

Employee Stock Option Plan (ESOP) – Regulatory framework

Continued from Geeta Saar 24th edition

5.10.3 Special Resolution No.3: Variations in Scheme: As per sub-rule (5)(a) of 12 of Companies (Share Capital and Debenture) Rules 2014, variations of terms of any scheme, the company is required to pass another special resolution. Only such scheme where options are granted from scheme but not yet exercised by the employees can be varied. However such other schemes where employee started exercising options granted can't be varied.

5.10.3.1 Explanatory statement to resolution No 3. Further explanatory statement to general meeting must contain

- (a) the full detail of variance and rationale thereof.
- (b) name, designation of employee, no of existing shares held by him, options granted to him, benefits derived by him from the proposed variance may include additional options.

It should be noted that proposed variance is not prejudicial to the interest of the option holders.

5.10.4 Special Resolution No 4: Financial assistance to employee for buying ESOS requires compliance with Section 67 and rules made thereunder: Where a public company including equity listed intends to provide whether directly or indirectly loan, guarantee, security or otherwise, any financial assistance (direct or indirect funding) to its employees for acquisition of its shares or its holding company under ESOS, the company needs to comply with section 67 and read with rule 16 of Companies (Share Capital and Debenture) Rules 2014 with respect scheme of loans, individual loans etc as follows:

- (i) Approval of scheme of direct or indirect funding by way of a special resolution
- (ii) Such funding shall not exceed 6 months of salary or wages of such employee (other than director or KMP)
- (iii) In case of listed company, buying of ESOS shares through private offer and arrangements is not allowed. (It seems the listed company can't lend money to employee to buy shares either through IPO or private placement or preferential offer etc.)
- (iv) In case of unlisted public company while buying shares for ESOS price of shares shall be valued by a registered valuer.
- (v) Value of ESOS shares acquired by the employee or trust from money lent by shall not exceed 5% of paid-up capital and free reserves of the company. (It would be intention of legislation, upto 5 % paid-up capital and free reserves of company can be lent to employee for buying of ESOS shares. Imposing ceiling on value of ESOS shares which would vary from time to time does not serve any purpose.)

5.10.4.1 Explanatory statement to special resolution No 4 seeking approval of shareholder for providing direct or indirect funding to employee for ESOS shall contain the following things:

- (a) Class of employee covered under said scheme;
- (b) If trust is established, detail of trustee like name, address, nationality etc.;
- (c) Particular of employee (it may be practical difficulty like preferential issue providing name etc);
- (d) Relationship of trustee with director and KMP, promoters of the company; (e) Interest of directors, KMP, promoter in the said scheme;
- (f) Benefits derived by employee from said scheme;
- (g) If the employee does not exercise voting rights on ESOS shares or shares are held in trust, provide details of person exercising such voting rights.

Continual Disclosure at Board Report:

If the employee does not exercise voting rights on ESOS shares or shares are held in trust the following disclosures to be made at board report:

- (a) Name of such employee
- (b) Reasons for not exercising voting rights
- (c) Name of person exercising voting right on such shares
- (d) % of such shares to total paid-up share capital
- (e) Date of meeting of GM in which voting rights was exercised
- (f) Detail of resolutions were voted by such person using ESOS shares
- (g) % voting to total voting on such resolutions
- (h) Such voting is favour or against

5.11. Director/KMP not eligible to take loan: By collective reading of sub-section 2 and 3(c) of section 67, it appears that for buying ESOS directors and KMP are not eligible to obtain loan from the company. Prohibition imposed under section 185 is also applicable in case of regular directors. Further by complying with sections 185 and 186, MD or WTD may be allowed to take loan from company for the purpose other than buying of ESOS. However subject to banking regulations, a banking company can give a loan to its director or KMP for buying ESOS shares.

5.11.1 Non-compliance of Section 19: Lending to trust for buying of shares of holding company for purpose of ESOS may lead at times to indirect holding of equity shares of the holding company, which is prohibited under section 19 of the Act. There is no clarity.

