CORPORATE GOVERNANCE Exclusives

Stock-linked pay for UGRO promoter raises governance concerns

Shachindra Nath, VC and MD, UGRO Capital

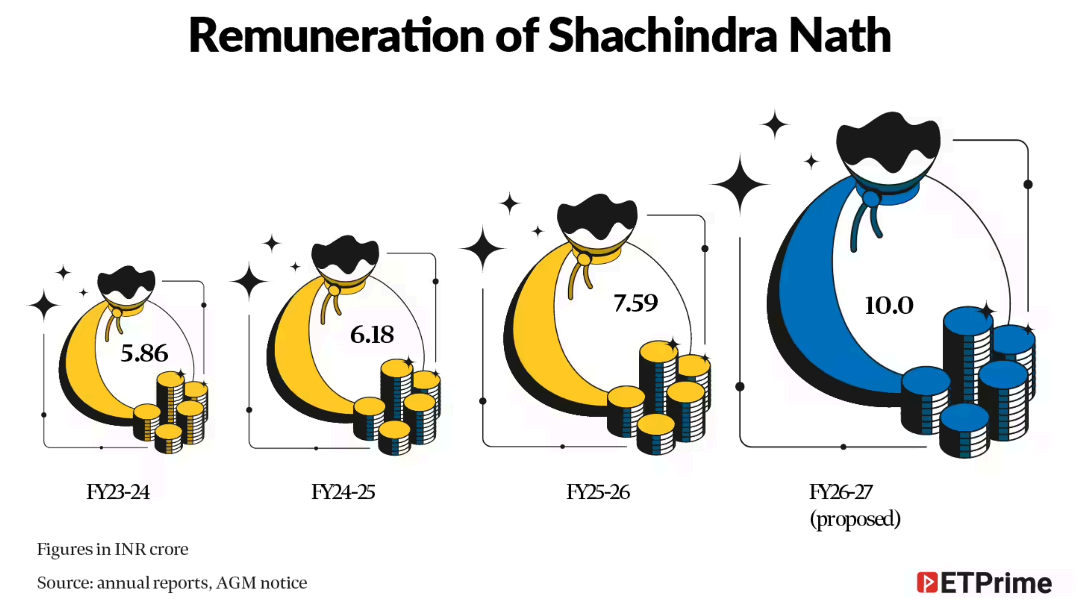
Synopsis

Proxy advisory firm SES asks shareholders to vote against a resolution seeking reappointment of UGRO Capital vice-chairman and managing director Shachindra Nath and the proposed remuneration package for him. The company says there are adequate safeguards.

Can you do something that is expressly prohibited by regulation by giving it some other name? This question is at the core of a resolution that is before the shareholders of **UGRO Capital**, which has its annual general meeting on May 29.

The non-banking finance company (NBFC) focussed on lending to MSMEs is planning to reappoint its vice-chairman and managing director, Shachindra Nath, with a fixed remuneration of INR10 crore annually. This includes a fixed pay of INR7 crore and a deferred fixed component of INR3 crore. While this package itself is comparable to peer NBFCs, it is the variable component that has got the attention of proxy advisors.

UGRO's board counts several former regulators as members. These included retired IAS and former head of central information commission **Satyanand Mishra**, former **Sebi** wholetime member Rajeev Agarwal, former RBI executive director Karuppasamy Singam, former LIC managing director Hemant Bhargava. A company with such a well-appointed board facing opposition over executive pay has piqued the interest of corporate-governance watchers.

