PRIMER ON ISSUANCE OF EMPLOYEE STOCK OPTIONS

Employee Stock Options ("**ESOPs**") is one of the effective ways of incentivizing employees of an organization all over the world. For early stage / startup companies, granting of ESOPs is a preferred option to hire, retain and reward senior level employees as well new talent.

This primer focuses on the regulatory framework governing implementation and grant of ESOPs by companies in India.

1. **Are ESOPs regulated under Indian law?**

   Issuance of ESOPs by an Indian company has to be in accordance with the provisions of Companies Act, 2013 ("**Companies Act**") and rules including, the Companies (Share Capital and Debenture) Rules, 2014. Additionally, issuance of ESOPs by Indian listed companies are regulated by the laws framed and implemented by the Securities and Exchange Board of India ("**SEBI**"), including the SEBI (Share Based Employee Benefits) Regulations, 2014 ("**SEBI (SBEB) Regulations**").

   Typically, a company while designing ESOP plans may prescribe additional terms and conditions.

2. **Are there any restrictions on types of employees to whom a company may issue ESOPs under Indian law?**

   A company can issue ESOPs to permanent employees- whether working in India or outside India, directors of the company, employees of a subsidiary company in or outside India or of the holding company of such subsidiary company.

   However, a company (other than a start-up company) cannot issue ESOPs to the following persons:

   (i) Promoters of the company;

   (ii) Directors whose shareholding exceeds 10% (ten) percent of the equity share capital of the company. For the purposes of calculating the director's shareholding, the shareholding of such director's relatives and indirect shareholding through a body corporate is also taken into consideration.

(iii) Independent directors.

A company which is recognized as a start-up by the Department for Promotion of Industry and Internal Trade (“**DPIIT**”) may issue ESOPs to promoters and directors whose shareholdings exceed the above-mentioned 10% (ten) percent threshold.

3. **Is a company required to obtain any approvals for issuance of ESOPs?**

A company must obtain approval of its shareholders by way of passing a special resolution. Details of total number of ESOPs granted, eligible employees and appraisal process of such employees, vesting period and conditions, exercise price and formula, exercise process and price, lock-in period, conditions under which the ESOPs will lapse etc. are required to be specified in the explanatory statement to the notice for convening the shareholders’ meeting.

Issuance of ESOPs by a company to employees’ resident outside India will require additional compliance with the provisions of the Foreign Exchange Management Act, 1999 and the rules and regulations issued thereunder. If a company proposes to issue ESOPs to a person resident outside India whose investment is subject to governmental approval under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, then issuance of such ESOPs will also require governmental approval.

4. **What are the rights available to an ESOP holder? Does an ESOP holder have the same rights of as a shareholder?**

An ESOP holder has the right but not the obligation to exercise the ESOP once such ESOP is vested. Once the ESOPs are vested, the ESOP Holder has a right to subscribe to the underlying equity shares of the company at a future date and at a pre-determined price.

Vesting means completion of the process by which an employee becomes eligible or entitled to receive the benefit under the ESOP granted to him / her by the company. The company may at its sole discretion prescribe conditions for vesting of the ESOP such as time-period or performance conditions.

An ESOP Holder is not at par with shareholders of a company. An ESOP Holder will not be entitled to benefits enjoyed by shareholders such as the right to receive dividend, right to vote or any other rights until equity shares are issued to the ESOP Holder pursuant to exercise of the ESOP.

5. **Are ESOPs transferable?**

ESOPs granted to employees are not transferable to any other person. ESOPs can be exercised only by employees to whom the ESOPs have been granted. However, in the event of the death or permanent incapacity of the employee, the ESOP may, if permitted under the ESOP scheme (“**ESOP Scheme**”), vest with his / her legal heirs or nominees.

6. **Can ESOPs be pledged, hypothecated, mortgaged, encumbered?**

ESOPs granted to employees cannot be pledged, hypothecated, mortgaged, encumbered, alienated in any manner.

7. **Can amounts paid by employees at the time of grant of ESOPs be forfeited?**

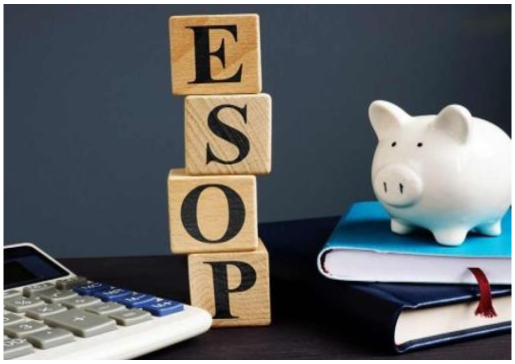
The company may forfeit amounts paid by an employee at the time of grant of ESOP in case such employee fails to exercise the ESOP within the exercise period.

