GEN ESOP

A peek into the evolving world of ESOP

A RuleZero Whitepaper | 2021

Glossary

DPIIT	Department for Promotion of Industry and Internal Trade
Exercise	The exercise of Options resulting in the issue / transfer of the underlying shares to the Grantee
Grant	A grant of Options
Grantee	The person to whom a Grant is made, typically employees of a startup
Options or Stock Options	Options granted under SOPs (including SARs)
FMV	Fair Market Value
M&A	Mergers and Acquisitions
SAR or SARs	Stock Appreciation Rights
SOPs	Stock Option Plans
Strike Price	The price payable by a Grantee to subscribe to the Shares. In case of SARs, the Strike Price is the amount that gets deducted from the amount payable to the Grantee when the SAR is liquidated
Shares	Equity Shares of a company
UHNI	Ultra High Net Worth Individuals
Vesting / Vest	The conditions of the Grant being satisfied resulting in the right to Exercise fructifying

A. Introduction

The first ever SOP was created way back in 1956 by a San Francisco lawyer Louis Kelso as a way to solve a business succession problem. Since then, SOPs have been used for a variety of reasons, the most striking being the need to enable wider participation in capital of the company; especially by the people who helped build it.

Historically, most employee wealth creation has taken place when the companies have either gone public or been acquired by a public company. These events have provided economic security for thousands of people employed in these organizations. One of the most famous examples is that of Bonnie Brown, an in-house masseuse at Google, who was given stock options as part of her compensation package. These options landed her millions of dollars completely changing her life. Since then, many similar stories have done the rounds.

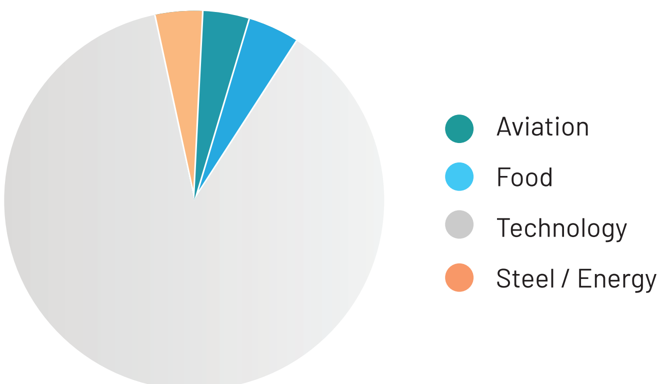
The startup boom in India over the past 10 years has not only seen many companies borrow the playbook from their Silicon Valley counterparts but also take it a step further. Well-funded startups have begun to have some employees cash out a portion of their Options while the company is being built, creating wealth for them as the company is growing rapidly. Startups staying private longer has made this necessary and increased capital availability has made this possible.

Employees spend the most productive part of their career helping build new age businesses. It is only fair that they get compensated as the business is growing rather than look for one single uncertain event. From the company's perspective, reasonable liquidity provides comfort and energy to the team.

This white paper is an initiative to understand the different aspects surrounding stock options in India - the trends which made news in 2021 (and some which didn't!), the attributes of Grants (what Grants are, how they have traditionally been made, how they should be looked at, how Grants lead to wealth creation), the different aspects which startups must consider while implementing Grants and the recommended regulatory relaxations. The whitepaper wouldn't have been complete without a survey from the likes of Rainmatter Foundation (Zerodha), Accel, Blume Venture Advisors Private Limited and other marquee venture capital firms. Finally, we have concluded with some interesting trends to watch out for in the near future.

B. Highlights of 2021

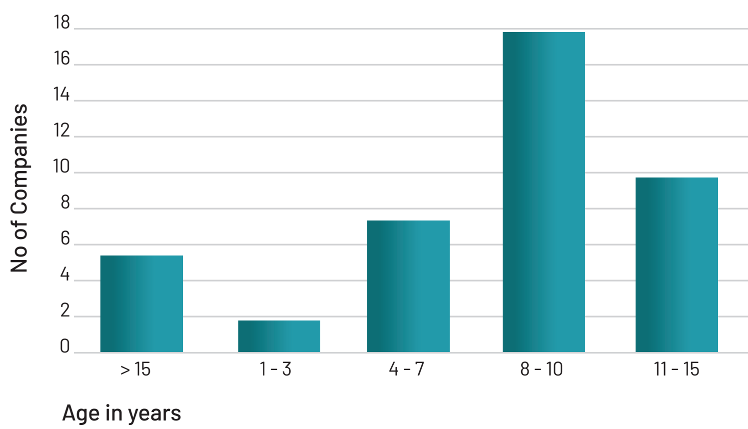
The COVID induced lockdowns have resulted in tremendous growths for startups and fuelled an eventful periods for SOPs. The charts below says it all!



