A.R.A LAW
Advocates & Solicitors

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LEGAL EYE

YOUR PEEK INTO THE INDIAN LEGAL SCENE

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Attn: WOLF D. BREIDING

Thought for the month

Turn your stumbling blocks into

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Note from the Editor

Employee Stock Option Plans or ESOPs as they are more commonly known have become a buzzword in the new information technology age for recruiting enterprising young talent. ESOPs have given the much-needed impetus to boost employee morale and participation, by providing an opportunity for personal gain to the employee and thereby ensuring the overall success of the enterprise.

This issue of our newsletter aims at providing a comprehensive legal guide on the legal aspects of ESOPs in India. Both our articles aim at giving our readers a valuable insight into the regulatory aspects of ESOPs as well as an overview of the main characteristics of the ESOPs.

Apart from our articles on ESOPs, we also present our regular feature of Snapshots, which provides a summary of the legal developments in India over the last couple of months, which the Indian government has initiated despite opposition from within its ranks.

As it has been our constant endeavour to provide our readers with comprehensive analytical articles on important current issues, we trust that this issue will be of interest to you and hope you enjoy reading this edition of our newsletter.

We look forward to receiving your comments and suggestions.

- Rajesh N. Begur, Editor, Legal Eye

Employee Stock Options

- DOEL KAR, ASSOCIATE, A.R.A. LAW

An Employee Stock Option Plan (*ESOP*) is an employee benefit plan, which makes the employees of a company owners of stock in that company. ESOPs are granted in the form of shares directly allotted, stock options, stock appreciation rights, etc. and each of these may have many variants.

Why ESOPs?

- to buy the stock of a retiring owner in a closely held company;
- an extra employee benefit or incentive plan;
- a technique for corporate finance to finance expansion;
- to make an acquisition;
- to spin off a division; and
- to buy out a failing firm that would otherwise close.

Types of ESOPs

- The employees are directly allotted shares at the prevailing market price or at a concession and employees buy such shares either from their own funds or from loans given by the company or other entity. This loan is usually paid back in the form of deductions from salaries.
- The employee is given an option to acquire the shares of the company at a price that may be the prevailing market price or lower. There is usually a waiting or vesting period during which the employee cannot exercise the option to apply for the shares. Thereafter, there is a period called the exercise period during which the employee can exercise the options any time at a predetermined price.
- An innovative variation that is fortunately permitted in India by the SEBI Guidelines is grant of stock appreciation rights (SAR). As per the scheme, the employee is neither allotted shares nor is given the option to acquire shares. A certain number of shares is notionally allotted to him at a certain price. After the specified period, it is ascertained whether the price of the shares has moved up or down. In case the price has moved up, the increase in the price multiplied by the number of shares notionally allotted is paid to him.

Establishing an ESOP

- Developing an idea of the type of plan that will best serve the company's interests.
- Selection - depending on various factors both internal and external, including company characteristics, objectives for setting up an ESOP etc. Generally, stock option plans are used both in closely held as well as listed companies. Stock purchase plans are generally used in listed companies more often to supplement a stock option plan.
- A qualified financial and legal consultant can assist in designing the specifics of the ESOP and its feasibility.

- The company will typically have a lawyer prepare a formal plan document[1] which will set forth the specific terms and features of the ESOP.
- An appraiser will then prepare a finished and formal evaluation report, based on data preferably no more than 60 days old at the date the ESOP is created.
- The job of ESOP administration entails maintaining all the individual records of the plan in order to keep track of exactly who the current participants in the plan are, the percent each participant is vested with, the content and value of each participant's account, etc.

Indian Law

The entire legal framework for setting up ESOPs is now in place. The Indian Companies Act permits grant of shares and sweat equity to employees. The Securities and Exchange Board of India (SEBI) has also announced detailed guidelines for grant of stock options and stock purchase plans by listed companies.

The taxability of gains arising out of the sale of shares by employees acquired pursuant to the exercise of the stock options has been clarified through necessary amendments to the Indian Income Tax Act.

