

## **Report of the Committee on Employee Stock Options**

### **Background and Terms of Reference**

In November 1997, the Securities and Exchange Board of India constituted a Group to review the existing regulations relating to Employee Stock Option Plans (ESOP) and recommend changes thereto. The Group consisted of the following members:

Prof J R Varma(Chairman )	Indian Institute of Management, Ahmedabad
Shri N R Narayana Murthy	Chairman and Managing Director Infosys Technologies Limited
Shri Nishith M Desai	Nishith Desai Associates International Legal and Tax Counsellors
Shri Saurabh Srivastava	President, NASSCOM
Shri Nihal Kothari	Head of Taxation - Hindustan Lever Limited (representing ASSOCHAM)
Shri Shantha Raju	General Secretary All India State Bank Officers' Federation
Shri A K Narayan	President Tamil Nadu Investors' Association
Shri Chinubhai Shah	President The Gujarat Investors' & Shareholders' Assn
Shri M K Khanna	Managing Director UTI Securities Exchange Limited
Dr Dinesh S Patel	President Indian Drugs Manufacturers' Association
Shri Vijay Ranjan (Member Secretary)	Executive Director Securities and Exchange Board of India

Shri. M. Natarajan, Division Chief, SEBI and Ms Ruchi Chojer, Officer, SEBI were nominated as the convenors.

The Group would like to place on record the valuable inputs provided by Ms. Lubna Kably (who was associated with Nishith Desai Associates at the time of inception of the Group) for the valuable inputs that she provided to the Group on the laws,

regulations and practices relating to Employee Stock Options in various parts of the world.

### **Draft Guidelines**

The detailed recommendations of the Group are in the form of draft guidelines attached to and forming an integral part of this report. The main body of the report discusses the issues involved, the guiding principles followed by the Group and the rationale for various recommendations.

### **Guiding Principles**

The Group recognises the important role that Employee Stock Options play in rewarding and motivating employees, in attracting and retaining the best talent, and in ensuring employee commitment and performance. In several knowledge based industries, India's competitive strength is derived from the skills and talent of its people and Employee Stock Options are critical to the success of Indian companies in the global marketplace.

The Group also takes note of the fact that the typical employee in India is not a hard nosed investor. To bring a significant number of employees on board a stock option scheme, the scheme has to be sufficiently attractive to convince the average sceptical employee. While a liberal stock option scheme would lead to earning dilution for existing shareholders, it could be beneficial to shareholders in the long run because of the enhanced commitment and motivation of the employees. This is a trade-off which shareholders have to make for themselves.

After extensive discussions on the various issues related to ESOP, **the Committee took the view that rather than impose numerous restrictions on the issue of Employee Stock Options to check possible abuses, it should rely on the twin principles of *complete disclosure and shareholder approval*.** After reviewing international experience in this regard, the Committee came to the conclusion that **issue of stock options at a significant discount to the market price should be regarded as another form of employee compensation and should be treated as such in the financial statements of the company.** Once these principles are accepted, it follows that regulators should interfere as little in the issue of Employee Stock Options as they do in other elements of the compensation package.

### **Pricing**

As already pointed out in 0 above, a stock option scheme has to be sufficiently attractive to convince the average sceptical employee. At least in the initial stages therefore, the stock options have to be priced at substantial discounts to market prices.

The Committee considered various proposals for laying down a floor price below which companies could not go while issuing stock options to employees at below

market prices. These included proposals to lay down a maximum percentage discount to the market price as also to let the book value of the share serve as the floor price.

After considerable discussion, the Committee took the view that companies should have the freedom to price Employee Stock Options at any price whatsoever provided that options issued at a significant discount to the market price should be treated as another form of employee compensation in the financial statements of the company. In other words, companies issuing stock options at substantial discounts would take a direct hit in their reported earnings. Turning to the definition of substantial discount, the Committee agreed that **an earnings hit would be mandatory if either of two conditions were satisfied:**

- a) **The exercise price of the option (including up-front payment, if any) is at a discount of more than 15% from the market price at the time of grant of the option. However, as a transitional measure, it was agreed that this requirement would be phased in over a period of three years. In the first year, the percentage would be 25%; in the second year, 20%; and from the third year onward, 15%.** The Group felt that in the long term, it may be possible to move to a regime where options are priced at the prevailing market price at the time of grant as in some other countries. However, in an environment where even public issues are made at substantial discounts to the market price and where Employee Stock Options have traditionally been at very low prices, it would be difficult to make such a change immediately. It therefore believes that a phased transition is desirable. It would have the further benefit of encouraging a quick adoption of ESOPs as companies try to take advantage of the laxer accounting requirements in the early years.
- b) **The aggregate monetary value of the discount on all Employee Stock Options granted during any accounting year exceeds 20% of the total employee compensation as reported in the profit and loss account of that year.**

Both the above criteria are based on the intrinsic value of the option (the difference between the exercise price and the market price). In the long term, it would be more appropriate to base all regulations on the fair value of the option as determined for example by the Black-Scholes formula.

