Employee Stock Option Plan (ESOP) – Regulatory framework

Continued from Geeta Saar 22nd edition

5. Regulatory frame work in India for ESOPs:

There are four types of regulatory controls in India to govern the issue of ESOPs as follows:

(i) Companies Act 2013
(ii) SEBI Regulations like ICDR, Share based benefits Regulations
(iii) RBI Regulations under FEMA for non-resident employees
(iv) Income tax

5.1 ESOS under Companies Act 2013

Being exposed to various cultures of multinational, many Indian companies especially in the field of information technology and IT enabled services in order to attract, nurture, retain the talented workforce started setting aside some portions of shares to employee as part of remuneration policy. This became trend from leading companies to start-ups and from listed company to unlisted either public or private companies as well. Till Companies Act 2013 came into force, there was no codified law available in the Companies Act 1956 to guide or regulate ESOPs in Indian scenario. However, there are references made at different perspectives at SEBI (Employee stock option scheme and Employee stock purchase scheme) Guidelines, 1999, FEMA- FDI Regulations and Income Tax Act 1991. Taking lead from SEBI –ESOP regulations, first time the Companies Act, 2013 codified issue of ESOP under clause (b) of sub-section (1) of section 62 read with Rule 12 of Companies (Share Capital and Debentures) Rules, 2014.

5.1.1 Definition: As per this clause 37 of section 2 the expression 'employees' stock option' is defined as 'means' the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

Regulation 3 of SEBI (Share Based Employee Benefits) Regulations, 2014 (SEBI-SBEB Regulations) specifies the following type of issue of employee benefits:

(i) employee stock option schemes;
(ii) employee stock purchase schemes;
(iii) stock appreciation rights schemes;
(iv) general employee benefits schemes; and
(v) retirement benefit schemes.

5.1.2 **ESOS Includes all share based benefits:** For better understanding of the expressions 'the benefits', 'right to purchase' 'to subscribe' used in definition provided under the Act one may need to draw correlation with various type of employees share based benefits defined under above said SEBI-SBEB regulations, which were framed subsequent to the enactment of this companies Act. The said expressions shall enable the listed companies to formulate any of said schemes.

ESOS	Expressions at Companies Act	SEBI- Schemes
Options	'the benefits'	Stock Appreciation Rights Schemes; General Employee Benefits Schemes; and Retirement Benefit Schemes
Options	'right to purchase'	Employee Stock Purchase Schemes
Options	'to subscribe'	Employee Stock Option Schemes;

By virtue of definition 'employees' stock option' the scope of the sub-clause (b) of sub-section of this section is very wide. A company who equity shares are listed can by passing special resolution and complying with SEBI-SBEB regulations create any of five types of schemes mentioned in the said regulations and extend all benefits that are inbuilt in said schemes.

5.1.3. **Certain Rules even applicable to listed companies:** Opening para of Rule 12 made under this sub-clause read with sub-rule (11) of said rule, equity listed companies are not required to comply with rules with respect to manner of creation, eligibility, type of options, disclosure to be made at explanatory statements attached to resolution to notice for passing resolution and terms associated to option. However, each and every company including listed is required to comply with such disclosures on options at board report; manner of maintaining and authentication of register of ESOS in Form No. SH-6.

5.1.4. **Inconsistency:** There is an inconsistency in the opening para which says 'listed company' whereas sub-rule (11) speaks about 'equity shares of the company are listed'. One may assume that where equity of shares of company are listed, while issuing ESOS alone can avail the exemption from rule. In another situation, where a company (may be public or private) whose debt securities alone are listed on any stock exchange wishes to issue ESOS to their employees, the company is required to comply with the rule made under this sub-clause not the SEBI (Share Based Employee Benefits) Regulations, 2014 as the sub-clause (4) of Regulation (1) of said SEBI regulation is only applicable to equity listed companies not debt listed companies.

5.1.5. **Understanding of schemes specified under SEBI-SBEB regulations one by one.**

5.1.5.1 **Employee Stock Option Schemes (ESOS):** This expression is defined in sub-clause (g) of regulation 2 of SEBI-SBEB regulations as "employee stock option scheme or ESOS means a scheme under which a company grants employee stock option directly or through a trust". Under ESOS, the employee or other eligible persons (collectively employees) are given options to subscribe such number of shares of the company at a future date at a pre-determined price. It is an option and a right to the employee. It is not an obligation. If the employee does not wish apply to shares, he need not apply for the same. There is no obligation under scheme to employee. To avail this right, the employee is required to fulfil all terms and conditions mentioned in scheme like performance, staying with the company at such time, exercise at time given etc. The options under this scheme can be granted directly or through a trust created for the welfare of the employee.

5.1.5.2 **Employee Stock Purchase Schemes (ESPS):** This expressed is defined in sub-clause (g) of regulation 2 of SEBI-SBEB regulations 'employee stock purchase scheme or ESPS' means a scheme under which a company offers shares to employees, as part of public issue or otherwise, or through a trust where the trust may undertake secondary acquisition for the purposes of the scheme. In this scheme the employees are directly offered the shares of the company either in the IPO or such other mode or through a trust. Majority of the cases, shares offered under this scheme are already issued shares. The employees will get all right as a shareholders subject to the lock-in period prescribed by the company. In case of listed company the shares of the company are acquired from stock market by the trust. The trust shall sell the shares to employees at such price at such quantity as may be decided. In case of ESOS, the grating of options is notional, in reality the underlying shares shall be issued from the unissued capital of the company later at time of exercising of options vested. In ESOS the company needs to have suitable authorised capital at time of granting of options. Whereas in case of ESPS, the company is required to issue the fresh shares immediately or procure the required quantity of its shares through trust from other existing shareholders to facilitate the purchase by the employees.

