



ESOP Direct

Whitepaper

# Proxy firms' view on ESOP resolutions— Trends in India

# 1 Introduction

Proxy Advisory firms, globally are known to play a crucial role in deciding the fate of all the key shareholder resolutions proposed by company Boards. In India also, these firms ( 2-3 in number) have been influencing the passing of major resolutions over the last few years. Amongst the resolutions they give their opinions on, topic of Equity compensation is one on which they have very strong views.

In order to understand their position on resolutions relating to Equity compensation, we analysed their opinions given in the last 4 years. We are pleased to submit our observations on this study.

## 2 Equity compensation is a sensitive topic for Proxy firms

Any Employee incentive instrument that is settled in equity leads to dilution for the existing shareholders and impacts the value of their investment. Quite understandably, unless the Incentive Plan is Value accretive to the investors, it will meet some resistance. Globally, not just in India, Proxy advisory firms scan these resolutions to minutest detail.

Investors, represented by Proxy firms, need assurance that terms of the Incentive plan will not provoke any management actions, which while increasing market valuations in the short term, may not be in the long-term interest of the shareholders.

## 3 What will pass the muster and what will not?

While admitting the right of the Proxy firms to have a close look, it is fair for the issuer companies to expect some guidelines on dos and don'ts for them to suitably design their Incentive instruments. Unfortunately, none exist. Companies are left to work on their own assessment on what will fly and then wait for the reactions.

This was one major reason we thought of coming out with this analysis, so that companies can know in advance what Proxy firms have approved and what did not get their nod. Our observations are detailed out in subsequent paragraphs.

## 4 Are they consistent and transparent?

In the absence of any guideline, past decisions and positions are the only way for companies to predict the approval or rejection. However, for this it is important that these Firms are consistent in their stand and also transparent about their thinking. This aspect is also addressed by our study later in this paper.

## 5 Trends and analysis of Opinions on Equity compensation resolutions

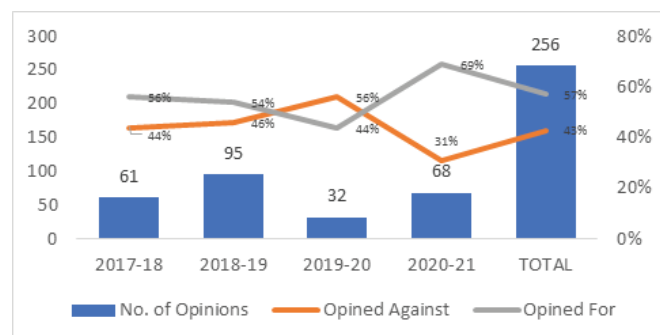
This analysis is based on the Opinions given by IIAS, by far the largest player in this field, in the last four years - 2017-18 to 2020-21

IIAS has opined on 256 resolutions of several companies during this period. The year wise split for the Opinions given by them and those opined Against and For can be seen in this chart.

Around 43% of the Equity compensation resolutions have got thumbs down from this firm. If the Pandemic period of 20-21 is ignored the rejection rate is close to half. This is an alarmingly high rate and needs attention of the Company Boards. Opposition in public for any resolution proposed by the Board is embarrassing.

Figures are a bit skewed in 20-21, since IIAS seems to have taken a sympathetic view on several companies who used ESOPs to compensate loss of pay during the year.

Another startling finding of our analysis is that 94% of the resolutions which IIAS opined



Against, were subsequently passed by the shareholders. This means that either the Investors, IIAS was representing, did not hold sizeable equity to defeat the resolution or they voted contrary to IIAS' advice.

In the absence of any specific published likes and dislikes of IIAS, we looked at how they have looked at four key factors – Instrument, Exercise price, Dilution and Vesting conditions. We have analysed the resolutions voted Against by IIAS.

Before getting into the analysis, we would like to put a disclaimer that view on a resolution is made up of combination of factors and not necessarily based on one feature. As such even though it is not entirely correct to draw conclusions looking at each factor separately, for want of any other publicly available data we have presented their responses for each factor separately. We believe this should give a sense of their mind if not the complete mindset.

### **5.1. Instrument: (perception – oppose RSUs - approve ESOPs)**

Contrary to the common perception, the firm has also opposed resolutions recommending ESOPs. Close to 50% of the resolutions opined against by IIAS were for ESOPs with Open ended Exercise price (not defined clearly or left to the discretion of the Board/ NRC). It is also seen that they have opposed 72% of the resolutions which proposed issue of RSUs.

### **5.2. Exercise Price: (perception – oppose discounted options - approve Market price options)**

The firm seems to have a negative view where the pricing is open ended and is at the discretion of the NRC or Board. Close to 60% of the resolutions which gave such discretion were opposed. Interestingly they also opposed 32 of the 77 (42%) resolutions which proposed grants at Market Price.

### **5.3. Dilution: (perception – oppose dilution in excess of 5% - approve lower dilutions)**

Close to 40% of the resolutions opposed prescribed dilution of less than 1%. On a different axis, 55% of the resolutions which prescribed dilution of less than 1% did not find favour of IIAS. On the contrary 14 out of the 25 (56%) resolutions which prescribed dilution of more than 5% obtained their nod.

### **5.4. Vesting conditions: (perception – oppose vague / open ended conditions - approve specific conditions)**

The firm seems to dislike unclear and vague conditions which is a mix of Time based and Performance based. More than 80% of the resolutions they opposed had mixed Vesting conditions with discretionary powers to the NRC or Board to define vesting conditions at the time of Grant.