The Committee deliberated on the modalities of imposing an appropriate accounting standard on issuers. One view was that SEBI could mandate this directly by issuing a directive under Section 11 of the SEBI Act without waiting for an accounting standard to be issued by the accounting profession. **Without getting into the legal implications of this, the Group decided that voluntary adoption of such an accounting policy by the company should be made a pre-condition (an eligibility requirement) for availing of the new stock option scheme.**

**Subject to the above, the Committee recommends that Employee Stock Options would not be covered by the pricing provisions of SEBI's Preferential Allotment Guidelines.**

## Quantum

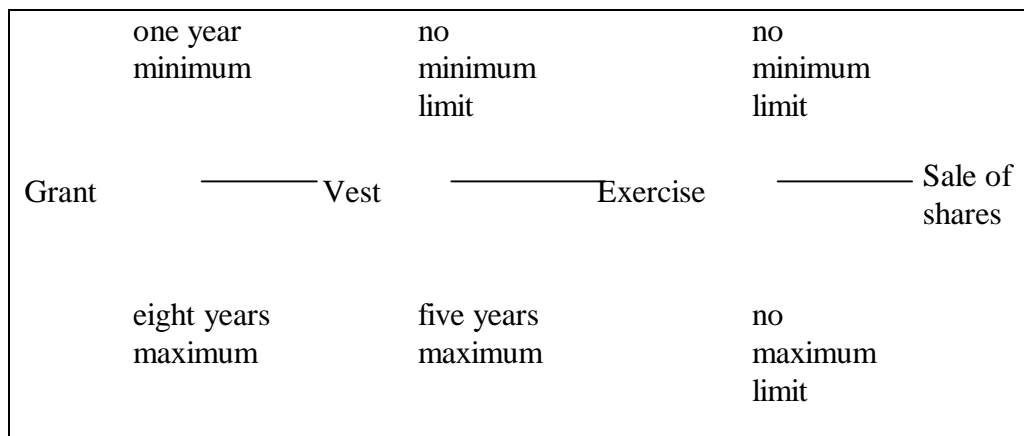
The Committee discussed at length the issue of whether there should be a ceiling on the quantum of Employee Stock Options that could be issued either in the aggregate or on a per employee basis. The Committee is of the view that **there is no need for an aggregate ceiling in view of the requirement for shareholder approval by special resolution.**

On the question of per employee limits, the Committee recognises that large option grants to a handful of employees could be abused by unscrupulous managements. On the other hand, it has been forcefully argued that there should be no fetters on the company's ability to reward stellar performers. The Committee therefore recommends **that large grants of stock options to specific employees should be individually voted on by the shareholders while approving the issue of Employee Stock Options.** The Committee agreed that **approval by shareholders by way of separate and specific shareholder resolution should be mandatory in case of employees who are granted stock options during any one year equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant.**

## Lock-in and vesting

The Committee discussed this issue at length and considered the four distinct events involved in stock options: (a) grant of the option, (b) vesting of the option (the point of time at which the option becomes exercisable), (c) the exercise of the option, and (d) the sale (if any) of the shares arising out of the option.

The Committee agreed that **there should be a minimum period of one year between the grant of options and its vesting.** Such a vesting period is customary in most Employee Stock Option schemes and is not therefore unduly restrictive. At the same time, it would make it more difficult for friendly take-overs to be disguised by issue of Employee Stock Options. It was also agreed that **employee options must vest within a maximum period of eight years from the date of grant and must be exercised within a maximum period of five years from the date of vesting.** This is intended to prevent a large overhang of unexercised options and also to reduce the scope of insider trading in the exercise of options. Diagrammatically, the position will be as follows:



### Safeguards

The Committee recommends that **the operation of the scheme should be under the superintendence and direction of a Compensation Committee of the Board of Directors in which there should be a majority of independent directors.** The Compensation Committee should approve the grant of options to individual employees. It should also put in place policies and systems to prevent the incidence of insider trading by employees in the course of the exercise of stock options.

### Definition of Employee

The Committee recommends that **stock option scheme should be open to all permanent employees (whether working in India or abroad) and to the directors of the company but not to promoters and large shareholders.** It also recommends that with specific approval of the shareholders, the scheme may cover employees of a subsidiary or a holding company.

