

SECURITIES AND EXCHANGE BOARD OF INDIA

CORPORATION FINANCE DEPARTMENT

DIVISION OF ISSUES AND LISTING

**Review of SEBI (Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Scheme (ESPS)) Guidelines, 1999**

**RECOMMENDATIONS MADE BY THE COMMITTEE ON ESOP REGARDING AMENDMENTS TO SEBI (ESOP & ESPS) GUIDELINES, 1999**

[Comments on the recommendations may be sent to the Corporation Finance Department, Division of Issues & Listing, SEBI, or emailed to Ms. Srishti Chavan, Officer at [srishtijc@sebi.gov.in](mailto:srishtijc@sebi.gov.in) or Srikanth M. K., Officer at [srikanth@sebi.gov.in](mailto:srikanth@sebi.gov.in), or faxed to 91-22-22045633, on or before April 21, 2004]

- I. **SEBI (Employee Stock Option Scheme (ESOP) & Employee Stock Purchase Scheme (ESPS)) Guidelines, 1999** (herein after referred to as the Guidelines) were notified and came into effect from 19<sup>th</sup> June 1999. Amendments to the Guidelines were carried out vide Circular no. SEBI/PMD/MBD/ESOP/2/2003/30/6 dated 30<sup>th</sup> June 2003. As stated in the covering letter to the abovementioned Circular, all amendments except clauses 22.3 and 22.6 shall come into force with effect from 30<sup>th</sup> June 2003. Clauses 22.3 and 22.6 shall come into force on the date/s specified by SEBI.

Subsequent to these amendments, SEBI received certain queries seeking clarification. An analysis of said queries revealed the need to elaborate on certain specific aspects as well as to streamline the existing requirements and to correct a few anomalies in the Guidelines. Accordingly, proposed amendments to the guidelines were made available on the SEBI Website on 26<sup>th</sup> December 2003 for receipt of public comments. In this regard, a number of suggestions and representations were received from the public, ESOP Direct and Indian Association of Corporate Treasurers (INACT). It was decided to place these public comments and other representations before the Committee on ESOP, set up under the chairmanship of Prof. J. R. Varma for consideration. Accordingly, these suggestions and representations were considered by the Committee on ESOP in its meeting held on 27<sup>th</sup> February 2004. On the basis of these suggestions and representations and further deliberation on these issues, the committee made certain recommendations which are given hereunder:

**1. *Applicability of the modified Guidelines:***

The committee considered the public comments as well as the recommendations of ESOP Direct in respect of the “applicability of the modifications carried out in SEBI guidelines”.

The committee noted that for the purpose of clarification, it would be better if the applicability of each clause is mentioned separately and clearly so as to avoid any ambiguity. Accordingly, the committee recommended that the amendments to the Guidelines carried out vide the above mentioned Circular should be made be

applicable as under:

<b>Clause No. of the modified Guidelines</b>	<b>Particulars of the Clause</b>	<b>Applicability of the Clause along with rationale</b>
5.1	<p>With every grant of Options a Disclosure document needs to be given to the option grantees. Contents of the Disclosure document are given in Schedule IV of the guidelines. Major issues to be covered in the document are:</p> <ul style="list-style-type: none"> <li>➤ Statement of Risks</li> <li>➤ Information about the company (format similar to the Offer document)</li> <li>➤ Abridged financial information, including the last audited accounts</li> <li>➤ Salient features of the ESOP.</li> <li>➤ Annual report along with the notice of shareholders' meeting is also to be given every year to the option grantee.</li> </ul>	All options granted on or after 30 <sup>th</sup> June, 2003.
5.3 (f)	Procedure to be followed by the Compensation committee for making a fair and reasonable adjustment to the number of options and exercise price in case of corporate actions has been laid down.	All corporate actions on or after 30 <sup>th</sup> June 2003.
6.2 (j) and (k)	The explanatory statement to the notice shall include a declaration by the company about the method of option valuation it is going to use for accounting ESOPs. A statement saying that the company shall disclose impact of fair value on company's profits and EPS if that method were used is also required to be inserted.	All notices of general meeting sent on or after 30 <sup>th</sup> June 2003.
7.5	Companies would be allowed to re-price their underwater options so long as the terms are not detrimental to the interest of employees and they are approved by the shareholders.	Any repricing of options done on or after 30 <sup>th</sup> June 2003.
Proviso to 8.1	In case the company was to follow intrinsic value method, impact of fair value on profits and EPS is to be disclosed.	All grants made on or after 30 <sup>th</sup> June 2003.
12.1 (l)	Impact of fair value on profits and EPS to be disclosed in the Directors' Report.	Grants made on or after 30 <sup>th</sup> June 2003

