

# Good governance: SEBI's new regulations for ESOPs

September 2022



The Securities and Exchange Board of India (SEBI) notified the SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 (New SEBI ESOP Regulations) on 13 August 2021. The new SEBI-Employee Stock Option Plan (ESOP) regulations govern all sweat equity shares and share-based employee benefit schemes dealing in securities, including employee stock options, employee share purchase, stock appreciation rights, general employee benefits and retirement benefits (share-based benefit schemes).

Purpose of the new regulation is to streamline and rationalise the provisions by:



**Making them more robust**



**Synchronizing them with global best practices**



**Improving ease of doing business**







# The legislative background

SEBI has notified a single regulation as SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 (herein referred as new SEBI ESOP Regulations)

## Erstwhile regulations

### SEBI (Issue of Sweat Equity) Regulations, 2002

Provided the framework for issuing sweat equity shares by listed companies.

### SEBI (Share Based employee benefits) Regulations, 2014

Provided the framework to regulate the Employee Stock Option Scheme, Employee Stock Purchase Scheme and other share-based employee benefits.

**Note:** Both regulations were notified on 24 September 2002 and 28 October 2014, respectively (collectively called erstwhile regulations). SEBI has merged the aforesaid erstwhile regulations into a single regulation in its Board Meeting held on 6 August 2021 and notified the new SEBI ESOP regulations with effect from 13 August 2021. Pursuant to this, the erstwhile regulations stand repealed.

## Key changes in the regulations

The new SEBI ESOP regulations include specific references to employees of a group company and its associate company. The term group has been included for the first time under the new regulations to mean two or more companies which, directly or indirectly, are in a position to:

- 1 Exercise 26% or more of the voting rights in the other company
- 2 Appoint more than 50% of members of the board of directors in the other company
- 3 Control the management or affairs of the other company

Through the addition of the term group, group companies will now be able to formulate common Share Based Benefit Schemes (SBBS).

## The meaning behind employee

<p><b>Definition of employees</b> [Regulation 2(1)(i)]</p>	<p>Contractual employees, gig workers and employees on probation or deputation that are eligible to receive benefits; provided they are designated as employees by their employers.</p> <p>The deletion of the word permanent from the definition of employee gives companies the flexibility to extend (SBBS) to all the such persons who are designated as employees by the Company. It may also include contractual, part-time, gig workers or employees on probation or deputation who all are designated as employees by the Company.</p> <p>This change would be an enabler to keep pace with the emerging trend of companies employing contractual employees.</p>
<p><b>Inclusion of employees of associate and group companies</b></p>	<p>The inclusion of the terms associate and group companies including a significant number of large conglomerates in India will ensure that SBBS is extended to a larger pool of employees.</p> <p>A non-executive director (who is not a promoter or member of the promoter group) and employees of group companies, subsidiary companies as well as associate companies are also eligible for the grant of employee stock options or other employee benefits.</p>

## Other relevant changes

Particulars	As per new regulations
<p><b>Implementation of the Scheme through Trust</b> [Regulation 3(1)]</p> <p>In the erstwhile regulations, the companies were required to decide the route of the scheme upfront at the time of obtaining the approval of the shareholders.</p>	<p>Companies have now been allowed to switch routes from trust to direct route or vice versa, subject to the approval of the shareholders by special resolution and provided it is not prejudicial to the interests of employees.</p> <p>Any modifications in relation to the trust deed shall be mandatorily filed with recognised stock exchange in case of listed companies.</p>
<p><b>Grant date</b> [Regulation 2(1)(q)]</p>	<p>Grant date means the date on which the compensation committee approves the grant. It will be determined in accordance with applicable accounting standards.</p>
<p><b>Compensation Committee</b> [Regulation 5(2)]</p> <p>Earlier as was provided under Section 178 of the Companies Act, 2013</p>	<p>As provided under regulation 19 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, flexibility has been given to designate the Nomination and Remuneration Committee (NRC) of a company as the Compensation Committee.</p>
<p><b>Utilisation of fund/shares held by the Trust in case of winding up of the scheme</b> [Regulation 8]</p> <p>In erstwhile regulations, the shares acquired by the trust were necessarily required to be sold off at the time of winding up of the Scheme.</p>	<p>In the event of winding up of the scheme, the trust can utilise the excess shares available with it, after meeting all the obligations, if any for the benefit of employees through a different scheme under these regulations on recommendation of the compensation committee and subject to the approval of the shareholders.</p>
<p><b>Applicability of minimum vesting period in case of death</b> [Regulation 9(4)]</p>	<p>The minimum vesting period of one year would not apply in case of death of an employee, the options shall be vested in the legal heirs or nominees from the date of his/her death.</p>
<p><b>Certificate from auditor</b> [Regulation 13]</p>	<p>It has been clarified that the audit certificate should be procured from a secretarial auditor, instead of statutory auditor being more conversant with ESOP regulations as compared to other categories of persons.</p>

