A Comprehensive Analysis of Amendments to SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999

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With a view to regulate ESOS[1] and ESPS[2], Securities and Exchange Board of India issued SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 as amended from time to time. Recently, SEBI has amended these Guidelines vide circular SEBI/CFD/DLI/ ESOP/4/2008/04/08, dated 4.8.2008 to allow a nominee director to participate in the ESOS of the company, if the terms of the contract/agreement so provide and further to bring the prescribed accounting treatment for options granted under graded vesting, in line with the accounting treatment provided by ICAI. In this Article, these amendments, which are to take effect immediately, have been described in detail.

Eligibility of Nominee Directors to participate in ESOS

To make a nominee director eligible to participate in ESOS of the company concerned in which he is nominated by his respective Institution as its representative, an explanation has been added after the existing Clause 4.1 of the Guidelines. According to the explanation, the contract/agreement entered into between the institution nominating its employee as the director of a company and the director so appointed shall, *inter-alia*, specify the following:

- the said employee in his capacity as director of the company is permitted to accept options granted by the company under its ESOS;
- the options, if granted to the director, shall not be renounced in favour of the nominating institution; and
- the conditions subject to which fees, commissions, ESOSs, other incentives, etc. can be accepted by the director from the company.

Filing of copy of the contract/ agreement: The explanation further provides that it is obligatory on the part of the institution nominating its employee as a director of the company to file a copy of the contract/ agreement with the said company. The company, in turn, shall file the copy with all the stock exchanges on which its shares are listed. In addition, the director so appointed shall furnish a copy of the contract/agreement at the first Board meeting of the company attended by him after his nomination.

Note: The Guidelines, before the above amendment, provided for that an employee could participate in the ESOS of the company if such employee was not a promoter, did not

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[1] “Employee stock option scheme (ESOS)” means a scheme under which a company grants employee stock option. Further, “employee stock option” means the 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.

[2] "Employee stock purchase scheme (ESPS)" means a scheme under which the company offers shares to employees as part of a public issue or otherwise.

belong to the promoter group and was not a director, who, either by himself or through his relative or through any body corporate, directly or indirectly held more than 10% of the outstanding equity shares of the company. However, after the addition of above explanation the nominee director becomes eligible to accept options granted by the company under its ESOS provided the terms of the contract/agreement provide to this effect.

Options granted under Graded Vesting Schemes – Change in Accounting Treatment

The other amendment relates to changing of accounting treatment where the employee stock option scheme provides for graded vesting of options. The changed accounting treatment is in tune with the accounting treatment prescribed by the Institute of Chartered Accountants of India (ICAI) for employee stock options through its Guidance Note on "Employee Share-based Payments". The changed accounting treatment has been made effective by substituting clause (c) in Schedule I[3] to the Guidelines. The substituted clause (c) provides that in case the accounting value of options is accounted for as employee compensation (i.e. it shall be equal to the aggregate, over all employee stock options granted during the accounting period, of the intrinsic value of the option or, if the company so chooses, the fair value of the option), the amount shall be amortized as under:

- *Where the Scheme provides for graded vesting:* In case the ESOS provides for graded vesting, either of the following option can be chosen for amortization:

    (a) the vesting period shall be determined separately for each separate vesting portion of the option, as if the option was, in substance, multiple option and the amount of employee compensation cost shall be accounted for and amortised accordingly on a straight-line basis over the vesting period;

    or

    (b) the amount of employee compensation cost shall be accounted for and amortised on a straight-line basis over the aggregate vesting period of the entire option (that is, over the vesting period of the last separately vesting portion of the option). It is, however, provided that the amount of employee compensation cost recognized at any date at least equals the fair value[4] or the intrinsic value[5], as the case may be, of the vested portion of the option at that date.

- *Where the Scheme does not provide for graded vesting:* In such a case, the amount shall be amortised on a straight-line basis over the vesting period.

Notes: **(i)** Prior to the above amendment, the amount was simply to be amortised on a straight-line basis over the vesting period i.e. in case of graded vesting of options the

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[3] Schedule I provides for accounting policies for ESOS.

[4] 'Fair value' of an option means the fair value calculated in accordance with Schedule III to the Guidelines.

[5] "Intrinsic value" means the excess of the market price of the share under ESOS over the exercise price of the option (including up-front payment, if any)

vesting period was to be determined separately for each portion of the option and the accounting value of each such portion was to be amortised on a straight-line basis over the vesting period of that portion. After the amendment, however, separate accounting treatment is to be resorted to based on whether the ESOS provides for graded vesting or not.

(ii) As a consequence of above amendment relating to adoption of changed accounting period clause 13.2[6] of the Guidelines stands omitted.

Conclusion

Prescribing eligibility norms for nominee directors to participate in the ESOS of the company in which they are nominated shall act as an incentive for such directors to participate in the advancement of the company with more enthusiasm besides shielding the interest of the parent institution. In case, however, the nominee director is lured through ESOS to compromise the interest of his nominating institution, it shall be suicidal though it is always open to the nominating institution to call back such a director but the action has to be prompt before it is too late. The change in accounting treatment of the ESOS which provides for graded vesting of options so as to bring it in tune with the accounting treatment provided by ICAI is reflective of the fact that the accounting of employee stock options will now be more realistic.

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[6] Prior to omission, Clause 13.2 read as under:

> "Where a scheme provides for graded vesting, the vesting period shall be determined separately for each portion of the option and shall be accounted for accordingly."