EMPLOYEE STOCK OPTION PLANS: THE NEW 'MANTRA' OF THE INDIAN FIRMS

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Employee stock ownership plans (stock options) have received increased attention in recent years both in India and abroad. Many organizations around the world have offered these stock options to their employees – managerial and non-managerial. The present paper gives the theoretical background of these stock options. The main features of the current Indian scenario have also been highlighted along with the SEBI guidelines.

THE BACKGROUND

The philosophy of nishkam karma (working without expecting any returns) has been an integral part of our scriptures. They advocated striving for kaushalam (excellence) in karma (action) without any anxiety for phalam (result). But the modern system of management emphasises reward to people for their performance. Pay for performance has become the popular slogan of the industry in every country. The efforts to link pay to performance have given rise to many incentive pay systems in addition to the base pay. Employee stock ownership plans (stock options) are an example of the same.

Stock ownership plans (ESOPs) is one of the two most important form of variable pay package, other being profit sharing (bonus), and is the new 'mantra' of the Indian industry. Employee ownership plans are understood to encompass any system that has a link between the performance of a company in a particular period and the compensation of an employee in that period. A stock option is granted to an employee to enable him to purchase a certain number of shares of the company stock at a determined price, usually within a specified period of time. In any stock option plans, the first stage is the grant of the option, second is the vesting (where the employee gets the right to apply for the shares under the options granted), the third stage is the exercise of the option. On payment of the exercise price, the employee is conferred the shares of the company. The ESOP trust provides a warehouse for the sponsoring company's shares by acquiring or holding which can be sold or transferred to employees in future.

The basic distinction between ESOPs and non-ESOPs stock plans are two fold: (i) an ESOP must be primarily invested in the employer's securities, and (ii) ESOPs may be leveraged and may receive credit from the sponsoring company, a feature that is not permitted in any other type of plan. Usually the sponsoring company provides guarantee for the loan taken by the ESOP

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from a third party and remains responsible for the shortfall in the assets of the ESOP in repayment of debt. The company takes a tax deduction for its loan payment (or, equally, for its contribution to the plan). Shares held by the ESOP trust are distributed to the employees through an employee share option scheme. Since ESOPs are required to invest primarily in employer securities, the return on an ESOPs portfolio is likely to be highly linked to company performance. However, profit sharing plans may demonstrate a very weak relationship as in majority of cases profit sharing bonus is entirely on managerial discretion.

Initially ESOPs were generally treated as employee benefit plans but its other potential uses, especially as a technique of corporate finance, were stressed. ESOP offers employees an opportunity to acquire company stocks through organisational channels rather than in the open market. While long accepted for managerial employees in US, UK, etc, stock plans for non-supervisory personnel are being adopted in many countries like Japan and India. Stock options provide added incentive to the employee to produce profits and achieve corporate growth. It permits the employee to share in the profits and growth of the firm without having to share in the losses. It establishes through ownership a motivational work environment that stimulates superior performance by improving their morale and efficiency besides making them committed to the company. Stock options are also used to attract and hold talented and competitive personnel.

The channel by which employee stock ownership (ESOP) may be translated into improved performance includes, providing (i) a direct monetary incentive for greater effort by each worker individually, as well as for reduced absenteeism and turnover; (ii) an incentives for workers to co-operate more fully in training, assisting or monitoring others in the process of production; (iii) an inducement to workers to take better care of the plant and capital equipment; (iv) improved information flows within the organisation; and (v) a greater willingness on the part of workers to accept technological change. Increased compensation flexibility, discouraging unionisation or gain concession from unions, gain tax incentives, have easy access to capital or avoid hostile take-overs are other potential reasons to implement employee stock ownership plans.

