

Draft Guidelines on Employee Stock Option Plans/ Employee Stock Purchase Plans (ESOP/ ESPP)

1 Definitions

i) Director

Director is a person who holds the office of Director under the Companies Act.

ii) Employee

Employee means:

- a) a permanent employee of the company working in India or abroad ; or
- b) a director of the company whether a whole time director or not
- c) an employee as defined in (a) or (b) above of a subsidiary, domestic or overseas, or of a holding company of the company.

i) Employee Compensation

Total employee compensation means the total cost incurred by the company towards employee compensation including basic salary, dearness allowance, other allowances, bonuses and commissions, and the value of all perquisites provided, but does not include

- a) the fair value of the options granted under an ESOP; and
- b) the price discount of shares issued under an ESPP.

i) Employee Stock Option Plan (ESOP)

Employee Stock Option Plan (ESOP) means a plan under which the company grants options to employees.

ii) Employee Stock Purchase Plan (ESPP)

Employee Stock Purchase Plan (ESPP) means a plan under which the company offers shares to employees as part of a public issue or otherwise.

iii) Exercise

The act of exercise implies an application being made by the employee to the company to have the options vested in him issued as shares upon payment of the option price. Exercise can take place as specified after vesting.

iv) Exercise period

Exercise period means the time period after vesting within which the employee should exercise his right to buy the shares by payment of the option price on the options vested in him. If the exercise period lapses the vested option lapses and no right shall accrue to the employee thereafter. The employee may exercise all the options vested in him in one stroke or choose to exercise a number of options within the exercise period. Unless shares are issued on exercise, the employee shall have no right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder.

v) Grant

Grant is a process by which an employee is given an option. It is the delivering of the options to the employee. The grant shall specify the number of options given, the time of vesting, etc.

vi) Independent Director

A director of the company who is not a promoter or part of the promoter group and who is not a whole time director.

vii) Market Price

Market Price of a share on a given date means the closing price on that date in the stock exchange on which it is listed. If the shares are listed on more than one stock exchange, but quoted only on one stock exchange on the given date, then the price on that stock exchange should be considered. If the share price is quoted on more than one stock exchange, then the stock exchange where there is highest trading volume during that date should be considered. If shares are not quoted on the given date, then the share price on the next trading day should be considered.

viii) Option

An option is a right but not an obligation granted to an employee under the ESOP to apply for and be allotted shares of the company at a price determined earlier, during or within a specific period of time, subject to the requirements of vesting.

ix) Option price/ grant price/ exercise price

An Option price/ grant price/ exercise price shall mean the price payable by the employee, determined by the Compensation Committee of the Board of the company for exercising the option granted to the him. In other words, this will be the price at which the employee will exercise his option.

x) Promoter and Promoter Group:

Promoter and promoter group shall be as defined in Clarification XIII of the Disclosure and Investor Protection Guidelines. Where a promoter of a company is a body corporate, the promoters of that body corporate shall also be deemed to be promoters of the company.

xi) Share

Share means equity shares, non voting shares (as and when introduced) and securities convertible into equity shares or non voting shares and shall include ADRs, GDRs or other depository receipts representing underlying equity shares, non voting shares or securities convertible into equity shares or non voting shares.

xii) Subsidiary/ holding company:

Subsidiary and holding company shall be as defined in Section 4 of Companies Act, 1956

xiii) Up-front payment

Up-front payment means amount, if any, payable by the employee at the time of grant of option. This amount may be adjusted against the exercise price payable subsequently for acquiring the shares on exercising the options. This up-front amount payable for the options would stand forfeited if the options are not exercised and may be refunded to the employee if the options are not vested, due to severance of employment.

xiv) Vesting

Vesting means the process by which the employee gets the right to apply for and be issued shares of the company under the options granted to him. Till the vesting takes place, the employee does not have a right to apply for the shares. Upon vesting, the employee gets an unfettered right to apply for the issue of shares upon fulfilment of the conditions. In the event of an employee resigning from the services of the company or his employment being terminated for whatever reasons, all unvested options shall expire as on that date, but the employee would, subject to 2.7.4 (a), retain all the vested options.

xv) Vesting period

Vesting period means the period over which the vesting of the options of the employee takes place. Vesting period can be a single time period or a series of time periods. In other words, vesting can take place in one stroke or in staggered time periods. For example, an employee may become entitled to have 500 options vested in him at the end of three years or of the 500 options granted to him, have 100 options vested in him at intervals of 12 months each.