Sector-wise Composition of Companies that made
ESOP ANNOUNCEMENTS IN 2021

Key Trend - 1

The technology sector including technology-led startups has galloped past all other sectors in making announcements – be it announcements on Option buybacks, Option pool creation or enhancement or other Option related announcements. Certain sectors like financial services, cement and automobiles have not made any such announcements.

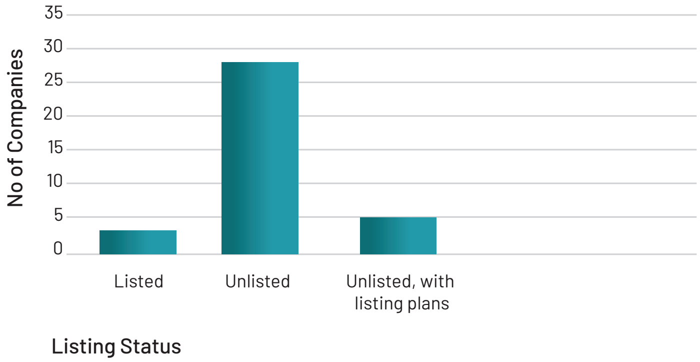


Age of the Company (Up to 2021)

Key Trend - 2

Majority of the Option related announcements were made by companies established 4 – 7 years ago, closely followed by those formed 8-10 years ago.

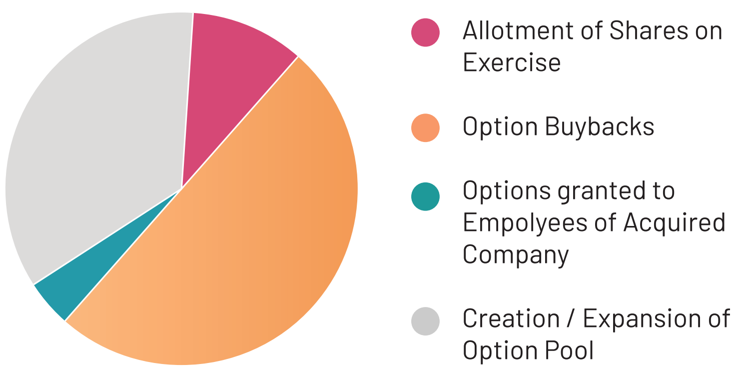
[1] *Businesses that are not "fintechs".*



Listing Status of Companies at the time of Announcement

Key Trend - 3

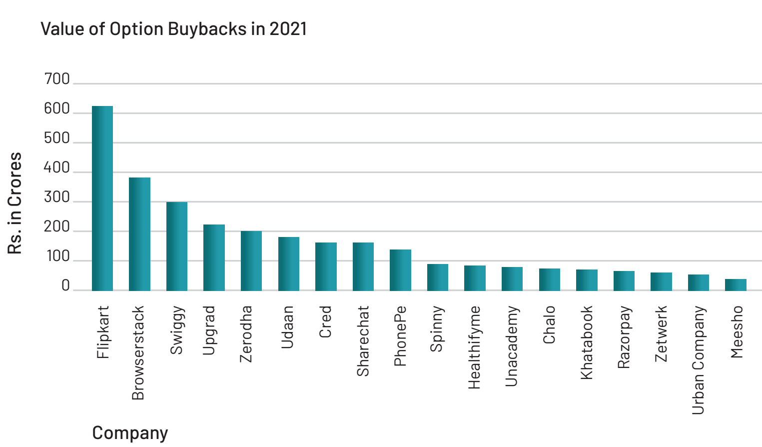
Unlisted companies were at the forefront in making SOP announcements. This reinforces the fact that startups prefer to remain private for a longer period. An interesting trend; it indicates that listing or M&A need not be the sole mechanism for wealth creation for people who make wealth creation possible.