### Disclosure

The disclosure (in the form of a direct earnings hit) in respect of options issued at substantial discount has already been discussed in 0 above. In addition, the following

disclosures would be required regardless of whether the stock options are issued at a discount or not:

- a) The total number of shares covered by the Employee Stock Option scheme as approved by the shareholders
- b) The pricing formula
- c) Options granted
- d) Options vested
- e) Options exercised
- f) Options forfeited
- g) Extinguishment or modification of options
- h) Money realised by exercise of options
- i) Total number of options in force
- j) Employee wise details of options granted to
  - senior managerial personnel
  - any other employee who receives a grant in any one year of options amounting to 5% or more of options granted during that year.
- k) Fully diluted Earnings Per Share (EPS) computed in accordance with international accounting standards.

### **Mechanism**

The Committee recommends that:

- a) It should not be mandatory to create an Employee Welfare Trust to administer the stock option scheme.**
- b) Stock options granted in ADRs and GDRs should be regarded as options on the underlying shares and regulated accordingly.**
- c) Stock options could be granted to employees of a subsidiary or a holding company with the specific approval of the shareholders.**

### **Stock options outstanding at public issue**

The Committee recommends that **the SEBI stipulations prohibiting an initial public offering by companies having outstanding options should not apply to**

**Employee Stock Options whether vested or not.** If any Employee Stock Options are outstanding at the time of an initial public issue by an unlisted company, the promoters' contribution shall be calculated with reference to the enlarged capital that would arise if all vested options are exercised. In all cases, however, full disclosure as discussed in 0 above would be required.

### **Employee Share Purchase Plans (ESPP)**

The Committee debated on the applicability of the proposed scheme to stock purchase plans as opposed to stock option plans. The Committee is of the view that **the principles of shareholder approval and full disclosure provide adequate safeguards to shareholders in case of ESPPs as well. The requirement for a minimum vesting period of one year would be replaced by the requirement of a minimum lock-in of one year. However, if the ESPP is part of a public issue and the shares are issued to employees at the same price as in the public issue, the shares shall not be subject to any lock-in.** Subject to these conditions, the Group recommends **that there should be no restriction on pricing or on the maximum number of shares to be issued to a single employee.** Companies should continue to have the alternative of issuing shares to employees in full compliance with the SEBI Guidelines on Preferential Allotment without subjecting themselves to the ESOP/ESPP guidelines.

### **Taxation**

The Group recognises that taxation of stock options does not come under the ambit of the Securities and Exchange Board of India (SEBI). However, some elements of the current taxation laws could become major impediments to the success of Employee Stock Option plans and the Group recommends that SEBI should take up this matter with appropriate authorities.

1. The Group recommends **that there should be no tax incidence at the time of grant of options** since at this time the options have not vested and the benefit to the employee is a mere contingency.
2. Taxation at the point of exercise of options also has its share of problems. It is necessary to avoid double taxation of the same amount both as a perquisite and later as a capital gain when the shares are sold. It is also necessary to avoid the asymmetry where employees are taxed on the perquisite value but the employer does not get a tax relief on this amount.
3. The National Task Force on Information Technology and Software Development has recommended that tax be charged only when the shares arising out of exercise of options are sold.

The Group agrees with the recommendation of the National Task Force on Information Technology and Software Development because it believes that a special treatment for ESOPs would enable their wider use and acceptance. The economy

would benefit from the increased employee commitment, productivity and performance that the ESOPs would bring in their wake.

While the Group recommends that **in terms of timing, the tax liability should be at the time of sale, it is of the view that the taxable income at this point of time could be partly in the form of a perquisite value (charged at normal tax rates) and partly in the form of capital gains (with the attendant concessional treatment)**. This is explained below in terms of a numerical example.

Market Price of Share	at time of grant	100
	at time of vesting	120
	at time of exercise	150
	at time of sale	190
Exercise price		75

Taxable income at the time of sale would have two components:

A.	Perquisite value	Market price at time of grant <i>less</i> exercise price	$100 - 75 = 25$
B.	Capital gains (subject to indexation etc.)	Sale price <i>less</i> cost of acquisition (equals market price at time of grant)	$190 - 100 = 90$
C.	Total	Sale price <i>less</i> exercise price	$190 - 75 = 115$



#### **14. RBI Exemption**

The Group recommends that the RBI may consider providing general permission under FERA for receiving, holding and exercising employee stock options and repatriating proceeds of the sale of shares resulting from such options.

**(Prof. J R Varma)**

**(Shri A K Narayan )**

**(Shri Chinubhai Shah)**

**(Dr Dinesh S Patel )**

**(Shri M K Khanna)**

**(Shri N R Narayana Murthy)**

**(Shri Nihal Kothari)**

**(Shri Nishith M Desai)**

**(Shri Saurabh Srivastava)**

**(Shri Shantha Raju)**

**(Shri Vijay Ranjan)**

**Mumbai, January 14, 1999**