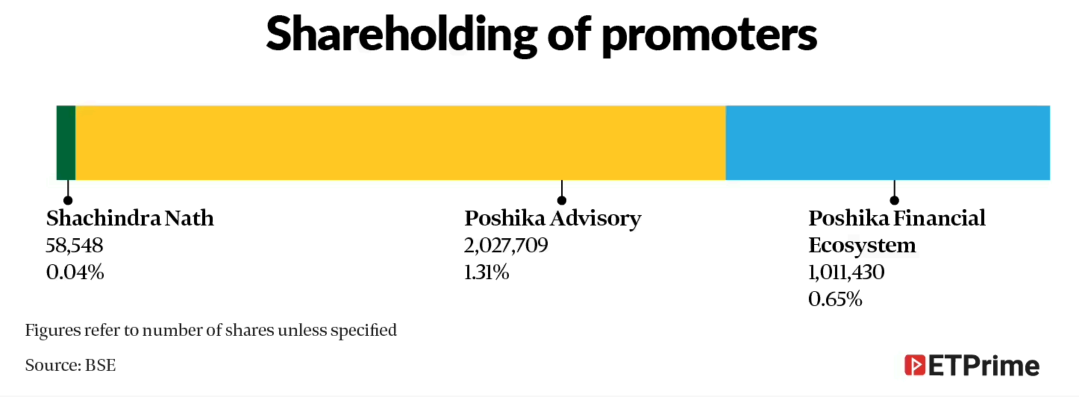


Stock-based variable pay
According to the resolution proposed by the company, the variable compensation framework approved and paid to Nath may include, as one of its design components, a variable pay component linked to the appreciation in the closing price of the company's equity shares on a recognised stock exchange over a defined reference period (a "share price-based variable pay" component).

"The inclusion of a share price-based variable pay component as one of the design options is considered appropriate in the context in which Mr. Nath, as a promoter in control, is regulatorily precluded from participating in any employee stock option plan or similar equity-linked compensation programme," the company said in an explanatory statement to the notice.

Nath, a former **Religare** executive, took control of listed merchant banker, Chokani Securities, in 2018 and rebranded it as UGRO Capital focusing on MSME loans and small-business financing.

Though Nath's shareholding directly and through Poshika Advisory LLP (1.31%) and Poshika Financial Ecosystem (0.65%) amounts to less than 2%, he is classified as a promoter group shareholder.



This classification makes him ineligible for stock-linked compensation such as ESOPs (employee stock options) or stock appreciation rights (SAR), as per Sebi norms.

According to Sebi, share-based employee benefits and sweat equity (SBEB) regulations, 2021, promoters are exempted from ESOPs and this is considered a fundamental corporate-governance principle.

The proposed variable pay structure appears to be designed in a manner that provides benefits akin to ESOP-linked upside to the promoter director, according to proxy advisor Stakeholder Empowerment Services (SES).

The proxy firm has identified two broad questions that arise here:
1) Is the share-based benefit proposed comparable to share-based benefits intended to be covered under Sebi SBEB & SE regulations?
2) Will the promoter holding a nominal stake make any difference?

“Although not structured through the Scheme (ESOPs) route, but logically, the proposed share-based benefit framework is akin to benefits granted through cash-settled SARs. Hence, as per SES, concerns applicable for share-based employee benefits to promoters will apply in the present case as well,” the proxy firm concluded.

There are well-founded reasons why promoters are disallowed from receiving ESOPs, with the primary concern relating to the element of control that promoters inherently possess. The concerns will not be mitigated merely because the design is structured in a distinct manner. Further, SES also notes that the quantum of voting rights is nominal at present. However, the element of control is present which is also acknowledged by the company itself and hence, the concern prevails.

Control may not always be entailed with board or voting control but can also be perceived. This may also explain why the law disqualifies promoters as a class from receiving ESOPs, rather than limiting the restriction only to promoters exercising demonstrable control.

In SES’ view, the underlying governance concerns include the ability to influence business decisions, the possibility of focusing on short-term market perception over long-term and sustainable value creation, and potential conflict-of-interest situations.

Further, it may not always be possible to objectively assess the extent to which perceived control could influence such outcomes.
The issue, therefore, is not whether such concerns demonstrably exist in the present case, but whether promoters should be permitted to receive benefits akin to cash-settled SARs.

SES points out that ESOPs are a tool to incentivise and retain employees, and not to further enrich those who already exercise control over a company.

Not backed by fundamentals

The second concern raised by SES is that the variable pay is solely linked to stock-price performance and does not take into account operational or financial fundamentals. For instance, the company may achieve its operational and financial targets, yet the target may not meet the required threshold due to adverse market conditions, or conversely, the share price may increase due to favourable market movements without corresponding improvement in the company's fundamentals.

"SES is of the view that linking variable remuneration to market price is not a good governance practice, as share price can be influenced by multiple external factors beyond the company's operational control," the voting recommendation to minority shareholders reads.

Such conditions may incentivise management and the board to pay more attention to the share price and, at times, may act as a trigger for possible market manipulation to support the price, the SES recommendation adds.

