## Employee Stock Option Plan (ESOP) – Regulatory framework

***Continued from Geeta Saar 23rd edition***

**5.3.1.2 Situations in which Directors are eligible:** Following directors are also eligible for ESOS shares under this Act:

(i) Director holding more than 10% equity shares in the subsidiary or holding preference shares (including convertible) in the company.

(ii) As aggregate holding of all directors need not to be considered here even if they hold upto 100%, still they are eligible in case each director either directly or indirectly does not individually hold more than 10% equity shares of the company.

(iii) Directors holding upto 10% of holding company of the company are also eligible for ESOS

**5.3.1.3 Other noteworthy points- employee definition**

Eligibility barrier of more than 10 % shareholding is applicable only in case of directors not to permanent employee.

However, if employee becomes a promoter or a person belonging to the promoter group, then he shall not be eligible employee under this rule for ESOS.

**5.3.2. Promoter:** The word 'promoter' defined under clause (69) of section 2 of the Act shall be taken into account while determining the status of employee whether he is a promoter or not. This definition is an exclusive one. As per three sub-clauses of the definition the following persons fall into category of promoter as follows:

(i) a person named as promoter in the prospectus or

(ii) a person identified as promoter in annual return filed under section 92 or

(iii) a person having direct or indirect control over the affairs of the company as a shareholder or director or otherwise.

(iv) a person in accordance with whose advice, directions, instructions the board of the company is accustomed to act.

**5.3.3 Practical issues: Promoter definition:** As it was discussed earlier, ESOS is best option adopted by the companies especially start-up companies particularly technology driven companies across globe. Technocrats behind creation of company once named as promoters would be not eligible for ESOS. The promoter definition creates a problem to

startup companies from rewarding / remunerating their hard-core-working-employees / directors by way of ESOS, if they are named as promoters. Cashless remuneration by way of ESOS is best model to save the capital outlays and which is essential at early stage. The definition of promoter needs be relaxed to private companies for ease of doing business, as issue of ESOS is regulated by the Act.

**Illustration:** Majority cases two or more persons say from IITs(technocrats) joining together to create a company. By using their knowledge and wisdom they may develop a particular innovative product. They may not have required funds to exploit their innovative. Banks may not be ready to fund their projects as there was no track record behind them. Venture capitalists / angel funds / HINS/ FII (investor) only show interest in investing these start-ups for commercial exploitation of product. As part of investment requirement, the investors shall invest in structured securities either optionally or fully convertible. As provided in the Act, indirectly they would be having control over the affairs of the company. Also operations of the company are particularly driven by shareholder/share subscription agreements through entrenchment provisions at articles. These agreements identify these technocrats as promoters and investor as investors. The said agreements invariable provide for ESOS/ sweat equity to technocrats. But the Act does not permit them. These technocrats work for company as their pet baby even not taking any monetary salaries. The investors though having control over affairs of the company would not be interested to name them in the annual return as promoters. The technocrats once they are named as "promoters" at annual returns, they shall be debarred from participation in the ESOPs scheme.

**5.3.4 Promoter Group:** The expression 'promoter group' is not defined either in the rules or Act. However, it is defined SEBI-SBEB regulations by giving a mere reference to definition provided under SEBI-ICDR Regulations, 2009.

Provided where the promoter or promoter group of a company is a body corporate, the promoters of that body corporate shall also be deemed to be promoters of such company;"

In case of unlisted company or private company, the above definition provided in SEBI-SBEB Regulations, can be referred by using the rule of maxim '*pari-materia*' as observed by the Supreme Court on various cases stating "Words and expressions defined in one statue as judicially interpreted do not afford a guide to construction of the same words or expressions in another statute unless the both the statutes are '*pari-materia*' legislations or it is specially so provided in one status to give the same mean in to the words as defined in other statue. Very recently the Supreme Court referred the parimateria in case of State of Gujarat & amp; Anr. v. Hon'ble Mr. Justice R.A. Mehra (Retd.) & amp; Ors., JT 2013(1) SC276.

*Pari-materia* means: The phrase used in connection with two laws relating to the same subject matter that must be analyzed with each other.

*Pari-materia* legislations: More the one legislations are related to same subject.

**5.4 Granting of Options:** Once the scheme of ESOS is framed with approval of shareholders, the board may identify the eligible employees. It is purely discretionary power of the board to identify the eligible employees within such hierarchy as per scheme. It is again

discretionary power of the board to include all employees or not in the ESOS. No employee can demand to include his name in the eligible list of employees. By way of formal letter or through interact net or appraisal letter, the identified employees will be given such number of options with a right to exercise by subscribing or buying underlying shares of the company after vesting of same in his favour. The communication of granting of options generally contains the terms and conditions of options such as number of shares, exercise price, market price of the share if any, time of vesting, manner of exercise, taxation issues, rights and obligations of employees, treatment of options in the event of resignation or termination such other particulars for better understanding. Employees shall not have any other right except to right to exercise. The right to exercise will be available only after vesting the options in his favour.