Particulars	As per new regulations
<p><b>Buyback of stock options</b></p> <p><b>Clarification on cashless exercise</b> [Regulation 5(3), 3(15) and 9(2)]</p> <p>Earlier, the term and the process of cashless exercise were not defined in the erstwhile regulations.</p>	<p>The Compensation Committee is required to formulate the detailed terms and conditions of the schemes under Schedule 1 (Part B) of the new regulations.</p> <p>Under the new regulations, the word cashless exercise has been replaced to define the mechanism by which the company or the trustee may fund or permit the empaneled stock brokers to make suitable arrangements for the same.</p>
<p><b>Vesting in case of superannuation/layoff</b> [Regulation 9(6)]</p> <p>In the erstwhile regulations, no specific treatment was prescribed with regards to the cessation of employment of an employee due to retirement or superannuation.</p>	<p>In such an event, the options, SAR or any other benefits granted to such an employee will now continue to vest in accordance with their respective vesting schedules even after retirement or superannuation in accordance with company policies and applicable law.</p>
<p><b>Maximum value of shares in case of General Employee Benefits Scheme (GEBS)</b> [Regulation 26(2)]</p> <p>As per erstwhile regulations, the shares of the company or shares of its listed holding company shall not exceed 10% of the book value or market value or fair value of the total assets of the scheme, whichever is lower, as appears in its latest balance sheet for the purposes of GEBS.</p>	<p>Provision to maintain the threshold limit of 10% at all times has been appropriately amended and now this assessment is required to be done as per its latest balance sheet whether audited or limited reviewed.</p> <p>The secretarial auditor of the company shall certify the aforesaid compliance at the time of adoption of the balance sheet by the company [Reg 26(3)].</p>
<p><b>In-principle approval from the Stock Exchange</b> [Regulation 12(3)]</p> <p>As per the erstwhile regulations, there was no clarity with regards to the stage at which the application for seeking the in-principle approval from the stock exchange shall be made</p>	<p>It is clarified that the application for seeking the in-principle approval from the stock exchange shall be made prior to the grant of options.</p>
<p><b>Objective for the Issue of Sweat Equity Shares</b> [Regulation 30]</p>	<p>With the introduction of new SEBI ESOP Regulations, a listed company may issue sweat equity shares in accordance with Section 54 of the Companies Act, 2013.</p> <p><b>*Permissible purpose/objectives for issuance of sweat equity shares were not defined in erstwhile regulations.</b></p>
<p><b>Maximum quantum of sweat equity shares</b> [Regulation 31]</p> <p>*there was no limit provided in the erstwhile regulations with regards to the maximum quantum of sweat equity shares, the listed companies were allowed to issue sweat equity shares to any extent.</p>	<p>Less than 15% of the existing paid-up equity share capital in a year.</p> <p>Not exceeding 25% of the paid-up equity share capital of the company at any time.</p> <p>*Pricing of the sweat equity shares will be at par with the pricing requirement stated under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations) with regards to preferential issue to a person other than a qualified institutional buyer. [Regulation 33]</p> <p>*Lock-in period should be consistent with the lock-in period prescribed in relation to preferential issue under the ICDR Regulations i.e., three years from the date of allotment of shares in case such shares are allotted to promoters or promoter groups. In case of shares being issued to any person other than promoters and promoter group, the shares shall be locked in for a period of one year. [Regulation 38]</p>



# Position with respect to unlisted companies

The new SEBI ESOP Regulations only apply to listed companies whereas unlisted companies are still regulated under Section 62(1)(b) of the Companies Act, 2013, read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014, which covers within its ambit only permanent employees and does not include employees of associate or group companies. Thus, the Companies Act, 2013, provides a narrower definition than the definition provided under the New SEBI ESOP Regulations.

