

Review of SEBI (Employee Stock Option Scheme & Employee Stock Purchase Scheme) Guidelines, 1999.

Recommendations of the ESOP Committee

(Interested persons and entities may send their comments on this issue to the e-mail address : amitk@sebi.gov.in or by post to the Primary Markets Department, Securities and Exchange Board of India, Mittal Court, 'A' Wing, Ground Floor, 224 Nariman Point, Mumbai 400 021.)

The Board had set up a committee (hereinafter referred as ESOP Committee) under the Chairmanship of Prof. J. R. Varma, the then Member, SEBI Board, to formulate guidelines for Employee Stock Option Scheme (ESOP) and Employees Share Purchase Scheme (ESPS). These guidelines were implemented in July 1999. Due to various changes in the market since 1999 and various representations/ clarifications sought by the companies, it was decided to review the SEBI (Employee Stock Option Scheme and Employees Share Purchase Scheme) Guidelines, 1999 (hereinafter referred as Guidelines) . Accordingly the ESOP committee was reconstituted. The committee comprised of the following members:

1. Shri J.R.Varma, Chairman of the Committee
2. Sh. Vinod Jain- ICAI
3. Sh. Kiran Karnik - NASSCOM
4. Sh. A.K. Narayana, Tamilnadu Investors Association.
5. Shri Nishith M Desai - Nishith Desai Associates
6. Shri Nihal Kothari – , Head of Taxation, Hindustan Lever Limited
7. Shri Harshu Ghate - ESOP Direct
8. Shri A Rammohan Rao - UTI Securities Exchange Limited
9. Shri R..M.Joshi, Executive Director - SEBI

The meeting of the Reconstituted committee was convened on 11th September 2002 to discuss various issues pertaining to ESOP guidelines.

Before proceeding with its deliberations, the Committee inter-alia observed the following main findings of all India survey conducted by M/s ESOP Direct, a consultancy Firm:

- ? In most of the cases companies issuing ESOPs did comply with vesting period, disclosure requirement as specified in SEBI Guideline.
- ? In case of IT companies, ESOPs were issued across the board whereas in case of companies from non-IT sectors, ESOPs were issued to top management only.
- ? Average life of the ESOPs issued is 4 years.
- ? In most of the cases ESOPs were issued at fair market value.
- ? Treatment of corporate actions on the ESOPs issued, varied from company to company.
- ? Unlisted companies willing to make an IPO faces problem with the ESOPs issued earlier.

- ? Wherever ESOPs are being issued across the board, allotment is fairly proportionate across the Board.
- ? Very few companies, issuing ESOPs, are found to be enclosing auditors certificate with the financial statement.
- ? In case of IT companies, ESOP is being used as a tool to motivate employees. Whereas in case of non IT companies, ESOP is being issued in lieu of remuneration.

The survey provided an insight in to the usage of ESOPs in the corporate sector.

The committee thereafter deliberated on various issues and gave its recommendations on each of the issue as under:

1. Applicability of the Guidelines

The existing SEBI (ESOP & ESPS) guidelines came into effect on 19th June 1999. The present guidelines are applicable to all the schemes by listed companies offered on or after 19th June 1999. SEBI has received representations from various companies as to whether the guidelines shall be applicable to the ESOPs granted prior to 19th June 1999. which are yet to be exercised and are outstanding. The committee recommended that guidelines will not be applicable to the Stock Options granted prior to 19th June, 1999, unless specified otherwise in the guidelines.

2. Revisiting the definition of Fair value given in the guidelines

As per the existing Guidelines, the Fair value means the option discount, or, if the company so chooses, the value of the option using the Black Scholes formula or other similar valuation method. The committee recommended redefining **FAIR VALUE** by restricting it to “the value of option using Black Scholes formula or any other similar valuation model” and accordingly recommended modifications in SEBI (ESOP & ESPS) Guidelines under the following heads

- (i) Modification in Schedule I
- (ii) Addition of New Schedule i.e Schedule II
- (iii) Addition of sub clauses in clause 12

Details are as under

i) Modification in Schedule I of the guidelines

Modify Clause (b) as below

“The accounting value of options shall be equal to the aggregate, over all employee stock options granted during the accounting period, of the intrinsic value of the option or, if the company so chooses, the fair value of the option.

