Employee Stock Options

In context of India

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How it started

- Infosys, IT Consulting giant was the first to implement
- Distributed ESOPs to over 20000 employees since inception in 1981
- Worth over 50000 Crore Rs (approx 7 Billion US Dollars)
- In the 1990s, it allotted ESOPs in three tranches, at Rs 50 a share. By 2000s, thousands of employees had become millionaires by encashing these when the stock was at Rs 7,000.
- After a legal battle, was considered a non-taxable event, if shares were held for more than 12 months

Regulatory Background

- **The Securities and Exchange Board of India** constituted a committee in November 1997 to review the existing regulations relating to ESOSs and give its recommendations.

- Pursuant to the Committee's report, SEBI has formulated the Securities and Exchange Board of India **(Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines** that have been in force with effect from June 19, 1999.

- Now, even foreign parent or foreign entity holding share in parent can issue ESOs, but
  - The parent company must offer the share plan globally on a uniform basis.
  - The Indian company must submit an annual return to the Reserve Bank of India giving details of remittances, beneficiaries, and so on.

- Onset of Indian salaried millionaires.

- **INDIA - IT Capital of the World**

Committee Recommendations

TWIN PRINCIPLES

- **COMPLETE DISCLOSURE**
- **SHAREHOLDER APPROVAL**

LOWER EXERCISE PRICE

- Options should be granted with an ***exercise price*** substantially ***lower than market price of the shares*** as long as certain conditions(***VESTING CRITERIA***) are fulfilled.

- options granted
- the pricing formula
- options vested
- Options exercised
- the total number of shares arising as a result of exercise of option
- options lapsed
- variation of terms of options

Who is an eligible employee?

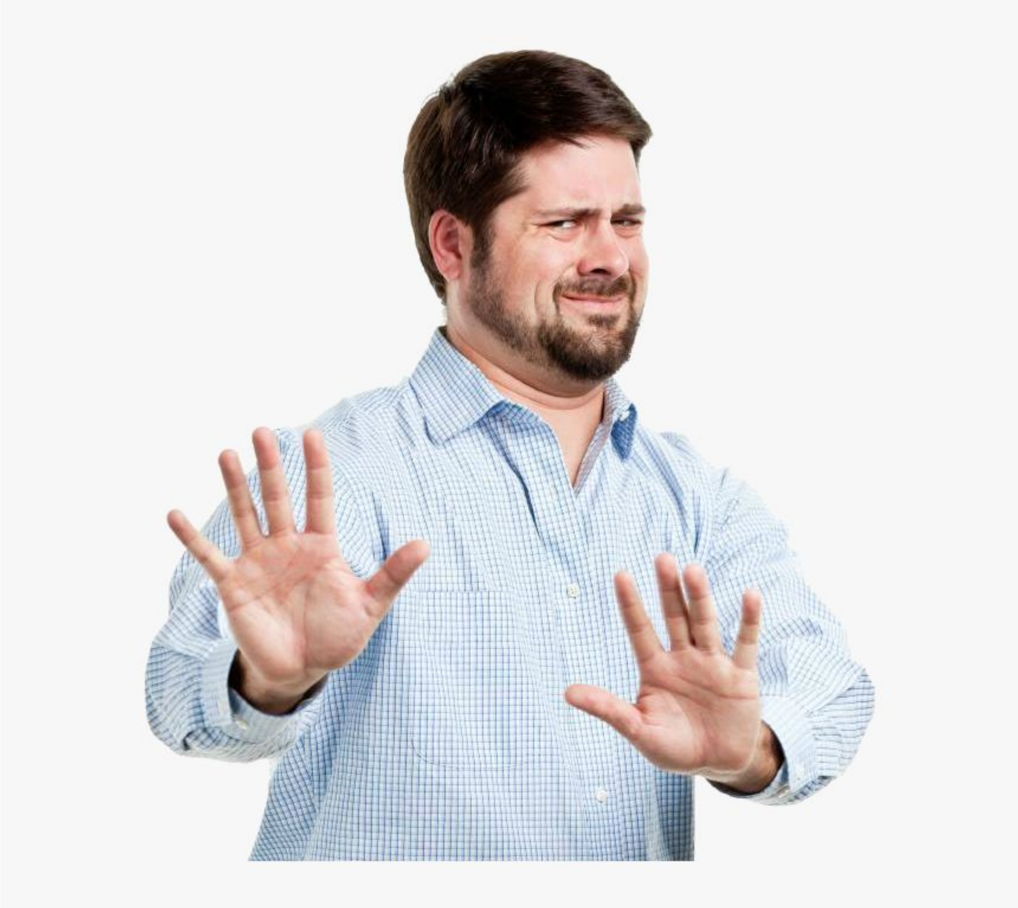
Pertaining to **Companies (Share Capital and Debentures) Rules, 2014** –