8. **Can the amounts paid by employees at the time of grant of ESOPs be refunded?**

The amounts payable by employees at the time of grant of ESOPs may be refunded if the options are not vested due to non-fulfillment of conditions relating to vesting as per the ESOP Scheme.

9. **What are the implications on ESOPs granted to an employee on his / her permanent incapacitation and termination / resignation?**

In case an employee suffers a permanent incapacity while in employment, all options granted to him / her as on the date of permanent incapacitation, shall vest in him / her on that day.



In the event of resignation / termination of employment, all options not vested in the employee as on that day shall expire. However, the employee can exercise the ESOPs granted to him / her which are vested within the specified period, subject to the terms and conditions of the ESOP Scheme.

10. **What are the compliances prescribed under the Companies Act for adoption of ESOP?**

A company is required to file the following e-Forms with the Registrar of Companies: e-Form MGT-14 within 30 (thirty) days from date of passing a board resolution for issue of ESOPs (except private limited companies); e-Form MGT-14 within 30 (thirty) days of passing special resolution for issuance of ESOP; and e-Form PAS-3 within 30 (thirty) days of allotment of equity shares pursuant to exercise of ESOPs.

In addition, the company is required to disclose details of ESOPs in its directors' report and maintain statutory registers for ESOPs in accordance with Companies Act.

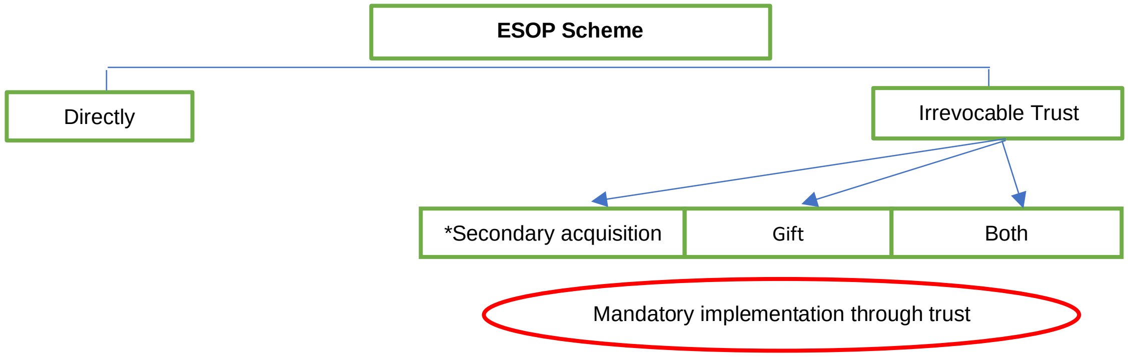
11. **Is a company required to make any filings with the Reserve Bank of India for issuance of ESOPs to persons resident outside India?**

In case of issuance of ESOPs to employees who are residents outside India, such company will have to file with the Reserve Bank of India: (a) Form ESOP within 30 (thirty) days of such issuance; and (b) file Form FC-GPR within 30 (thirty) days of issuance of equity shares further to ESOPs.

12. **What the additional compliances to be undertaken by a listed company under SEBI (SBEB) Regulations?**

(i) The compensation committee of the listed entity shall be responsible for formulating detailed terms and conditions of the ESOP Scheme, and for administration and superintendence of the ESOP Scheme.

(ii) A listed company may implement the ESOP Scheme in the following manner:



**'Secondary acquisition' means an acquisition of existing shares of the company by the trust through a recognized stock exchange for cash consideration.*

In case of implementation of ESOP Scheme through a trust, SEBI may specify minimum provisions to be included in a trust deed which along with any modifications shall be mandatorily filed with the stock exchange where the company's shares are listed. The following persons cannot be appointed as trustees: (a) director, (b) key managerial personnel, (c) promoter of the company / holding / subsidiary / associate company, (d) relative of such director, key managerial personnel, promoter or (e) persons beneficially holding 10% (ten) percent or more of the paid-up share capital of the company.

(iii) The trustee should ensure that appropriate shareholders' approvals have been sought so as to enable implementation of the ESOP through trust and undertake secondary acquisition.

(iv) Secondary acquisition in a financial year shall not exceed 2% (two) percent of the paid-up share capital as at the end of the previous financial year.

