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Indian Regulatory Framework

Implementation of employee stock option plan (ESOP) by an Indian company is governed by the Companies Act, 2013 (Companies Act). If the Indian company is listed on a stock exchange in India or an insurance company, then the regulations notified by Securities and Exchange Board of India (“**SEBI**”) viz., SEBI (Share Based Employee Benefits) Regulations, 2014 (SBEB Regulations) have to be complied with. Furthermore, if the Indian company is proposing to implement ESOP for the benefit of its employees in offshore jurisdictions or employees of its offshore subsidiaries, then the regulations framed under Foreign Exchange Management Act, 1999 will also have to be observed.

A. Adoption of ESOP

Companies Act read with Companies (Share Capital and Debenture Rules), 2014 (Rules) provides that a company can issue shares to its employees under an ESOP provided certain conditions are met. In case the company is listed on Indian stock exchanges, then any implementation of plans in the nature of ESOP have to be in accordance with SBEB Regulations. The conditions mentioned under the Companies Act and SBEB Regulations

are similar in relation to the following matters:

- (i) Exceptions to issuance of ESOP: Benefit under an ESOP can only be offered to employees of the Indian company and/or its holding or subsidiary company. It cannot be offered to directors holding more than 10% of issued and paid-up capital of the Indian company, independent directors or to promoters. In case of unlisted company which is a start-up registered with Department for Promotion of industry and Internal Trade, this exception is not applicable. This means that a registered start-up can even issue benefits under ESOP to a promoter.
- (ii) Shareholders resolution: A company is required to obtain a special resolution of the shareholders for adoption and implementation of an ESOP. Separate shareholders’ resolutions are required in case the Indian company proposes to issue benefits under ESOP to the employees of its subsidiary

company and/or holding company. Furthermore, separate shareholder resolution is also required in the event the Indian company proposes to issue benefit under an ESOP which translates into more than 1% of issued capital of the company on the date of grant.

- (iii) Amendment to ESOP: An amendment to ESOP can only be undertaken by way of shareholders resolution provided that the amendment is not detrimental to the interests of the employees.
- (iv) Minimum vesting period: There should be minimum 1 year vesting period between grant of benefit and allotment of shares pursuant to grant.
- (v) Accelerated vesting: In case of death or termination of employment due to permanent disability of an employee who holds benefits under ESOP, then all the benefits will be considered to have vested on the date of demise / termination of employment.

While a listed company is mandated to administer ESOP through a nomination and remuneration committee of the company (NRC) constituted under Section 178 of the Companies Act, if an unlisted company is required to have an NRC then such a company will also have to administer the ESOP through the NRC (as against its board or any committee formed by the board).

A company can also make use of an employee welfare trust (EWT) for the purpose of transferring shares to its employees on exercise of benefit under ESOP. However, the law is unclear on the aspect if there is a fresh issuance of shares to the EWT whether such issuance has to be on a fair value basis or can it be equivalent to the exercise price (which is often discounted vis-à-vis the fair value of the shares).

The Companies Act allow extending of loans by a company (be it listed or unlisted) to an EWT to enable purchase / subscription of shares for the benefit of employees provided it complies, inter alia, the following conditions:

- (i) The loan can be extended to the EWT only upon receiving shareholders' approval vide a special resolution.
- (ii) If the loan has been extended for the purpose of purchasing shares, then:
 - a. in case of listed company: shares can be purchased only through a recognised stock exchange;
 - b. in case of unlisted company: shares can be purchased at a value determined by a registered valuer.
- (iii) The value of the shares to be purchased or subscribed in the aggregate together with the money provided by the company cannot exceed 5% of the aggregate of the

paid-up capital and free reserves of the company.

The Companies Act also mandate that the accompanying explanatory statement seeking shareholders' approval for the purpose of granting of loan to an EWT need to have a number of disclosures including the particulars of the employees and trustees, interest of key managerial personnel, directors or promoters in the scheme being implemented by EWT. Further, the trustees of such EWT cannot be: (a) a director, a key managerial personnel or a promoter of the company or its holding or subsidiary company or associate company or any relative of the foregoing individuals; or (b) a person who beneficially holds more than 10% of the paid-up share capital of the company.

In case, the voting rights in the shares held by the EWT are not being exercised by the employees then the board of directors in its report have to disclose the details, inter alia, the reason for not exercising such voting rights.

B. Listed company, EWT, ESOP, etc.

It is pertinent to note that SBEB Regulations not only allow implementation of classic ESOP by a listed company but also the following kind of share-based incentive plans:

- stock appreciation rights plan – where the upside in the value of the shares is settled in cash and/or shares of the company;

- employee stock purchase plan – where shares are allotted upfront at a discounted price; however the shares are subject to a lock-in;
- general / retirement benefits plan – where shares of the listed company implementing the plan, are used for implementing welfare schemes for the employees.

In case of listed company, at the time of adoption of ESOP, they have to get an in-principle approval from the stock exchanges, procure a merchant's banker certificate and file the same along with the plan documents with the stock exchanges.

A shareholders' approval is required for implementation of employee incentive schemes by a listed company through an EWT. In the event, the company envisages funding of shares for the incentive scheme through a secondary acquisition, then implementation of such a scheme has to be via an EWT. The trust deed under which the EWT is settled has to have the minimum provisions as prescribed by SEBI. The shares held by the trustees of an EWT are designated as 'non-promoter; non-public' shareholding and they are prohibited from voting on the same.

An EWT in a particular year cannot acquire shares through secondary mode beyond 2% of the paid-up equity capital of the company as at the end of the previous financial year. Furthermore, the overall holding of shares by an EWT through a secondary acquisition cannot exceed 5% of the

paid-up equity share capital as at the end of the financial year immediately preceding the year in which the shareholder approval was obtained for such acquisition.

An EWT is required to hold the shares acquired through secondary acquisition for a minimum period of 6 months except when transferring to the employees in accordance with the schemes, participating under an open offer, buy-back, delisting or any other exit offered by the company generally to its shareholders.

The EWT is also required to make disclosures and comply with other requirements applicable to insiders or promoters under SEBI (Prohibition of Insider Trading) Regulations, 1992.

C. Ongoing obligations

A company (be it listed or unlisted) implementing ESOP (or similar incentive schemes) is required to disclose the details of ESOP annually in the directors' report. In case of listed companies, the board of directors is required to obtain a certificate from the auditors and place it before the shareholders in the annual general meeting certifying that ESOP (and related incentive schemes) are in accordance with SBEB Regulations. Further, there are certain other disclosure requirements under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 that the listed company

would have to observe at the time of adoption of ESOP, granting and exercise of benefits under the ESOP.

D. Offshore Employees

As per Foreign Exchange Management (Non-debt Instruments) Rules, 2019, an Indian company may issue benefits under ESOP to its employees or directors or employees/directors of its holding company, joint venture or wholly owned subsidiary who are resident outside India provided that:

- (i) the ESOP has been drawn in terms of applicable law (Companies Act, SBEB Regulations)
- (ii) the shares being issued under ESOP will be in accordance with the sectoral caps applicable to the company
- (iii) if foreign investment in the company requires prior government approval, then issuance of options/benefits under ESOP will require prior government approval. Further, if the options are proposed to be issued to a citizen of Bangladesh or Pakistan, then too a prior government approval will be required.

Any option/benefit that is issued to an employee prior to he/she becoming a person resident outside India, can exercise the option and the shares so allotted will be held on a non-repatriable basis.