(a) a permanent employee of the company who has been working in India or outside India; or

(b) a director of the company, whether a whole time director or not

Who is not?

- Contractual Employees
- Independent directors
- Directors holding more than 10% capital in the company



The Companies Act, 1956, defines the **Sweat Equity Shares under Sec. 79 - Companies Act, 2013 Sweat Equity Shares**`

- A special resolution (3/4th majority) is required to be passed in a general meeting.

- These shares are to be valued at a price determined by a registered valuer as the fair price, giving justification to such valuation.

- Copy of valuation is to be sent to shareholders along with the notice of the general meeting.

Maximum value of shares. No prescribed maximum value of shares in respect of which options can be granted, either on a per-company or per-employee basis.

Market value. A company can determine the exercise price that it deems fit, provided that the proposed exercise price complies with the accounting standards issued by the accounting regulator.

Maximum value of sweat equity shares. An unlisted company cannot issue, in any given year, sweat equity shares that exceed the higher of:

- 15% of the existing company's existing paid-up equity share capital.
- Shares of the value of INR 50 million.

In addition, the total number of sweat equity shares can never exceed 25% of the company's paid-up share capital at any point of time.

However, a company that is considered a "start-up", in terms of notification issued by the Central Government, can issue sweat equity shares that represent up to 50% of its paid-up capital for a period of five years from incorporation.

Types

The most popular type is **share option plan** in India.
Shares will vest in tranches, usually ranging between one to four years.

The share options are non-transferable, exception: death. On termination of employment, the employee typically must exercise the vested options by the date of termination. Unvested options will generally be cancelled on termination of employment.

The minimum vesting period under company law is one year.

Indian law allows both listed and unlisted companies to implement share option plans through a trust.

Securities regulations provide that a trust cannot purchase more than 2% of the company's paid-up equity share capital.

Types other than share option plan

Share purchase plan

Under a share purchase plan, shares of the company are allotted upfront to an employee. Owns immediately without reference to any vesting schedule. However, the employee cannot sell the shares until the expiry of a lock-in period. The lock-in period requirement does not apply where the shares are allotted to an employee both:

- As part of a public issue of shares.
- At the same price as it is offered to the public.

Sweat equity shares

Both listed and unlisted companies can issue sweat equity shares.

Sweat equity shares can be issued to an employee for contributing know-how, value additions or intellectual property rights to the company.
A company that is at least one year old can issue sweat equity shares.
Shares are allotted upfront without any vesting, but are subject to a lock-in period of three years from the date of allotment.

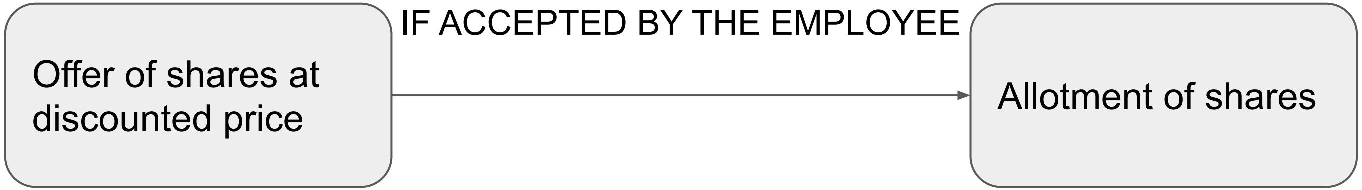
EMPLOYEE STOCK OPTION PLAN(ESOP)

A right offered by a company to its employees to take equity shares of company at discounted price.