Nature of Option Announcements

Key Trend - 4

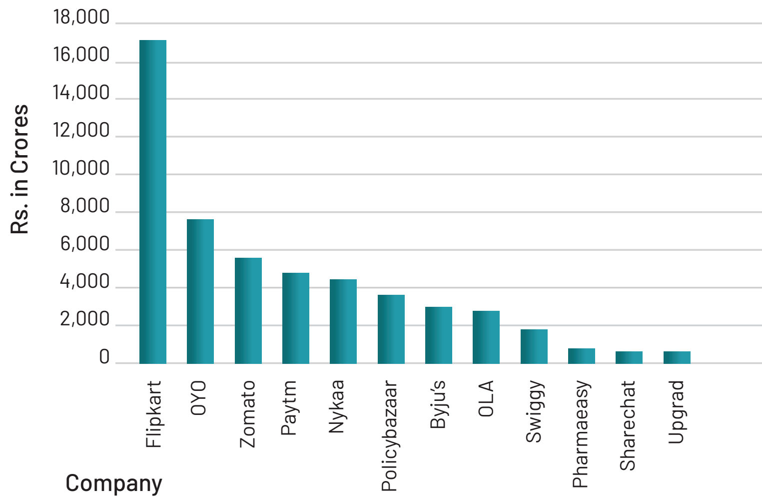
Amongst all the Option related announcements, Option buyback and Option pool related announcements ruled the roost in 2021. Option buyback emerged as a win-win mechanism for startups desirous of rewarding and incentivising employees.



Value of Option Buybacks in 2021

Key Trend - 5

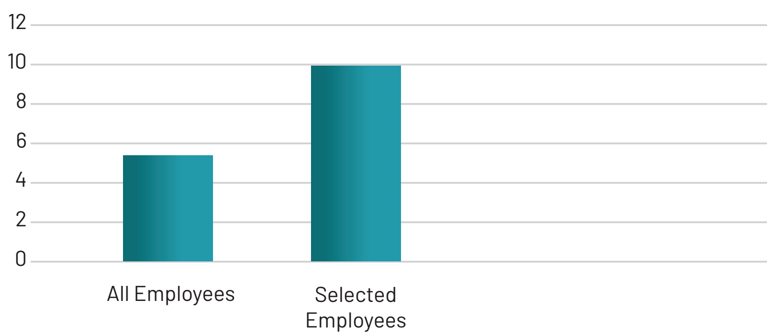
Traditionally, listing was the most popular liquidity mechanism for Options. The volume and number of buybacks executed in India has defied this belief. New-age businesses, mostly unlisted, have announced record Option buybacks with Flipkart, Browserstack and Swiggy leading the pack.



Option Pool Size

Key Trend - 6

While some companies announced Option buyback, there were others which expanded their Option pool size. Flipkart led the pack with the highest pool size of Rs. 17,000 crores.



Coverage of Option Pool Announcement

Key Trend - 7

Amongst the companies which have made an announcement for creation or expansion of the Option pool, the trend has been to offer Grants to selected employees, most probably senior executives. However, the number of companies issuing Options to a vast majority of the employees is encouraging.

Option plans are well understood and therefore we will delve into some relevant aspects alone.

C. Attributes of Grants

1. Purpose and Objectives

Growth requires strong committed teams; be it employees or advisors and consultants. Committed teams require good compensation policies and structures; with Option Grants being an important part of such structures. The upside is potentially very high and therefore, it is motivating for the employees to Exercise Options. It also builds a sense and loyalty to the organization.

2. What are Option Plans / SAR Plans?

In simple terms, Options provide employees with an opportunity to participate in the growth of the company on payment of the Strike Price. SOPs may be in the form of Option Plans or SARs. Option Plans are much more prevalent in India than SARs.

- Option Plans provide Grantees with the option to acquire the underlying Shares.

- SARs entitle the Grantee to the appreciation in value of the startup, measured against the underlying Shares. The appreciation is calculated as the difference between the FMV of the underlying Shares (in respect of Vested SARs) at the time of the liquidation (of the SARs) less the Strike Price.