5.1.5.3 **Stock appreciation rights schemes (SARS):** This expressed is defined in sub-clause (ze) of regulation 2 of SEBI-SBEB regulations. 'Stock appreciation right' or "SAR" means a right given to a SAR grantee entitling him to receive appreciation for a specified number of shares of the company where the settlement of such appreciation may be made by way of cash payment or shares of the company. This type of scheme is largely prevalent in western world. In general initially a notional number of shares shall be granted to employee free of cost. The prevailing market price of shares of the company at that time shall be taken as basis for calculation of the appreciation. With a notion that performance of the company shall be depending upon performance of employees and in turn the appreciation of market price of shares of the company shall be depending upon performance of the Company. So there shall be direct co-relation between appreciation of stock price at market and the performance of the employee. Hence it is known as employee appreciation right. After expiry of such defined term the appreciation in market price of shares shall be taken as basis to arrive at the amount payable on notional shares granted to employees. The appreciation entitlement shall be generally paid to employee in cash or sometimes by way of issue of actual shares to employees either directly or through trust. If the appreciation amount is paid in cash or in shares, the same shall be treated as expenditure to the company as a party of employee remuneration. In case of cash payouts, there shall not be any impact in the share capital or shareholdings of company.

5.1.5.4 **General Employee Benefits Scheme (GEBS):** This expressed is defined in sub-clause (i) of regulation 2 of SEBI-SBEB regulations. 'General employee benefits scheme' or 'GEBS' means any scheme of a company framed in accordance with these regulations, dealing in shares of the company or the shares of its listed holding company, for the purpose of employee welfare including healthcare benefits, hospital care or benefits, or benefits in the event of sickness, accident, disability, death or scholarship funds, or such other benefit as specified by such company.

GEBS is an employee welfare benefit. Providing welfare to someone is a voluntary activity. It is guided by passion and high spirit of person. It may be provided on humanitarian grounds to establish what is just in the society. There is no obligation on person to provide the same. Benefits provided under GEBS are similar to directive principles of state policy. Where any welfare scheme of employees is linked with dealing of shares of the company or its listed holding company, then such scheme is required to be framed in accordance with the Companies Act and the SEBI-SBEB regulations. There is no requirement to comply with any other law for these schemes.

5.1.5.5 **Retirement benefit scheme (RBS):** This expression is defined in sub-clause (y) of regulation 2 of SEBI-SBEB regulations. "Retirement benefit scheme or RBS" means a scheme of a company, framed in accordance with these regulations, dealing in shares of the company or the shares of its listed holding company, for providing retirement benefits to the employees subject to compliance with existing rules and regulations as applicable under laws relevant to retirement benefits in India. This definition seems to be very general in nature. Any scheme providing retirement benefit to employee is linked with dealing of shares of the company or its listed holding company, it shall be designed in accordance with these regulations and all other applicable laws for retirement benefits in India. One may notice the difference between GEBS and RBS. GEBS is intended to provide welfare benefits like health care, disability, death or scholarship for education etc. of employee during the employment. In case of RBS, the benefits shall be provided at the time of retirement or after retirement like provident fund, superannuation fund, gratuity etc.

5.2 **All above scheme are not available to unlisted public and private companies:** From above one can understand that ESPS, SAR, GEBS and RBS out of five type of schemes specified in SEBI-SBEB regulations are associated stock market where equity shares of the company are listed. It appears that unlisted public and private companies can frame only scheme under ESOS. It may be possible to frame any other scheme like share purchase scheme etc. The company however may not find any secondary acquisition mechanism to facilitate the purchasing of shares by the employees.

5.3 Other important provisions under the Act:

5.3.1 Eligible Employee – The term employee is defined under explanation given under Rule 12(1) for the purpose of clause (b) of sub-section (1) of this section and for the purpose of rule itself. The definition is an exhaustive one with exclusions. Subject to exclusions the following can be exhaustive list of employee:

(i) A permanent employee of the company working in India
(ii) A permanent employee of the company working outside India
(iii) A permanent employee of the subsidiary company of the company working in India
(iv) A permanent employee of the subsidiary company of the company working outside India
(v) A permanent employee of the holding company of the company
(vi) A director other than independent director of Company whether whole time or not
(vii) A director other than independent director of subsidiary of the company whether whole time or not, whether in India or out-side India
(viii) A director other than independent director of holding company of the company whether whole time or not, whether in India or outside India

5.3.1.1 Not eligible employees: The following employees are not eligible to participate in ESOS schemes under this Act:

(i) An employee who is not permanent, in other words temporary employees, contract employees, consultants of the company
(ii) An employee who is a promoter
(iii) An employee who is a person belonging to the promoter group
(iv) Director who holds more than 10% of outstanding equity shares of the company either directly
(i) himself or indirectly
(ii) through his relative or
(iii) through any board corporate
(iv) Independent director (section 197(7) of the Act)

To be continued