Grant of Options → Vesting → Exercise → Allotment of shares

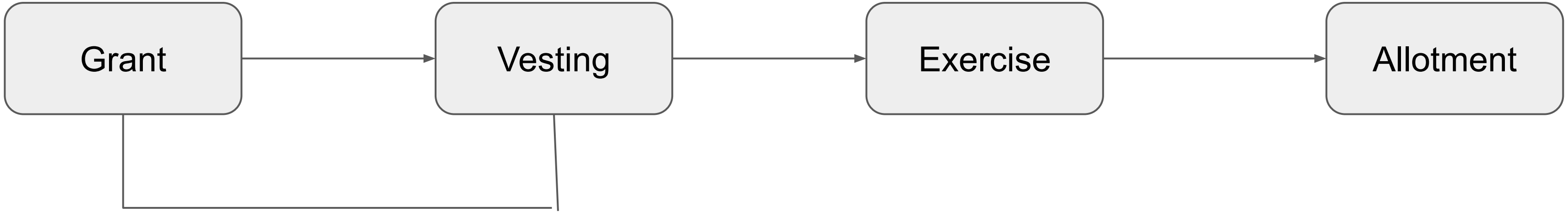
EMPLOYEE STOCK PURCHASE PLAN(ESPP)

Allows Employee to purchase Company’s shares, often at a discount from Fair Market Value.



RESTRICTED STOCK UNIT(RSU)

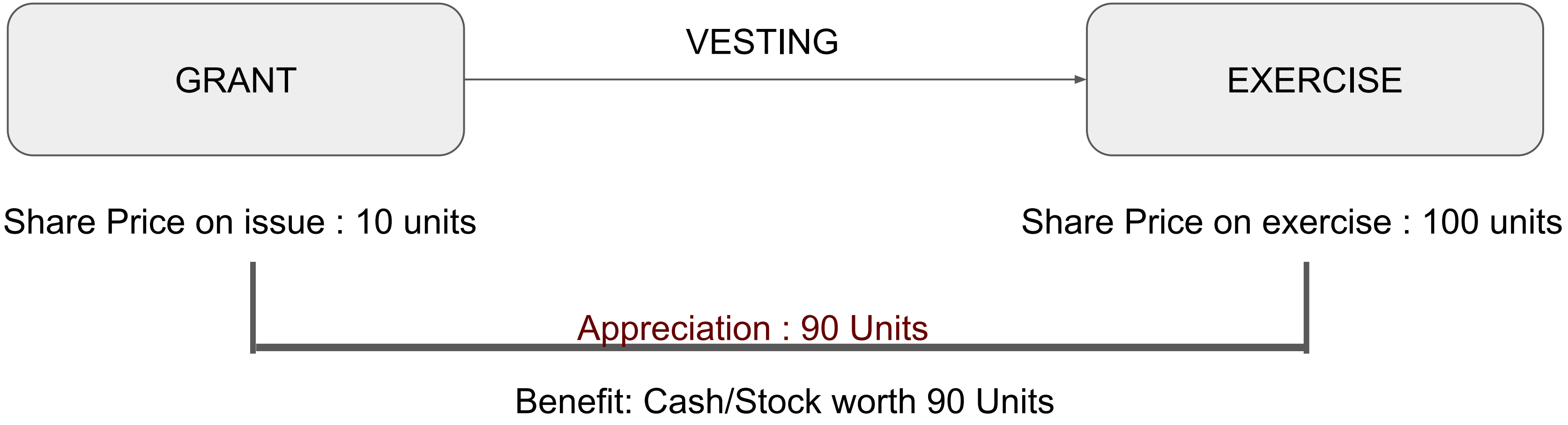
Employee is ENTITLED to be awarded with the shares subject to fulfillment of certain underlying conditions.



Fulfill performance based condition:
Target/Revenue

Stock Appreciation Rights(SAR)

- Employees do not have to pay the exercise price with SARs. Instead, they receive the sum of the increase in stock or cash.
- Employee need not own any asset or contract.
- SARs are beneficial to employers since they do not have to dilute share price by issuing additional shares.