In India, economically there is no difference between option & SARs. Option Plans are categorised as "Free Exercise Plans" and "Restricted Exercise Plans".

Free Exercise Plans

Grantee's Perspective

- Grantee has the right to Exercise Options at any time after they Vest.
- Upon Exercise, the Grantee becomes a shareholder of the company and gets shareholder rights in respect of exercised Options.
- Gains arising from Options are bifurcated between employment income and capital gains. The taxability of gains is determined based on how income is categorized, viz.
    - Gains at the time of Exercise are taxed as employment income. The amount is calculated as the difference between the FMV at the time of Exercise and the Strike Price.
    - The gains made on disposal of Shares are taxed as capital gains. The difference between the sale price and the FMV at the time of Exercise is capital gains (there could be a capital loss as well!). The holding period (calculated as the difference between the sale date and date on which shares are issued) determines whether the gains are treated as short term gains or long term gains.
- The Grantee becomes a shareholder upon Exercise. Certain key rights that are available to the Grantee as a shareholder: (a) right to receive all notices and information sent to shareholders, (b) right to inspect certain statutory records, (c) right to attend shareholder meetings, (d) legal right to take action if the startup fails to comply with Company Law, (e) right to seek legal remedies before courts / tribunals in certain situations that affect the company.

[2] Tax has been paid at the time of Exercise, basis the FMV at the time of the Exercise. Hence tax is calculated on the upside from this point to the sale.

Startup's Perspective

- The Grantees' rights as a shareholder, are the responsibility of the startup and its Board / founders.
- The startup becomes a public company if the number of shareholders exceed 200 (except employees who Exercise the Options and are issued shares prior to the termination of their employment).
- Unless Exercised within a defined duration from the date of termination of employment, the Options lapse (usually a few months at the most). Given the significant amount of taxes that need to be paid at the time of Exercise, this becomes a useful retention tool for the startup. Employees would rather not want to lose the Options or pay taxes upon Exercise without clarity on liquidity.
- In an M&A, the startup is often faced with the challenge to track down shareholders if the buyer wants to acquire 100% of the company.

Restricted Exercise Plans

Grantee's Perspective

- Grantees can Exercise Options only if there is a liquidity event. Generally, 'liquidity event' includes events like listing, M&A, strategic sale etc.
- Grantee cannot have shareholder rights until he or she becomes a shareholder (this usually happens only after Listing).
- Gain is usually considered as employment income, except following a listing of the shares (when Options may be Exercised).
- Payment received in a buy-back programme (against cancellation of Options) is considered as employment income.

Startup's Perspective:

- A startup does not have to worry about shareholder related compliances until the liquidity event occurs.
- Since Grantees are not allowed to Exercise the Options until the liquidity event, termination of employment cannot result in the Vested Options lapsing. Startups therefore provide long exercise periods.
- The startup loses a key retention tool because of the long exercise period.

Stock Appreciation Rights

Grantee's Perspective

- Under SARs, the Grantee gets only the economic incentives associated with appreciation in the value of underlying shares.
- Entire gains are considered as employment income for the Grantee.

Startup's Perspective:

- The sartup does not have to worry about shareholder related compliances.
- The startup must record the value of the Vested Grants as a liability on its books. This may potentially affect the solvency of the startup as well.
- The startup loses a key retention tool because of the long exercise period.

A good via media to get the benefit of Free Exercise Plans is to use trust structures. In trust structures, employees are permitted to Exercise Options at any time after they Vest. However, the trust is recorded as the shareholder in the books of the company though the Grantee enjoys all associated economic interests. The table below provides an overview of different kinds of SOPs:

Particulars	Free Exercise Plans	Restricted Exercise Plans	SARs
Does Grantee become a shareholder?	Yes	Usually only upon listing	No
How are gains taxed for the Grantee?	Employment income and capital gains	Employment income (Gains may be bifurcated into capital gains too if Exercise follows listing)	Employment income
Does it offer a significant retention tool for the startup?	Yes	No	No
Is the startup responsible for company law compliances when Grantee becomes a shareholder?	Yes, with risk of becoming a public company (unlisted) if shareholders exceed 200	Usually, only following listing	No

3. Vesting Structures

Options have different Vesting structures. The most common Vesting structure is a simple four-year Vesting cycle with a one-year cliff. After the first year, vesting may be monthly, quarterly or half-yearly; with quarterly and annual vests being more common.