The Reserve Bank of India also permits employees of Indian subsidiaries of foreign companies to acquire shares of the foreign holding company.

The regulations framed by SEBI ("Regulations") allow the following schemes:

- Employee Stock Option Scheme (ESOS) –the company grants *option* to its employees.
- Employee Stock Purchase Scheme (ESPS) – the company *offers* shares to its employees as part of a *public issue* or otherwise.

These Regulations apply to companies whose shares are listed on any recognised stock exchange in India. The Regulations stipulate that the shares which arise pursuant to an ESOS, and the shares issued under an ESPS, are eligible for listing on any recognised stock exchange in India, only if both schemes, ESOS and ESPS are in accordance with the Regulations, and will not be allowed to list the shares which arise pursuant to the grant of stock options/shares if adopted in any other mode.

Though it is specifically provided that the guidelines shall apply to those companies whose shares are listed on a recognised stock exchange, it does not mean that unlisted companies cannot issue stock options. In a publicly traded company employees may sell their distributed shares on the market. In a privately held firm, the company must give the employees a put option on the stock.

Neither options (ESOS) nor shares (ESPS) can be offered by the company to its employees unless the shareholders of the company approve them by passing a special resolution in a general meeting. There is no limit either of quantity or percentage of capital or the shares or stock options issued under any scheme.

The process of setting up an ESOP is complicated, but that should not discourage interested firms from investigating employee ownership. The process is understandable and manageable, and the many benefits which flow from ESOPs, such as increased employee motivation, a market for existing shareholders' shares, and tax and financial advantages, are substantial. ❖

[1] The plan document should include language addressing the plan's purpose and operation, eligibility requirements, participation requirements, company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution rules and put options, employee disclosures, and provisions for plan amendments. Depending on the particular circumstances of the establishment of the ESOP, it may be prudent to address any future contingencies in the plan document.

Taxation of employee stock options

- STATIRA RANINA, ASSOCIATE, A.R.A. LAW

The Finance Act, 2000 has greatly simplified the issue of taxation of stock options and the new provisions meet the growing demands of the industry to a large extent.

Prior to the Finance Bill, 2000, shares given to employees under an Employee Stock Option Plan (ESOP), were treated as a perquisite and were therefore liable to be taxed at the rate of 33% at the time the shares were issued to the employee. The value of the perquisite was the difference between the fair market value on the date of the issue of the shares to the employee and the option exercise price. The employer was required to withhold tax on the value of the perquisite at the time of issue of shares to the employee. Further, the employee who wished to sell his shares would have to pay capital gains tax, depending on the period of the holding of the shares, the difference between the sale price and the fair market value on the date he received the shares.

The government has now announced that the shares given to employees under an ESOP will be taxed only at the time of sale of the shares by the employee. Shares given to an employee would no longer be treated as a perquisite and there would therefore be no withholding tax burden on the employee and no withholding obligation on the employer.

With the change in policy, the employee will have to pay capital gains tax (long-term or short-term) only at the time of sale of the shares, depending on the period of holding prior to selling the shares i.e. whether they were held for a period of less than one year or more than one year. The capital gains tax applicable would be on the difference between the sale price and the exercise price of the shares.

Illustration: Assume:

i. the exercise price of shares (EP) issued under an ESOP is Rs. 30;

ii. the fair market value (FMV) on the date of the exercise is Rs. 230; and

iii. sale price is Rs. 430.

Then under the old provisions:

Perquisite = Fair Market Value – EP = 230 – 30 = Rs. 200 Taxed @ 33% Employer has to withhold tax	Capital Gains = Sale Price – FMV = 430 - 230 = Rs. 200 Taxed @ 10% or 33% depending on whether it is a short term or a long-term capital gain.