1.2 Applicability

1.2.1 These Guidelines shall apply to any company whose shares are listed on any stock exchange in India.

- 1.2.2 These guidelines will come into force with immediate effect. The stock exchanges are being advised separately that the shares issued pursuant to an ESOP would be eligible for listing only if such instruments were in accordance with these Guidelines.

2 Operation of Employee Stock Option Plans

2.1 Scope of Stock Option Plans

- 2.1.1 An employee who is a promoter or a part of the promoter group shall not be eligible to participate in the Employee Stock Option Plan of the company.
- 2.1.2 A director who either by himself or through his family or through any investment company, directly or indirectly holds more than 10% of the outstanding equity shares of the company shall not be eligible to participate in the Employee Stock Option Plan.

2.2 Shareholder Approval

- 2.2.1 The ESOP shall be approved by the shareholders by a special resolution. The resolution shall contain terms and conditions of the Plan which *inter-alia* shall include the following:
- a. Identification of classes of beneficiaries entitled to participate In the ESOP.
 - b. Vesting of the Stock Option
 - c. Period of exercise and process of exercise.
 - d. Exercise price or pricing formula.
 - e. The appraisal process for determining the eligibility of employees to the Stock Option Plan.
 - f. Upper limit on the quantum of stock options to be issued in the aggregate.

The special resolution shall also state that the company shall conform to the accounting policies mandated in 3.2.1.

- 2.2.2 Specific shareholder approval shall be obtained in the case of grant of stock options to employees of subsidiary /holding company
- 2.2.3 Grant of stock options to specific employees, 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 shall be subject to approval by the shareholders by way of separate resolution.
- 2.2.4 In extra ordinary situations, the company in general meeting may by special resolution vary the terms of options granted but not yet exercised in a manner not prejudicial to the interests of the option holders. The notice for such resolution shall provide full

details of the beneficiaries of such variation of terms and the rationale therefor. The provisions of 2.2.2 and 2.2.3 shall apply to such variation of terms as they do to the original grant of options.

2.3 Pricing

2.3.1 The companies will have the freedom to fix the exercise price at any level provided they conform to the accounting policies mandated in 3.2.1.

2.4 Stock Options outstanding at Public Issue

2.4.1 The provisions of the SEBI guidelines prohibiting initial public offering by companies having outstanding options shall not apply to employee stock options.

2.4.2 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.

2.4.3 If any employee stock options are outstanding at the time of a public issue, the offer document shall disclose all the information enumerated in 3.1.1.

2.5 Lock-in period, vesting and exercise of options

2.5.1 There should be a minimum period of one year between the grant of options and vesting.

2.5.2 There should be a maximum period of eight years between the grant of options and vesting.

2.5.3 Employee options must be exercised within a maximum period of five years from the date of vesting.

2.5.4 Shares issued in exercise of options shall not be subject to any lock-in period.

2.6 Non transferability of stock options

2.6.1 Options shall not be transferable, and only the employee shall be entitled to exercise the options. They can not be pledged, hypothecated, mortgaged or otherwise alienated in any other respect. However, the company may allow cashless system of exercise under which empanelled stock brokers (or, subject to company law requirements, the company itself) may fund the exercise price of the options against the sale proceeds of part or whole of the shares arising out of the exercise.

2.6.2 In the event of the death of the employee, while in employment, all the options granted to him as on the date of death shall pass along his estate and shall be fully vested in his estate as on that date and may be claimed by his legal heirs.

2.6.3 In the event that the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall fully vest in him on such date.

2.7 Compensation Committee of the Board

2.7.1 The Scheme would be administered under the superintendence and direction of a Compensation Committee of the Board of Directors. The Compensation Committee shall consist of a majority of independent directors.

2.7.2 The quantum of issue of options under an Employee Stock Option Plan to employees both in the aggregate and to any single employee shall be determined by the Compensation Committee subject to the limits laid down by the company in general meeting.

2.7.3 The Compensation Committee should put in place policies and systems to guard against violations of the SEBI (Insider Trading) Regulations, 1992 by employees in the course of the exercise of stock options.