There is a clamour from some quarters to front-end the Vesting. Equally, there is a practice in some large enterprises globally, where Vesting is back-ended. As you would know, it takes time to build companies and patience is key. Therefore, it is important to get the balance right. One size will definitely not fit all on Vesting structures. It may also be different for different teams within the company. The demand – supply gap between talent and requirements will, obviously play a role in determining the Vesting Structure.

4. **Exercise Price or Strike Price**
The startup must, by law, at least receive the par value of the Shares on Exercise. The startup may determine the Strike Price to be anything beyond that. In other words, the Strike Price for Options may be par value or a discount to the FMV (at the time of the Grant). Companies often facilitate cashless Exercises. SARs plans need not have any Strike Price as the Grantee is not entitled to receive any shares.

5. **Stages**
The life cycle of Option plans or SARs Schemes broadly involves the following stages:

Grant
- Identification of the Grantee
- Determining the number of Options, the Strike Price and the Vesting conditions

Vesting
- Vesting conditions are satisfied, i.e., the Grantee's right in relation to the underlying Share fructifies (whether to Exercise or receive the upside).

Exercise / Liquidation
- Exercise - Grantee becomes a shareholder by paying the Strike Price
- Buy-Back: The startup liquidates / buys-back the Vested Options / SARs by paying the Grantee

Sale / Disposal
- Grantee disposes of the Shares issued and realizes the value. This may be pursuant to an M&A, pursuant to a listing of or a startup facilitated sale of the Shares.

6. **Liquidity**
Traditionally, Grantees could liquidate Options only at the time of acquisition by a public company or post listing. However, as evident from the quantum of Option buybacks in 2021, over the last couple of years, startups in India have advanced liquidity for the Grantees starting from the growth stage itself. This is happening for several reasons as pointed out above. From an employee morale perspective, this is a great thing. People building the startup understand how uncertain the future is and that there is no guarantee that even a unicorn will list or be bought out it may simply just die. If startups are not able to hold the teams together during bad times, there is no startup left. Making sure they are rewarded during good times, shows respect for them and helps during bad times that may just be around the corner!!!

If founders can get pay-outs (and rightly so), why not employees!!!!

D. Key Takeaways from Market Survey

This whitepaper cannot be complete without some field research and contributions from the market participants. All data insights are from the best. We had four respondents from the Tier 1 venture capital funds like Accel, Rainmatters Foundation and other marquee funds to participate in our whitepaper. Some of the key takeaways which emerge from the market survey are:

ZERODHA BLUME Accel

1. **Form and Structure**

1 Stock Options are much more popular than SARs

2 Time-based Vesting is most common.

3 Par value Strike Price more prevalent than a discount to fair market value

2. **Beneficiaries**

   a. Grants are mostly allotted based on the seniority of employees. Other factors like employee's performance or role in the company play a smaller role.
   b. Some companies make Grants to co-founders.
   c. Startups sometimes encourage the Grant of Options in lieu of salary, rather than in addition to salary.
   d. A well-implemented liquidity program eases the hiring process for a startup.
   e. Companies are not very proactive in conducting employee awareness programs, open house sessions or periodic sessions.

Beneficiaries of Grants
- Senior employees - mostly
- Co-founders - to a very small extent

3. **Exit mechanism**

The proportion of startups that permit the exercise of Options other than in relation to a liquidity or buy-back event is very low.

4. **Administrative and Regulatory**

The use of the trust structures has not yet gained traction; management of an additional entity and compliance costs acting as a deterrent to the formation of a trust.

- Trust structures are not very popular
- Traditional structures preferred because of administrative convenience

a. Managing Grants can be challenging. While the majority of the companies use traditional excel models, few have graduated to a customised digital platform. Few more have outsourced to professionals in the field.

