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January 9, 2016

PHANTOM STOCKS OPTIONS

A contemporary mode of incentivising employees

Introduction

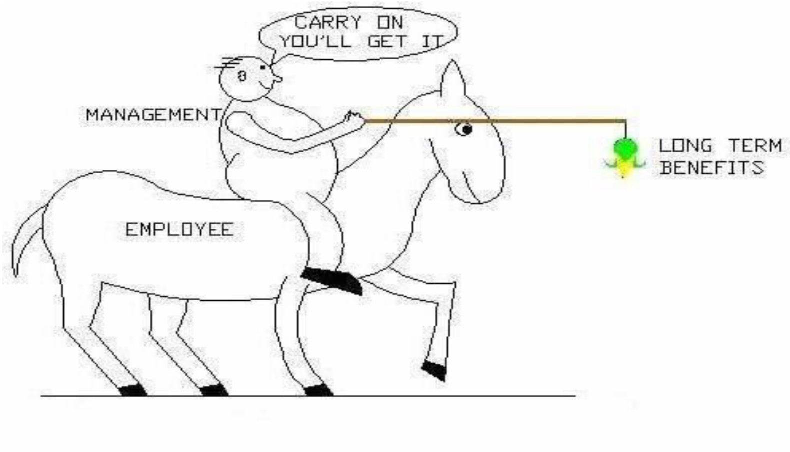
Employees are critical to the growth and success of any organisation. The recent times have witnessed a start-up deluge and booming e-commerce which, coupled with increased opportunities and prevailing competition, have resulted in higher levels of attrition. This has necessitated companies to offer to their employees, particularly senior and key employees, attractive remuneration packages and incentives so as to retain the employees in the long run. These incentives and benefits include employee stock options and stock purchase plans, stock appreciation rights, other general benefits, retirement benefits etc.

ESOPs – A conventional mode of employee incentive

Among the various incentives and benefits offered to the employees, employee stock option and stock purchase plans ("***Stock Plans***") are one of the most effective tools, traditionally utilised for retaining employees within the organisation. Stock Plans, as the nomenclature suggests, entitles an eligible employee to equity stake in the company. Upon fulfilment of defined criteria, the employee becomes eligible to subscribe to, or purchase, specific number of shares at a pre-determined price. While the Stock Plans formulated by listed companies in India are specifically governed by the Securities and Exchange

Board of India (Share Based Employee Benefits) Regulations, 2014 ("***SEBI Employee Benefit Regulations***"), the Stock Plans formulated by unlisted companies are governed by Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 ("***Companies Act ESOP Provisions***"). Both these enactments contain detailed provisions on the introduction and implementation of Stock Plans by listed and unlisted companies.

SARs - A contemporary mode of employee incentive



ESOPs have been the conventional mode of a deferred reward plan for employees. However, a number of factors including specific preferences and requirements of companies coupled with the need to evolve traditional concepts to meet the changing pace of time, have lead to the introduction of hybrid incentive plans which also include stock appreciation rights *("***SARs***")*. SARs, as the name suggests, entitles an employee to receive appreciation, for a specific number of shares of a company where the settlement of such appreciation may be made either by way of cash payment or shares of the company. Thus, SARs granted to employees results in two forms of underlying entitlements at the time of exercise of SARs by the employees, one form being equity stake in the company and other being a cash entitlement. [1]SEBI Employee Benefit Regulations specifically mentions that SARs which are settled by way of shares of a company are referred to as equity settled SARs.

1. Explanation to the Regulation 2(1)(ze) of the SEBI Employee Benefit Regulations

The concept of Phantom Stock Options

'*Phantom Stocks Options*' or '*Shadow Stocks Options*' ("***Phantom Stock Options***") is a popular nomenclature derived from usage for SARs which are settled by way of cash entitlement. A Phantom Stock Option is a performance-based incentive plan which entitles an employee the right to receive cash payments after a specific period of time or upon fulfilment of specific criteria and is directly linked to the valuation and the appreciated value of the share price of the company. Thus, the underlying entitlement for an employee at the time of exercise of Phantom Stock Options is a cash payment unlike the Stock Plans which entitles an employee to an equity stake in the company.

In recent times, Phantom Stock Options are becoming increasingly popular as they enable companies to share a portion of their profits or appreciated valuation, thereby incentivising and retaining employees in such a manner that does not result in a dilution of the shareholding of such companies. However, while Phantom Stock Options may be beneficial to companies and its management (*read employers*), they may not be an attractive option for employees who may be seeking an equity stake in the company in the form of Stock Plans or equity settled SARs as against a cash incentive.

Tax Implications of Phantom Stocks

The income received by an employee, in the form of cash entitlement at the time of the exercise of Phantom Stock Options, is taxed under the head of [2]salary income as perquisites in the hands of the employee. No incidence of the tax arises in hands of the company (*read the employer*) at the time of making payment of the cash entitlement to the employee. However, considering that

2. Section 17(2) of the Income Tax Act, 1961

the cash entitlement received by the employee upon the exercise of the Phantom Stock Options is taxed under the head of salary income, the company is required to withhold taxes (*read tax deducted at source*) just before making payment of the cash entitlement to the employees.