2.7.4 The Compensation Committee shall formulate the detailed terms and conditions of the option scheme including

- a) the conditions under which options vested in employees may lapse in case of termination of employment for misconduct.
- b) the procedure for making 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
- c) the grant, vesting and exercise of options in case of employees who are on long leave or sabbatical
- d) the procedures for cashless exercise of options

2.7.5 The Compensation Committee may provide that in the event of an employee resigning from the services of the company or his employment being terminated for whatever reasons, the employee should exercise the vested options within a specified period after such resignation or termination.

3 Disclosure, accounting policies and audit

3.1 Directors' Report

3.1.1 Board of Directors shall disclose either in the Directors Report or in the annexure to the Director's Report, the following details of the Stock option plan:

- 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) diluted Earnings Per Share (EPS) calculated in accordance with International Accounting Standard (IAS) 33

3.2 Accounting Policies

3.2.1 In respect of options granted during any accounting period, the accounting value of the options shall be treated as another form of employee compensation in the financial statements of the company. The accounting value of options shall be equal to the maximum of:

- a) the aggregate over all employee stock options granted during any accounting period of the excess of the fair value of the option over the specified percentage of the market value of the share on the date of grant of the option; or
- b) excess of the aggregate of the option discounts on all employee stock options granted during any accounting period over 20% of the total employee compensation as reported in the profit and loss account of that period.
- c) zero.

For this purpose:

1. 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.
 2. Option discount means the excess of the market price of the share at the time of grant of the option over the exercise price of the option (including up-front payment if any)
 3. Specified percentage means 25% in case of options granted within 12 months of the effective date, 20% in case of options granted during the 13 to 24 months after the effective date, and 15% in case of options granted after 24 months of the effective date. Effective date is the date on which these guidelines come into effect.
- 3.2.2 Where the accounting value is accounted for as employee compensation in accordance with 3.2.1, the amount shall be amortised on a straight-line basis over the vesting period.
- 3.2.3 When an unvested employee stock option lapses by virtue of the employee not conforming to the vesting conditions after the accounting value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense equal to the amortized portion of the accounting value of the lapsed options and a credit to deferred employee compensation expense equal to the unamortized portion.
- 3.2.4 When a vested employee stock option lapses on expiry of the exercise period, after the accounting value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense.
- 3.2.5 The accounting treatment prescribed above can be illustrated by the following numerical example. Suppose a company grants 500 options on 1/4/1999 at Rs 40 when the market price is Rs 160, the vesting period is two and a half years, the maximum exercise period is one year and the total employee compensation for the year 1999-2000 is Rs 900,000. Also supposed that 150 unvested options lapse on 1/5/2001, 300 options are exercised on 30/6/2002 and 50 vested options lapse at the end of the exercise period. The accounting value of the option being the maximum of:
- a) $500 \times [(160-40) - 25\% \times 160] = 500 \times [120 - 40] = 500 \times 80 = 40,000$
 - b) $500 \times (160-40) - 10\% \times 900,000 = 60,000 - 90,000 = -30,000$
 - c) zero
- would be equal to Rs 40,000.

The accounting entries would be as follows:

1/4/1999	Deferred Employee Compensation Expense Employee Stock Options Outstanding (Grant of 500 options at an accounting value of Rs 80 each)	40,000	40,000
31/3/2000	Employee Compensation Expense Deferred Employee Compensation Expense (Amortisation of the deferred compensation over two and a half years on straight-line basis)	16,000	16,000
31/3/2001	Employee Compensation Expense Deferred Employee Compensation Expense (Amortisation of the deferred compensation over two and a half years on straight-line basis)	16,000	16,000
1/5/2001	Employee Stock Options Outstanding Employee Compensation Expense Deferred Employee Compensation Expense (Reversal of compensation accounting on lapse of 150 unvested options)	12,000	9,600 2,400
31/3/2002	Employee Compensation Expense Deferred Employee Compensation Expense (Amortisation of the deferred compensation over two and a half years on straight-line basis)	5,600	5,600
30/6/2002	Cash Employee Stock Options Outstanding Paid Up Equity Capital Share Premium Account (Exercise of 300 options at an exercise price of Rs 40 each and an accounting value of Rs 80 each)	12,000 24,000	3,000 33,000
1/10/2002	Employee Stock Options Outstanding Employee Compensation Expense (Reversal of compensation accounting on lapse of 50 vested options at end of exercise period)	4,000	4,000

The T-Accounts for Employee Stock Options Outstanding and Deferred Employee Compensation Expense would be as follows:

Employee Stock Options Outstanding Account					
1/5/2001	Employee Compensation/Deferred Compensation	12,000	1/4/1999	Deferred Compensation	40,000
30/6/2002	Paid Up Capital/Share Premium	24,000			
1/10/2002	Employee Compensation	4,000			
		<u>40,000</u>			<u>40,000</u>

Deferred Employee Compensation Expense Account					
1/4/1999	ESOP Outstanding	40,000	31/3/2000	Employee Compensation	16,000
			31/3/2001	Employee Compensation	16,000
			1/5/2001	ESOP Outstanding	2,400
			31/3/2002	Employee Compensation	5,600
		<u>40,000</u>			<u>40,000</u>

Employee Stock Options Outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Equity. Deferred Employee Compensation will appear in the Balance Sheet as a negative item as part of Net Worth or Shareholders' Equity.

3.3 Certificate from Auditors

- 3.3.1 In the case of every company that has passed a resolution for an Employee Stock Option scheme under 2.2.1 of these guidelines, the Board of Directors shall at each annual general meeting place before the members a certificate from the auditors of the company that the scheme has been implemented in accordance with these guidelines and in accordance with the resolution of the company in general meeting.

4 Employee Stock Purchase Plan (ESPP)

4.1 Scope of Employee Stock Purchase Plans

- 4.1.1 An employee who is a promoter or a part of the promoter group shall not be eligible to participate in the Employee Stock Purchase Plan of the company.
- 4.1.2 A director who either by himself or through his family or through any investment company, directly or indirectly holds more than 10% of the outstanding equity shares of the company shall not be eligible to participate in the Employee Stock Purchase Plan.

4.2 Shareholder Approval

- 4.2.1 The ESPP shall be approved by the shareholders by a special resolution which shall specify the price of the shares and also the number of shares to be offered to each employee. The number of shares offered may be different for different categories of employees. The special resolution shall state that the company shall conform to the accounting policies mandated in 4.4.2.

4.3 Pricing and Lock-in

- 4.3.1 Companies shall have full freedom to price the shares under an ESPP at any level provided they conform to the provisions of 4.4.2.
- 4.3.2 Shares issued under an ESPP shall be locked in for a period 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

4.4 Disclosure and Accounting Policies

- 4.4.1 The details of the shares issued under the ESPP and the terms and conditions thereof shall be disclosed in the Directors' report or in an annexure thereto.
- 4.4.2 In respect of shares issued under an ESPP during any accounting period, the accounting value of the shares so issued shall be treated as another form of employee compensation in the financial statements of the company. The accounting value of shares issued under ESPP shall be equal to the maximum of:
- a) the aggregate over all shares issued under ESPP during any accounting period of the excess of the price discount over the specified percentage of the market value of the shares on the date of issue;
 - b) the excess of the aggregate of the price discounts on all shares issued under ESPP during any accounting period over 20% of the total employee compensation as reported in the profit and loss account of that period;

c) zero.

For this purpose:

1. Price discount means the excess of the market price of the shares at the date of issue over the price at which they are issued under the ESPP.
2. Specified percentage means 25% in case of shares issued within 12 months of the effective date, 20% in case of shares issued during the 13 to 24 months after the effective date, and 15% in case of shares issued after 24 months of the effective date. Effective date is the date on which these guidelines come into effect.

4.4.3 The accounting treatment prescribed above can be illustrated by the following numerical example. Suppose a company issues 500 shares on 1/4/1999 under an ESPP at Rs 40 when the market price is Rs 160 and the total employee compensation for the year 1999-2000 is Rs 900,000. The accounting value of the shares being the maximum of:

a) $500 \times [(160-40) - 25\% \times 160] = 500 \times [120 - 40] = 500 \times 80 = 40,000$

b) $500 \times (160-40) - 10\% \times 900,000 = 60,000 - 90,000 = -30,000$

c) zero

would be equal to Rs 40,000.

The accounting entry would be as follows

1/4/1999	Cash	20,000	
	Employee Compensation Expense	40,000	
	Paid Up Equity Capital		5,000
	Share Premium Account		55,000
	(Issue of 500 shares under ESPP at a price of Rs 20 each when market price is Rs 100)		

4.5 *Preferential Allotment*

Nothing in these guidelines shall apply to shares issued to employees in full compliance with the SEBI Guidelines on Preferential Allotment.