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Theme 198

EMPLOYEE STOCK OPTION PLANS (ESOP)

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SOUTH INDIAN Bank

Experience Next Generation Banking

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Experience Next Generation Banking

The South Indian Bank Ltd., H.O. : 'S.I.B. House', Thrissur, Kerala

Theme No. 198 : EMPLOYEE STOCK OPTION PLANS (ESOP)

Employee Stock Option Plans (ESOP) have been in vogue for over a decade in India and they still create excitement and hope among employees to own shares of the employer company and create wealth all on a sudden in tandem with movements in stock market. Human Resource professionals and Managements, especially in ICE Sector (Information Technology, Communication and Entertainment), pharmaceutical and tech driven companies use ESOPs as a tool to reward and motivate employees.

What is a stock option?

ESOP is abbreviated form of Employees Stock Option Plan. Under this plan, the employees get an option to acquire shares of their employer company over a period of time at a reduced price. ESOP is a kind of incentive to hold the employees to the company's fold. Therefore, question of taxing this perquisite and capital gains at the time of sale of shares received by the employees arise.

Why is an option valuable?

An option is valuable as it gives you a right, with no obligation, to purchase the shares at a pre-set price. As a result, if the shares increase in value, you will be able to purchase the shares at the lower option price provided the options have vested. However, if the share price decreases and goes down below the exercise price after the option is granted and vested, you may choose not to exercise the options.

What is vesting of ESOP?

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 retain all the vested options.

Vesting has two components – vesting percentage and vesting period. Vesting percentage refers to that portion of total options granted, which you will be eligible to exercise. Vesting period is the period on the completion of which the said portion can be exercised. Vesting period can be a single time period or a series of time periods. Inother words, vesting can take place in one stroke or in staggered time periods. The following table presents an example of an employee who is granted 1000 options on January 1, 2008 with a vesting schedule of 30%, 30% and 40% at the end of 1st year, 2nd year and 3rd year from the date of grant respectively.

Vesting Details	Date of grant: January 1, 2008		
	1st Vesting	2nd Vesting	3rd Vesting
Percentage	30%	30%	40%
Date	Jan. 1, 2009	Jan. 1, 2010	Jan. 1, 2011
Options vested	300	300	400

What is exercise of options and exercise price?

The activity of converting the options granted to you into shares by paying the required exercise price is known as exercise of options. Exercise price is the price that you have to pay to convert the options into shares e.g. if the options are granted at an exercise price of Rs.30 and you want to exercise 300 options then you have to pay Rs. 9,000 (30 x 300). Exercise period is the period within which you can decide to exercise your options and this period starts from the date of vesting.

What is the new taxation scheme of ESOP?

The new scheme of taxation of Employees Stock Option Plan initiated by Finance Bill passed on 11th May 2007 and effective from 1/4/2007 is as follows :No taxation of perquisite in hands of employees. Employer has to pay Fringe Benefit Tax at the time of vesting of shares in Employees. Employee has to pay capital gains tax at the time of sale of shares received under ESOP, if sold within one year from the date of allotment.

How the value for fringe benefit on ESOP computed?

Fair market value (FMV) of shares has to be taken for valuation purpose. The valuation date for FMV is the date on which the shares are vested in employee. The value of fringe benefit shall be FMV reduced by amount paid by employee. The applicable FBT (Fringe Benefit Tax) will be charged and it has to be paid by the employer company.

What happens when employer sells the shares received under ESOP?
The gains shall arise on sale of those shares. The value of capital gains shall be computed by reducing fair market value (FMV) on the date on which the shares are vested in the employee, from the sale consideration. FMV is equal to the average rate on either NSE or BSE on the date of valuation.

What are the SEBI guidelines on ESOP?
SEBI defines Employee stock option as “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 predetermined price.”There would be no restriction on the maximum number of shares to be issued to a single employee. However, in cases of employees being offered more than 1 percent shares, a specific disclosure and approval would be necessary in the shareholders’ meeting.A minimum period of one year between grant of options and its vesting has been prescribed. There should not be more than eight years between the grant of options and vesting. Employee options must be exercised within a maximum period of five years from the date of vesting. Shares issued in exercise of options shall not be subject to any lock-in period.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. 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.

What is the procedure for granting ESOP?
The Company should issue a detailed Offer document containing the terms and conditions of ESOP offer. The Offering Company should constitute a Compensation Committee (a committee of Board of Directors) for administration and superintendence of the ESOP. Options can be granted only to eligible permanent employees of the Company but excluding (i) employees belonging to promoter group and (ii) Directors holding 10% or more of capital base either directly or with relatives. ESOP Scheme must be approved by shareholders at a general meeting by a special resolution. The terms and conditions of ESOP scheme can be amended by special resolution at Shareholders’ meeting. The Directors’ Report should contain disclosure regarding allotment of ESOP. The shares issued and allotted under ESOP scheme should be listed immediately upon allotment in any recognized stock exchange where the securities of the company are listed.

What are the possible flip sides of ESOP?