ESOP landscape today

- Unlisted Company :
  - Companies Act, 2013 + Rules
  - Income Tax Act, 1961

- Listed company :
  - SEBI (SBEB) Regulations, 2014
  - SEBI (LODR) Regulations, 2015
  - SEBI (PIT) Regulations, 2015
  - Income Tax Act, 1961

- For foreigners : Foreign Exchange Management Act, 1999

- Buybacks through negotiated deals or private arrangements is prohibited.

Taxation

- The grant of an option is not a taxable event under India's income tax law, however exercise is..
- (Fair market value of the share) - (the exercise price of the option) = taxable income (in the "perquisites" category)
- The rate of tax depends on the employee's individual tax bracket. The maximum marginal rate of taxation for resident individuals in India is 30%.
- The company must deduct and deposit the taxes from the employee's salary

The difference between the sale price and the fair market value of the share will be subject to capital gains tax.

Sale of shares in a listed company.

If holding period > 1 year, considered as long-term capital gains (LTCG). - Tax Exempt

If holding period < 1 year, considered short-term capital gains (STCG). Tax rate = 15%.

Sale of shares in an unlisted company.

If holding period > 2 years, LTCG tax rate of 20% for residents. The rate is 10% for non-residents.

If holding period < 2 years, Tax rate is 30%.

Taxation on Non-cash benefits/Perquisite

- Tax at the time of allotment

FMV on Exercise :- INR 100/-

Exercise Price :- INR 10/-

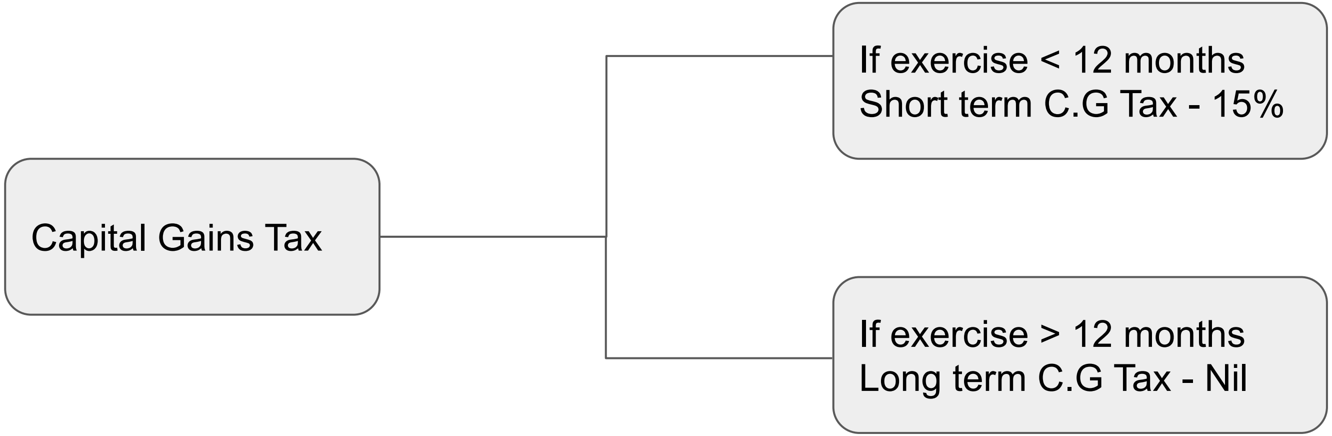
Perquisite Value :- (INR 100 – INR 10) = INR 90/-

Perquisite Tax @ 20% :- INR 18/-

Taxable value = FMV of shares on date of exercise - Exercise price

Taxation on Non-cash benefits/Perquisite

- Tax at time of transfer of shares



Taxable value = Sale price of shares - FMV of shares at time of exercise

Sale value :- INR 150/-

Holding period less than 1 year - Short Term Capital Gain

Gain Value: - (INR 150– INR 100) = INR 50

Tax @ 15% :- INR 7.5/-

Exercising before a liquidation event

You are liable to pay taxes in two parts - Once at the time of exercising and once at the time of selling the acquired shares.

You have to pay the exercise cost along with the tax on the difference between the current value of the shares and the strike price (FMV - Exercise Price) .

