There exists immense need for standardized disclosure norms. SEBI's proposals are in alignment with the Companies Act, 2013. Compensation Committee when constituted in line with SEBI's proposal with representation of non-executive directors, including those who are independent directors, can enforce proper internal control on executive compensation, protecting the interests of different stakeholders. Such committee can ensure executive compensation and benefits are properly aligned with performance benchmarks and business goals of the companies and can ensure balance between fixed and variable pay of all directors. Regulatory bodies' insistence on disclosure of the ratio of compensation to each director to the median employee compensation in the proxy note, when enforced diligently, can enforce external control on executive compensation.

Thus, *prima facie*, undeterred increase in executive compensation in India is not attributable to poor regulatory framework; rather it is more for reluctance of Indian companies to comply with such requirements. Some good organizations, however, believe in designing executive compensation plan, linking with long-term growth, and make adequate disclosures on the same. One such case is Infosys, the IT major in India. Incidentally, this company recently faced temporary crisis on corporate governance norms, particularly on CEO and CXO level employees' compensation issue, and that even persuaded the CEO to step down. The company, however, could quickly resolve the crisis, putting one time-tested old timer to CEO's position, and subsequently hiring a new CEO. But we also have examples of many other organizations, both in India and abroad, which literally failed to ensure executive compensation in alignment with executives' and companies' performance and balancing different stakeholders' interest.

Another critical issue in executive compensation in India is wrong selection of performance criteria. Such wrong selection literally doles out incentives and bonus, in the name of PRP, even when companies suffer in terms of profitability. Widening pay disparity in terms of ratio of executive compensation to the median compensation of employees, poor disclosure on compensation practices and philosophies, etc. often create challenge to attract and retain talent, particularly in middle management level.

Good and bad side of executive compensation in India

Shareholders' Advisory services in India are strictly regulated by SEBI through Investment Advisors Regulations, 2013 and Research Analysts Regulations, 2014. The 2014 regulations detail the terms of references (duties, checks and balances) of proxy advisory firms. Recently, however, these firms are facing the challenge from corporate India. One such case is ITC's filing of a defamation case against Institutional Investor Advisory Services (IIAS) to the tune of Rs. 1000/- crore, for their adverse report on non-executive chairman's compensation. IIAS's contention was non-executive Chairman, who was earlier CEO of the company, not only continuing control over the company, even disproportionately raised his compensation. Accordingly, IIAS recommended shareholders to vote against this resolution. Although in the AGM, ITC could get all their resolutions passed, the company feels such adverse reporting significantly affected company's image before different stakeholders, resulting reduced stock prices and market capitalization, hence they filed the suit. This will certainly act as deterrent to SOP, and so also for corporate governance in India, and ultimately benefit those companies who wish to continue their age-old practices of paying high executive compensation, at the cost of sufferings of other stakeholders'.

In India, we have also faced another crisis in Infosys. But here the case is reverse. Here inadequate disclosure on corporate governance practices, including disclosure on executive and CEO's compensation was challenged by erstwhile promoter, who hold only 1% stake of the company. The problem escalated to such a level; CEO had to resign. However, problems were resolved with the induction of one old-timer who is known for turning around the company during his days. Later on, however, company recruited a new CEO.

Tata Group also had similar crisis, resulting dismissal of the top boss. The crisis now however got resolved.

Larsen & Toubro (L&T) in India is a recent success story, both in terms of change of guard, and in terms of executive compensation issues. Present CEO has been groomed in-house, and successfully positioned.

A Forbes report indicates Indian CEOs get as high as 1200 times of the median pay of employees in their companies. Glaring example is HEG, the leading graphite electrode manufacturer in India. In this company the pay gap between CEO and the least paid employee is as high as 4045 times during the year 2019. This sets the world record in pay disparity. This compelled SEBI recently to insist companies to publish their compensation data. However, many companies are yet to comply. Among companies who are yet to comply even we have those who are ranked in top slots of market capitalization. This contrasts with the US and UK figures. In the USA, such CEOs get maximum 335 times of the median pay of their employees.

In India, we have on record shareholders' voting against the executive compensation in Ambuja Cement and Eicher Motors. On stock options again shareholders resented in case of ZEE, which was primarily attributable to non-disclosure of terms. Tech Mahindra's move to raise CEO's compensation did not escape the attention of press and social media. While on the other hand we have good example of voluntary acceptance of pay cut by chairman of Wipro for drop in profits of the company; by the chairman and non-executive director of Idea Cellular; by the CEO and CFO of Hindustan Unilever (HUL); by CEO of Cognizant; by CEO and COO of Snapdeal, etc. Globally also we see IBM's CEO's cut in annual compensation package. On the one hand, such compensation cut indicates growing awareness among Indian companies the need for balancing stakeholders' interest, on the other hand such move benefits companies because of concentrated ownerships in most of the cases, maintaining high market capitalization.

Conclusion

Shareholders' activism in India primarily rests on the Companies Act, 2013 and its time to time updates. Another source is SEBI's Listing Obligations and Disclosure Requirements Regulations, 2015. These are further supported by Securities Appellate Tribunal and finally the Supreme Court of India. Other than these legal and institutional pressures, in line with the USA, in India also we have handful of proxy advisory companies. Such companies influence on shareholders' voting has started changing the paradigm of corporate governance and disclosure norms in India, including executive compensation. Institutional shareholders' participation in voting has also increased significantly and will continue to increase in coming years. Review of several years in India indicates companies were able to get majority of their proposed resolutions passed by the shareholders. Gender pay gap, policy on accelerated vesting of equity awards in case of change in control, stock retention and holding requirements, adoption and amendment of claw back policy, etc. are some of the executive compensation issues debated in shareholders' meetings in India and abroad.

Important steps in making executive compensation practices in India more transparent and meaningful with minimum shareholders' dissent are; alignment of CEO's compensation with total shareholder return (TSR), benchmarking with peer group companies, rationalizing multiple of median compensation in relation to benchmarking with peer group companies, and finally balancing between fixed and variable compensation. Other recommended steps are developing suitable performance metrics, some of which are like; return on capital invested (ROIC), return on assets (ROA), return on equity (ROE), earnings before interest, tax, depreciation and amortization (EBITDA), growth in cash flow, and growth in revenue. In all such cases, benchmarking with peer group companies, and other companies that follow best compensation practices, are necessary.