For this purpose:

1. Fair value of an option means the fair value calculated in accordance with Schedule II (*New insertion as detailed (ii) below*).
2. Intrinsic value means the excess of the market price of the share at the date of grant of the option under ESOS over the exercise price of the option (including up-front payment, if any)

Addition of new Schedule

Insert Schedule II which is as below

- a. The fair value of a stock option is the price that would obtain for that option in an arm's length transaction between a willing buyer and a willing seller.
- b. The fair value shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current market price of the underlying stock and its expected volatility, expected dividends on the stock, and the risk-free interest rate for the expected term of the option.
- c. The fair value of an option estimated at the grant date shall not be subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock, or the risk-free interest rate.
- d. Where the exercise price is fixed in Indian Rupees, the risk-free interest rate used shall be the interest rate applicable for a maturity equal to the expected life of the options based on the zero-coupon yield curve for Government of India securities.
- e. The expected life of an award of stock options shall take into account the following factors:
 - ? The expected life must at least include the vesting period.
 - ? The average length of time similar grants have remained outstanding in the past. If the company does not have a sufficiently long history of stock option grants, the experience of an appropriately comparable peer group may be taken into consideration.
 - ? The expected life of ESOPs should not be less than half of the exercise period of the ESOPs issued until and unless the same is supported by historical evidences with respect to ESOPs issued by the company earlier.
- f. If the company does not have a sufficiently long history of traded stock prices to estimate the expected volatility of its stock, it may use an

estimate based on the estimated volatility of stocks of an appropriately comparable peer group.

- g. The estimated dividends of the company over the estimated life of the option may be estimated taking into account the company's past dividend policy as well as the mean dividend yield of an appropriately comparable peer group
- h. Justification is to be given for significant assumptions. If at the time of further issue of ESOPs there are any changes in the assumptions, give reasons for the same.

ii) Addition of sub clauses in clause 12

Add sub clauses (l) to (n) as below in clause (12) on disclosure in director report in guidelines

- (l) Where the company has calculated the employee compensation cost using the intrinsic value of the stock options, the difference between the employee compensation cost so computed and the employee compensation cost that would have been recognized if it had used the fair value of the options, shall be disclosed. The impact of this difference on profits and on EPS of the company shall be disclosed.
- (m) Weighted-average exercise prices and weighted-average fair values of options shall be disclosed separately for options whose exercise price either equals or exceeds or is less than the market price of the stock on the grant date.
- (n) A description of the method and significant assumptions used during the year to estimate the fair values of options, including the following weighted-average information: (1) risk-free interest rate, (2) expected life, (3) expected volatility, (4) expected dividends and (5) the market price of the underlying share at the time of option grant.

3) Mandatory disclosure of Fair value of ESOPs

As per the existing guidelines, the company has an option to choose either intrinsic value or a fair value (as per Black Scholes or similar models) for actual expensing of ESOPs in the financial statements.

The committee recommended mandatory disclosure of:

- ? The fair value of the ESOPs (i.e using Black Scholes or similar models)
- ? The impact on profits and on EPS of the company, had the company expensed the ESOPs on fair value basis.

4) ESOPs by Trust Route:-

The ESOP committee in the earlier report had recommended that it shall not be mandatory to create an Employee Welfare Trust to administer the stock option scheme. As such the company today has an option to administer the ESOP through Trust route. However, the guidelines do not carry any procedure and accounting principles to be followed in case of Grant of options through a trust. The Committee recommended that since this is a consolidation issue rather than an ESOP issue, the ESOP trust should be consolidated with the company under AS 21 and the existing ESOP guidelines should be applied by the consolidated entity.

5) Listing and lock in of Pre IPO ESOP Shares.

Listing of pre IPO ESOP shares:-

- a. The existing guidelines state that in the case of listed companies, ESOP shares shall be eligible for listing only if the scheme is in accordance with the guidelines. In case of an unlisted company going in for an IPO, which has implemented an ESOP prior to going public there is a possibility that options granted prior to going public would vest and be exercised after the company is listed. (referred as Pre IPO ESOP shares), In such a case the shares would come into existence after the company is listed. Moreover, as per the current procedure a company has to comply with a lot of steps for listing of ESOP shares. Considering the volatility in the market and the time lag between issue of shares on exercise of options and listing of the same on an stock exchanges, an employee could lose the advantage of any uptrend in the prices of the shares or even the share price may go below the exercise price. The time taken also prohibits cashless exercise of vested options.

The committee recommended that ESOP shares issued by an unlisted company may be allowed to get listed after the IPO subject to fulfillment of the following requirements:

- i. Ratification of the resolution passed for issuance of ESOP
The notice for ratification of earlier resolution shall include all the disclosures required in terms of SEBI (ESOP guidelines).
- ii. Disclosures in the offer document
 - ✍ A disclosure about the intention of the ESOP holders to sell their ESOP shares within 3 months after the date of listing of shares in the said IPO (aggregate number of shares intended to be sold by all ESOP holders put together to be disclosed regardless of whether the shares arise out of options exercised before or after the IPO),
 - ✍ Specific disclosures about the intention of sale of ESOP shares within 3 months after the date of listing, by directors, Senior Managerial personnel and also large option grantee i.e persons having ESOP shares amounting to more than 1 % of the issued capital (excluding outstanding warrants and conversions), which

inter-alia shall include name, designation and quantum of ESOP shares and quantum they intend to sell within 3 months..