Under the new provisions:

No longer treated as a perquisite	Capital gains =Sale price – EP =430 – 30 = Rs. 400 Taxed @ 10 % or 30% depending on whether it is a short term or a long term capital gain

As can be seen from the above illustration, a substantial change has been brought about in respect of the taxation of stock options and there is no doubt that this change is for the better. ❖

LEGAL SNAPSHOTS

RBI can clear ECBs up to $100 million

The Finance Ministry has announced the External Commercial Borrowings (ECB) Policy for 2000-2001. Under this new policy the Reserve Bank of India (RBI) is empowered to approve ECBs upto $100 million. Further, all ECBs under $50 million have been liberalised under the new policy and are thus made subject to RBI approval. All ECB above $100 million would now require Government approval.

The new policy also provides that non-banking finance companies would now be eligible for ECBs subject to certain conditions. These conditions include registration with the RBI, earning profits for the last three consecutive years and 'AA' credit rating. The new policy also permits companies to raise ECBs in seven sectors, including power, telecommunications, railways, roads, ports, industrial parks and urban infrastructure. Projects in any of these sectors would qualify for ECBs up to $200 million. ❖

The Right to Information Bill

The Right to Information Bill has been passed by the Maharashtra government. The main object of this Bill is to make governance a transparent affair. The Bill would enable the public to get details of the government's various schemes implemented by various departments. A similar bill has also been passed by Madhya Pradesh, Tamil Nadu and Goa and has been recently introduced in the Rajasthan Assembly. ❖

Proposed hike of taxes by Mauritius for offshore companies

The Government of Mauritius, in its recent budget, has proposed the following measures in respect of offshore entities:

- 15% flat rate of taxation for all offshore companies. Earlier, offshore companies registered before 30 June 1998 were allowed to choose a rate of tax between 0 to 35 percent and those entities incorporated after this date were required to pay a flat rate of tax of 15%. In order to provide a level playing field for all offshore entities, the government has now proposed a uniform flat rate of taxation of 15% for all companies, irrespective of when they have been incorporated.
- 'Deemed' foreign tax credit to be diluted and eventually phased out. This is expected to lead to higher tax payments in Mauritius by offshore entities
- Companies to submit audited accounts within six months of financial year-end

Foreign institutional investors (FIIs) who have set up offshore companies in Mauritius with the main objective of availing of the tax benefits under the Indo-Mauritius Double Tax Avoidance Agreement (DTAA), feel that the proposed amendments by the Mauritian government would have a negligible impact on them. According to the provisions of the Indo-Mauritius DTAA, capital gains shall be taxable in the country of residence. Mauritius has, for all practical purposes, not taxed capital gains and hence it is believed that the amendments proposed by the Mauritian government would not have any major impact on the FII. ❖

Companies Act to be amended in favour of e-commerce

The Department of Company Affairs is considering several amendments to the Companies Act, 1956, to facilitate e-commerce and e-governance. The Department is planning to permit the use of electronic medium such as e-mail and Internet for voting on resolutions at annual general meetings. The government is also expected to direct all companies to make their financial statements available on the net to enable investors to access relevant data. ❖

Department of Telecom Services bifurcated

The Ministry of Communications has bifurcated the Department of Telecom Services (DTS) into the Department of Telecom Operations (DTO) and DTS. While the DTO shall be responsible for operations and maintenance of telecom services in the country, the DTS will be involved in policy issues, including the corporatisation of DTO and DTS. There will therefore now be three departments under the Communications Ministry, the Department of Telecommunications, the DTS and the DTO. ❖

Finance Minister gives banks a free hand to crack whip on large defaulters

Bank chiefs were given the go-ahead by the Government to crack the whip on big borrowers who have failed to repay their loans. This has been done with the intention of cleaning up the balance sheets of banks and bringing down the Rs 51, 000-crore non–performing assets (NPA's) of the banking sector.

In the case of small borrowers, i.e. Rs 10 crores and below, the Reserve Bank of India (RBI) will formulate detailed, transparent, non-discriminatory guidelines.