13.2	In case of graded vesting, the amortization of compensation cost is to be done by determining the vesting period separately for each portion of the option.	Accounting periods commencing on or after 30 <sup>th</sup> June 2003
17.2 (c)	Disclose total number of shares to be granted under ESOS in the explanatory statement to the notice.	All notices issued on or after 30 <sup>th</sup> June 2003.
17.5	Separate resolution needs to be passed if ESOS is to be implemented for employees of subsidiary or holding companies or more than 1% each is proposed to be granted to identified employees.	All notices issued on or after 30 <sup>th</sup> June 2003.
22.1	Shares arising out of ESOS will now be listed immediately upon exercise, provided: <ul style="list-style-type: none"> <li>➤ ESOS is in accordance with these guidelines</li> <li>➤ A statement in the prescribed format is filed with the stock exchanges and an in-principle approval is obtained before the exercise.</li> <li>➤ Prescribed information is filed with the stock exchanges after the exercise.</li> </ul>	All IPOs after 30 <sup>th</sup> June 2003.
22.2	In case of companies which were unlisted when the options were granted and are listed at the time of exercise, the shares issued on exercise of such options shall be listed if the shareholders ratify the earlier resolution (along with all the necessary disclosures) after the company is listed. For the companies going public now, the offer document will have to include a clause on the intentions of the holders of ESOS shares to sell their shares within 3 months of listing.	Ratification aspect dealt with separately. Additional disclosures in the offer document would apply to IPOs on or after 30 <sup>th</sup> June 2003.
22.3	Application to Central listing authority for listing of ESOS shares.	On date notified by SEBI.
22.4	Pre IPO ESOS shares shall not have a lock-in period of one year as specified in SEBI (Disclosure and Investor Protection) guidelines 2000 unless they are issued to Promoters provided that adequate disclosures in the offer document are made and the shareholders pass the ratification resolution after the company has gone	This exemption has been available to ESOS shares in DIP guidelines. The same has been reproduced here. This would be effective from the date when

	public.	amendment to DIP guidelines were carried out viz., vide circular dated August 14, 2003.
22.6	ESOS and ESPS schemes are to be filed through EDIFAR filing as and when it is implemented.	As and when EDIFAR facility is implemented by SEBI
22.7	In case the employees of a subsidiary are covered by the Plan of the holding company, the financial statements of the subsidiary company should disclose the cost incurred by the holding company in its Notes to Accounts.	Accounting periods commencing on or after 30 <sup>th</sup> June 2003.
22.8	Appointment of merchant banker.	ESOP Schemes approved on or after 30 <sup>th</sup> June 2003.
22A	In case a company has implemented ESOP through a Trust, then the accounts of the Trust shall be consolidated with the company's accounts as per Accounting Standard (AS 21).	Accounting periods commencing on or after 30 <sup>th</sup> June 2003.
23.1	These guidelines will be applicable from 19 <sup>th</sup> June 1999.	Amendments carried out vide circular dated June 30 <sup>th</sup> , 2003 to come into force as per the above schedule.

**2. Listing approval from stock exchanges and filing of additional information with the stock exchange as a control measure:**

SEBI received various public comments in relation to the listing approval from stock exchanges and the filing of additional information with the stock exchanges as a control measure. On consideration of these public comments, the committee noted that the listing approval for ESOP shares is granted in two stages as under:

- In principle approval is given by stock exchanges for the aggregate number of shares proposed to be allotted under an ESOP Scheme. The in principle approval is granted pursuant to filing of Schedule V. At this stage, various documents are required to be submitted along with Schedule V, viz., auditors' certificate, shareholders' resolution, etc.
- The second stage approval is the trading approval. This is pursuant to filing of

Schedule VI after the options are exercised and shares are allotted. Stock exchanges ask for certain documents at this stage, e.g., the distribution schedule.

After deliberation, the committee suggested that stock exchanges may not insist on the distribution schedule as the shareholding pattern along with names of shareholders, holding more than 1%, is submitted to the stock exchanges on a quarterly basis as per the requirements of clause 35 of the Listing Agreement. Thereon, the stock exchanges assured that listing can be given within one day pursuant to the exercise of options.

- The committee also recommended that all certificates should be filed by the company on a quarterly basis except certificates from compliance officers/ company secretary in Schedule VI, which would be required to be filed at the time of each listing.

### **3. *Elaboration on role of merchant banker:***

Upon examination of the public comments, the committee advised that there was a need to clarify the role of merchant bankers vis a vis statutory auditors.