Note: It is vital for unlisted companies that are proposing to undertake an initial public offering (IPO) to review the terms of their SBBS and ensure that they bring the definition of employee in consonance with the new SEBI ESOP Regulations. At the time of filing the draft red herring prospectus, they would have to comply with the requirements of both the Companies Act, 2013, and the SEBI ESOP regulations.

## Compliances for private companies

**A private company is required to comply with the following compliances in regard to the issue of ESOPs.**

- Issue of the ESOPs shall be approved by the shareholders of the company by passing an ordinary resolution
- The board of directors of the company must disclose the details of the ESOP in the Directors' report
- The company may vary the terms of ESOPs not yet exercised by the employees, by special resolution, provided such variation is not prejudicial to the interests of the option holders
- A company must make the following disclosures, in the explanatory statement annexed to the notice, for the passing of the resolution as per prescribed rules
  - Maintain a Register of ESOPs in Form No. SH.6 and shall enter the particulars of the option granted
  - The Register of ESOPs shall be maintained at the registered office of the company or such other place as the board of directors of the company may decide
  - The entries in the register shall be authenticated by the company secretary of the company or by any other person authorised by the board of directors for this purpose



# Conclusion

The new regulations notified by SEBI are a welcome step at a time when the markets are overwhelmed with positive intent owing to many new generation companies having listed their shares. The regulations provide additional flexibility, transparency and good governance in relation to dealing with equity shares in connection with share-based employee benefit schemes.

To make the erstwhile regulations more robust and in sync with ease of doing business and best global practices, the newly promulgated regulations are expected to bring the needed change to the industry.

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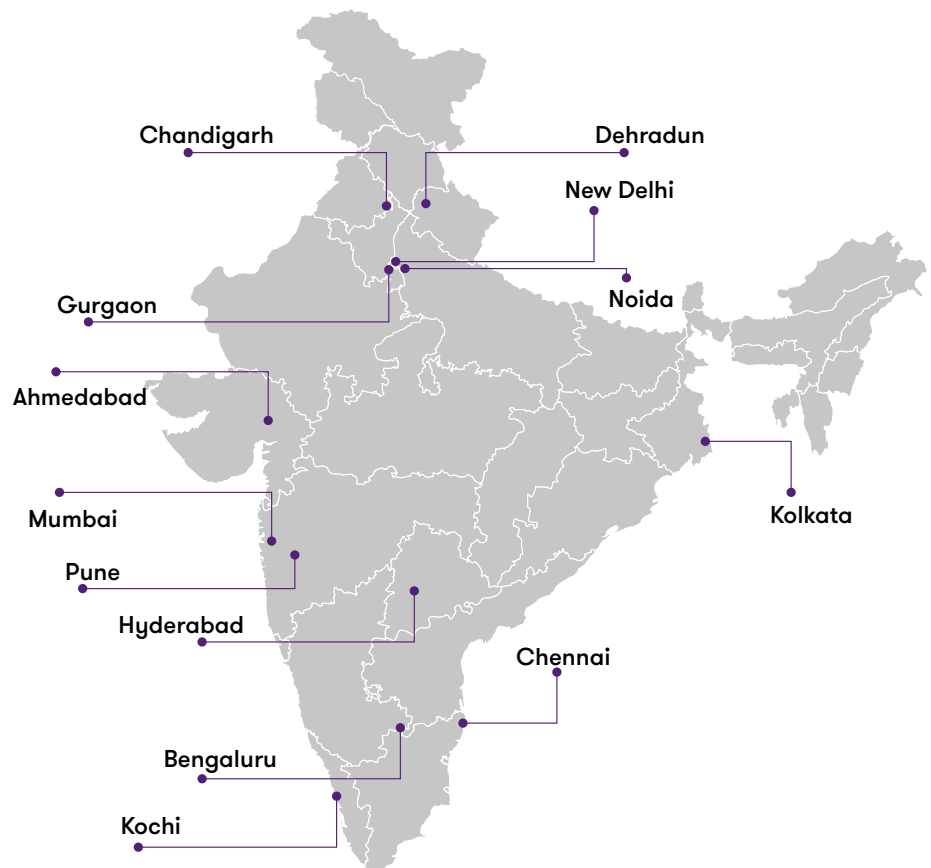
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## Sources:

[www.sebi.gov.in](http://www.sebi.gov.in)

FAQs on Regulation

Economic Survey 2020-21

Grant Thornton Bharat Analysis



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