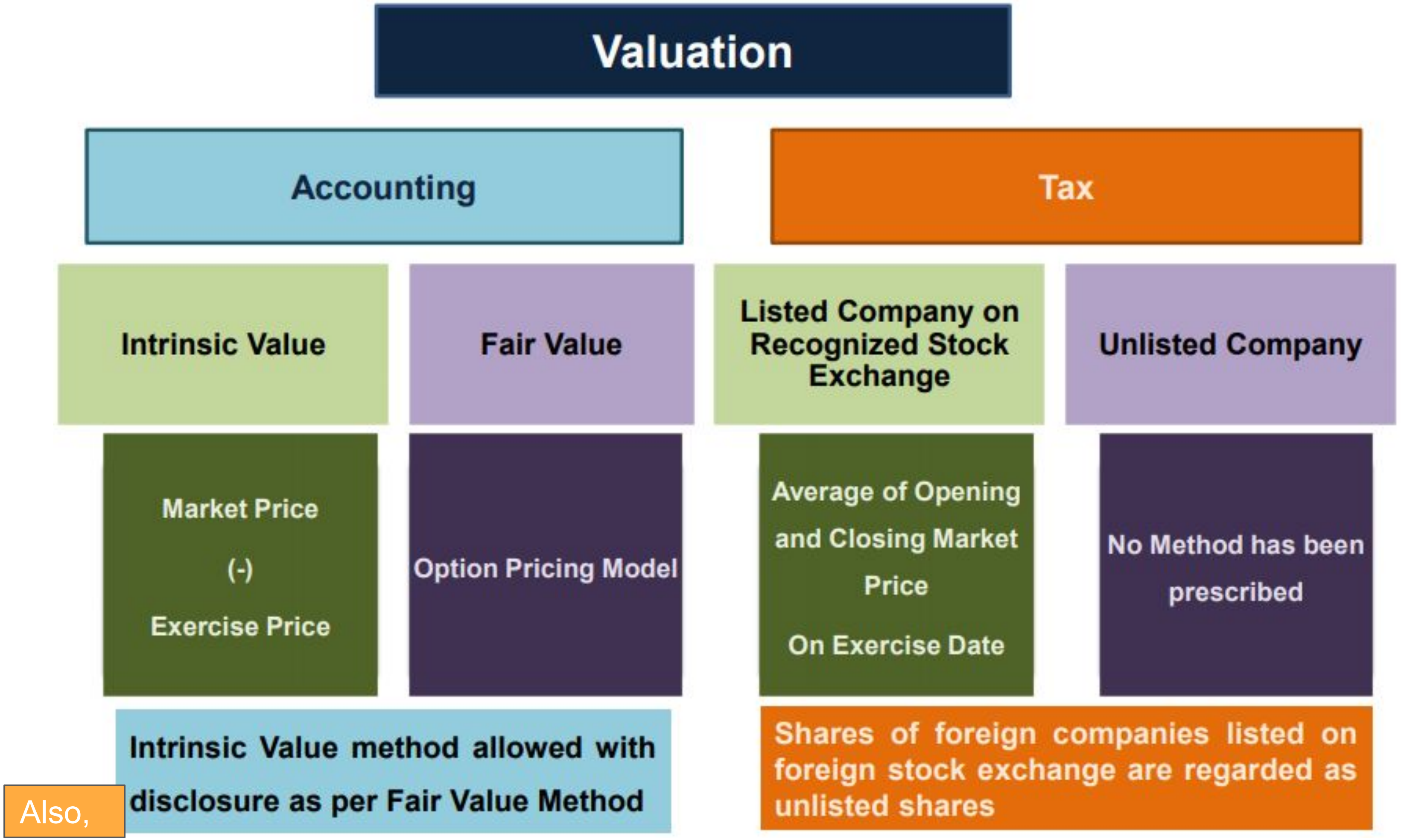
Second, when you end up selling these acquired shares later, you are again liable to pay taxes on the difference between the value of shares at that time and the value of the shares at the time you acquired the shares.