- ✍ A disclosure in line with the guideline 12 of ESOP guidelines, regarding all the ESOPs issued in last 3 years (separately for each year) and on a cumulative basis for all the ESOPs issued prior to that in the prospectus.

- b) The committee also recommended that the provisions may be made for getting in principle approval for listing of ESOP shares from Stock Exchanges so as to avoid delay in listing of ESOP shares as and when issued. As the issue is primarily an operational one, the committee recommended that the same should be referred to the Stock Exchanges.

Lock-in of pre IPO ESOP shares:-

As per the existing SEBI (DIP) Guidelines 2000, , all the pre IPO shares in existence gets locked in for a period of 1 year post IPO. This discourages employees in private limited companies from exercising options as on the company getting listed, they will get locked in for a period of one year. In view of the lock in, even employers are promoting employees to exercise the options post IPO. The committee recommended that the existing provisions of Lock-in specified in SEBI (DIP) guidelines 2000 shall not be applicable on the pre IPO ESOP shares held by employees other than promoters subject to the ratification of the earlier resolution and disclosures in the prospectus as mentioned at (a) (i) & (ii) above respectively. However, ESOP shares held by the promoters will be subject to lock-in as per the relevant provisions of SEBI (DIP) Guidelines, 2000.

6) Adjustment in case of Corporate Actions

As per the existing guidelines, the Compensation Committee is to formulate the procedure for taking a fair and reasonable adjustment to the number of options and to the exercise price in case of rights issues, bonus issues and other corporate actions. Currently companies are not very clear of action to be taken in event like bonus/rights issue, merger, sale of division etc. In case of merger or acquisition, the unvested options have accelerated vesting or some companies swap the old options with the options of the new company. Thus there is no consistency with respect to the actions taken in such events. The committee recommended that in case of corporate actions like bonus/rights issue, merger, sale of division etc, the compensation committee should adjust the no. of ESOPs and the price of ESOPs in a manner such that total value of the ESOPs should remain the same after that corporate action. For the purpose of adjustment, the compensation committee should consider global best practices in this area including the procedures followed by the derivative markets in India and abroad. As far as possible, the vesting period and the life of the options shall be left unaltered even in a merger to protect the rights of the option holders.

7) Accounting norms for graded vesting

The existing guidelines (guideline 13) has not provided specifically for accounting for compensation cost in the case of options, which vest in a graded manner. Where a scheme provides for such graded vesting the allocation or amortisation of compensation expense to the period until the full vesting has occurred is to be done in a manner proportional to the number of shares to which rights to exercise the option have vested. The service period is determined separately for each portion of the option. For example if an option vests 20% each year it will vest over 5 years. In this case the 20% which vests in the first year is deemed attributable to the services performed in the first year only, while the 20% which vests in the second year is attributed to the services performed in the years 1 and 2. The committee recommended that ESOP with graded vesting period can be recognized as several separate ESOPs and can be accounted for accordingly.

8) Accounting norms for Variable ESOPs

The companies may like to go for different variants of ESOPs where on the date of grant, the exercise price or the vesting period or number of options is contingent on a future event viz may be based on future performance i.e. "Performance-Linked Vesting (the number of options that would be granted and/or the vesting period of the options is linked to a specific performance parameter). The Committee recommended that the existing accounting treatment may continue for all ESOPs. Further it was informed that ICAI is in process of laying down the detailed accounting norms, which may take care of all accounting norms.

9) Repricing of Options

There were cases where companies wanted to reprice the options because the market price fell to the extent that the ESOPs were rendered unattractive. The existing guideline 7 permit the changes in terms & conditions of the ESOPs offered pursuant to an earlier resolution of a general body but not yet exercised by the employee, provided it is not detrimental to the interests of the employees and subject to shareholders' approval. The committee recommended that the existing provisions may continue. The committee noted that many issues referred to the committee are mainly accounting matters pertaining to ESOPs. The committee was informed that ICAI is in process of laying down detailed accounting norms for ESOPs, which may take care of all the accounting matters.

10) Relaxation in requirement of Shareholders Approval

The guidelines require a separate resolution in case the company wants to grant more than 1% of the issued capital (including options granted) to an identified employee in a year. Generally the shareholders meeting are held once in a year. In case of urgency, it may not be possible to call shareholders meeting for grant of more than 1% options to an identified employee. In view of the above, post-

facto approval from the shareholders be permitted, subject to the same being obtained within a period of 1 year from the date of grant and in case the same is not obtained or is not accorded approval by the shareholders the options would lapse. The committee recommended that there is no need to relax the requirement regarding Shareholders approval.