Though the emphasis is to deliver superior returns to shareholders, the current stock option plans reward both mediocre and superior performance. The problem lies in the way conventional stock options are structured. In the fixed – price options the price remains fixed over the entire option period. If the share price rises above the exercise price, the option holder can cash in on the gains. It rewards executives for any increase in share price – even if the increase is well below that realised by competitors or by the market as a whole. The increase in share price could also be due to any bull run in the share market or lower interest rates and declining inflation, factors beyond the control of management. Some companies like Colgate-Palmolive have recently introduced premium-priced stock option plans. In those plans the exercise price is fixed at a premium above the market price on the date the options are granted, and they remain at that level through out the life of the options but such options offer no guarantee that the performance will be superior. In the indexed

options, the options can be tied to a selected index; either of their competitors or a broader market index and the board can increase the pay of superior performers while appropriately penalising poor ones. Let's assume that the exercise price of a CEO's options are refixed every year to reflect changes in a benchmarked index. So if the benchmark index increases by 10 percent then the exercise price of option also would go up by the same percentage. The CEO then is rewarded only if his or her company out-performs the index.

Some economists however, have also argued that profit sharing and ESOPs may result in potential negative effects on productivity. Alchian and Demsetz (1972) and Jensen and Meckling (1979) develop and extend a formal theory of team production that predicts negative effect from profit sharing and ESOPs, at least for large firms. Their argument is that profit sharing and ESOPs may be associated with inefficient management and labour shirking. The difficulty in monitoring the performance of each individual members of the team, since production activity generally occurs in teams creates an incentive for shirking and enjoying on the job leisure. Efficient monitoring requires that the managers of the firms be the 'residual claimants' to the profits of the firm (Alchian and Demsetz, 1972, p.786).

However, despite these reservations by some economists ESOPs have been widely used in many countries of the world. Employee stock ownership has received increased attention in recent years both abroad and in India (see e.g. Weitzman 1984, Blinder 1990). While they are common phenomena in industrialised economies, they are in their infancy in the developing world. In Japan they are pervasive and significant. In 1968 only 20 percent of all firms had an ESOP and covered 6 percent of the labour force. By 1984 the percentages had gone up to 60 and 40 and still went up to 90 and 50 by 1988 respectively for firms and labour. In USA 40 percent of the firms in 1988-89 had ESOPs with 50 percent of the employees participating in them. Stock options now account for more than half of total CEO compensation in the largest US companies and about 30 percent of senior operating manager's pay. The international experience gives evidence of the positive inter-relationship between the adoption of stock options and increase in profitability and employment stability of an organisation (see Kumbhakar and Dunbar 1993; Jones and Kato 1993, 1995; Chelius and Smith 1990; Wilson, Cable and Peel 1990.). Even developing countries like India have started adopting them, though they have yet to gain popularity.

THE INDIAN SCENARIO

Having been impressed with the success of the ESOPs in the western world, the Indian industry also started adopting ESOPs during the 1990's when the Indian economy was opened to the outside world. It was tempted to adopt the salary structure being followed by their big brothers in the industrialised countries as it started feeling an intense competition for trained manpower. In order to retain and attract the best-trained workers, it became necessary for them to offer the same compensation packages as being offered elsewhere by their competitors. As a result the stock options became an important component of salary structures especially in the private sector. So much so, that in 1999 nine companies offered stock options to the new recruits from IIM Calcutta to attract the best talent. The introduction of

stock options has made many millionaires and billionaires out of employees in companies like Infosys, Mastek, etc. It was believed that these stock options would increase productivity in India, as it did in many other countries. As a result many firms now have either already introduced these ESOPs (e.g. Wipro, Zee Network, Godrej- GE, Mastek, Infosys, HCL, Pentafour Software and Exports Ltd, HSBC, Proctor and Gamble, DSQ Software, Castrol, Global Trust Bank, etc) or have decided to introduce them (e.g. HDFC, ICICI, M.T.N. Ltd, IDBI, Larsen and Toubro, Sterlite Industries, RPG Enterprises, etc).

The introduction of stock options has been made easier by the relaxation of rules in the form of ceiling on remuneration in the Companies Act. The rules were relaxed in a phased manner and since 1994 the limits have been removed with very few restrictions. However there is no uniformity in the grant of stock options and differs from company to company. While HDFC and L&T offered up to 5 percent of the paid up equity capital, Pentafour Software and Exports Ltd proposed to offer up to 10 percent of the paid up share capital and ICICI will eventually issue 1 percent of the total outstanding equity capital.