For Example: You exercised 1000 stock options at Rs. 10 per share in the year 2018 while their value at that time actually had increased to be Rs. 100 per share. So, at that time you'd be liable to pay taxes on the difference i.e. on Rs. 90 per share. Now at the time of IPO in the year 2020 you decide to sell these shares at Rs. 500 per share, so you'll again be liable to pay taxes on the earnings of Rs. 400 per share. In India, your tax rates may vary anywhere between 15 - 30% based on your earnings and the length of time you've held shares.

Exercising during a liquidation event

You incur costs only once : pay the strike price to exercise the options and you sell the shares at the same time but on a higher valuation (FMV) so, the tax liability here is only on the difference between FMV and your strike price. This tax is levied like a normal income tax.

Your Profit = Payout - Exercise Cost - Taxes


Valuation
Accounting
Tax
Intrinsic Value
Fair Value
Listed Company on Recognized Stock Exchange
Unlisted Company
Market Price
(-)
Exercise Price
Option Pricing Model
Average of Opening and Closing Market Price
On Exercise Date
No Method has been prescribed
Intrinsic Value method allowed with disclosure as per Fair Value Method
Shares of foreign companies listed on foreign stock exchange are regarded as unlisted shares
Also,

VALUATION

Valuation is required to amortize the Employee Compensation Cost during the vesting period;

For listed companies :

- if not traded on recognised stock exchange, its priced at market value one day prior to grant
- If traded on recognised stock exchange, pricing of issue of stock options should be average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date/or on the last date.

For unlisted companies :

Valuation done at the time of exercise by merchant banker

Accounting Valuation

-This Valuation is required for calculating Employee Compensation Cost during the vesting period.

-Performed by any valuer.