- 5.12. Lock-in:** The underlying shares issued to employee may be kept in lock-in for transfer or sale by the company for such period as the company wish. However rule does not mandate any lock-in to shares issued under ESOS.
- 5.13 No dividend-No voting rights on options:** The employees having grants of ESOS shall not have right to receive dividend or any voting rights. However once underlying shares are issued, subject to any lock-in period if any imposed by the company, the employee being one of the shareholders shall enjoy all rights, benefits.
- 5.14. Forfeiture /refund of amount:** In case employee does not exercise the options granted within vesting period, the amount if any paid by employee to the company at time of grating of options may be forfeited or refunded by the company. Similarly, in case employee is not able to fulfil vesting terms, amount paid if any may be forfeited or refunded.
- 5.15 Options not transferable:** Options granted to employees can't be transferable to any person including another employee of the company.
- 5.16 No Encumbrance:** Either employee or company can't create any charge, pledge, hypothecation or mortgage or conveyance on the options granted.
- 5.17. Only legal heir/nominee can exercise:** In the event of death, no third person except legal heir or nominee of employee can exercise options granted to employee. All options granted till date of death of employee shall vest with legal heir or nominee. It is interesting. It seems that the company Act recognizes the right of the employee to appoint a nominee. However there is no procedure given.
- 5.18 Permanent disability of employee:** During in the employment, if employee suffers permanent incapability, all options granted till date shall immediately vest in him.
- Situation of Resignation or termination:** Options vested till date of resignation or termination, can be exercised within such period as specified in the scheme by the board. Options granted but not vested shall elapse and go to the main pool.
- 5.19 Disclosures at board report:** Every company including equity listed which has any scheme of ESOS formulated and implemented is, till all options are exercised by the employees, required to disclose its directors report at every year the following particulars:
- (a) options granted;
 - (b) options vested;
 - (c) options exercised;
 - (d) the total number of shares arising as a result of exercise of option;
 - (e) options lapsed;
 - (f) the exercise price;
 - (g) variation of terms of options;

- (h) money realized by exercise of options;
- (i) total number of options in force;
- (j) employee wise details of options granted to:
 - (i). key managerial personnel;
 - (ii). any employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.
 - (iii). identified employees who were granted option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

5.20 Maintenance of Register and authentication: Every company including equity listed which has any scheme of ESOS formulated and implemented is, at its registered office or such other place as decide by the board, required to maintain a register in Form No. SH.6 with the particulars of options granted/ exercised/ elapsed etc. The company secretary if any or such other person authorised by the board is required to authenticate the said register.

5.21 Filing of Forms with ROC: For all special resolutions as and when they are passed the form MGT-14 is required to be filed within 30 days from date of passing. For allotting underlying shares form No. PAS-3 is required to be filed within 30 days.

5.22. Issue of Share Certificates / Demat: For allotting underlying shares, the company after payment of applicable stamp as per state stamp acts, is required to issue share certificates within two months to allottee- employees. In case of demat, the company should ensure crediting of shares in demat to respective allottee employee's demat- account.

5.23 Position of ESOS creation under old act: Any scheme of ESOS created by the unlisted public company or private company prior to 01-04-2014 i.e. before commencement of this section and the scheme was in force as on date of commencement of this section, shall be valid. The Company can grant any ESOS to its employees and employees can exercise vesting right and the company can also allot the shares for the same as long as there are no variations in the terms of the ESOS taken place after commencement of this Act. If there is any variance in such old ESOS, while seeking the approval of shareholder, the company may need to revisit entire scheme to ensure same falls in line with the provisions of this act.

5.24 Further compliance-Equity Listed Company: Where equity listed companies intends to issue any scheme of ESOS it is required to comply with specially SEBI (Share Based Employee Benefits) Regulations, 2014 and all other applicable SEBI Regulations as narrated earlier.

5.25 FEMA Compliance: Where non-resident employee are offered ESOS scheme, the company is required to company with terms and conditions specified FDI-master circulars issued under sub-section (3) of Section 6 of the Foreign

Exchange Management Act, 1999 read with Notification No. FEMA 20/2000-RB dated May 03, 2000 from time to time.

