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ESOPS

16.1 Meaning

Employee Stock Option Plans or ESOPs are increasingly being accepted as a reward for Employee Productivity. Earlier, the use of ESOPs was restricted to knowledge-based companies only but now they have spread across the entire spectrum of industries. ESOPs have been recognised the world over as an important tool for Employee Wealth Sharing and Employee Motivation. ESOPs create a sense of ownership in the employees in relation to their employer company and they feel that they are part of the organisation. Companies such as Infosys, Wipro, etc., have made several millionaires out of their employees due to ESOPs.

Simply put, an ESOP is an option (but not an obligation) given by a company to its employees to buy shares in their company at a predetermined price within a prescribed time period. The purchase price may or may not be at a discount to the ruling/ fair market value of the shares of the Company.

Given below are a few Terms relating to ESOPs which the employer company and the employee must understand:

- Grant: Grant of the Option means giving an Option to the Employee to subscribe to the Shares of the Company.
- Vesting Period: it is the time period over which the Shares are to be granted to the Employee. The Employer is free to decide the Vesting Period as per his requirements but in the case of listed companies, the SEBI Guidelines provide for a minimum vesting period of one year from the date of grant of the options. At the end of the Vesting period, the employee can exercise his right to subscribe to the shares.
- Option: An Option is a choice given to the Employee to subscribe to the shares of the Company at a given price. As the name suggests, it is only an Option- he is not bound to subscribe to the shares.
- Trust: Whether or not to have a Trust Structure to implement the ESOP is entirely the Company's choice. In case of a trust, the company grants the

options to the trust and the trust then allocates the options as per the guidelines of the ESOP.

16.2 Regulatory framework

16.2.1 The primary legislation which concerns an ESOP is the Companies Act. Every company which wants to issue an ESOP would need to comply with the provisions of the Act. Depending upon whether the company issuing the ESOPs is a listed company or an unlisted company the applicable laws would vary. Listed companies are subjected to the SEBI Guidelines on ESOPs. In addition, in order that these ESOPs remain tax neutral in the hands of the employees, the ESOPs should also comply with the Guidelines issued by the Central Government u/s. 17(2)(iii) of the Income-tax Act, 1961. Hence, any ESOP by a listed company would be subjected to both these legislations. In case of an unlisted public limited company, the Unlisted Public Companies (Preferential Allotment) Rules would apply along with the Income-tax Guidelines. In case a private limited company issues an ESOP, the only applicable legislation would be the Income-tax Guidelines. However, even in case of unlisted private/ public companies, it is advisable that the ESOPs comply with the SEBI Guidelines, because only then can the shares issued under the ESOP prior to the IPO be listed. Further, any outstanding options under the ESOP at the time of the IPO would be allowed to remain outstanding only if the scheme is in accordance with the SEBI Guidelines. Post-IPO, the company can issue fresh options under its pre-IPO ESOP only if the ESOP is in accordance with the SEBI Guidelines.

16.2.2 Companies Act

Every public company, whether listed or unlisted, would need to pass a special resolution u/s. 81(1A) of the Act. The Explanatory Statement to the Notice calling the meeting would require certain information which would vary depending upon whether the company is a listed company or an unlisted company. Further, s. 77 of the Act prohibits a public company from directly or indirectly providing any financial assistance for the purpose of or in connection with a purchase of any shares in such company or in its holding company. However, this prohibition does not apply if, in accordance with any scheme for the time being in force, the company has provided a loan to a Trust for purchase of such shares to be held for the benefit of employees including working directors. Thus, if the company provides a loan to an ESOP Trust for acquiring shares under the ESOP and distributing them to the employees, then s.77 would not apply. S. 77 also permits the company to give a loan directly to the employees for the purchase/ subscription of its shares. However, such loan is restricted to a maximum of 6 months' salary of the employee. It may be noted that the restriction in s.77 applies only to cases where the loan is granted by a company directly to its employees for the purchase of the company's shares. This restriction does not apply to the loan granted to a Trust for the purchase of shares to be held for the benefit of the employees.

16.2.3 SEBI Guidelines

The SEBI Guidelines contain several restrictions and conditions for a company implementing an ESOP. Some of the key features of these Guidelines are summarised below:

(a) According to the Guidelines, only the following persons can be granted ESOPs:
  - a permanent employee of the company working in India or out of India; or
  - a director of the company, whether a whole-time director or not; or
  - an employee as defined above of a subsidiary in India or out of India, or of a holding company of the company.

(b) An employee who is a promoter or who belongs to the promoter group is ineligible to participate in an ESOP. Further, a director holding > 10% of equity shares of a company, whether directly or indirectly, is ineligible to participate in the ESOP.

  The term Promoter has been defined to include:
  - the person or persons who are in over-all control of the company;
  - the person or persons who are instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public;
  - the persons or persons named in the prospectus as promoters(s).

  However, persons who are merely professional directors would not be included within this definition.

  Promoter Group is defined to mean:
  - an immediate relative of the promoter (i.e., spouse, parents, siblings, children)
  - persons whose shareholding is aggregated as shareholding of the promoter group for disclosing in the offer document.

(c) A Compensation Committee comprising mainly of independent directors is required to take all decisions relating to the ESOPs.

(d) A Special Resolution of the shareholders is required. The Explanatory Statement to the Notice must contain the prescribed information and disclosures.