Management of Grants

- Traditional Excel Models - still popular amongst small companies
- Outsource to professionals - alternate mechanism
- Customised SOP management platforms - preferred by larger companies

b. Companies generally follow the iGAAP for accounting purposes.

c. Companies believe that there is fair amount of clarity in taxation of Grants; they would like to see the taxability in relation to Grants being deferred to the time of actual sale of shares. Essentially, link taxation to realisation of cash.

E. What Startups Must consider

ESOPs are at the forefront of employment engagement programs in startups. Since this trend is only getting stronger, here are a few flagship pointers that we consider will create favourable environments for startups and employees to grow simultaneously.

1. Exercise Price or Strike Price:

As we have pointed out, the Strike Price of a vast majority of Grants is the par value of the Share. In most cases, even in Seed companies, the FMV of the Share is significantly higher than the par value. This literally means that the FMV of the Share is offered to the Grantee, subject to Vesting. Employees will then be making money even if the value of the startup goes down. Companies must consider granting a higher number of options at a discounted FMV.

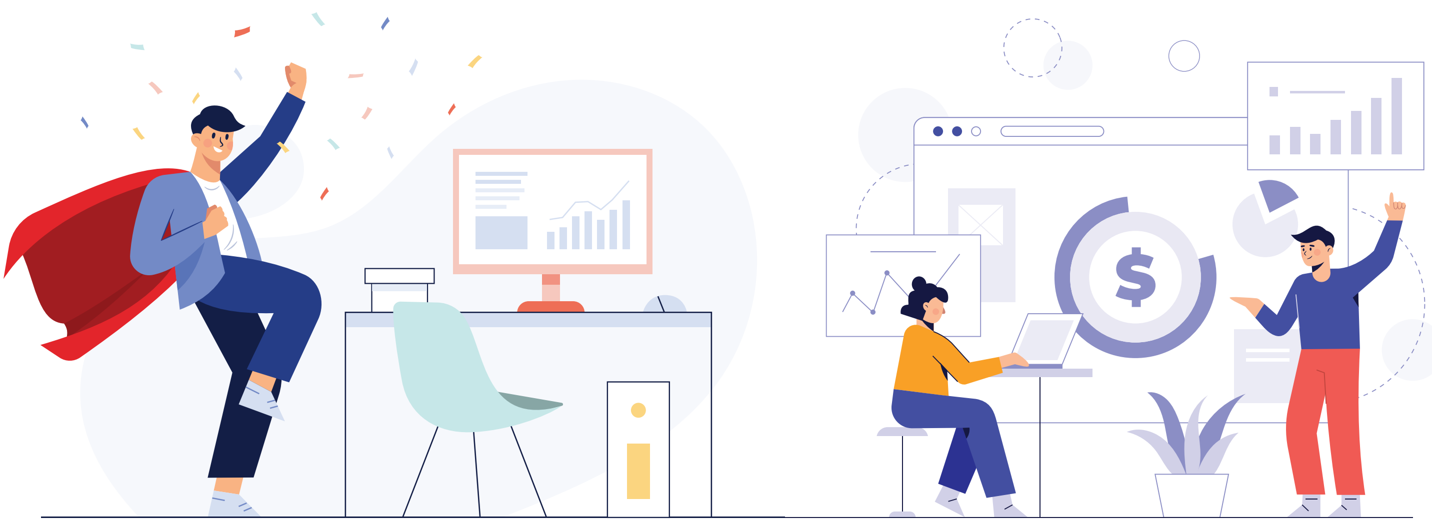
The following table enlists some samples to think about:

Par Value	10
FMV @ Grant	10,000

	Model A - Par Value	Model B - discount to fair value of 25%
Number of Options	10,000	20,000
Strike Price	10	7,500
Value at the time of Grant	9,99,00,000	5,00,00,000
Exit Values		
FMV @ 8000	7,99,00,000	1,00,00,000
FMV @ 20000	19,99,00,000	25,00,00,000
FMV @ 80000	79,99,00,000	1,45,00,00,000

Key takeaways:
Higher number of Options at a discount to FMV can actually offer a better return to the employees in the case of fast growing companies. This brings a good balance as employees cannot make much money if the startups does not perform well. Some of the potential things which startups may consider are:

- Startups can consider splitting grants between low Strike Price grants and grants with discount to FMV.
- Different models can be considered at different levels of seniority.
- Employees may be offered choices. The more entrepreneurial employees may opt for a higher number of Options. Of course, the demand supply gap will play a key role here.