Most of the ESOPs are Call Option granted by a Company to its employees. The employee will not exercise his option so long as exercise price exceeds the market price and hence the option may ultimately lapse or be forfeited. These types of options whose exercise price are higher than market price are also referred as underwater option. During the dot com bubble, stock options issued by some leading blue chip companies were rendered underwater due to adverse market conditions. SEBI guidelines authorise companies to vary the terms and conditions, including re-pricing of options, if they become underwater.

FEMA Guidelines

A resident individual, who is an employee or a director of an Indian office or branch of a foreign company or of a subsidiary of a foreign company or of an Indian company in which the foreign equity holding is not less than 51 per cent, can make remittances for the acquisition of foreign securities under Employees Stock Option Scheme without any monetary limit. Also, an Indian company in the knowledge based sector may allow its resident employees to purchase foreign securities under the ADR/GDR linked stock option scheme. An Indian company may issue shares under the Employees Stock Options Scheme to its employees or employees of its joint venture or wholly owned subsidiary abroad, who are resident outside India, directly or through a trust, provided that face value of the shares to be allotted under the scheme to the non-resident employees does not exceed 5% of the paid-up capital of the issuing company.

Conclusion

Some corporates prefer to offer ESPS (Employees Stock Purchase Scheme) which provides immediate gratification to employees vis-à-vis ESOP which has longer vesting period. ESOP schemes have an inbuilt uncertainty due to fluctuating stock market prices. The option may turn out to be worthless in case of downtrend in stock markets. The opponents of ESOP scheme thus feel that outright allotment of shares (under ESPS) is a superior tool vis-à-vis ESOP. The success of any share benefit scheme (ESOP or ESPS) depends upon management objective, leveraging employee expectation and, above all, stock market dynamics, which are unpredictable.

ESOP Procedure Flow Chart

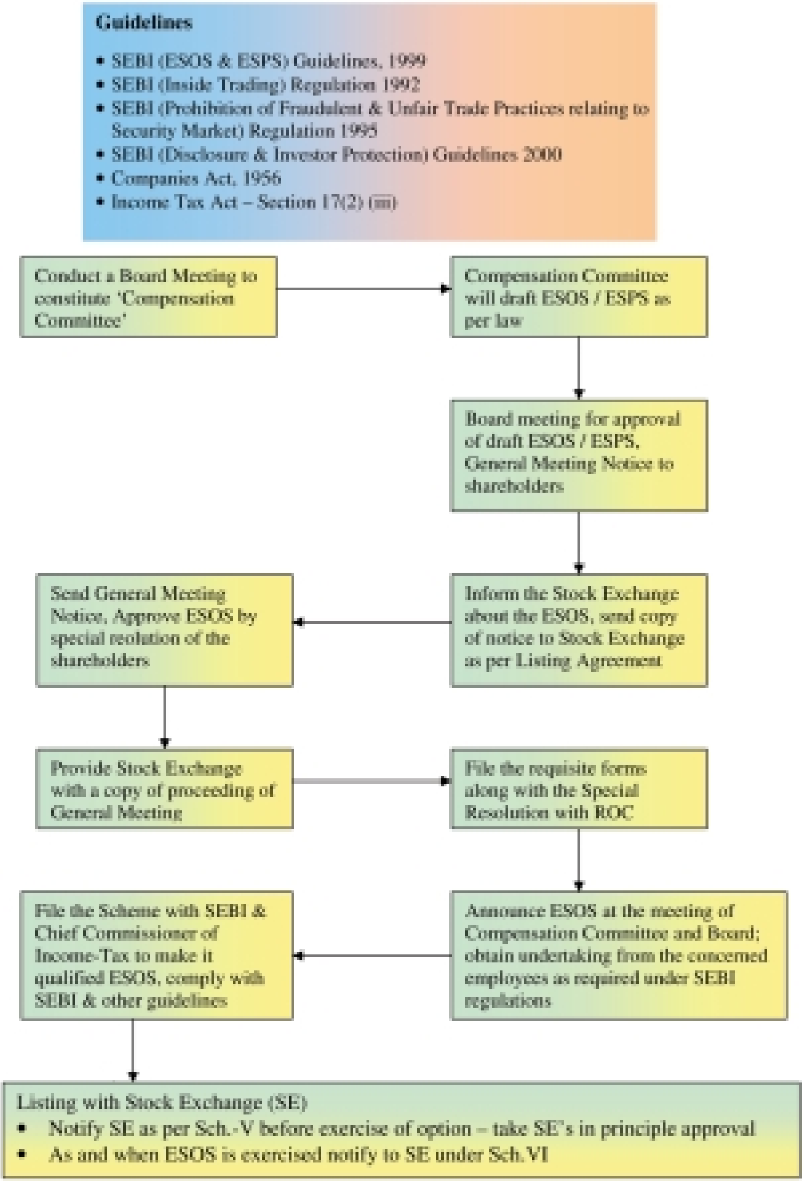

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ABB Clearing/Transfer per month	**Rs.50,000**	**Rs. 1 lac**	**Rs.2 lac**
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