Legal Framework for Phantom Stock Options

Under the Companies Act 2013

While the [3]Companies Act, 2013 has prescribed rules for issuance of shares to employees under Stock Plans, it is silent on the grant and exercise of SARs including issuance of equity settled SARs and Phantom Stock Options.

Under the SEBI Employee Benefit Regulations

The SEBI Employee Benefit Regulations read with the Companies Act ESOP Provisions prescribe rules and regulations for formulation of Stock Plans and the grant and exercise of equity settled SARs by listed companies.

3. Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014

It would be interesting to mention here that with respect to SARs, the Securities and Exchange Board of India ("***SEBI***") has, by way of its [4]informal guidance, clarified that one of the criteria for determining the applicability of the SEBI Employee Benefit Regulations to an employee benefit scheme is that such scheme should actually involve "*dealing in, or subscribing to, or purchasing, securities of the company directly or indirectly*". SEBI has further stated that if the proposed scheme does not involve dealing in securities of the company, directly or indirectly, then the SEBI Employee Benefit Regulations are not applicable to the scheme. A brief write-up on the SEBI informal guidance to Mindtree Limited is set out below, more particularly since it touches upon the concept of phantom stocks whilst concluding on the non-applicability of the SEBI Employee Benefit Regulations to the Phantom Stocks proposed to be issued by Mindtree Limited as an employee benefit scheme.

4. Informal Guidance Note dated July 27, 2015 issued by SEBI in response to a request for informal guidance sought by Mindtree Limited in relation to (among others) the applicability of the SEBI Employee Benefit Regulation to a proposed Phantom Stock Scheme read with the Informal Guidance Note dated July 24, 2015 issued by SEBI in response to a request for informal guidance sought by Saregama India Limited

SEBI Informal Guidance in response to Mindtree

We set out below a brief summary of the informal guidance (*as cited above*) ("***Mindtree Informal Guidance***") issued by SEBI by its letter dated July 27, 2015 in response to a request for informal guidance sought by Mindtree Limited ("***Mindtree***") on the applicability of the SEBI Employee Benefit Regulations to the phantom stock scheme of Mindtree.

During August 2013, Mindtree introduced an employee benefit scheme ("***Mindtree Phantom Stock Scheme***") pursuant to which cash settled stock appreciation right units were granted to six employees, being also the promoters of Mindtree. These units were issued at a pre-determined grant price which entitled the promoters to receive cash payment for appreciation in the share price (*over the grant price*), subject to achievement of specific revenue targets. Thus, the underlying entitlement of the units granted to the employees was not equity shares of Mindtree but a cash payment which was linked to the equity share price of Mindtree. With this background, Mindtree approached SEBI to seek guidance (*among others*) on whether or not the SEBI Employee Benefit Regulations would be applicable to the Mindtree Phantom Stock Scheme.

In response to the guidance sought by Mindtree, SEBI in its communication relied upon Regulation 1(4) of the SEBI Employee Benefit Regulations. Regulation 1(4) provides that the SEBI Employee Benefit Regulations shall apply to employee benefit schemes formulated by listed companies provided that certain conditions are met, which (*amongst others*) stipulate the employee benefit scheme to involve dealing in or subscribing to, or purchasing securities of the company, directly or indirectly. The Mindtree Phantom Stock Scheme did not involve a purchase or subscription of shares of the company by eligible employees at the time of the exercise of the right but was in the form of cash payments for appreciation in the share prices of the company. In light of the provisions of Regulation 1(4), SEBI clarified that the SEBI Employee Benefit Regulations would not be applicable to Mindtree Phantom Stock Scheme. However, considering that the views contained in the Mindtree Informal Guidance are specific to facts and clarifications sought therein, the views of SEBI expressed in the Mindtree Informal Guidance cannot be applied generically.

Our view

While SEBI has clarified in the Mindtree Informal Guidance that the SEBI Employee Benefit Regulations are not applicable to phantom stocks, the definition of the term [5]"*Stock Appreciation Rights*" covers within its ambit, cash settled stock appreciation rights. Further, Regulation 1(3)(iii) provides that the SEBI Employee Benefit Regulations are applicable to stock appreciation right schemes but does not provide a carve out for cash settled stock appreciation rights from its applicability. Thus, in our view there still exists a conflict between Regulation 1(4) and Regulation 1(3) read with definition of "*Stock Appreciation Rights*" under the SEBI Employee Benefit Regulations in so far as cash settled appreciation rights are concerned.

The existing legal framework is silent on the grant and exercise of Phantom Stock Options. Hence, till such time that specific provisions are introduced under the Companies Act or until SEBI amends the SEBI Employee Benefit Regulations to bring Phantom Stock Options within its purview, companies will have the liberty of formulating schemes for the grant and exercise of the Phantom Stock Options in a manner as they may deem fit.

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5. In terms of Regulations 2(1)(ze) of the SEBI Employee Benefit Regulations, stock appreciation rights is defined to mean a right given to a SAR grantee (being an employee to whom SAR is granted) entitling him to receive appreciation for a specified number of shares of the company where the settlement of such appreciation may be made by way of cash payment or shares of the company

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