(e) The percentage of Equity Capital set aside for the ESOP depends entirely on the company. There is no statutory requirement for this and it varies from company to company.

(f) The Issue Price of an ESOP is the price at which the Company would issue shares to its Employees under ESOP. Traditionally, the issue price was kept at par or at a substantial discount to the market price. However, due to the accounting requirements issued by SEBI, a large number of listed companies have started issuing them at closer to the Market Price.

The Issue Price may be determined by any of the following methods:

- Fixed Price, e.g., Rs. 100
- Formula based, e.g., at a discount to the 6 weeks High/Low of the Stock Market Prices
- Market Value.

Under the SEBI Guidelines, companies have freedom to determine the exercise price or issue price. However, companies need to recognise the employee compensation cost arising as a result of the discount given by them to the employees.

(g) The minimum vesting period provided under the SEBI Guidelines is one year. A longer or graded vesting period may also be provided, but much depends on the Company's objective of the ESOP.

(h) Post-vesting, the company may or may not provide a lock-in period in respect of the equity shares.

(i) The options per se are not transferable.

(j) Several disclosures are required to be made in the Directors' Report

(k) Shares issued pursuant to an ESOP would be listed subject to compliance with several procedural requirements and conditions.

(l) The SEBI DIP Guidelines provide that the entire pre-IPO capital of an unlisted company would remain locked-in for a period of one year from the date of the allotment. However, this provision does not apply to shares allotted to employees under a pre-IPO ESOP of the company.

(m) The company can account for the compensation cost either by using the Intrinsic Value or the Fair Value of the options. The intrinsic value means the excess of the market price of the shares over the exercise price of the option. Whereas the fair value is worked out by using an option-pricing model such as the Black-Scholes or a binomial model. Most companies use the intrinsic value. Such companies are required to disclose the impact on the profits had they used the fair value method. The ICAI has also issued a Guidance Note in this respect, which is applicable in respect of grants made on or after 1st April, 2005.

(n) Practice Pointer: The Company's Auditor must certify that the ESOP is implemented in accordance with the Guidelines and the Resolution passed in the General Meeting. There is no specified format for the same. A copy of such Auditor's Certificate must be placed before each General Meeting.

16.2.4 Unlisted Company Rules

The Preferential Allotment Rules, 2003 are applicable to a preferential issue u/s. 81(1A) of the Companies Act by unlisted public companies. The Rules do not provide an exemption for an ESOP issue and hence, they would need to be complied with by an unlisted public company instituting and ESOP. The main requirements of these Rules are as follows:

- A Special Resolution of the shareholders is required
- If the issue consists of convertible warrants, then the price of the resultant shares must be determined beforehand
- Several disclosures are required in the Explanatory Statement to the Notice, including the price or price band at which the allotment is proposed
- The relevant date on the basis of which the price has been arrived at must be stated
- The shareholding pattern pre and post issue must be stated
- The Special Resolution must be acted upon within 12 months
- Practice Pointer: The Company's Auditor or a practising Company Secretary must certify compliance with the Rules. There is no specified format for the same. A copy of such Auditor's Certificate must be placed before the General Meeting held for considering the issue.

16.3 FEMA Provisions

With an increasing number of Indian companies either operating abroad or having employees abroad, the provisions of the FEMA Regulations also become relevant in case of a foreign employee and an Indian ESOP or vice versa. The important provisions of the FEMA Regulations as applicable to ESOPs are summarised below:

(a) Issue of Shares under ESOP to persons resident outside India

- ESOPs can be issued by an Indian Company
- It can be issued directly or through a Trust
- The issue can be to its own employees abroad or to those of its Joint Venture or Wholly Owned Subsidiary abroad
- The ESOP must be as per the SEBI Guidelines
- The Shares allotted under ESOP should not exceed 5% of the paid-up capital of the issuing company
- The company must report the same to RBI within 30 days of the date of issue of shares.

(b) Cashless ESOP

Indian resident employees can acquire foreign securities under a Cashless ESOP instituted by a Company outside India.

(c) Foreign ESOPs

Resident Employees and Directors of an Indian office/branch of foreign company or an Indian company where foreign equity, whether directly or indirectly, is more than 51% may purchase Equity shares of foreign company. The ESOP may be offered directly by the issuing company or through a trust/ a Special Purpose Vehicle/ a subsidiary.

(d) JV/ WOS abroad

An Indian company's domestic employees and directors may purchase the shares of the promoter company's Joint Venture or Wholly Owned Subsidiary abroad in the field of software, if:

- the maximum purchase consideration does not exceed the ceiling stipulated by the RBI from time to time (US$10,000 per employee in a block of five calendar years);
- the Shares do not exceed 5% of the paid-up capital of the issuing Company; and
- the post-allotment holding of the Indian promoter company and the shares held by the employees must not be lower than the pre-allotment holding of the Indian promoter company.

(e) ADR linked ESOPs

Resident employees and working directors of Indian Companies operating in knowledge based sectors can purchase foreign securities under the ADR/ GDR-linked Stock Option Schemes provided that the maximum purchase consideration does not exceed the ceiling stipulated by the RBI from time to time (US$50,000 in a block of five calendar years). The current sectors designated as knowledge based sectors by the Government are information technology, pharmaceuticals and biotechnology.