2. Vesting Structures

Time-based Vesting is the simplest and most popular Vesting mechanism. Vesting linked to individual employee performance or company related goals (for instance, achieving profitability or achieving certain revenues etc.) are not very common.

Time-based vesting is the easiest to adopt and does not need much thinking. Linking vesting to individual performance or company level goals can be cumbersome and sometimes counter-productive.

Individual performance linked goals can also be subjective and lead to conflict as in the case of performance linked bonuses. Only startups with robust processes can adopt individual performance linked Grants unless the conditions are extremely objective.

Company goals change. Employees will resist the change if it affects their ability to achieve vesting. For instance, Options could be linked to the startup achieving some revenue targets. If the startup changes its goals to profitability, all grants will need to be re-worked.

Something that a company can consider is time based Vesting for all employees other than senior management. Senior management may get a combination of time based Grants and annual company performance linked goals. This must be thought through in detail.

3. Exercise Models

Indian companies generally permit Exercise of Options only where the company is contemplating an Option buyback or if there is a liquidity event (M&A, listing etc.). In other words, employees do not have the flexibility to Exercise Options at their will. This results in the following unintended consequences:

a. Since employees cannot Exercise at their will, they cannot plan their taxes. This results in employees ending up paying the highest marginal rate as tax, which could be as high as 42.74%.

b. Companies are forced to offer a long Exercise period and delink this from termination of employment. In Free Exercise Plans, Options lapse within a short period following termination of employment (to the extent they are not Exercised). The options that will lapse becomes a deterrent for Employees leaving the company.

The primary reason for not allowing Exercise at free will is that the startup does not have to deal with a large number of shareholders, take the risk of becoming a public company etc. Given the complexity around Company Law in India and the risk of litigation, this is a fair risk. A good viable model that provides a balance between both scenarios is where Exercise is permitted through trust structures.

Key aspects of trust structures

- Company creates a trust and appoints trustees
- Trustee is the shareholder of the company for all legal purposes; exercises all rights in relation to the shares including voting rights, executing agreements, making sale decisions etc. The trustee functions within a defined framework.
- Employee gets the full economic benefit on his or her shares held by the trust; tax liability is the same for the employee, whether he or she exercises the Options directly or via a trust.
  - Trustee sells in an M&A and distributes cash
  - Trust is dissolved in relation to a listing

4. Regulatory Recommendation

The timing of taxation for the Grantees (on Exercise and Disposal) often acts as an impediment to the success of Grants. In tangible terms, it leads to cash outflow due to taxation of notional income. Income taxes are structured around higher taxes for higher income levels. However, one-time events and triggers like Exercise of Options are pushing up the taxation on one-time wealth creation events and that too when the wealth creation is notional. Exits may or may not happen. Therefore, the regulator must consider postponing the tax liability to the point of cash realization.

A large number of employees who receive stock options comprise of the middle-class. The tax slab of 31.2% to 42.74% (depending on the income level) would seem unfair in respect of one-time wealth creation events. The regulator must consider reducing the tax liability in respect of such one-time wealth creation events. One time wealth creation events cannot be compared with annual incomes.

5. **Options to persons other than Employees and Directors:**

Issue of Options to promoters or promoter group has been rightly prohibited, except in the case of DPIIT registered startups. The exemption is taken away when the revenue of the startup goes beyond 100 CR. This needs to be reconsidered considering that promoters' shareholding in startups is often very small. Adequate guardrails can be introduced in the form of cap on Grants to be issued to the promoters' / promoter group.

The Stock Option related regulations restrict companies from making grants to consultants, vendors, advisors etc. These regulations also need to be re-looked in the case of startups. Startups usually do not have the funds to pay fees commensurate with market standards. The only tool they have is to offer Options. The government must therefore consider whether these restrictions are relevant in the case of startups.