The Committee noted that merchant bankers being the intermediaries registered with SEBI are in better position to understand the SEBI guidelines and hence their certification about compliance of guidelines would result in effective compliance of the regulatory provisions. The committee recommended that the role of the merchant banker is primarily to certify that the ESOP scheme is compliant with the SEBI Guidelines. This certification would be the part of schedule V to be filed with Stock Exchanges for getting in principle approval. The auditor's certification shall be primarily as to whether the ESOP scheme has been implemented as per the scheme approved by the shareholders. The auditor would inter alia also certify the accounting treatment thereof.

As a matter of clarification, the Committee advised that the appointment of merchant bankers would only be in respect of new ESOP schemes approved on or after 30<sup>th</sup> June 2003 and the same would not apply to existing ESOP Schemes.

### **4. *Code of conduct for Prevention of Insider Trading:***

The committee noted that in terms of Clause 4.2 of the Model Code of Conduct for Prevention of Insider Trading for listed companies, employees are required to hold their investments in securities for a minimum period of 30 days from the date of allotment. In this respect, the committee noted that as per ESOP guidelines there is a minimum one year lock-in on the shares allotted under ESOS and on options granted under ESOS. In case of ESOPs, as the employees have already held the options for one year, the date of allotment (for the purpose of Clause 4.2 of the Model Code of Conduct) shall be taken as date of grant of options and in case of ESOS, the said date of allotment shall be taken as the date of allotment of shares under ESOS.

### **5. *Grant of ESOS/ ESOS to employees of the holding/ subsidiary covered by the***

***guidelines:***

The committee recommended that the definition of “employee stock option” under sub-clause (2A) of clause 2.1 be modified to include an explanation stating that employee means an employee as defined under sub-clause (1) of clause 2.1 of the guidelines.

**6. *Repricing of the options:***

The committee clarified that both vested as well as unvested options, which are not exercised, are allowed to be repriced, subject to shareholders’ approval.

**7. *Shareholder approval:***

In respect of clause 6 of the guidelines pertaining to shareholder approval, the committee recommended that the aforesaid clause be modified to specify that a resolution authorizing the Board of Directors or a committee thereof to decide these matters would not be sufficient compliance with this clause. The items in this clause require approval by the shareholders and this decision-making power **cannot be** delegated to the Board.

**8. *Disclosures in Directors Report:***

The committee recommended that sub-clause (k) of clause 12.1 of the guidelines be modified to say that the diluted earnings per share pursuant to issue of shares on exercise of option shall be calculated in accordance with Accounting Standard (AS) 20 “Earnings Per Share” instead of as per International Accounting Standard (IAS) 33.

**9. *Revised definition of market price:***

The committee noted the public comments received on the revised definition of market price, which is, an average of two weeks prior to the date of grant, as against the market price as on the grant date. Prof. Varma, chairman of the committee stated that there is no concept of averaging in market price; rather the market price at any given point of time is the latest available quotes of the scrips. He also stated that US GAAP also provide for market price as a price on a particular date for calculation of intrinsic value. The committee also noted that the companies which have to prepare their accounts as per Indian accounting principles as well as US GAAP may encounter problems in case the market price is taken as an average price. In view of this, the committee recommended that the market price should be redefined as the latest available closing price prior to the date of the meeting of the Board of Directors.

**10. *Listing of pre IPO ESOP shares:***

Clause 22.2(i) of the guidelines provide that earlier resolution passed for issuance of ESOS / ESPS (by the then unlisted company) shall be ratified by the shareholders of listed company in the General Meeting.

The committee deliberated on the need for ratification resolution. Some members opined that once shareholder approval is in place and company makes disclosures in terms of the Guidelines in the prospectus for IPO, it is unfair to insist on a subsequent approval by another set of shareholders. Some members also opined that the ESOP Scheme would already be in various stages of implementation. In such a scenario, if the second set of shareholders advise changes or refuse approval, the whole scheme could be adversely affected. The committee noted that there was a need to clarify the matter. The committee advised that the intention was to ensure that in the case of a listed company, all ESOP Schemes are compliant with SEBI Guidelines and in case it is not, the company must approach shareholders for their consent for continuing with the same in its original form.

The Committee noted that there was a possibility of misuse wherein an unlisted company could grant a large number of options just before the company went public. There were many suggestions on this issue, viz., that a company going for an IPO shall ensure that its ESOP scheme is in compliance with SEBI guidelines. If the Scheme is compliant with SEBI guidelines, the requirement of ratification may be removed, however, in case it is not, the ratification by shareholders shall be made mandatory. Further, it was also suggested that since the offer document contains all the disclosures about the ESOP schemes implemented by the company before IPO, additional disclosure of the features of company's ESOP scheme which vary from the ESOP scheme stipulated by SEBI, may also be considered. In addition to these disclosures, it may be made clear that ratification would be required only if the company grants new options under the old scheme. Alternatively, the company shall terminate the scheme or come with a new scheme which is required to be SEBI compliant. The committee also noted suggestions on various measures like freezing grant of options for specific period before the IPO, etc. Pursuant to the deliberations and discussions in this regard, the committee opined that disclosures at the IPO stage and continuous disclosures may be enhanced to ensure sufficient protection to the investors.