(v) The limit of total number of equity shares under secondary acquisition held by a trust with respect to ESOP Scheme shall not exceed 5% (five) percent. These limits are based on the paid-up share capital as at the end of the financial year immediately preceding the year in which shareholders' approval was sought for such secondary acquisition.

13. **What are the differences between an ESOP and sweat equity shares?**

Sr. No.	Heading	ESOP	Sweat Equity Shares
1.	**Nature**	ESOP is an option of the employee to subscribe to equity shares of a company and subject to fulfillment of vesting conditions.	Sweat equity shares are shares which are issued by a company to employees and directors at a discount or for consideration other than cash for providing know-how or for making available rights in the nature of intellectual property rights or value additions.

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2.	**Voting and Dividend Right**	Not applicable until the employee subscribes to equity shares of the company pursuant to exercise of ESOP.	Sweat equity shares entitles the employee to voting rights and dividend rights depending upon the class of shares issued to the employee.
3.	**Restriction on issuance to certain employees and directors**	ESOPs cannot be issued to: (i) an employee who is a promoter or a person belonging to a promoter group; and (ii) independent directors and directors whose shareholding either through himself or through his relatives in the company exceeds 10% (ten) percent of the equity share capital of the company.	Exclusion is not applicable. However, relationship of directors or employees with promoter and / or key managerial personal is required to be disclosed in the notice of convening shareholders' meeting for issuance of sweat equity shares. Additionally, the director's report is required to disclose the individual names of allottees holding 1% (one) percent or more of the issued share capital.
4.	**Valuation**	The company has the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.	The sweat equity shares shall be issued at a price determined by a registered valuer that is the fair value.
5.	**Lock-in period**	Minimum lock-in period in respect of shares issued pursuant to exercise of ESOPs can be determined by the company.	Minimum lock-in period is 3 (three) years from the date of allotment of sweat equity shares.
6.	**Vesting Period**	Minimum vesting period is 1 (one) year from the date of grant of options. Post the expiry of the vesting period, the employee can subscribe to equity shares of the company in accordance with the ESOP Scheme.	Not applicable
7.	**Issuance thresholds**	In case the options issued to employees during a year is equal to or exceeds 1% (one) percent of the issued share capital of the company, then such issuance is required to be approved through a special resolution at the company's shareholders' meeting.	Aggregate sweat equity shares issued by a company should not exceed: (i) 25% (twenty-five) percent of the paid-up equity share capital of the company at any time; and (ii) higher of 15% (fifteen) percent of the paid-up share capital of

Sr. No.	Heading	ESOP	Sweat Equity Shares
			the company in a year; or shares of issue value of INR 5 crores (Indian Rupees Five crores) However, a start-up company may issue sweat equity shares not exceeding 50% (fifty) percent of its paid-up share capital up to 10 (ten) years from the date of its incorporation / registration.
8.	**Taxation**	While ESOPs are a non-cash incentive, there is a taxation element to it - two stages with respect to charge of tax on shares allotted under ESOP: (i) First charge – This occurs upon completion of vesting period and during exercise period - the event being exercise of options under the ESOP scheme when equity shares are allotted to the employee after he / she has exercised his / her option to purchase shares against ESOPs. (ii) Second charge – This occurs when the employee opts to sell the allotted (i.e. purchased) equity shares under the ESOP. At the time of allotment of equity shares on the exercise date, the difference between fair market value ("**FMV**") of the equity shares as on exercise date and the amount that employee have paid for the exercise or subscription to the equity shares is calculated and taxed accordingly. The FMV will be determined by a registered valuer as on the date of exercise of the option. This taxable value is called perquisite value. This difference calculated is eligible for tax deducted at source ("**TDS**") deduction by the company and forms part of salary of the employee. Thus, even if there is no	Just like ESOPs, sweat equity shares acquired by an employee would be subject to taxation in hands of employee as salary income i.e. perquisite. The perquisite value would be the excess of FMV of shares as on date of issue by the company to an employee over the amount actually paid by or recovered from an employee in respect of such shares. When an employee sells the abovementioned sweat equity shares acquired by him, profits made by him are taxed as capital gains earned during the year. These capital gains are calculated by subtracting the above FMV from the sales consideration of such shares.

Sr. No.	Heading	ESOP	Sweat Equity Shares
		cash flowing from employer (company) to the employee at the time of exercise of ESOPs, such taxation leads to huge cash outflow in hands of the employee. When an employee opts to sell the equity shares previously allotted under the ESOP, profits made by him / her are taxed as capital gains earned during the year. These capital gains are calculated by subtracting the FMV as on the exercise date from the sales consideration of such equity shares.	