- 5.25.1 Eligibility and quantum of ESOS:** Employees of its joint venture (It should be a subsidiary under as companies Act) or wholly owned subsidiary abroad who are resident outside India, other than to the citizens of Pakistan are eligible to participate in ESOS upto 5% of paid-up share capital of the company. Citizens of Bangladesh can invest with the prior approval of the FIPB.
- 5.25.2 Reporting no. 1** -Intimation of granting of options to RBI in plain paper- The issuing company is required to report the details of issuance of ESOPs to its employees to the Regional Office concerned of the Reserve Bank, in plain paper reporting, within 30 days from the date of granting of ESOPs.
- 5.25.3 Reporting No. 2**-Advance reporting of application money: The Company after receipt of share application money from non-resident employee within 30 days shall report in Advance Reporting Form enclosed in Annex – 6 of FEMA FDI circular together with KYC and copy of FIRC through its authorised dealer through it received inward remittance.
- 5.25.4 Reporting No.3** –Filing of FC-GPR: Further, at the time of allotment of shares for options exercised by non-resident employees, the company shall report to the Regional Office of the Reserve Bank in form FC-GPR, within 30 days of allotment of such shares together with valuation report and certificate from Company Secretary of company or practicing company, through its authorised dealer through which it received inward remittance.
- 5.26 Income tax:** Like in many countries, in India, the income tax is levied on ESOS two times at time of exercising the options granted to employees as perquisite as part of salary income tax at normal rate of taxation and another time over the capital appreciation at time of selling of shares as capital gain tax. It may be short term capital gain or long term capital gain. However in case of equity listed company, there will not be any capital gain taxation over the capital appreciation at time of selling of shares if employee holds more than 12 months and the sale proceeds are subjected to Securities Transaction Tax (STT)
- 5.27 Non-compliance of section:** This section does not prescribe any penal provision for contravention of the section. However section 450 of the Act will be applicable. Accordingly, the punishment for contravention, the company and every offer of the company who is in default shall be punishable with a fine upto Rs.10,000, in case the contravention continues then the fine shall be Rs.1,000 every day. The offenses under this section are compoundable under section 441 of the Act.

Relevant Corporate Laws viz. FEMA, Listing Agreement

In the case of a listed company - Listing Agreement Clause 23(c)and FEMA, 1999 ESOP-SEBI Guidelines, Income Tax Act, RBI Guidelines. Detailed Analysis: This section seeks to provide that a company having a share capital can increase its subscribed capital by the issue of further shares to its existing members by sending a letter of offer, containing certain conditions, to employees through employee's stock option, subject to approval by special resolution, or to the general public, after having the shares valued by registered

valuers. This provision does not apply to conversion of debentures or loans into shares of the company in certain cases. It is to prevent discrimination amongst shareholders and prevent the directors from offering shares to outsiders before they are offered to the shareholders. So long as these two requirements are complied with, the action of the directors in selecting the time when they will issue the shares as also the proportion in which they should be issued is a matter left to their discretion and it is not the province of the court to interfere with the exercise of that discretion. This is subject to the general exception that the directors are not to act against the interest of the company or mala fide. This is not a fruit of stock ownership, in the nature of a profit, nor does it amount to a division of any part of the assets of the company. It is not an organic product of the original stock like the young of animals or the fruit of trees, but, as described by the Supreme Court This right to subscribe to new stock is but a right to participate in preference to strangers and on equal terms with other existing shareholders in the privilege of contributing new capital called for by the corporation-an equity that inheres in stock ownership under such circumstances as a quality inseparable from the capital interest represented by the old stock. Shares offered to the existing shareholders of a company are called rights shares. In this regard to the rights shares, the shareholders of a company have a pre-emptive right to subscribe to these shares. Where a company proposes to increase the subscribed capital of a company by issuing further shares, these shares are offered for subscription to the existing shareholders of the company on a certain basis or in a certain proportion. The shareholders who receive offers for the rights shares are also entitled to renounce these to other persons, but the persons who are not shareholders have no right of direct subscription to these shares. It is common to vest in the Board of directors of a company the power to issue unsubscribed rights shares to any persons selected by the Board. Rights issue is a method by which companies raise capital by offering shares to their shareholders. This is a privilege given to the shareholders of a company to subscribe pro rata to a new issue of securities. The name rights issue arises from the principle of pre-emption right, according to which any new shares issued by a company must first be offered to the existing shareholders in proportion to their holding of old shares, that is pro rata. The shareholders, who receive offers for subscribing to the rights shares are also entitled to renounce those shares. Renunciation connotes the surrender to someone else of rights to shares in a rights issue. The person to whom the shares are offered fills in the renunciation form in favour of the person to whom he wishes to renounce his rights. Persons who are not shareholders of the company are not entitled to subscribe to the rights shares. ESOP-ESOP is a structures way of issuing companies equity to the employees with an objective of motivating them and creating a sense of ownership amongst them. In a typical SOP the company grants options to the employees which can be converted into shares by the employees on paying exercise price. An employee has an option but not an obligation to convert the option into shares. However, for a company it's an obligation, if the employee decides to exercise his option. Normally the options can be converted into shares on fulfilment of some conditions from the employees. Some of these conditions could be continuing in the employment of the company, achievement of pre-determined performance parameters. etc.

Concluded