However, in the case of large borrowers, banks have been empowered to recover their dues either through rehabilitation or one-time settlement till 31st August. In case these measures fail, the banks would be free to take recourse to filing for recovery under the Debt Recovery Tribunal, which provides for stringent provisions.❖

Competition Law: Panel for minimum regulation

The Competition Policy Committee has made recommendations on competition law and competition policy. Competition policy, the Government avers, must include all Government measures that have the objective of creating and sustaining the appropriate environment. The committee report lays down the following:

- The competition law will have universal applicability, whether it is a domestic company or a foreign company.
- Certain anti-competition practices should be presumed to be illegal.
- Agreements that contribute to the improvement of production and distribution and promote technical and economic progress, while allowing consumers a fair share of the benefits should be dealt with leniently.
- The relevant market should be clearly identified in the context of horizontal agreements.
- Blatant price, quantity, bid and territory sharing agreements and cartels should be presumed to be illegal. ❖

State agrees to Electricity Act ordinance

The State legislative assembly passed an ordinance for amending section 8 of the Electricity (Supply) Act, 1948 (EA), following which the Chairman and the Board of Directors of MSEB would henceforth continue in office subject to the intention of the State Government.

The Electricity (Supply) (Maharashtra Amendment) Bill, 2000, Maharashtra, has also amended section10 of the EA, 1948, which empowers the State Government to suspend or remove the Chairman or members of MSEB. However, before doing so, the State must give the members a chance to disprove the charges levelled against them. ❖

Centre to permit 100% FDI in tea companies

The Indian Government is lifting restrictions on ownership of tea companies after being convinced that the denial of foreign direct investment (FDI) in tea plantations will make India a net importer of the commodity in the long run. It is to allow 100 percent automatic foreign ownership of tea companies. The new policy will ensure that future foreign acquisitions do not run into bureaucratic hurdles. ❖

SEBI's lock- in period for one year

The Securities & Exchange Board of India (SEBI) announced a lock-period of one year on all preferential allotments. This was done with the intention to ensure that funds did not take positions in momentum driven stocks by entering into these through preferential shares and exiting after these shares had been ramped up by some operators.

However, this particular move did not go down well with the market, the reason being that, by curbing liquidity for FII's and mutual funds for one year, the regulator has in fact killed the preferential allotment route. On account of the unpopularity of the lock-in period on all preferential allotments, SEBI is expected to subject only those preferential allotments to a one-year lock-in where notices to shareholders have been issued after 15th June. ❖

Lock-in period of one year since investment for VCF's

The Securities & Exchange Board of India (SEBI) is planning to put a one-year lock-in on venture capital funds (VCF) from the date of their

investment in a venture. This implies that VCF's registered with SEBI will not be affected by the regulator's move of having a lock-in period in respect of preferential allotments. ❖

SEBI relaxes price bands to16% for 200 scrips in rolling mode

The Securities & Exchange Board of India (SEBI) decided to relax the price bands, effective 3rd July, to 8+8 percent, totalling 16 percent from 12 percent, for 200 top scrips and those in the compulsorily rolling settlement mode. SEBI also decided to scrap additional volatility margins in rolling mode, rationalise the additional volatility margins in the weekly settlement, withdraw the five percent additional margin on sales and allow investors to bring all margins on delivery–based trades in the form of bank guarantees.❖

IPO norms further tightened

As per the revised guideline, which would be applicable to all forthcoming initial public offers or issues by existing companies, IPO's up to 5 times the pre-issue net worth will be allowed in the conventional mode only if they have a track record of profitability and net worth, as specified by SEBI.

The Securities & Exchange Board of India (SEBI), in order to tighten the norms for initial public offerings (IPO), has announced that IPO's of more than five times the pre-issue net worth of a company will be allowed only through the book building route. However the issue must be subscribed to the extent of 60% by institutions.

The minimum promoters' contribution will be locked in for three years as is presently done, and the rest of the entire pre-IPO capital, held by the promoters or others, will be locked in for one year from the date of allotment of the IPO.