We also evaluated whether there have been major variations in the way they opined For or Against. Surprisingly their views, norms have not changed or evolved in this period.

It is quite evident that in the absence of any specific guideline, it is very difficult to predict which way the Proxy firms will recommend voting. What is apparent though, is that they dislike vague terms and more discretion to the NRC/ Board. They will certainly have some internal yardsticks. Unless these are made public and transparent, companies will always be left guessing and hope for the best.

## 6 What are the learnings for the Issuer companies?

Proxy firms have a role to play and they are here for good. Most of them look at Equity compensation from Governance point of view and it is in issuer company's interest to engage with them in time and get their buy-in for the Plan.

Hopefully the analysis presented in this paper should help companies in avoiding some design features which do not find favour with these firms.

Our experience shows that Proxy firms do come on-board if –

- issuer companies have a strong rationale for what they are proposing and are able to explain their objectives and the context
- companies are willing to clearly define more and more features rather keeping the decision discretionary to the NRC or Board
- companies approach them pro-actively rather than responding to their decided view

## 7 What are Global practices and trends?

ISS (Institutional Shareholder Services Inc) and Glass Lewis are 2 major Proxy Advisory firms in the US. Their website spells out in detail their thought process and also publicly share their Equity Plan Scorecard policy. Based on this Score card, issuer companies can reasonably predict the outcome of their resolutions.

Some of the significant pointers to the thought process of these firms are as follows:

- They compare the SVT (Shareholder Value Transfer) which is the “cost of the Plan” (the accounting charge), with the Plans for peer companies.
- They favour use of secondary shares, which prevents dilution. Cost of purchase of shares is factored while calculating SVT
- They have issued separate guidelines to evaluate Equity compensation policies, Pay for Performance, Total Shareholder Return as a Vesting criteria
- ISS also has separate guidelines for Indian issuer companies wherein they indicate their preferences:
  - Dilution should be less than 5% (less than 10% for Growth companies)
  - Exercise price should not be at Discount to market price
  - In case of RSUs, Vesting should be linked to challenging Performance conditions
- India specific guidelines of Glass Lewis state that all Plans which allow Options re-pricing would get an “Against” vote.

The Stock market regulator, SEC has directions that gives the Issuer companies a window of 48 hours to respond to the observations of the Proxy firms.

A practice that is gaining ground in the US in the last couple of years is that companies are bypassing the Proxy firms and directly approaching Investors to communicate their Plan features. This is primarily driven by the stringent norms these firms apply before giving the nod. Companies find them too rigid to appreciate the ground realities and business needs.

## Suggestions for the Indian Proxy firms

At the outset, we would like to confirm that our interactions with the Proxy firms in India have been quite productive and meaningful. They have given us and our clients adequate time to understand the reasoning behind a particular design feature or an instrument or a performance condition. During such interactions they have also been transparent with their thinking and apprehensions. At times they have also indicated tweaks that will make the Plan more acceptable.

We, however, have a few suggestions for them:

- Considering large number of resolutions relating to Equity compensation being proposed annually, it is time for the Proxy firms to come out with detail guidelines on their preferences and dislikes. Ideally there should be a Score card to facilitate self-assessment.
- While adapting global practices and guidelines, it would be good to consider Indian context with respect to Regulations, Accounting and Tax treatment, etc. For instance, Indian companies claim Tax deduction for the Perquisite value to the employees. This needs to be factored while calculating SVT.
- While their preference for a broad-based Plan coverage vis-à-vis large grants to few is well known and understandable, there is no clarity on what is meant by “broad based” or “few”. While broad based Share Purchase Plans are quite common in western countries, Equity compensation in India is still offered to Senior and Middle management. This is so not entirely because more people are not offered but also because lower hierarchy prefers cash over stock.

In conclusion, accountability of the Proxy firms and need for their regulation is a global hotly debated topic. Proxy firms, globally, are perceived as adversaries of the Boards. Whether the perception is right or wrong is a debate for another day. However, it is imperative for the Proxy firms to take an extra step to address this perception by being more transparent and predictable in their thought process and recommendations.

We hope that you find the information in this newsletter useful in understanding the newly announced accounting rules on ESOPs. In addition, you should be aware that the information provided in the newsletter is presented in a general format and is not a comprehensive summary. With these factors in mind, it is important that you do not consider this note to be legal advice, and do not rely solely on the information provided in the newsletter. We would be pleased to help you review all pertinent information and can assist you in ESOP accounting compliance or in developing a comprehensive strategy to implement Share based employee benefits plan vis-à-vis new accounting rules.

## About ESOP Direct

We are a leading solutions company in the space of equity based compensation. ESOP Direct is a part of the Kirtane Pandit Group comprising the flagship accounting and consulting firm established more than five decades ago, a software services company and a business process consulting company.

As a group, we operate globally through subsidiaries in US, UK, Germany, France and Poland and strategic alliances in over 100 countries.

ESOP Direct has a team of professionals with experience in preliminary analysis, planning, designing and implementation of ESOPs. Each of our consulting team members is a qualified Chartered Accountant/Company Secretary.

## About Our Services

Our service offerings spans the entire life cycle of ESOPs including Plan conceptualization, design, documentation, Plan management, participant services, compliance and reporting. We are the first and the only company in India to offer the full spectrum of integrated on-line stock plan management services., We also offer a web based platform MyEsops, for financial reporting of stock options which includes valuation , expensing and reporting under IFRS, IGAAP, FAS123R.

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