Infosys Technologies Ltd initiated ESOPs in 1994 and feels that it has been successful in enhancing the employee commitment and reducing the attrition. As on March 31, 1999, 1747 employees have become beneficiaries under this ESOP. Under a new ESOP (the 1999 Option plan) the company has decided to grant of options for up to 33,00,000 new equity shares. These are to be issued, during the next few years at fair market price to be determined by the Board of Directors or the Compensation Committee to be appointed by the Board for the purpose. The options to be granted to eligible employees shall be determined by the Board based on an appraisal process consisting inter alia of the employee's grade, years of service, present performance, future potential contribution, conduct and such other factors as may be specified.

ICICI decided to make options available to all permanent employees above the grade of middle management "1" and directors of ICICI, its subsidiary companies and holding company at any time. The options were issued at the market rate on the day of allotment, April 1999. Wipro Ltd came out with a new stock option plan under which it decided to issue 50 lakhs equity shares of nominal value of Rs.2 each to all its employees, including the employees of the subsidiary companies and overseas ones but excluded the promoter directors. The stocks were issued at the market value existing at the time of allotment. L& T also decided to offer its stock options to all permanent employees and the directors of the company and its associate companies on the basis of performance and other parameters as may be decided by the compensation committee. The price will be computed on the basis of the average of the high and low on the Bombay Stock Exchange.

SEBI GUIDELINES

In order to bring in uniformity, fairness and transparency into the system of issue of ESOPs, SEBI has been issuing guidelines from time to time. Section K of the consolidated SEBI guidelines makes it clear that reservation up to 5 percent can be made by the issuer of the company for the bonafide employees of his company or the promoters company as the need may arise.

The key features of the recent SEBI guidelines to be effective from 19th June 1999 are as follows:

(i) All employees except promoters and part time directors are eligible to participate in Employee Stock Option Scheme (ESOS) of the company. (ii) ESOS are to be offered by a compensation committee of Board of Directors consisting of majority of independent directors. They will be responsible to decide all terms and conditions relating to ESOS, like quantum of options, the conditions of options, the exercise period, the exercise price and other corporate actions, the procedure for cashless options, etc. (iii) No ESOS can be offered unless the shareholders approval is taken by passing a special resolution indicating all details about the ESOS. (iv) Pricing of the ESOS to be governed by schedule 1 (clause 13.1) and the accounting value of options granted during any period shall be treated as another form of employee compensation in the financial statement of the company. The aggregate of the 'fair value' of the options granted during the accounting period is regarded as the accounting value of the option. Where the accounting value is accounted for as employee compensation, the amount shall be amortised on a straight-line basis over the vesting period. (v) There shall be a minimum period of one year between the grant of options and vesting of options, and the company shall have the freedom to specify the lock in period. (vi) Options granted to an employee shall not be transferable to any person. Under the cashless system of exercise, the company may itself fund or permit the empanelled stock brokers to fund the payment of the exercise price which shall be adjusted against the sale proceeds of some or all the shares, subject to the provisions of the Companies Act. (vii) The board of directors shall disclose in the directors' report the necessary details about the ESOS.

The stock option guidelines define a 'share' as equity shares and securities convertible into equity shares, including American Depository Receipts (ADRs), Global Depository Receipts (GDRs) and other depository receipts representing underlying equity shares or securities convertible into equity shares. The SEBI guidelines deal separately with Employee Stock Purchase Scheme (ESPS).

The guidelines by SEBI are more stringent than the recommendations of the Verma committee and companies will have to take a hit in their profit and loss account in all cases. Stock options as they exist today, are however facing a problem of double taxation. They are not only taxed as perquisites when option are granted at discounted prices, but also as a capital gain. The stock option offered by a foreign parent company to employees of its Indian subsidiary would also be covered as taxable under the provisions of the Income Tax Act. FICCI and many other industrial organisations have however asked the government to tax employee stock options only at the time of sales as capital gain and not as perquisites. It will then avoid double taxation and make the options more attractive.

CONCLUSION

Though the Indian industry is already gung-ho about the introduction of the employee stock option scheme, yet it still has to learn many lessons from the experience of the developed world. Stock options no doubt had a positive impact on the productivity

increase in these countries but it might take few more years in India before the impact is fully realised.

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