The amount of promoters' contribution brought in the form of cash, either before or along with the issue will have to be kept in a separate escrow account and released to the company with the public issue records.❖

Carry forward system cleared

The Securities & Exchange Board of India (SEBI) has decided to introduce the carry forward system in the rolling settlement and shall move the entire forward group or 'A' group shares to rolling settlement.

The SEBI Board cleared the introduction of the continuous net settlement by exchanges. At the existing carry forward system, SEBI will introduce specific eligibility criteria for scrips both in the account period and the rolling settlement as well as for scrips in the continuous settlement. Trades in this segment are to be settled on a net basis between rolling settlements, and not in the normal gross payments basis. SEBI has also scrapped the current 75-day limit on carry forward trades. SEBI has decided to hike the cap of Rs. 20 crores per settlement allowed to a broker for carry forward to Rs 40 crores. There will be a scrip–wise limit of Rs 5 crores per broker. ❖

Internet disclosures a must

The Securities & Exchange Board of India (SEBI) has kicked off an exercise to get companies to disclose every detail about themselves on the Internet. SEBI has also initiated discussions with NSE and BSE to come together and set up an outfit where all such disclosures could be made. The aim is to ensure that investors can get the maximum possible information about a company. ❖

Crackdown on debenture defaults in the offing

The Securities & Exchange Board of India (SEBI) has decided to crackdown on debenture defaults by tightening the guidelines in the following manner:

- SEBI will recommend to the Department of Company Affairs that failure by a debenture trustee to create security within the specified time shall attract criminal liability on the officers in default and the company.
- The revised guidelines will ensure that there is an arms length relationship between the issuer and the trustee.
- The trustee will not be associated or be a lender to the issuer company. In respect of existing cases where such relationship exists, a transitional period of two years will be allowed for change of trustees.
- The trustees will have to appoint a nominee director on the Board of the issuer in the event of two consequential defaults in payment of interest or default in creation of security or in redemption. ❖

Meet the A.R.A. LAW Team

In each issue, we will be profiling one person who is part of A.R.A. LAW. They will also be sharing their experience of working at A.R.A. LAW.

PRIYARANJAN SINGH SEKHON graduated from the National Law School Of India, Bangalore in 1996. At college he specialized in law, accountancy and financial management, alternate dispute resolution techniques and appellate advocacy and also presented seminars on air and space law, election laws and human rights law and practice. Thereafter he joined a leading law firm in Mumbai where he was involved in arbitration proceedings and litigation relating to corporate laws, constitutional law, indirect taxes, civil laws, environmental laws, property laws and consumer protection law. He enrolled as an Advocate with the Bar Council of Maharashtra & Goa in 1997. He joined A.R.A. LAW in October 1999. This is what Priyaranjan thinks about work at A.R.A. LAW -

I feel the legal community in India today can be broadly classified into two schools. One, the traditional school which has existed over the decades with its evolved and established systems of the practice of law. The second is the modernist school of young generation lawyers schooled in the traditional school and witness to a host of economic reforms carving a niche in the legal practice for themselves. A.R.A. LAW belongs to the latter school.

I came to A.R.A. LAW after schooling in the traditional system of legal practice to find a modern law firm with a growing legal practice with a fresh and highly effective perspective on legal services. Working with A.R.A. LAW has exposed me to a host of emerging areas in law and legal practice which have enhanced my professional skills to a great extent. Teamwork is a prominent feature of the work ethic at A.R.A. LAW and that is the main strength of the firm, as it should be in any association of lawyers today. It is because, apart from being merely people who work at the same place, the A.R.A. LAW team is a closely knit and bonded unit of close interpersonal relationships that the firm is always able to meet even the most challenging of assignments with relative ease (when viewed in perspective!!). ❖

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This newsletter is intended to provide an informational summary of the breaking legal developments in India as they happen. It is not intended to provide definitive legal advice in connection with any particular article, and counsel should be consulted with respect to any of the articles.

Should you require any clarifications or additional updates, please feel free to contact us at:

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