11) Definition of Market Price

As per the existing guidelines the market price of a share on a given date means the closing price of the share on that date on the stock exchange on which the shares of the company are listed. It was felt that to have a more realistic value of the share the period average price over a period of time should be taken into consideration. The committee recommended that we may stick to the existing definition of 'Market Price'.

12) Definition of Employee Stock Option as given in the Companies Act

The following definition is given in section 2(15 A) of Companies Act: "*employee stock option*" means the option given to the whole time directors, officers or employees of a company, which gives such directors, officers or employees the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a pre determined price. The Committee was asked to reconsider the definition given in the present ESOP guidelines so as to have uniformity in all the guidelines. The committee recommended that we may incorporate the definition given in Section 2(15A) of Companies Act, 1956 in our Guidelines. The committee further recommended that definition of 'Pre-determined price' should be clarified as a 'fixed price or a price determined through a pre-determined pricing formula'

13) Shareholders Approval

Since the spirit of Guideline 6 (ESOS) of the existing guidelines which talks about approval of shareholders by way of separate resolution in case option is granted to employees of subsidiary or holding company or grant of option to identified employees in excess of 1% in a year is same as Guideline 17 of ESOS), the Committee recommended that the relevant provisions of the Guideline 6.2 & the provisions of Guideline 6.3 may be made applicable to Guideline 17 also.

14) New Forms Of ESOPs

Over a period of time, new forms of equity compensation to employees have emerged. The Committee was of the view that existing guidelines give enough flexibility to the issuer to introduce new forms of ESOPs. The Committee recommended that new forms can be introduced provided it fit in the existing definition of ESOPs of providing a pre determined formula.

15) Insider Trading Guidelines

Recently SEBI amended the guidelines for prohibition of Insider Trading. One of the provisions require all directors/officers/designated employees to hold their investments in securities for a minimum period of 30 days in order to be considered as being held for investment purposes. This restriction prohibits cashless exercise and same day sale, which is expressly permitted by the guidelines. The Committee discussed the need for exemption of ESOP shares from this condition. The committee recommended that no relaxation from insider Trading regulations should be given to the designated employees, going by the spirit of Insider Trading regulations.

16 Additional recommendations of the committee

- ? Filing of ESOP schemes by the listed companies through EDIFAR filing may be made mandatory.
- ? When parent company issues ESOPs to the employee of its subsidiary, the cost incurred by the parent company for issuing the aforesaid ESOPs should be disclosed in the 'notes to accounts' of the financial statements of the subsidiary company.
- ? SEBI must mandate a minimum set of disclosures by the company to the grantees so as to protect the rights of option grantee in their capacity as investors. The minimum disclosures to be given to option grantees are as per Annexure A

Simplified Disclosure Document for Employee Stock Option Grantees

Part A: Statement of Risks

All investments in shares or options on shares are subject to risk as the value of shares may go down or go up. In addition, employee stock options are subject to the following additional risks:

1. *Concentration*: The risk arising out of any fall in value of shares is aggravated if the employee's holding is concentrated in the shares of a single company.
2. *Leverage*: Any change in the value of the share can lead to a significantly larger change in the value of the option as an option amounts to a levered position in the share.
3. *Illiquidity*: The options cannot be transferred to anybody, and therefore the employees cannot mitigate their risks by selling the whole or part of their options before they are exercised.
4. *Vesting*: The options will lapse if the employment is terminated prior to vesting. Even after the options are vested, the unexercised options may be forfeited if the employee is terminated for gross misconduct.

Part B: Information about the company¹

1. *Business of the company*: A description of the business of the company on the lines of item V(a) of Part I of Schedule II of the Companies Act.
2. *Abridged financial information*: Abridged financial information for the last five years for which audited financial information is available in a format similar to that required under item B(1) of Part II of Schedule II of the Companies Act. The last audited accounts of the company should also be provided unless this has already been provided to the employee in connection with a previous option grant or otherwise.
3. *Risk Factors*: Management perception of the risk factors of the company in accordance with item VIII of Part I of Schedule II of the Companies Act.
4. *Continuing disclosure requirement*: The option grantee should receive copies of all documents that are sent to the members of the company. This would include the annual accounts of the company as well as notices of meetings and the accompanying explanatory statements.

Part C: Salient Features of the Employee Stock Option Scheme

The Part would contain the salient features of the employee stock option scheme of the company including the conditions regarding vesting, exercise, adjustment for corporate actions, and forfeiture of vested options. It shall not be necessary to include this Part if it has already been provided to the employee in connection with a previous option grant, and no changes have taken place in the scheme

¹ It shall be sufficient for the company to update this document once a year when the audited accounts become available.

since then. If the option administrator (whether the company itself or an outside securities firm appointed for this purpose) provides advisory services to the option grantees in connection with the exercise of options or sale of resulting shares, such advice must be accompanied by an appropriate disclosure of concentration and other risks. The option administrator should conform to the code of conduct appropriate for such fiduciary relationships.