After due deliberation, the committee recommended as under :

- The Committee recommended that after the company is listed, no option grants can be made under any pre-IPO ESOP Schemes unless:
  - the ESOP scheme is in conformity with SEBI Guidelines, and
  - the ESOP scheme is ratified by the shareholders of the company after the IPO. Such ratification may be made at any time prior to the grant of new options under the scheme.
- If no new grants are proposed to be made under the pre-IPO ESOP Scheme, ratification by the shareholders of the company after the IPO would not be necessary. Even if the shareholders advise any change or reject the scheme, it would not affect the options granted prior to IPO (i.e., when the company was unlisted). However, any change in the terms of such pre-IPO options (other than adjustments for corporate actions in accordance with SEBI guidelines) including repricing, change of vesting period or maturity would require approval by the shareholders.

- The committee recommended modifying existing clause 15.3 to impose a disclosure requirement (both in offer document and on a continuing basis), as under:

15.3 If any options granted to employees in pursuance of ESOS are outstanding at the time of initial public offering, the offer document of the company shall disclose all the information specified in clause 12.1 *and also disclose the impact on the profits and on the EPS of the last three years if the company had followed the accounting policies specified in clause 13 in respect of options granted in the last three years.*

(Italics hereinabove indicate the modifications proposed.)

- The Committee also recommended following additional disclosures in the Directors Report:
  - Until all options granted in the three years prior to the initial public offering have been vested or have lapsed, the Board of Directors shall inter alia disclose, either in the Directors' Report or in the Annexure to the Directors' Report, the impact on the profits and on the EPS of the company if the company had followed the accounting policies specified in clause 13 in respect of such options.
  - Until all options granted in the three years prior to the initial public offering have been exercised or have lapsed, the Board of Directors shall inter alia disclose, either in the Directors' Report or in the Annexure to the Directors' Report, the information specified in clause 12.1 in respect of such options.

#### **11. Representation made by Indian Association of Corporate Treasurers (INACT)**

The representation made by the Indian Association of Corporate Treasurers (INACT) on the guidelines was discussed. The committee considered the issue of removal of lock-in on ESOP/ ESPS allotted in lieu of ESOP / ESPS in case of Mergers and Acquisitions. The committee noted that, in the context of mergers and acquisitions, it would be difficult for the Acquirer Company to insist on lock in of one year as regards the Options of the Target, in view of the fact that the options of the target would in some cases have already fully vested in the employee or would be vesting within a certain period of time post acquisition (which may be less than 12 months) and they would be unwilling to comply with the additional one year lock-in period. In other words, the employees of the Target would insist upon maintaining the same Vesting Schedule as was applicable to the Options issued by the Target prior to acquisition.

- II. The Institute of Chartered Accountants of India (ICAI) has, through its Research Committee, issued a draft Guidance Note on Accounting for Employee Stock Option Plans (ESOPs) and Employee Stock Purchase Plans (ESPPs). This guidance note establishes financial accounting and reporting principles for ESOPs, ESPPs and stock appreciation rights. 1999. The committee considered the abovementioned draft guidance note. It was decided that pursuant to the publication of the guidance note by ICAI, the accounting policies for ESOP and ESPS as given in Schedules I and II of the

guidelines be done away with. **However the date for removal of the schedules and consequent changes in the guidelines would be informed by SEBI pursuant to finalization of the guidance note by ICAI.**

- III. The committee considered the representations made by the public and ICAI in respect of clause 22A of the guidelines which speaks about the accounting treatment for ESOS/ ESOS administered through the trust route. In this regard, one of the members of the committee stated that on close reading of AS 21, it can be interpreted that if there is any element of control, AS 21 would be applicable. However, an ICAI representative on the committee clarified that it is control as well as economic benefit to the company, which attracts applicability of AS 21. The committee stated that idea of stating that accounting should be done in terms of AS 21 was to ensure that the principles of consolidation are followed in such cases. The committee further noted that ICAI in its guidance note has stated that AS 21 may not be the right standard to be followed in such cases, however, accounting in such cases needs to be done as if the enterprise itself is administering the scheme. **The committee unanimously agreed to remove reference to AS 21 from the guidelines and to incorporate the principle of “as if company itself is administering the scheme”. Before doing this, however, the committee desired that ICAI explain the detailed accounting treatment of ESOPs issued by a trust including how the EPS would be correctly computed under AS 20 and how accounting entries would be passed in the company when a transaction takes place between the trust and the employee.**