6. **Transfers to Option Pools:**

Founders and other shareholders often transfer Shares to Stock Option Pools for the benefit of employees. If the price is below the value (calculated under tax law), these transfers are taxable in the hands of the transferor though the transferor does not receive any benefit. Tax is payable by the transferee as well. These provisions are relevant in the context of several other types of transactions. However, in the case of startups, these are genuine transactions being done for the benefit of the startup / the employees. The government must therefore consider exempting such transfers from taxation in the hands of the transferor. The recipient may be required to pay taxes under the general provisions relating to Grants as opposed to paying taxes upon settlement to the Option Pool.

F. Interesting Trends to Watch Out For

Various initiatives have turbocharged the startup ecosystem in India. New deals and corporate structures are emerging every passing year making startups a prominent contributor to the economic development. Elements that standout and are worth watching out for are:

1. **Exercise Price or Strike Price:**

   As more and more startups make SOP announcements, we could see many interesting changes taking place in this sphere...

- Expansion in coverage of Grants
  - Traditionally, Options are offered to individuals at the top of the pyramid. The trend is gradually changing. Companies are implementing plans which are all-encompassing, i.e., employees across the organization are entitled to Options. The hybrid workplace model may also push the regulators to warm up to this idea of allotment of stock options to non-permanent employees or external consultants.
  - SARs may be used largely to reward consultants, advisors and vendors, to whom Option Grants cannot be made.
  - Grants being made to employees of associate companies, joint ventures and group companies.

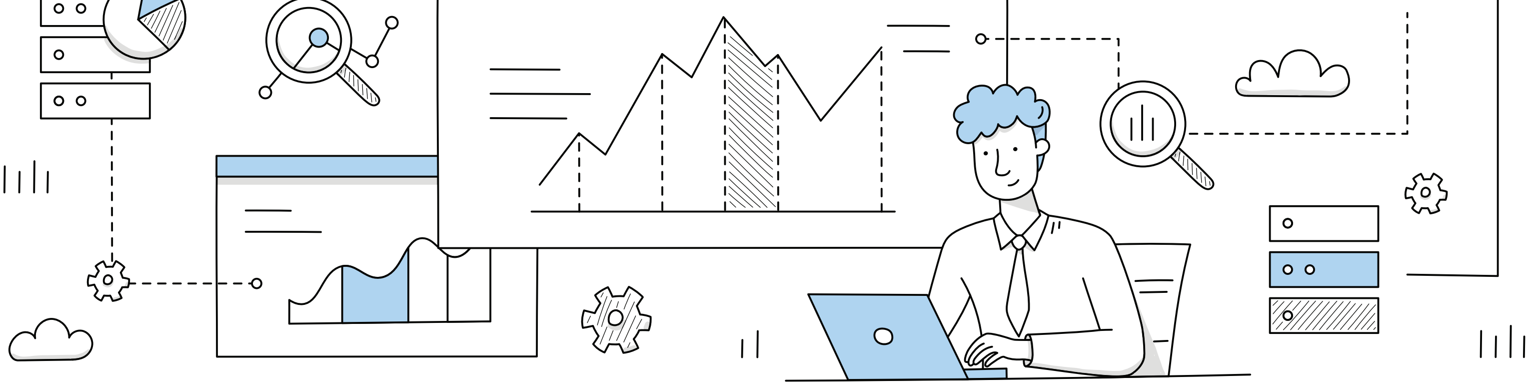
Expansion in coverage of SOPs

- Liquidity Structures
  Liquidity structures and pricing for liquidity is generally controlled by the companies. Companies prioritise their own capital needs and rightly so. Companies control the frame-work of liquidity, who comes in and becomes shareholders and their rights. Employees have to make liquidity decisions based on what companies tell them. We do see structures evolve where companies will provide a framework to protect themselves from a governance and the quantum of perspective and the employees determine (or at least have a significant say) on the terms and pricing of the liquidity structures .

- Financing
  - Startups may innovate on structures to encourage employees to exercise Options including financing the tax liabilities and even the Strike Price.
  - There could be more UHNI participation in the providing liquidity to the Grantees. This may be observed particularly in late stage and pre-IPO companies.

Limitations and Qualifications

This paper is limited to Indian practices. RuleZero is not a law firm and does not provide legal or tax advice. All matters relating to law and legal advice need to be confirmed by professionally qualified law firms and tax advisors. This whitepaper covers Grants by private companies alone.



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