"Hence, market-linked benefits without being complemented by objective performance parameters linked to fundamental performance such as revenue, profits raise concerns. A holistic parameter that considers both fundamental and market performance together will ensure that market growth is backed by growth in fundamentals. Further, the lack of any absolute cap on the benefits that can be provided through share-based variable pay and absence of clarity over what period the performance will be assessed, making it an open-ended package, accentuating the governance concerns leading to recommendation for an "against" vote."

Severance pay

The company has disclosed a contingent condition that in case there is a change in control, Nath will be paid a sum of five years' total fixed cost (TFC) + average of variable compensation and deferred fixed compensation (DFC). The proposed arrangement provides a fixed payout equivalent to five years of total pay, irrespective of the tenure completed post the change-in-control event. Accordingly, it is unclear whether the payout would still remain equivalent to five years of total pay even if the resignation occurs before completion of the three-year reference period, or whether such entitlement would be computed on a proportionate basis.

Accordingly, excluding the undisclosed variable compensation component, the minimum potential payout upon resignation following a “change in control” appears to be approximately INR50 crore. The quantum will be more if there will be an increment in TFC and on account of annual variable pay as well. SES is of the opinion that without the aforesaid disclosures and caps, shareholders may not be able to take an informed decision. “The company should also clarify as to why it should be held liable to pay Nath such an amount in case of change in control,” SES asked in its note.

Checks and balances

In response to the SES recommendations, UGRO defended its proposals saying its board had adequate representation from investors and the nominations committee was independent enough to design an appropriate framework. It also argued that the structure is not violative of Sebi regulatory framework.

“It is the NRC’s (nomination and remuneration committee’s) considered legal and governance view that a cash compensation component calculated by reference to share-price appreciation does not constitute an equity-linked instrument within the scope of the Sebi (Share Based Employee Benefits and Sweat Equity) Regulations, 2021, as the proposed arrangement confers no beneficial interest in, or right to acquire, equity shares of the company,” the company response reads.

The Sebi SBEB regulations exhaustively enumerate the instruments within their scope – each involves rights over equity shares or instruments convertible into equity. A cash payment right with a share-price reference metric is outside that enumeration. This position has been recorded in the NRC's contemporaneous minutes, UGRO adds in its response.

Explaining the governance structure, it says that the governance architecture of UGRO Capital substantially addresses the concern that promoter control could distort incentive outcomes. “The board is majority-independent (6 of 9 directors). The NRC – the body that will design any variable compensation framework – is 100% independent.”

UGRO Capital's two largest institutional shareholders (IFU with 15.78% and ADV Partners) currently have direct board representation. The variable compensation framework will require recommendation by NRC and approval by the current board that includes the direct representatives of investors holding a combined 25% of the equity. The risk of an excessive or governance-compromised structure being approved through this architecture is not material, according to the company.

On market-linked performance without fundamental backing, the note explains that Nath's role as vice-chairman and managing director was explicitly oriented towards strategic functions – broadening the shareholder base, improving the valuation, and achieving equitable market recognition of the company's intrinsic worth. Share-price appreciation over a defined reference period was the most directly relevant metric for this strategic mandate. Nothing in the framework prevents the NRC from including fundamental metrics alongside share price – the framework is enabling, not limiting. The NRC retains full design authority, the company says.

On no cap and no assessment period, the company points out that the enabling special resolution requires 75% shareholder approval to activate any variable compensation framework. The detailed framework – including performance metrics, measurement period, absolute cap, deferral mechanics, and malus/clawback – will be designed and approved by the NRC and board at that stage, and will be governed by the RBI NBFC Governance Directions 2025.
“It is an appropriate and sound governance practice to seek enabling authority first and then design the detailed framework,” UGRO concludes.

“The company’s position appears to be that this is a pure cash-settled managerial remuneration arrangement and not a share-based employee benefit scheme involving grant, transfer or issuance of securities. Merely using share price as a reference metric for determining variable pay does not, by itself, bring the arrangement within the ambit of the Sebi SBEB regulation,” says Sumit Agrawal, senior partner, Regstreet Law Advisors, and a former Sebi officer.

Shareholders will have the final call on Nath’s package when they convene for the annual general meeting on Friday.

(*Graphics by Sadhana Saxena*)