**5.5 Vesting period:** In general vesting means to give an immediately secured right of present or future. The vesting period is the time that an employee must wait in order to be able to exercise ESOS. Exercise of ESOS, where the employee notifies the company that he or she would like to buy the share, allows the employee to buy the referenced shares at the strike price indicated in the ESOS options intimation/ letter. It is non-forfeitable right against the company. As per sub-rule 6 of the rule, there must be a minimum of waiting time of one year, however the company specify a period more than one year. In case of amalgamation and merger, the vesting period of ESOS elapsed at transferor company shall be taken into account while reckoning one year minimum vesting period.

**5.6 Exercise of options:** Exercise means to put into effect the right specified in a contract. For exercise of options, the employee has the right, but not the obligation, to subscribe or buy the underlying shares at a specified price on or before a specified date in the future.

**5.7 Exercise price:** It is also known as strike-price. In general the strike price fixed by the seller of a security after receiving bids in a tender offer, typically for a sale of new securities or a new stock market issue. Exercise price for an option contract is a price at which a put or call option can be exercised. In case of ESOS exercise price is a pre-determined price at which the options granted can be purchased by the employee at a future date.

**5.7.1 Freedom to fix of price:** It should be noted as per the rule, the company is at liberty to fix the exercise price. However, such price shall be in conformity with applicable accounting policies of the company.

**5.8 ESOS Trust:** As per SEBI- SBEB Regulations trust means a trust established under the provisions of Indian Trusts Act, 1882 including any statutory modification or re-enactment thereof, for implementing any of the schemes covered by these regulations.

**5.8.1 Establishment of trust- Irrevocable Trust to Listed Company:** ESOS trust is created by the company for administration and implementation of ESOS options. As per the companies Act establishment of trust is not a mandatory for unlisted and private companies. However in case equity listed company for implementing any scheme covered under said regulations by way of secondary acquisition or gift or both creation of irrevocable trust is a mandatory. Same trust may implement several scheme. The Trust will be managed by Trustees. The

trust would have multifarious functions like holding shares to be offered to the employees, extending financial support, handling investments and undertaking buy-back of shares etc.

**5.9 Directors/KMP can' act as trustees:** As per SEBI-SBEB Regulations read with 16 of Companies (Share Capital and Debenture) Rules 2014, trustee means trustee of the trust. The following persons are not eligible to be appointed as trustees:

(i) Promoter/ Directors/KMP of the company or holding or subsidiary or associated company and relative of such promoter/ director/ KMP
(ii) Any other person if he holds even 10 % or more beneficial interest in the paid-up capital of the company.

**5.9.1 No voting Rights to trustees:** If trustee is an individual or OPC, there must be two trustee. Otherwise one trust will do. The trustee shall not have any voting right on shares held by the trust and shall avoid misusing the voting rights.

It is the responsibility of trustee (s) to ensure that the company obtains necessary approval from shareholders for implementation of schemes.

**5.9.2 Trust is not Mandatory:** It appears that the creation of trust for unlisted companies and private companies is not mandatory.

**5.10. Other matters:**

**5.10.1 Special Resolution No.1: Creation of ESOS and Scheme thereof:** As per clause (b) of sub-section (1) of this section read with sub-rule (2) of 12 of Companies (Share Capital and Debenture) Rules 2014, for issue of ESOS and creation of scheme thereof, approval of shareholders by way of special resolution is required. However in case of private company as per private companies exemption notification dated 05-06-2015, ordinary resolution is enough.

**5.10.1.1 Explanatory statement to resolution No1.** The following detail are required to be provided at explanatory statement including by a private company where section 102 is not applicable.

(a) the total number of stock options to be granted;
(b) identification of classes of employees entitled to participate in the Employees Stock Option Scheme;
(c) the appraisal process for determining the eligibility of employees to the Employees Stock Option Scheme;
(d) the requirements of vesting and period of vesting;
(e) the maximum period within which the options shall be vested;
(f) the exercise price or the formula for arriving at the same;
(g) the exercise period and process of exercise;
(h) the Lock-in period, if any ;
(i) the maximum number of options to be granted per employee and in aggregate;
(j) the method which the company shall use to value its options;

(k) the conditions under which option vested in employees may lapse e.g. in case of termination of employment for misconduct;

(l) the specified time period within which the employee shall exercise the vested options in the event of a proposed termination of employment or resignation of employee; and

(m) a statement to the effect that the company shall comply with the applicable accounting standards.

**5.10.2 Special Resolution No.2:** other specified employees As per sub-rule (4) of 12 of Companies (Share Capital and Debenture) Rules 2014, the company is required to pass another special resolution for issue of ESOS:

(i) to employees of subsidiary or holding company;

(ii) to any identified employee if percentage of underlying shares of options granted during any one year is 1% or more to the issued capital of the company excluding outstanding warrants and conversions at the time of granting.

In this 2nd instance, it seems to grant 1 % or more in any year (year could be a calendar year) the special resolution is required only one time as an enabling power to board of directors while framing a particular scheme. The resolution may specify such category or hierarchy of employees to whom board is entitled to grant 1% of more than. No need to mentioned names of employees at resolution.

***To be continued***