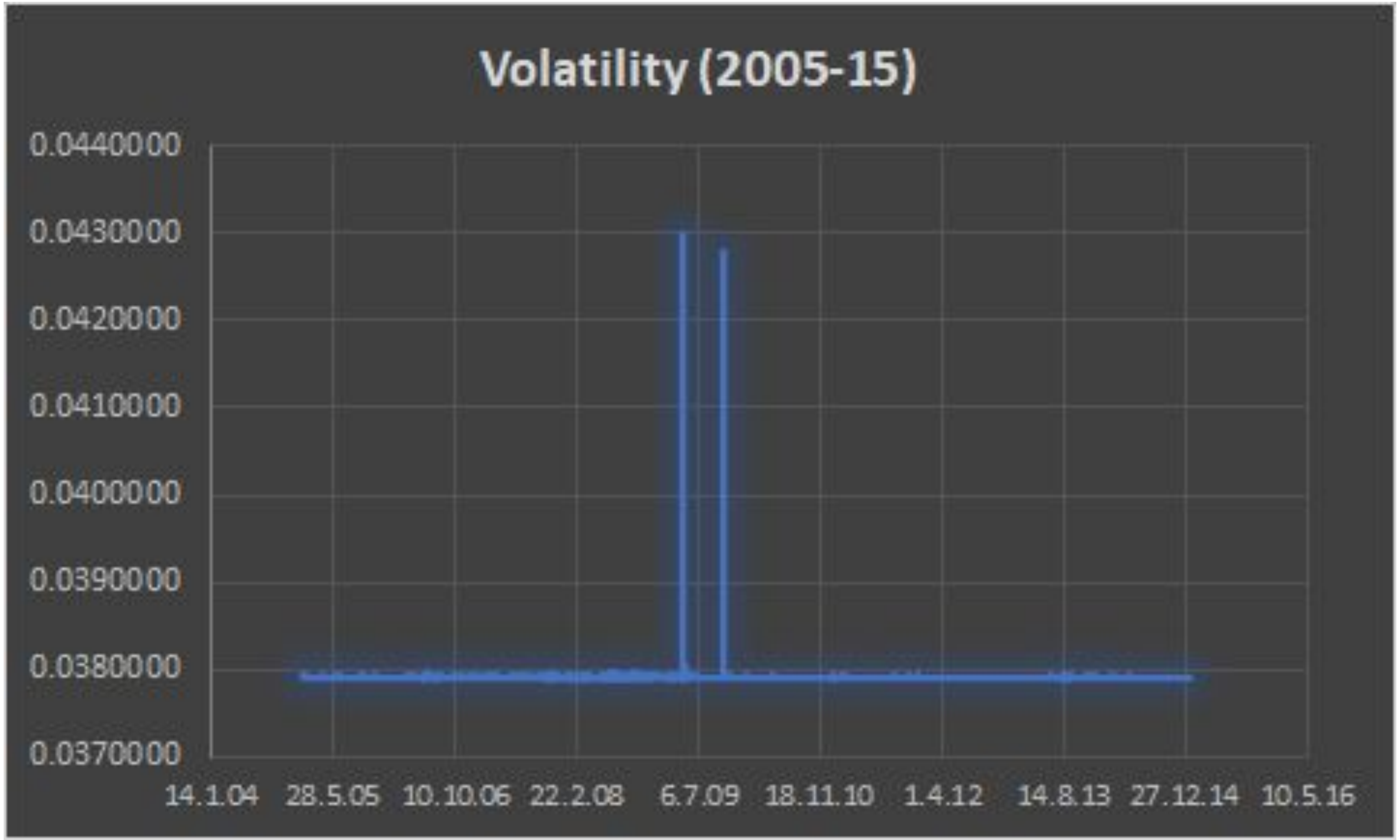
Perquisite Valuation

-Only in case of Unlisted Companies, done at the time of Exercise of Options by the Employee to know the value of the perquisite in employee’s hands, performed by merchant banker.

Case study - HDFC Bank ESO (HDFCBANK.NS)

- HDFC Bank Limited, an Indian banking and financial services company headquartered in Mumbai.
- Over 100,000 permanent employees, India's largest private sector bank by assets.
- Largest bank in India by market capitalisation as of March 2020.
- The price of the options shall be the closing market price quoted on the immediately preceding working day of the date of grant of Options, on the stock exchange, where there is highest trading volume.
- Listed on National Stock Exchange, SENSEX, Options announced : 27th June, 2007
- Exercise price set at grant : INR 1098.70, Stock(TU) Price on day of Grant: INR 1090.35,
- Peak when stock price hit its peak on 30th April, 2009, Value(TU)- INR 2210, Option value: INR 1255.123
- Option price went zero as Stock Price < Strike Price (**2008 - 2009 Financial Crisis**)
- Method used: BSM method, Excel. Option treated as a call option.
- No Dividends given in the period under consideration

Source: Own Elaboration



Source: Own Elaboration

- Volatility stayed relatively undisturbed before, during and after the Option grant announcement period.

- Peaks show value of volatility of 0.043, a jump of **only 0.004 bp** from mean of 0.038 on date pre-option expiry, 30.04.2009 and post option expiry on 13.10.2009. **India Averted 2008-09 Financial Crisis**

- Both these jumps are accounted for by external factors, hence not any ESO's impact.

- It seems to fit well with ideology of the paper titled, "Markov-switching GARCH models in determining ESOs effects, Łukowski M., Kapuścińska W.P. " that for properly defined ESO programs, ESO announcements don't impact the volatility shocks as much, as they may do for poorly defined ESOPs; however more detailed study is required for any conclusions.

Risky Gambit for startup employees : Case of India

- Makes most sense for startups to give away ESOs to attract talents.
- Failed examples

  RedBus(Travel Startup), QikPod (Ecommerce), TechProcess(Payment service)

  Reason: Poorly executed, Fraudulent/Biased framework, Company failures
- Successful examples:

ESOP Practices India, 2001 Survey

- While around 43% of the IT companies have given ESOPs to more than 90% of the employees, only 17% of the Non-IT companies have done so. A related finding is that more than 75% of the Non-IT companies offer ESOPs only to the senior and middle management employees

- **Smaller companies offer more and to more employees the benefit of ESOPs**.Within the IT companies, while only 23% of the large companies offer ESOPs to more than 90% of the employees, the number is as high as 60% in case of smaller companies. A significant 54% of the large IT companies offer ESOPs to less than 25% of their employees.

- While in around 90% of the IT companies the vesting is time based, the figure is only 67% in the non-IT sector. (33%) of Non-IT companies link the vesting to individual performance

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When to Exercise?

Perfectly time the exercise! -

1. Exercise when Market price > Grant price, however Market price is also not very high, to keep perquisite tax low.

2. Sell after holding over a year, and pay no capital gain tax!